Companies & Securities Advisory Committee

Corporate Groups
Final Report

May 2000

Membership of the Advisory Committee

The members of the Companies and Securities Advisory Committee (the Advisory Committee) are selected by the Minister in their personal capacity from throughout Australia on the basis of their knowledge of, or experience in, business, the administration of companies, the financial markets, law, economics or accounting. The members during preparation of this Final Report were:

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The Advisory Committee thanks each of them for their contributions to this review, including the very detailed comments on the Discussion Paper provided by Professor Blumberg and Professor Wymeersch.

Professor Hommelhoff, Professor Hopt, Professor Lutter and Professor Wymeersch are members of a Steering Committee of the Forum Europaeum Konzernrecht, which has developed principles and proposals for a harmonised European corporate group law.[1] These proposals have been compared with relevant Corporations Law provisions and the Recommendations in this Report.[2]

The Advisory Committee also acknowledges the contribution by David Goddard, Barrister, Wellington, New Zealand, in the Paper he presented to the 1999 Law Council of Australia Business Law Section Corporate Law Workshop "Directors and Corporate Groups - the New Zealand Experience".

Further copies

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1 Forum Europaeum Konzernrecht, "Corporate Group Law for Europe" 1 *European Business Organization Law Review* (2000) [post June].

2 J Kluver, "European and Australian Proposals for Corporate Group Law: A Comparative Analysis" 1 *European Business Organization Law Review* (2000) [post June].

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Table of Contents

Paras

Summary of the Report

Purpose and outline of the review 0.1-0.7
Structure and ambit of the Report 0.8-0.11
Synopsis of the Recommendations 0.12-0.15

Chapter 1. Methods of regulating corporate groups

The nature of corporate groups 1.1-1.7
Why corporate groups exist 1.8-1.10
The legal concept of a corporate group 1.11-1.13
Legal definition of the corporate group
Two approaches 1.14
Holding, subsidiary and related companies 1.15-1.17
Parent and controlled companies 1.18-1.23
Other legislation 1.24-1.27
Law reform options 1.28-1.29
Issue 1 - Recommendation 1 1.30-1.41
Regulation of corporate groups
Two approaches 1.42
The separate entity approach 1.43-1.58
The single enterprise approach 1.59-1.71
Application of separate entity and single enterprise approaches in common law countries 1.72-1.80
Future possible regulatory direction 1.81-1.92
Issue 2 - Recommendation 2 1.93-1.110

Chapter 2. Directors of group companies

Intra-group financial dealings

Application to wholly- and partly-owned group companies 2.1-2.5
Separate entity or single enterprise fiduciary loyalty
The problem in practice 2.6-2.8
Intra-group loans and other transfers 2.9-2.19
Intra-group guarantees 2.20-2.26
Law reform options 2.27-2.40
Issue 3 - Recommendation 3 2.41-2.64

Sale of a group company subject to an ASIC Deed of Cross-Guarantee
Current law 2.65-2.68
Issue 4 - Recommendation 4 2.69-2.73

Nominee directors of group companies
Application only to partly-owned group companies 2.74
Role of nominee directors 2.75
Disclosure of nominee directors
Current law 2.76
Law reform options 2.77-2.79
Issue 5 - Recommendation 5 2.80-2.93
Fiduciary duties of nominee directors
Current law 2.94-2.96
Law reform options 2.97-2.103
Issue 6 - Recommendation 6 2.104-2.116
Nominee directors passing on information
Current law 2.117-2.125
Law reform options 2.126-2.134
Issue 7 - Recommendation 7 2.135-2.143
Liability of nominators
Current law 2.144-2.150
Law reform options 2.151-2.155
Issue 8 - Recommendation 8 2.156-2.162

Dissenting directors
Current law 2.163-2.166
Law reform options 2.167-2.169
Issue 9 - Recommendation 9 2.170-2.177

Chapter 3. Minority shareholders of group companies

Application only to partly-owned group companies 3.1
Current law 3.2-3.8
Buy-outs following a shareholder authorisation 3.9-3.12
Issue 10 - Recommendation 10 3.13-3.31
General buy-out rights
The issue 3.32
Issue 11 - Recommendation 11 3.33-3.38
Further disclosure
The issue 3.39
Issue 12 - Recommendation 12 3.40-3.45
Intra-group fair dealing
The issue 3.46-3.48
Issue 13 - Recommendation 13 3.49-3.53

Chapter 4. Tort liability of group companies

Application to wholly- and partly-owned group companies	4.1
The position of tort claimants	4.2-4.4
Current law	4.5-4.10
Law reform options	4.11-4.16
Issue 14 - Recommendation 14	4.17-4.22

Chapter 5. Corporate group reconstructions

Mergers

Application to wholly- and partly-owned group companies	5.1
External and internal mergers	5.2-5.12
Short-form amalgamations by approval of directors	
Overseas precedents	5.13-5.18
Issue 15 - Recommendation 15	5.19-5.27
Amalgamations by approval of shareholders and directors	
Overseas precedents	5.28-5.34
Current law	5.35
Issue 16 - Recommendation 16	5.36-5.40
Amalgamations by court approval	
Overseas precedent	5.41-5.43
Issue 17 - Recommendation 17	5.44-5.48
Tax implications of mergers	5.49-5.50

Asset transfers

Application to wholly- and partly-owned group companies	5.51-5.52
Asset and liability transfer schemes	
Current law	5.53-5.56
Issue 18 - Recommendation 18	5.57-5.60
Transfer of assets through a voluntary liquidation	
Current law	5.61-5.65
Issue 19 - Recommendation 19	5.66-5.70

Voluntary administration

Application to wholly- and partly-owned group companies	5.71
Current law	5.72-5.74
Law reform options	5.75
Issue 20 - Recommendation 20	5.76-5.80

Chapter 6. Liquidation of group companies

Application to wholly- and partly-owned group companies	6.1-6.4
Separate entity approach	6.5-6.8
Current law	6.9-6.25
Limitations of the current law	6.26-6.28
Law reform options	6.29-6.33
Contribution orders	
Overseas precedents	6.34-6.40
Australian proposals for contribution orders	6.41-6.44
Issue 21 - Recommendation 21	6.45-6.59
Pooling orders	
Overseas precedents	6.60-6.73
Current law	6.74-6.80
De minimis pooling by liquidators	6.81
Issue 22 - Recommendation 22	6.82-6.85
Court-ordered pooling	6.86-6.87
Issue 23 - Recommendation 23	6.88-6.97
Tax implications of pooling	6.98
Subordination of intra-group claims	
Overseas precedents	6.99-6.106
Current law	6.107
Issue 24 - Recommendation 24	6.108-6.112

Appendix 1. List of Respondents

Appendix 2. List of Recommendations

Summary of the Report

Purpose and outline of the review

0.1 It is commonplace in Australia, as in other countries, for medium to large commercial enterprises to operate through a corporate group structure. In turn, this has generated debate, both in Australia and overseas, on whether company law sufficiently accommodates corporate groups and whether any further changes are necessary to take into account this commercial arrangement.

0.2 In Australia, various changes that particularly affected corporate groups were introduced into the national scheme laws in the 1990s. These included the related party provisions, the extended consolidated accounting requirements and the provisions for making holding companies liable in some circumstances for the debts of their insolvent subsidiaries. However, no systematic examination of corporate group law was undertaken.

0.3 The Advisory Committee published its *Corporate Groups Discussion Paper* (the Discussion Paper) in December 1998. This Paper sought to comprehensively review Australian corporate law as it applied to corporate groups.

0.4 The Discussion Paper set out a framework for general debate and analysis of specific issues involving corporate groups. It sought to stimulate discussion on whether Australian corporate law needs adjustment to better recognise and respond to the way corporate groups operate in practice. The objectives of the Discussion Paper were to put forward various ways to resolve possible legal difficulties for corporate groups and their directors in effectively performing their functions, while considering whether further safeguards were needed for minority shareholders and outsiders who dealt with these groups.

0.5 The Advisory Committee published a *Draft Proposals Paper* (the Draft Proposals Paper) in September 1999. That Paper contained a concise summary of the submissions on each of the issues raised in the Discussion Paper, followed by draft recommendations on each of those issues. The Paper invited further submissions on those draft recommendations.

0.6 In this Final Report, the Advisory Committee, with the assistance of its expert Legal Committee, puts forward various recommendations to assist the efficient and effective management of corporate groups while ensuring appropriate protection for minority shareholders and outsiders.

0.7 The Advisory Committee considers that some adjustments to the Corporations Law are necessary to achieve these objectives. However, fundamental changes to corporate law principles are not required. Also, in various areas examined in this Report, the current law already appears to satisfactorily meet the objectives. The Committee therefore proposes no change to the existing law in those areas.

Structure and ambit of the Report

0.8 This Report sets out each stage of the corporate groups review. Each topic begins with a full legal analysis of the relevant law, as found in the Discussion Paper, followed by the relevant Issue raised under that topic. The Report then summarises the submissions on the relevant Issue and sets out the relevant Draft Recommendation put forward in the Draft Proposals Paper. The Report then summarises the submissions on each Draft Recommendation, the Advisory Committee's response and its final Recommendation. The Report contains 24 Recommendations.

0.9 This Report deals only with corporate law issues affecting corporate groups. It does not discuss the legal implications of using other entities, such as partnerships, trusts or other unincorporated entities, that may form part of an overall group structure. Also, it does not consider market competition or other trade practices issues affecting corporate groups, or issues arising under contract, partnership or fiduciary principles as applied to corporate joint ventures.

0.10 This Report does not deal with any accounting or taxation issues affecting corporate groups. Accounting issues are a matter for the Australian accounting standards setting bodies. Corporate group tax issues were comprehensively reviewed by the Review of Business Taxation, which reported in 1999.

0.11 This Report deals with the application of corporate law principles within the jurisdiction of Australian law. It does not deal with extra-territoriality and international law issues related to the regulation of cross-border corporate groups.

Synopsis of the Recommendations

Proposed changes

0.12 Set out below are those areas where the Advisory Committee considers that reform is appropriate.

Methods of regulating corporate groups

- A single uniform control test should replace the holding/subsidiary and related company tests.
- A wholly-owned corporate group should have the choice to be a consolidated corporate group for all or some of its group companies and be governed by single enterprise principles.
- The prescribed ASIC Deed of Cross-Guarantee should clearly indicate that a wholly-owned corporate group does not retain liability under that Deed for the pre-sale debts of a group company once that company has been sold.

Directors of group companies

- Directors of a solvent partly-owned group company should be permitted to act in the interests of the parent company if authorised by the minority shareholders of the partly-owned company. Where that authorisation is

given, all minority shareholders who did not vote in favour of the resolution should have buy-out rights.

- In lieu of any statutory provisions regulating nominee directors, directors of all companies should be subject to the same fiduciary duties and be required to disclose all situations that may put them in positions of conflict of duty or interest.

Corporate group reconstructions

- Wholly-owned group companies should be able to merge with each other or with their parent company with the approval of the directors of each of the merging companies.
- Any other companies should be permitted to merge, with the approval of the board of directors, and the shareholders by special resolution, of each company.
- There should be a new court-approved merger provision.
- The provisions regulating asset and liability transfer schemes of arrangement should be amended to apply to partial consolidations and/or partly-owned group companies.
- Liquidators should be permitted to assign a company's liabilities with the consent of all the creditors or the court.
- An administrator should be permitted to pool the administration of several companies where no creditor who attends the creditors' meetings votes against the proposal or the court otherwise approves.

Liquidation of group companies

- Liquidators should be permitted to pool the unsecured assets of two or more companies in liquidation with the prior approval of all unsecured creditors of those companies.
- Courts should be permitted to make pooling orders in the liquidation of two or more companies.

No change necessary

0.13 The principal areas raised for debate during the course of this review where the Advisory Committee recommends no change to the current law are:

- the common law principles governing nominee directors and their nominators
- directors' fiduciary duties of confidentiality and disclosure
- the law of defamation as it applies to resigning directors in making public statements explaining the reasons for their resignation

- the scope of the related party transaction provisions as they apply to corporate groups
- the common law principles governing tort liability within corporate groups
- the priority of intra-group claims in the insolvency of a group company.

0.14 The List of Respondents to the Discussion Paper and the Draft Proposals Paper is set out in Appendix 1.

0.15 The 24 Recommendations in this Report are set out in Appendix 2.

Chapter 1

Methods of regulating corporate groups

This Chapter examines the role of corporate groups in Australian commerce and the economic and business benefits that the group structure offers. It discusses different ways of defining a corporate group, reviews the application of fundamental corporate law principles to a group, and examines the relative merits of viewing a group either as a collection of separate legal entities or as a single enterprise. The Chapter also reviews the regulation of corporate groups in various overseas jurisdictions and the extent to which those jurisdictions have applied either separate entity or single enterprise principles.

The Chapter recommends that corporate groups be regulated by a general control test rather than holding/subsidiary and related company tests and that wholly-owned corporate groups be permitted to choose to be regulated solely by single enterprise principles.

The nature of corporate groups

1.1 Many medium to large commercial enterprises in Australia are structured as corporate groups. The size and complexity of some corporate groups may not be readily apparent, given that they may present a public image of a unitary organisation operating under a single corporate identity.

1.2 The University of Melbourne's Centre for Corporate Law and Securities Regulation conducted a study of the group structures in Australia's Top 500 listed companies in 1997. The study showed that:

- 89% of the listed companies surveyed controlled other companies
- the greater the market capitalisation of a listed company, the more companies it was likely to control. This ranged from an average of 72 controlled companies for those in the largest market capitalisation quartile to an average of 9 controlled companies for those in the smallest quartile. The overall average was 28 controlled companies
- 90% of those controlled companies were wholly-owned. The remaining 10% of controlled companies consisted of 9% that were 50% to 99% owned and 1% that were less than 50% owned
- the number of vertical subsidiary levels in a corporate group chain ranged from one to eleven, with an overall average in the two largest market capitalisation quartiles of three to four subsidiary levels.[3]

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[3] IM Ramsay and GP Stapledon, *Corporate Groups in Australia* (Research Report, Centre for Corporate Law and Securities Regulation, University of Melbourne, 1998). The Research Report defined control as "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

1.3 There are few legal restrictions on the ability of businesses to conduct their affairs through corporate groups and determine their own group structure. Managers or controllers of a corporate group may plan, instigate and co-ordinate its managerial, operational and financial activities on a group basis, while conducting them through individual group companies. Some corporate groups may have a primarily hierarchical structure, with succeeding layers of parent and controlled companies. Other groups may maintain a more lateral structure, with many sibling group companies, often with a high level of cross-ownership between them.

1.4 From an economic perspective, corporate groups could be organised horizontally (for instance, several group companies operating at the same level in a production or distribution process) or vertically (group companies operating at different points in that process). Also, groups may be formed as, or develop into, “conglomerates”, whereby group companies conduct a diverse range of businesses in unrelated fields.

1.5 The degree of financial and decision-making autonomy of group companies can vary considerably. Some group companies may be active trading entities, with primary responsibility for their own business goals, activities and finances. For instance, conglomerate groups may operate under a highly decentralised structure, given their involvement in a range of industries. In other groups, strategic and budgetary decisions may be centralised, with group companies effectively operating as divisions of a larger business and exercising little independent discretion within this cohesive economic unit. A parent company may exercise close control by allocating equity and loan capital to group companies through a central group treasury mechanism, prescribing their operational and financial policies, setting their performance targets, choosing their directors and other key personnel, and continuously monitoring their performance and staffing.

1.6 The “power centre” of some corporate groups may be the ultimate holding company. More commonly, companies the next step down the group chain may effectively direct a group’s operation, with the ultimate holding company owning the key corporate group shares, but not having any direct productive or managerial role.

1.7 The degree of economic and organisational integration of different corporate groups can be compared according to various organisational, market and public image criteria.[4]

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to operate with it in pursuing the objectives of the controlled entity”. This test can be applied to companies that are less than 50% owned.

[4] *Economic organisation:*

- Do the subsidiaries have an administrative infrastructure that will enable them to operate independently, or do they depend on a central group organisation for essential administrative support services?
- Do the subsidiaries depend on the group for financing or loan guarantees?
- Is there interchange or rotation of personnel between group companies and utilisation of group-wide personnel programmes?
- To what extent does the parent make the vital decisions on policy, operations and budget, even though these may not extend to day-to-day control of management?

Market:

- What is the extent of horizontal or vertical integration of the businesses being conducted?

Why corporate groups exist

1.8 There are many economic and commercial benefits in conducting an enterprise through a corporate group structure. These include:

- reducing commercial risk, or maximising potential financial return, by diversifying an enterprise's activities into various types of businesses, each operated by a separate group company

- preserving intangible commercial property of existing companies by acquiring the companies themselves to expand an enterprise or increase market power. A corporate group may wish to continue operating an acquired company as a separate group entity to utilise its corporate name, goodwill and public image. Also, it is frequently preferable, for taxation reasons, to acquire companies as a going concern, rather than merely their assets[5]

- attracting capital without forfeiting overall control. A group controller may want outside investment in only part of its overall business. This can be achieved by incorporating that part of the business as a separate subsidiary and allowing outside investors to acquire a minority shareholding in it

- lowering the risk of legal liability by confining high liability risks, including environmental and consumer liability, to particular group companies, with a view to isolating the remaining group assets from this potential liability

- providing better security for debt or project financing. For instance, a lender may require that the borrower shift specific assets into a separate company incorporated for that purpose, thereby ensuring that the lender has a first charge over the whole or most of the new company's property.[6] Likewise, a separate group company may be formed to undertake a particular project and obtain additional finance by means of substantial charges over its own assets and undertaking[7]

- What is the extent of the division of economic functions?
- How important are intra-group sales and purchases?
- To what extent do the constituent companies within the group utilise common trade names, trademarks, logos and advertising programmes?
- Who guarantees the products?

Public image:

- To what extent is the group held out to the public as a single integrated enterprise, with the constituent companies described as components of the group?
- In annual or interim reports to shareholders and to the regulator and in materials prepared for investors and for trade, to what extent are the activities of the constituent companies described as operations of the group?

5 Stamp duty is significantly higher for asset sales than for share sales. Also, the taxation advantage of carrying forward any losses of the acquired company (if the requisite tests are satisfied) may not be available to the acquirer of assets. See further HAJ Ford, RP Austin & IM Ramsay, *Ford's Principles of Corporations Law* (loose leaf, Butterworths) at [23,020].

6 P Crutchfield, *Corporate Voluntary Administration Law* (Second Edition, Law Book Company Limited, 1997) at 27.

7 K Lightman, "Voluntary Administration: The New Wave or the New Waif in Insolvency Law" (1994) 2 *Insolvency Law Journal* 59 at 84.

- simplifying the process of partial sale of an enterprise. It is often easier, and more tax effective, to transfer the shares of a group company to the purchaser, rather than sell discrete assets as would be necessary if the enterprise were conducted through divisions of one company

- complying with various regulatory requirements. Some enterprises may need to maintain separate subsidiaries to satisfy prudential or other statutory requirements. In the case of multinational groups, the domestic law of particular countries in which those groups wish to conduct business may require that the local businesses be conducted through separate subsidiaries (sometimes subject to minimum local equity requirements).

1.9 A corporate group may also develop incidentally where, for instance, the group acquires an outside company which itself is a holding company of various other companies. Also, some companies whose shares are undervalued may be attractive takeover targets, and therefore be acquired by a corporate group merely as an investment.

1.10 Some corporate groups may become excessively large and unduly complex as a result of direct and incidental growth, but nevertheless not be simplified due primarily to the taxation disincentives for corporate group reconstructions.

The legal concept of a corporate group

1.11 Australian courts have acknowledged the concept of corporate groups. The High Court has said that:

> "The word 'group' is generally applied to a number of companies which are associated by common or interlocking shareholdings, allied to unified control or capacity to control."[8]

1.12 More recently, another Court has commented that:

> "close and common management links, as well as an interlocking web of complex mutual shareholdings are features sufficient in de facto terms to constitute the various companies in question within the group as being properly described as such, being responsive to the needs and interests of each other as corporate entities through their management".[9]

1.13 UK Courts have also recognised that a corporate group may operate as a common economic unit[10] and have an identifiable corporate image and reputation[11] which can be protected in law.

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8 *Walker v Wimborne* (1976) 3 ACLR 529 at 532, per Mason J.

9 *Re Enterprise Gold Mines NL* (1991) 3 ACSR 531 at 540, per Murray J.

10 In *The Albazero* [1977] AC 774, the Court of Appeal allowed an action for the recovery of insurance money to continue, despite the named plaintiff being the wrong company in the corporate group. The Court ruled that the corporate group as a collective was the beneficiary of the claim.
In *DHN Food Distributors Ltd v London Borough Council Tower Hamlets* [1976] 1 WLR 852, a subsidiary owned land on which its parent company operated a wholesale grocery business. The

Legal definition of the corporate group

Two approaches

1.14 The Corporations Law does not specifically define corporate groups. In one sense, the phrase ‘corporate group’ is an umbrella concept which covers a large number of different forms of economic organisation using corporate combinations. However, the legislation applies two corporate group concepts:

- holding, subsidiary and related companies
- parent companies and controlled entities.

Holding, subsidiary and related companies

1.15 Company A is a holding company of Company B (and Company B is a subsidiary of Company A) if Company A:[12]

- controls the composition of the board of Company B (including by exercise of any power to appoint or remove all, or a majority of, the directors of Company B)[13]
- is in a position to cast, or control the casting of, more than 50% of the total voting shares of Company B[14]
- holds more than half of the issued share capital of Company B,[15] or
- is the holding company of any holding company of Company B (this also applies where there are any number of intermediate holding and subsidiary companies between Company A and Company B[16]).

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local authority compulsorily acquired the land and paid compensation to the subsidiary for the value of the land taken. The parent company was able to recover compensation for the disruption to its business on the basis that the parent and the subsidiary were one economic unit. The loss of the land to the subsidiary also meant disruption to the business of the parent company.

11 *McDonald’s Corporation and McDonald’s Restaurants Ltd v Steel and Morris*, Queen’s Bench Division No 1990-M-No 5724, delivered 19 June 1997.

12 s 9 definitions of “holding company”, “subsidiary”, ss 46-49. See generally HAJ Ford, RP Austin & IM Ramsay, *Ford’s Principles of Corporations Law* (loose leaf, Butterworths) at [4.330].

13 Section 47 gives instances of where one company controls the composition of the board of another company.

14 This test includes shareholding or like arrangements that fall short of legally enforceable rights. In *Bluebird Investments Pty Ltd v Graf* (1994) 13 ACSR 271 at 282, Santow J gave the example of a person who held few voting shares but enough proxies to have an absolute majority of the voting shares. According to His Honour: “Even if the proxy be revocable, in the absence of revocation, the [person] is presently in a position of being able to cast more than 50% of the votes. It follows that such an underlying arrangement, though not legally enforceable, may still satisfy the voting control test” (at 282).

15 This test deals with all shares, whether or not they are voting shares: *NCSC v Brierley Investments Ltd* (1988) 14 ACLR 177 at 184. However, shares that have a limited right to participate in a distribution of either profits or capital beyond a specified amount are excluded from the calculation.

16 s 49.

1.16 In Australia, holding companies and all their subsidiaries are related companies, thereby forming a corporate group.[17] The New Zealand legislation includes in its definition of related companies an additional and less definite "intermingled business" test of related companies, namely: "the businesses of the companies have been so carried on that the separate business of each company, or a substantial part of it, is not readily identifiable".[18]

1.17 There can be difficulties with applying the holding/subsidiary and related company tests to corporate groups. For instance, whether one company controls the board of directors of another company turns on a legal, rather than de facto, power.[19] Also, the potential liability of an ultimate controlling company for the insolvent trading of a group company far removed down the corporate chain may turn on whether all intermediate group companies satisfy the holding/subsidiary company definition.[20]

Parent and controlled companies

1.18 Australian accounting standards and the Corporations Law currently apply control tests to corporate groups for particular purposes. These tests are broader than the holding/subsidiary and related company tests.

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17 s 50.

18 New Zealand Companies Act 1955 s 2(5)(d), New Zealand Companies Act 1993 s 2(3).

19 In *Mount Edon Gold Mines (Aust) Ltd v Burmine Ltd* (1994) 12 ACSR 727, the Court held that the test of controlling the composition of the board of directors in s 46 is concerned with legal power and not de facto power: "It is not sufficient … that, as a matter of commercial practice, possession of a substantial percentage of the shares of a company, being less than 50%, will ordinarily be enough to determine the result of an ordinary resolution at a general meeting of a company" (at 748).
In this case, the Court held that a company was not a holding company, notwithstanding that it effectively controlled the composition of a board of directors of another company, given that it had no legally enforceable power to do so. The Court reasoned that to apply a de facto test might create uncertainty in the following manner:

> "If [a de facto power test is applied] the legislature must have intended the relationship of holding company and subsidiary to be something entirely uncertain and unascertainable, save at the moment a general meeting is held, whereupon an assessment can be made as to whether a certain body corporate has in fact controlled the composition of the board, at least at that meeting. The fact that at a specific meeting the majority shareholder with the power to control the composition of the board has refrained from attending will mean that, at the time of the meeting, a certain [other] shareholder can be said to control the composition of the board because the directors it puts forward are voted into office and directors to whom it is opposed are either removed or are not voted into office.
> At that moment of time, the shareholder constitutes the holding company of the [second] company which becomes its subsidiary. At the next meeting, perhaps called within a short period thereafter by the shareholder with the power to control the board, the directors appointed by the minority shareholder are removed and directors nominated by the majority shareholder are voted into office, over the opposition of the former, temporary, holding company. At that point, the company ceases to be the subsidiary of the minority shareholder. It is difficult to see what useful purpose could be served, in the context of [the definition of subsidiary in the Corporations Law] by so temporary and shifting a relationship" (at 747-748).

20 Section 588V provides that, in some instances, a holding company is liable for insolvent trading by its subsidiary. Whether one company is a holding company of another company far removed down the corporate group chain is usually determined by the test in ss 46(b) and 49, which requires that all intermediate group companies satisfy a holding/subsidiary company test.

1.19 Under the control test in the accounting standards, control is defined as:

"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 pursuing the objectives of the controlling entity",

while "capacity" is defined as:

"ability or power, whether direct or indirect, and includes ability or power that is presently exercisable as a result of, by means of, in breach of, or by revocation of, any of or any combination of the following: (a) trusts; (b) relevant agreements; and (c) practices; whether or not enforceable".[21]

1.20 Whether control exists is therefore determined by the substance of the relationship between the entities, rather than reliance on strict legal form. This emphasis on substance ensures that the test applies to all entities whose financial and operating policies are being dominated by the parent entity.

1.21 A comparable control test is set out in the Corporations Law, as follows:

> "(1) For the purposes of this Law, an entity controls a second entity if the first entity has the capacity to determine the outcome of decisions about the second entity's financial and operating policies.
>
> (2) In determining whether the first entity has this capacity:

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21 AASB 1024 definitions of "control" and "capacity".

According to the Commentary accompanying AASB 1024, any of the following factors would normally indicate the existence of control by one entity of a second entity:

- the capacity to dominate the composition of the board of directors or governing board of the second entity
- the capacity to appoint or remove all or a majority of the directors or governing members of the second entity
- the capacity to control the casting of a majority of the votes cast at a meeting of the board of directors or the governing board of the second entity
- the capacity to cast, or regulate the casting of, a majority of the votes that are likely to be cast at a general meeting of the second entity, irrespective of whether the capacity is held through shares or options, and
- the existence of a statute, agreement, trust deed or any other scheme, arrangement or device which, in substance, gives an entity the capacity to enjoy the majority of the benefits and to be exposed to the majority of the risks of the second entity, notwithstanding that control may appear to be vested in another party.

The Commentary also points out that the concept of control is defined as a capacity, thereby allowing for the role of dominance to be a passive one, rather than one which is necessarily actively exercised. Furthermore, it may be possible to control the voting rights of another entity without holding a majority interest in the voting rights. This could occur in the absence of another entity dominating the composition of the board of directors. Also, the definition of control may result in an entity being under the control of two unrelated entities. An example would be where an entity exercises dominance of the decision-making in relation to the operating policies of a second entity, while another entity simultaneously possesses the capacity to dominate decision-making of that second entity, but without exercising that power (AASB 1024 paras xv-xxiv).

(a) the practical influence the first entity can exert (rather than the rights it can enforce) is the issue to be considered; and

(b) any practice or pattern of behaviour affecting the second entity's financial or operating policies is to be taken into account (even if it involves a breach of an agreement or a breach of trust)."[22]

1.22 This control test does not require that control be actively exercised. What is relevant is the practical influence that the controlling company can assert. Therefore, "the mere fact that an entity acts in a manner consistent with the interests of a 'controlling' company may be sufficient to indicate control".[23] The test may therefore encompass de facto forms of control not within the scope of the holding/subsidiary and related company tests.

1.23 The accounting and Corporations Law control tests may better identify de facto control than the holding/subsidiary company test. For instance, there is no requirement that control depend on shareholding or control of the composition of the board of directors. The control tests could be applied to corporate group structures employing a series of interlocking shareholdings, each less than the holding/subsidiary company threshold, or vertical corporate groups that do not have a holding/subsidiary company continuity.[24] However, some of the criteria used in the control tests may be less precise in their application than those used in the holding/subsidiary company test.[25]

Other legislation

Australia

1.24 The corporate group concept is recognised in other commercial legislation. For instance, the Trade Practices Act defines a corporate group by reference to holding/subsidiary and related company tests similar to those in the Corporations

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22 Section 50AA; cf s 259E. Section 50AA also provides that:

"(3) The first entity does not control the second entity merely because the first entity and a third entity jointly have the capacity to determine the outcome of decisions about the second entity's financial and operating policies.

(4) If the first entity:

(a) has the capacity to influence decisions about the second entity's financial and operating policies; and

(b) is under a legal obligation to exercise that capacity for the benefit of someone other than the first entity's members;

the first entity is taken not to control the second entity.".

23 Company Law Review Act 1998 Explanatory Memorandum para 12.61 on s 259E, which is in similar terms to s 50AA. The EM also stated that a short-lived ability to control the outcome of decisions taken by the company would be unlikely to satisfy the control test, as it would be unlikely in practice to give a company the ability to determine the outcome of decisions about the company's policies.

24 For instance, ss 46(b) and 49 provide that companies separated by intermediate companies in a corporate group chain will nevertheless be holding and subsidiary companies if all those intermediate companies satisfy the holding/subsidiary company test.

25 P Edmundson, "Indirect Self-acquisition: The Search for Appropriate Concepts of Control" (1997) 15 *Company and Securities Law Journal* 264 at 274 ff identifies some of the possible uncertainties with the control test under s 259E, for instance, that the extent of "practical influence" required may be difficult to determine in a borderline case.

Law.[26] That Act recognises that in some instances its provisions could be avoided unless the activities of all group companies are taken into account.[27] In other instances, the legislation may work unfairly if corporate group activities are not exempted.[28]

1.25 Australian tax law also identifies corporate groups for various purposes. For instance, the taxation legislation currently provides relief for some transactions within wholly-owned corporate groups.[29] In this context, a company will form part of a wholly-owned group only where all of its issued shares (including any of its other securities that have been converted into shares) are owned, directly or indirectly, by the parent company of the group. The current tax legislation does not here apply any of the "control" tests found in the Corporations Law. By contrast, some State payroll tax legislation treats companies as a group where they are related companies (as defined under the Corporations Law) or where their businesses are integrated either through common control by the same persons or through the sharing of employees. That legislation acknowledges that companies can operate as a single economic unit, even where they are not related companies.

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26 The Trade Practices Act s 4A provides (in part):

"(1) For the purposes of this Act, a body corporate shall ..... be deemed to be a subsidiary of another body corporate if:

(a)that other body corporate:

(i) controls the composition of the board of directors of the first-mentioned body corporate;

(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 first-mentioned body corporate; or

(iii) holds more than one-half of the allotted share capital of the first-mentioned body corporate (excluding any part of that allotted share capital that carries no right to participate beyond a specified amount in a distribution of either profits or capital); or

(b) the first-mentioned body corporate is a subsidiary of any body corporate that is that other body corporate's subsidiary (including any body corporate that is that other body corporate's subsidiary by another application or other applications of this paragraph).

(4) A reference in this Act to the holding company of a body corporate shall be read as a reference to a body corporate of which that other body corporate is a subsidiary.

(5) Where a body corporate:

(a)is the holding company of another body corporate;

(b) is a subsidiary of another body corporate; or

(c)is a subsidiary of the holding company of another body corporate, that first-mentioned body corporate and that other body corporate shall, for the purposes of this Act, be deemed to be related to each other."

27 For instance, the Trade Practices Act s 46(2) makes it clear that the market power of all related companies must be considered when assessing the market power of a particular company.

28 For instance, the Trade Practices Act s 45(8) provides that the prohibition against anti-competitive contracts, arrangements and understandings does not apply to contracts, arrangements or understandings between related corporations.

29 The existing tax provisions are summarised in paras 1.73-1.75 of the *Corporate Groups* Discussion Paper (December 1998). However, the *Report of the Review of Business Taxation: A Tax System Redesigned* (July 1999) proposes major changes to the taxation system, including the taxation of corporate groups.

Overseas

1.26 European and US law has to an increasing extent adopted "control" tests in the regulation of corporate groups. European law includes a "dominant influence" test in determining what is a parent company for the purposes of preparing consolidated accounts and annual reports.[30] The tests under US law focus on the capacity of one company to determine, or in some cases influence, the decision-making of another company, and therefore achieve a coordinated central direction for the activities of the corporate group. For instance, the US Securities Code defines control, inter alia, as:

> "… the power, directly or indirectly, to exercise a controlling influence over the management and policies of a company … (either alone or pursuant to an arrangement or understanding with one or more other persons), whether through the ownership of voting securities, through one or more intermediary persons, by contract, or otherwise".[31]

1.27 In addition, various US statutes seek to apply to a corporate group collectively, by extending their application beyond one corporate group company to any other company "directly or indirectly controlling, or controlled by, or under direct or indirect common control with" the initial group company.[32]

Law reform options

1.28 Currently, the Corporations Law predominantly applies holding, subsidiary and related company tests to corporate groups. However, the question arises whether it may be appropriate to have increasing resort to a control test in the regulation of corporate groups, for instance in the following areas.

- *Disclosure of emoluments.* Currently, a specified percentage of shareholders may require a company (the first company) to disclose the emoluments and other benefits received by the directors of that company or of any subsidiary.[33] This obligation does not extend to any other company that the first company controls, but which is not its subsidiary.

- *Directors' indemnification and insurance.* Currently, there are restrictions on a company or a related body corporate indemnifying an officer or auditor or paying insurance premiums in respect of certain liabilities for those persons.[34] These provisions do not apply to companies that are not related, but nevertheless may come within the broader test of control.

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30 European Union Seventh Council Directive 1983 Section 1 Article 1(1). Forum Europaeum Konzernrecht, "Corporate Group Law for Europe" 1 *European Business Organization Law Review* (2000) proposes that the regulation of corporate groups in Europe be based on the control test as defined in the Article, while Member States should remain free to apply broader "dominance" or "integrated management" tests discussed by the Forum Europaeum Konzernrecht.

31 US Securities Code (1980) s 202(29).

32 PI Blumberg points out that the American experience has decisively confirmed the importance of the use of de facto concepts of control. See, for instance, Securities Exchange Act 1934 §78c(a)(8).

33 s 239.

34 ss 241, 241A.

- *Financial assistance transactions.* Currently, there are restrictions over a company (the first company) financially assisting a person to acquire shares in itself or its holding company.[35] These restrictions do not apply where the first company provides financial assistance for the acquisition of shares in a company that controls the first company but is not its holding company.

- *Insolvent trading.* A holding company which ought to suspect the insolvency of its subsidiary can be made liable for the debts of that subsidiary incurred when it was insolvent.[36] This liability does not apply to a controlling company that is not the holding company of the insolvent company.

1.29 One possible consequence of applying a control test, particularly in the context of insolvent trading, is that, theoretically at least, more than one group company could control another group company. Presumably, if a control test were adopted for insolvent trading, all the controlling group companies could be held to be jointly and severally liable in the insolvency of a controlled group company, subject to one or more of the controlling group companies establishing a defence, as provided by the Corporations Law.[37]

Issue 1. *Should a control test, rather than a holding/subsidiary and related company test, apply to:*

- *disclosure of emoluments*
- *directors' indemnification and insurance*
- *financial assistance transactions*
- *insolvent trading*

respectively? Alternatively, should a control test be added to the holding/subsidiary and related company tests in relation to any of the above?

Should a control test substitute for a holding/subsidiary and related company test in any other areas of the Corporations Law? Alternatively, should a control test be added to the holding/subsidiary and related company tests in any other areas of the Corporations Law?

If a control test is to be applied (either by itself or in addition to a holding/subsidiary and related company test), should it be the test applied for consolidated financial accounts or the test under s 50AA?

Submissions on Issue 1

Submissions favouring holding/subsidiary and related company tests

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35 s 260A.

36 ss 588V-588X, as discussed in detail at paras 6.11-6.14.

37 The defences are set out in s 588X.

1.30 Some submissions favoured retaining the holding/subsidiary and related company tests where they currently appear, rather than changing to a control test,[38] for the following reasons.

- There would be uncertainty about when control actually exists, given the imprecise nature of the existing and proposed control tests. In particular, the more precise, though narrower, holding/subsidiary and related company tests should apply where potential liabilities are involved.
- Any extension of liability for insolvent trading, in particular, may discourage appropriate risk taking.

Submissions favouring control test

1.31 Some submissions favoured using a control test instead of the more technical holding/subsidiary and related company tests, to ensure that the intention of the legislation cannot be circumvented.[39]

1.32 The submissions were divided on whether the control test should be based on the accounting standard (AASB 1024)[40] or the Corporations Law (s 50AA).[41] However, it was generally agreed that a single control test was preferable to a series of different control tests. One of the respondents pointed out that to have more than one control test may cause a combination of companies to be classified as a group for some purposes but not for other purposes.[42]

1.33 Another respondent considered that both a control test and holding/subsidiary and related company tests should be used in relation to financial assistance transactions and insolvent trading, thereby ensuring that the provisions apply in all relevant circumstances.[43]

1.34 One respondent supported a control test where there is a real risk that the holding/subsidiary and related company tests could be avoided. Conversely, if such risk is minimal, the holding/subsidiary and related company tests should be retained, as they are easier to apply.[44]

1.35 A further submission[45] argued that:

- the control test is potentially broader and more flexible than the holding/subsidiary and related company tests. However, the submission acknowledged that the control test requires subjective interpretation and thus involves potential uncertainty

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38 Australian Institute of Company Directors, Carter Holt Harvey Limited, Coles Myer Ltd.
39 Australian Accounting Research Foundation, AMPAM, Law Council of Australia, P Edmundson.
40 Australian Accounting Research Foundation.
41 P Edmundson, Law Council of Australia.
42 Law Council of Australia.
43 Australian Credit Forum.
44 ASIC.
45 P Edmundson.

- the holding/subsidiary and related company tests rely upon concepts which are specific to corporations, such as directorships, voting and shareholding. The obligations that a company would have if it were a subsidiary can be avoided by interposing a trust or a company that is not technically a subsidiary. By contrast, the control test can cover different types of entity including partnerships, trusts and individuals and can thus cope with hybrid structures.

Possible areas for application of control test

1.36 *Control test in lieu of holding/subsidiary test.* One respondent[46] identified various areas where he considered that a control test was preferable to the holding/subsidiary test, namely:

- *the liability of a parent company for insolvent trading by its child entity.* Corporations Law s 588V(1)(a) should be amended to read: "the corporation *controls a company* at the time when the company incurs a debt". Corresponding amendments should be made to s 588V(1)(d)(ii)(A) and (B), Another respondent was concerned that, if a control test is applied, liquidators may have a greater ability to pursue claims against another group company

- *disclosure of emoluments.* Corporations Law s 202B(1) should be amended to read: "A company must disclose the remuneration paid to each director of the company, *or to each director of a company controlled by the first-mentioned company*, by the company or by an entity controlled by the company…". Another respondent said that, if a control test is applied, it should be made clear to the shareholders of the controlling company whether or not that company has paid the emoluments[47]

- *financial assistance in the acquisition of shares.* Corporations Law s 260A should be amended to read: "A company may financially assist a person to acquire shares (or units of shares) in the company, *or a company which controls the first-mentioned company*, only if…" Corresponding alterations should be made throughout Part 2J.3

- *determining whether a company is a public or proprietary company.* Corporations Law s 113(2)(b)(i) should be amended to read "a shareholder who is an employee of the company, *or of a controlled entity* of the company". Corresponding changes should be made to s 113(2)(b)(ii) and s 113(3)(b).

1.37 *Control test in lieu of related company test.* The same respondent also identified various areas where he considered that a "common control group entity" test or a "common control group company" test should substitute for a related company test. Under his definition, two entities are "common control group entities" where:

- both entities are controlled by the same entity, or

46 P Edmundson.

47 Coles Myer Ltd.

- one entity controls the other entity.

Where appropriate, this definition could be restricted to "common control group companies".

1.38 The areas where these common control tests could be applied are:

- *indemnification and insurance of officers and auditors.* Corporations Law s 199A(1) should be amended to read: "A company, or a common control group entity of that company, must not exempt…". Likewise, s 199B should be altered to read: "A company, or a common control group entity of that company, must not pay…"

- *restrictions on appointments as a receiver.* Corporations Law s 418(1)(e) should be amended to read "…is an officer of a common control group company of the corporation…" A corresponding amendment should be made to s 418(1)(f). Similarly, consideration should be given to the substitution of the common control group company concept for the related body corporate concept in s 324 (dealing with the appointment of auditors) and s 448C (in relation to administrators)

- *certain frauds by officers.* Corporations Law s 596(a) should be amended to read "… induces a person to give credit to the company or to a common control group entity of the company". Similar alterations should be made to the remainder of s 596, although they may have to be restricted to "common control group companies"

- *directors' disclosure of interests in contracts.* Corporations Law s 191(2) should be amended to refer to a common control group entity of the company

- *statutory derivative actions.* Corporations Law s 236(1)(a)(i) should be amended to read: " … of the company or of a common control group company of that company". Similar amendments should be made to other provisions in Part 2F.1A which refer to related bodies corporate.

Advisory Committee response to submissions on Issue 1: Draft Recommendation 1

1.39 The control test is preferable to the holding/subsidiary and related company tests. The former test may better identify all forms of de facto control, as it is not limited to control through majority shareholding or control through composition of the board of directors. A control test should apply in all circumstances. Accordingly:

The Corporations Law should have a single uniform control test, to be introduced in lieu of the holding/subsidiary and related company tests. That control test should be as set out in s 50AA.

Issue. Are there any areas where the holding/subsidiary and related company tests should be retained?

Submissions on Draft Recommendation 1

1.40 All submissions supported the Draft Recommendation. No submission identified any areas where the holding/subsidiary and related company tests should be retained, though one view was that the test of control should specifically incorporate the existing holding/subsidiary and related company tests as a minimum guideline.[48]

Advisory Committee response to submissions on Draft Recommendation 1

1.41 The Advisory Committee maintains the view that the general control test in s 50AA should apply in all instances in lieu of the current holding/subsidiary and related company tests, which should not be retained, even as part of the general control test. A control test focuses on real power and influence, rather than on the sometimes more formal criteria in the holding/subsidiary tests.

Recommendation 1

The test of control under the Corporations Law s 50AA should apply throughout the Corporations Law in lieu of the holding/subsidiary and related company tests, which should be repealed.

Regulation of corporate groups

Two approaches

1.42 Regulation of corporate groups in different countries is generally based on one of two approaches, or a combination of them:

- the separate entity approach
- the single enterprise approach.

The separate entity approach

1.43 Corporate law in common law countries has developed from the separate entity approach. In essence, this involves three inter-related principles, originally developed for single companies, but subsequently applied to corporate groups, namely:

- separate legal personality of each group company (corporate autonomy)
- limited liability of shareholders of each group company
- directors' duties to the separate group company.

Corporate autonomy

1.44 Each company in a corporate group is a separate legal entity with its own rights and duties, even when controlled or wholly- or partly-owned by another company and

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48 Australian Institute of Company Directors, Australian Society of Certified Practising Accountants, R Schulte.

collectively engaged in the business of the group.[49] This has various consequences at common law, including:

- the debts incurred by each company are debts of that company, not of the controllers of that company or of the corporate group collectively. The assets of the group cannot be pooled to pay for these debts[50]
- parent companies are not automatically parties to contracts entered into by other group companies with external persons[51]
- a parent company cannot take into account the undistributed profits of other group companies in determining its own profits[52]
- a group company may breach its obligations to an external party if it passes confidential information about that party to its parent company.[53]

1.45 The application of traditional corporate autonomy principles to corporate groups partly protects unsecured creditors of solvent group companies by avoiding the financial loss which those companies might incur if they could be held liable for the debts of other group companies. Arguably, to deny corporate autonomy and impose joint or ultimate liability for the group's debts on a parent or controlling company could make the extension of credit to that company more costly. Prospective creditors of a parent company might need to investigate the creditworthiness and debt burden

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49 In *Briggs v James Hardie & Co Pty Ltd* (1989) 7 ACLC 841 at 861, Rogers AJA said:
"The proposition that a company has a separate legal personality from its corporators survived the coming into existence of the large numbers of fully-owned subsidiaries of companies and their complete domination by their holding company … There was continued adherence to the principle recognised by *Salomon v A Salomon & Co Ltd* [1897] AC 22, notwithstanding that for a number of purposes, legislation recognised the existence of a group of companies as a single entity".
Likewise, in *Adams v Cape Industries plc* [1991] 1 All ER 929 at 1019, the UK Court of Appeal said that: "Our law, for better or worse, recognises the creation of subsidiary companies, which though in one sense the creatures of their parent companies, will nevertheless under the general law fall to be treated as separate legal entities with all the rights and liabilities which would normally attach to separate legal entities".

50 *Walker v Wimborne* (1976) 137 CLR 1 at 6-7.

51 *Pioneer Concrete Services Ltd v Yelnah Pty Ltd* (1986) 11 ACLR 108.

52 In *Industrial Equity Ltd v Blackburn* (1977) 137 CLR 567, a holding company wanted to treat various profits earned by one of its subsidiaries as its own profits prior to their being passed to the holding company by way of dividend. The holding company argued that, as it was required to prepare group accounts for itself and the subsidiary, the Court should treat the group as a single entity and therefore permit the subsidiary's profits to be treated as the holding company's profits. The High Court rejected this argument, holding that, notwithstanding the obligation to prepare group accounts, each group company remained a separate legal entity. The holding company could not treat the subsidiary's profits as its own profits before the subsidiary formally distributed those profits to the holding company by way of dividend.
However, there is no restriction on the right of a subsidiary company to pass on profits to its holding company via a distribution to shareholders. In *H Timber Protection Limited v Hickson International plc* (1995) 7 NZCLC 260,740 at 260,745, the New Zealand Court of Appeal said that:

> "There is no principle of company law precluding a wholly-owned subsidiary from paying over its [profit] reserves to the parent company by some act which it has capacity to perform, provided that this does not improperly prejudice the interests of its creditors."

53 *Bank of Tokyo v Karoon* [1986] 3 All ER 468 at 476.

of all the group companies. However, the benefits to a corporate group of corporate autonomy can be overstated, given that it is common for creditors to require security on a group basis, for instance by intra-group cross-guarantees.

1.46 At common law, unsecured creditors of particular group companies are at risk to the extent that assets of their debtor company can lawfully be moved to other group companies. For instance, unsecured creditors of a parent company have no general right to assets held by subsidiaries or other controlled companies (except for rights under relevant liquidation provisions or by virtue of the parent company's share or security holdings in those controlled companies).[54] However, the ability to move assets between corporate group companies with a view to maximising group commercial opportunities or profits is one of the significant benefits of operating through a group structure.

1.47 One means of protecting unsecured creditors of group companies is to look behind the separate corporate personality of those companies and hold the group controllers (typically the immediate or ultimate holding company within a corporate group) liable for the actions or debts of the group companies ("lifting the corporate veil").

1.48 In Australia, the corporate veil has been lifted if the corporate form has been used improperly, or if one company is the agent, trustee or partner of another company.[55] However, control or domination of a subsidiary by a parent, or other forms of close economic integration within a corporate group, has not sufficed to justify disregarding the separate legal personality of each group company.[56] In

54 In *ANZ Executors and Trustee Co Ltd v Qintex Australia Ltd* (1990) 8 ACLC 980, the creditors of a parent company sought unsuccessfully to make the subsidiaries responsible for the debts of the parent company. The Court ruled that "each company in a group is a separate entity having assets and liabilities of its own that are distinct from those of all the others" (at 984).

55 See, generally, HAJ Ford, RP Austin & IM Ramsay, *Ford's Principles of Corporations Law* (loose leaf, Butterworths) at [4.350-4.420]. They argue that the agency ground is of particular relevance to corporate groups: "Where a parent company withholds from the subsidiary company the normal consequences of being a separate legal entity, there is a possibility that the courts will identify it with the controller. This may happen where a parent company forms or acquires a subsidiary ostensibly to do something for which the subsidiary needs a minimum level of resources but the parent does not give it adequate proprietors' capital or loan money, or equip it to run its own business by loan of personnel or other resources or give it a reasonable chance of independently obtaining credit or resources from third persons. In such a case a court may hold that the dominated subsidiary is an agent of the parent or a partner with it" (at [4.370]).

56 In *Briggs v James Hardie & Co Pty Ltd* (1989) 7 ACLC 841 at 862, Rogers CJ said:
"In the result, as the law presently stands, in my view the proposition advanced by the plaintiff that the corporate veil may be pierced where one company exercises complete dominion and control over another is entirely too simplistic. The law pays scant regard to the commercial reality that every holding company has the potential and, more often than not, in fact, does, exercise complete control over a subsidiary..... It remains to be seen whether the time has come for the development of a more principled approach than the authorities provide at present."
In the earlier case of *Pioneer Concrete Services Limited v Yelnah Pty Ltd* (1986) 11 ACLR 108 at 119, the Court held that "it is only if the court can see that there is in fact or in law a partnership between companies in a group, or alternatively where there is a mere sham or façade that one lifts the veil. The principle does not apply in the instant case where it would appear that there was a good commercial purpose for having separate companies in the group performing different functions even though the ultimate controllers would very naturally lapse into speaking of the whole group as 'us'".

consequence, courts have not displayed any greater willingness to lift the corporate veil merely because they are dealing with a corporate group.[57]

1.49 In the United States, the main grounds for lifting the corporate veil in the corporate group context are fraud, failure to follow the formalities of treating group companies as separate legal entities, inadequate capitalisation of particular group companies and commingling of assets and control of those group companies.[58] Also, US courts may be increasingly willing to find a parent company directly liable for the torts of its controlled companies.[59] However, the role of under-capitalisation as a factor in lifting the corporate veil in the corporate group context remains unclear and controversial.[60]

In *Pascoe Ltd v Lucas* (1998) 27 ACSR 737 at 767, the Court held that a wholly-owned subsidiary remained a separate legal entity from its holding company which was its only shareholder. The Court also held that the wholly-owned subsidiary was not the agent of that controlling shareholder. This ruling was adopted on appeal: *Pascoe Ltd v Lucas* (1999) 33 ACSR 357 at 385 (para [261]).

57 IM Ramsay and GP Stapledon, *Corporate Groups in Australia* (Research Report, Centre for Corporate Law and Securities Regulation, University of Melbourne, 1998) at 20 set out their conclusions based on their empirical research into cases involving lifting the corporate veil: "Are courts more prepared to lift the corporate veil where there is a corporate group? Although further analysis needs to be done to fully answer this question, the preliminary results indicate that the question would be answered in the negative".

58 For a critical analysis of the US case law on lifting the corporate veil in corporate groups, see PI Blumberg, *The Multinational Challenge to Corporation Law* (Oxford University Press, 1993) at 84-88, PI Blumberg, "The increasing recognition of enterprise principles in determining parent and subsidiary corporation liabilities" (1996) 28 *Connecticut Law Review* 295 at 329-332. See also J Cox, T Hazen, F O'Neal, *Corporations* (Little, Brown & Co 1995) at §7.16 (p 7.41).
See also D DeMott, "The Mechanisms of Control" 13 *Connecticut Journal of International Law* (1999) 233 who analyses the various forms of control within corporate groups, including the interrelationship with US case law on lifting the corporate veil. This issue is also discussed by R Thompson, "Piercing the Veil within Corporate Groups: Corporate Shareholders as Mere Investors" 13 *Connecticut Journal of International Law* (1999) 379.

59 PI Blumberg, "The increasing recognition of enterprise principles in determining parent and subsidiary corporation liabilities" (1996) 28 *Connecticut Law Review* 295 at 332 states that "while most tort cases follow the older doctrines of entity law, with each related corporation in an integrated group liable only for its own acts, an impressive number of tort cases have imposed intra-enterprise liability on the parent corporation for the subsidiary's torts". The article refers (at 332-334) to a number of cases involving significant injury or environmental damage (for instance, the Amoco Cadiz oil spill in the English Channel, the Bhopal disaster in India and the Exxon Valdez oil spill in Prince William Sound, Alaska) where the courts found the parent company directly liable for the negligence of a subsidiary company or the parent company chose not to contest its liability for the negligence of its subsidiary.

60 For instance, J Cox, T Hazen, F O'Neal, *Corporations* (Little, Brown & Co 1995) at §7.11 (pp 7.27-7.28) make the following observations on the inadequate capitalisation test:

> "On close inspection, the role of inadequate capitalisation is best left as a surrogate for the promoter's possible bad faith as that factor may relate on the overall equities of disregarding the corporate entity. Consider in this regard that the inadequacy of the firm's capital is to be measured at the time of the corporation's inception. Capital must then have been sufficient to meet the prospective risks of the business in which the corporation is to engage. To apply the test when the claim that is the subject of the suit arose would be tantamount to a denial of limited liability; limited liability exists to protect the shareholders from the situation where its assets are insufficient to satisfy a claim when it arises.
>
> Testing capital adequacy at the corporation's inception and evaluating its amount strictly in terms of the magnitude of future business risks introduce a great deal of ambiguity and unreasonableness into the equation. Are the risks to be perceived only those that are normal

1.50 In the United Kingdom, the corporate veil can be lifted where the corporate structure is merely a façade. However, the courts have generally accepted the use of the corporate group structure in commerce. They have been unprepared to lift the corporate veil merely because a group has conducted some of its business through wholly- or partly-owned subsidiaries or has arranged the group structure to ensure that any legal liability in respect of particular activities will fall only on one group member.[61] Also, UK courts (like US courts) have been reluctant to accept that under-capitalisation of particular group companies justifies lifting the corporate veil.[62] For instance, in one recent case the Court held that:

> "Neither agency nor nomineeship — nor, still less, sham or something akin to sham — is to be inferred simply because a subsidiary company has a small

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for a business, or do they include a highly unusual tort claim that greatly exceeds the firm's liability insurance? Does the test demand that the total amount the shareholders invest must literally equal the present value of all future liabilities of the firm or does it entail some lesser amount that is simply necessary to launch the firm such that its future cash flows will meet its normal operating expenses? The former is clearly an unreasonable demand because no company can be expected to endow its future operating expenses and liabilities as a precondition to opening its doors. As for gauging capital adequacy in terms of massing assets sufficient to generate a positive cash flow, it must be borne in mind that the mere fact a business fails in terms that it produced a negative, rather than a positive, cash flow is customarily explained by a good many factors other than the relative amount invested in the firm. And to require an investment that assures a positive cash flow surely will have a chilling effect on entrepreneurial activity because a central risk of any business venture is that it will not, because of competition and other market forces, be able to generate a cash flow sufficient to support it. It would therefore appear that inadequate capitalisation has correctly assumed a limited role in veil-piercing cases, that of being a surrogate for the problem bad faith of the firm's promoters."

61 In *Adams v Cape Industry plc* [1990] Ch 433 at 544, the Court of Appeal said: "We do not accept as a matter of law that the court is entitled to lift the corporate veil as against a defendant company which is the member of a corporate group merely because the corporate group structure has been used so as to ensure that the legal liability (if any) in respect of particular future activities of the group (and correspondingly the risk of enforcement of that liability) will fall on another member of the group rather than the defendant company. Whether or not this is desirable, the right to use a corporate structure in this manner is inherent in our corporate law."

In *Yukong Line Ltd of Korea v Rendsburg Investments Corporation of Liberia (No 2)* [1997] 1 WLR 294, the Court refused to lift the corporate veil in the context of a corporate group notwithstanding its finding that the purpose of an asset transfer within the group was to put those assets beyond the reach of an external plaintiff in the event of litigation. The Court took a narrow approach to lifting the corporate veil: "In the main the concept that a duly incorporated limited liability company, if not a real thing, is at least not to be identified with its shareholders has been faithfully followed by British and other Commonwealth courts ever since *Salomon's* case. But there has been some gnawing away at the edges of the doctrine, a process commonly described as piercing or lifting the corporate veil. I believe that there is only one broad class of cases where this is truly consistent with the *Salomon* reasoning. They are all cases where, under the enactments such as those against fraudulent or wrongful trading, or on the permissible interpretation of an enactment or contract, or for the purposes of common law or equitable principles against fraud or oppression or relating to agency it is necessary to look at what has happened in fact rather than in form" (at 306).

62 Contrast *Re F G Films Ltd* [1953] 1 WLR 483 (under-capitalisation as evidence of a façade) with *Re Polly Peck International plc* [1996] BCC 486 (where a subsidiary was not held to be a façade even though it had very little issued capital compared with the funds borrowed).

> paid-up capital and has a board of directors all or most of whom are also directors or senior executives of its holding company".[63]

In some cases, the UK courts have lifted the corporate veil to confer a benefit on the corporate group.[64]

Limited liability

1.51 At common law, shareholders of a limited liability company are not personally liable, as shareholders, for the debts of that company, except to the extent of any unpaid capital on their shares.[65] Only their capital investment can be called upon to discharge the company's debts.

1.52 Limited liability achieves various economic goals:

- *facilitating enterprise.* Limited liability facilitates investment and otherwise encourages economic activity by separating investment and management functions and shielding investors from any corporate loss in excess of their equity capital. This protection for investors reduces the costs of raising capital. Also, corporate controllers may be more willing to undertake entrepreneurial activity through their controlled companies, given that, as shareholders of those companies, they are shielded against unlimited liability for the debts of those companies

- *reducing monitoring.* Limited liability decreases the need for shareholders to monitor the managers of companies in which they invest. The risk to those shareholders of a company's failure is confined to the loss of the equity invested

- *promoting market efficiency.* Limited liability promotes the liquidity and efficient operation of securities markets, as the wealth of each shareholder of a public company is irrelevant to the trading price of its shares. This allows shares to be freely traded, as their price is set by factors other than their owners' wealth. The free transfer of shares may in turn promote efficient

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63 *Re Polly Peck International plc* [1996] BCC 486 at 496. In that case, a Cayman Island company that had no assets, but which raised bank borrowings of £400 million on the strength of the guarantees of its parent company, was held to be a separate entity from that parent company.

64 In *The Albazero* [1977] AC 774, the Court of Appeal allowed an action for the recovery of insurance money to continue, despite the named plaintiff being the wrong company in the corporate group. The Court ruled that the corporate group as a collective was the beneficiary of the claim.
In *DHN Food Distributors Ltd v London Borough Council Tower Hamlets* [1976] 1 WLR 852, a subsidiary owned land on which its parent company operated a wholesale grocery business. The local authority compulsorily acquired the land and paid compensation to the subsidiary for the value of the land taken. The parent company was able to recover compensation for the disruption to its business on the basis that the parent and the subsidiary were one economic unit. The loss of the land to the subsidiary also meant disruption to the business of the parent company.
The UK case law on lifting the corporate veil within the corporate group structure is further summarised and analysed in D Prentice, "Some Aspects of the Law Relating to Corporate Groups in the United Kingdom" 13 *Connecticut Journal of International Law* (1999) 305.

65 The principle of limited liability was originally introduced by the UK Limited Liability Act 1855, which was soon repealed and incorporated into the Joint Stock Companies Act 1856.

management, given that shares in a poorly managed company may trade at a discount, creating the climate for a takeover and the replacement of incumbent management

- *encouraging equity diversity.* Limited liability permits investors to acquire shares in a number of companies. This might not be possible for particular investors if the principle of unlimited liability applied and they could lose all or most of their personal wealth through failure of one company in which they held equity.[66]

1.53 *Application of these economic grounds to corporate groups.* The economic justifications for limited liability are particularly strong when applied to companies in isolation. However, they do not necessarily have equal force when applied to corporate groups.

1.54 In the context of corporate groups, the *reducing monitoring* ground is valid mainly where shareholding in a particular group company is widely dispersed. It would be impractical, as well as unduly costly, to impose any monitoring obligation on shareholders in those circumstances. However, this argument is less convincing where a group company is effectively controlled by its parent company. The parent can use its shareholding to control the decisions of any wholly-owned subsidiary[67] or otherwise monitor the activities or financial performance of other controlled companies. Limited liability can operate in this context as a disincentive for a parent company to closely monitor its group companies.

1.55 The *market efficiency* argument is relevant to listed group companies whose shares are publicly traded. It has no application to closely or wholly-owned subsidiaries whose shares are not tradeable. Nor is the *equity diversity* argument relevant where shares in a group company are issued primarily to control that company, rather than to invest equity capital in it.

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66 The various arguments that limited liability supports economic efficiency are summarised and discussed in FH Easterbrook and DR Fischel, "Limited Liability and the Corporation" (1985) 52 *University of Chicago Law Review* 89, *The Economic Structure of Corporate Law* (Harvard University Press 1991) at 41-44, RA Booth, "Limited Liability and the Efficient Allocation of Resources" (1994) 89(1) *Northwestern University Law Review* 140. For a criticism of the application of these economic arguments to corporate groups, see PI Blumberg, "Limited Liability and Corporate Groups" (1986) 11 *The Journal of Corporation Law* 573, PI Blumberg, *The Multinational Challenge to Corporation Law* (Oxford University Press, 1993) Chapter 6.

67 In *Pascoe Ltd v Lucas* (1999) 33 ACSR 357 at 386-387, the Court ruled that "where, as in this case, the directors have entered into a transaction the unanimous vote of the shareholders of the company, if passed before the transaction can amount to an authorisation and, if passed after the transaction, can amount to a validation. More particularly, for the purpose of this case, the shareholders may authorise or affirm a decision of the directors of the company which would otherwise be voidable because it involved a breach by those directors of their fiduciary duties to the company ... However that proposition is subject to qualification. First the company must be solvent ... Second the transaction itself must be intra vires. Third the directors must make full disclosure to the shareholders. Fourth the directors must be acting in good faith. ... It is not necessary that a formal decision of the shareholders should be made; an informal consent will be sufficient. Again provided that the company was solvent when it entered into these transactions and when the authority or ratification was given by the directors a liquidator subsequently appointed to the company is in no better position than the shareholders who authorised or ratified the transaction".

1.56 Possibly the strongest argument for limited liability in the corporate group context is its role in *facilitating enterprise*. Without limited liability, controlling shareholders of wholly- or even partly-owned subsidiaries may risk all or much of their wealth through the activities of these subsidiaries. Nevertheless, permitting parent companies, as controlling shareholders, to rely on limited liability can increase the risk of "moral hazard",[68] or displacement of business risks to outsiders, in some circumstances:

> "If limited liability is absolute, a parent can form a subsidiary with minimum capitalization for the purposes of engaging in risky activities. If things go well, the parent captures the benefits. If things go poorly, the subsidiary declares bankruptcy [to the detriment of its outstanding unsecured creditors], and the parent creates another [subsidiary] with the same managers to engage in the same activities. This asymmetry between benefits and costs, if limited liability is absolute, would create incentives to engage in a socially excessive amount of risk activities."[69]

Directors' duties

1.57 The orthodox common law position is that directors of a company in a corporate group owe fiduciary duties to that company and not to other entities in that corporate group. The interests of other group companies may be taken into account only to the extent that this furthers the interests of the directors' own companies. However, directors would breach their fiduciary duties if they sought to put the interest of the corporate group above that of their companies.

1.58 Directors of a group company may face difficulties in balancing their fiduciary duties to that company against the overall commercial and financial interests of the group. This problem may arise, for instance, where directors of a particular group company consider that to advance, or preserve, the corporate group requires the financial support or sacrifice of their company by providing other group companies with loans, assets, securities or guarantees.

The single enterprise approach

1.59 This approach recognises and attaches considerable legal significance to economic integration within a corporate group. In its pure form, it treats the corporate group as a unitary economic enterprise functioning to further the interests of the group as a whole, or those of its dominant corporate body.

1.60 The single enterprise approach may more closely reflect the economic functioning and organisational structure of those corporate groups that operate under a highly centralised governance system. Managers of some corporate groups may

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68 In this context, moral hazard refers to the situation where a person can engage in economically risky behaviour, while displacing any possible financial losses from that behaviour onto some other person or group. All transactions by companies entail some element of moral hazard, given that the principles of limited liability provide a means to shift losses from the directors or shareholders to creditors and other outsiders, such as tort claimants.

69 FH Easterbrook and DR Fischel, 'Limited Liability and the Corporation' (1985) 52 *University of Chicago Law Review* 89 at 111.

structure the operations and activities of group companies on a single enterprise basis, for instance by:

- borrowing as a group and using group treasury arrangements to offset the credit and debit balances of each group company
- permitting one or more group companies to operate at a loss, or be undercapitalised, for reasons related to the overall group financial structure and strategy
- moving assets and liabilities between group companies, as the need arises. This may involve moving resources between group companies under the description of "interest", "dividends" or "management fees", or providing intra-group loans, guarantees or other financial arrangements on uncommercial terms.[70]

1.61 The financial and other resources of the group may therefore be directed primarily to maximising the profit, or ensuring the survival, of the group enterprise as a whole, rather than its individual constituent companies. As one commentator has pointed out: "There are no economically compelling reasons why the profit centres within the group should correspond with the centres of legal right and entitlement, namely, the individual companies".[71]

1.62 A single enterprise approach may also better reflect the expectations of any creditors dealing with a corporate group who have been led to believe that they are doing business with the group as a whole and can rely on the creditworthiness of the overall group rather than that of an individual group company.

1.63 In contrast to a separate entity approach, a single enterprise approach might adopt the following governing principles:

- the dominant company in a group is entitled to operate companies it controls for the benefit of the corporate group collectively, even if this is contrary to the interests of particular controlled companies or their minority shareholders
- directors of corporate group companies owe their fiduciary loyalty primarily to the parent company or to the corporate group collectively, not to their individual group companies

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70 On one view, "the managers of the enterprise would be acting irrationally if they failed to use the resources of one company to salvage another if such assistance would ultimately enhance the profitability of the corporate enterprise": A Nolan, "The Position of Unsecured Creditors of Corporate Groups: Towards a Group Responsibility Solution Which Gives Fairness and Equity a Role" (1993) 11 *Company and Securities Law Journal* 461 at 485.

71 D Prentice, "Groups of Companies: The English Experience" in K Hopt, *Groups of Companies in European Law* (New York, 1982) p 103, note 17.

- the parent is liable for all the debts of its insolvent controlled companies, whether or not wholly-owned[72] (possibly subject to any contrary voluntary arrangement with particular lenders[73]).

1.64 The problem in applying these principles is to accommodate the organisational complexities of corporate groups. If applied inflexibly, they may expose a parent company to full liability for all the group's debts, even where group governance is decentralised and particular group companies exercise considerable autonomy. They may also encourage managers to structure the group in a highly hierarchical and centralised manner, even where this is inefficient, to reduce the parent's financial exposure. Also, the value of the recovery rights of unsecured creditors of a parent company could be diminished through that company's exposure to the financial risks of all the group's activities. At the same time, creditors of controlled group companies could gain a windfall from the parent company providing, in effect, a form of liability insurance against any defaults by its group companies.

Germany

1.65 Like common law countries, German corporate law treats each group company as a separate legal entity. However, German legislation expressly permits various categories of corporate groups to operate as a single enterprise, in exchange for enhanced protection of creditors and any minority shareholders.[74]

1.66 German law classifies corporate group structures involving public companies into three categories:

- integrated groups
- contract groups
- de facto groups.

For each category, a set of harmonised single enterprise principles on corporate governance and liability applies, on the assumptions that the basic decisions and conduct of management are oriented towards a common corporate group purpose and that liability should be linked to the source of decision-making power in the group.

1.67 *Integrated groups.* An integrated group is created where 75% of the shareholders voting at a meeting of a holding company, which owns at least 95% of the shares of a subsidiary, approve the complete integration of the subsidiary. That subsidiary becomes a wholly-owned subsidiary through the holding company

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72 PI Blumberg, *The Multinational Challenge to Corporation Law* (Oxford University Press, 1993) at 123 points out that no American or English case has used enterprise principles to impose liability on the minority shareholders of a partly-owned group company. Instead: "when courts impose liability under enterprise principles on the parent corporation (or controlling shareholder) of partly-owned subsidiaries (or controlled corporations) they impose 100% of the liability on the controlling shareholder, notwithstanding its lesser share of the stock of the subsidiary".

73 This possible exemption would preserve private loan bargaining rights, particularly non-recourse loans under which a lender agrees to receive a higher return on funds borrowed by one group company in substitution for enforceable rights against all the group companies.

74 The Stock Corporation Act 1965 (Aktiengesetz).

compulsorily acquiring the subsidiary's minority shareholdings, subject to those shareholders receiving adequate compensation. The holding company has unlimited power to give directions to the wholly-owned subsidiary, including to dispose of its assets, to forgo corporate opportunities or otherwise to act in a manner that is detrimental to its interests as a separate legal entity. In return, the holding company is jointly and severally liable for all the debts and obligations of the subsidiary.

1.68 *Contract groups.* A contract group is created by 75% of the shareholders in each of two companies resolving that their companies enter into an enterprise contract, granting to one company (the parent company) the right to direct the other company (the controlled company), even where this is detrimental to the controlled company, provided that these directions are consistent with the interests of the parent company or the corporate group as a whole. In return for giving the parent company this power to direct the controlled company in the interests of the whole group, minority shareholders and creditors are given enhanced protection.

1.69 The parent company must offer to pay a guaranteed dividend to minority shareholders in the controlled company or to buy out their shares at a fair price. If the amount for either purpose is not agreed, it may be determined by the court. The parent company is jointly liable for all the outstanding trading debts of the controlled company, regardless of whether it exercised its control rights in creating those debts. The enterprise contract can also require the controlled company to transfer all or part of its profits to the parent company or to pool its profits with those of the rest of the corporate group. The parent company is then obliged to cover any losses of the controlled company. Any minority shareholders of the controlled company can seek an independent audit or judicial review of the adequacy of this loss-covering arrangement.

1.70 *De facto groups.* A de facto group exists where one company may exercise, whether directly or indirectly, a dominant influence over another company. This group structure arises where, without any formal agreement to enter into a contract group, there is nevertheless, in fact, broad and systematic involvement by the parent company in the affairs of the controlled company. The parent company may only use its influence to the detriment of the controlled company if it compensates the controlled company for any consequential financial detriment. The directors of the controlled company must prepare an annual report identifying any such detriment and stating whether compensation has been paid. That statement must also be independently audited. Minority shareholders of the controlled company may apply for judicial review of those dealings between the parent and controlled companies.

1.71 The German law has not been adopted by other States within the European Union or by common law countries. However, a recent proposal for a European law on corporate groups has supported giving specific recognition to some corporate groups. Under the proposal, a parent company holding sufficient shares (directly or indirectly) to pass a special resolution to alter a subsidiary's constitution (in Australia, 75%) should have the power, by approval of its general meeting, to declare the subsidiary dependent on the parent company. That declaration by the parent company should be formally registered. Thereafter, the parent company would be entitled to direct the management of the subsidiary. In return, the parent company would be liable to pay the subsidiary's debts if the subsidiary went into insolvent liquidation,

and would also be obliged to indemnify the subsidiary's minority shareholders against loss.[75]

Application of separate entity and single enterprise approaches in common law countries

Australia

1.72 Australian corporate law, like UK company law, has traditionally applied the separate entity approach to corporate groups. It does not permit the controllers of a corporate group to treat the group as a single enterprise for the purpose of their entrepreneurial activities. Instead, the separate legal personality of each company must be maintained.

1.73 However, the Corporations Law contains various provisions that override the strict application of the separate entity approach. It specifically regulates corporate groups in a number of areas, including:

- *consolidation of corporate group accounts.* A company must prepare consolidated accounts for itself and any controlled entity.[76] That company must also list in its annual report the entities that it controls. These requirements seek to enhance the ability of users of financial reports to assess the overall performance and financial position of corporate groups, rather than having to rely on the accounts of individual group companies. They also seek to ensure that the true financial position of various group companies cannot be concealed by intra-group transactions designed to artificially create profits or conceal losses in particular group companies, or otherwise manipulate the balance-sheet of individual group companies.[77] However, each group company must, in addition, maintain its own accounts concerning its assets and liabilities.[78] For instance, one group company cannot lawfully declare a dividend based on profits generated, and held, by another group company.[79]

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75 Forum Europaeum Konzernrecht, "Corporate Group Law for Europe" 1 *European Business Organization Law Review* (2000).

76 Part 2M Div 6 (Special provisions about consolidated financial statements); AASB 1024. This accounting standard defines the terms "parent entity", "reporting entity" and "control".

77 The effect of consolidation accounting is that all transactions between a parent entity and any reporting entity over which it has control must be eliminated, including any inter-entity balances existing at the end of the current period and any unrealised profit resulting from inter-entity transactions.
For a critique of the proposition that consolidated accounts give an accurate picture of the profit and loss and state of affairs of the corporate group, refer to F Clarke and G Dean "Law and Accounting - The Separate Legal Entity Principle and Consolidation Accounting" (1993) 21 *Australian Business Law Review* 246.

78 s 286.

79 In *Industrial Equity Ltd v Blackburn* (1977) 137 CLR 567, a holding company, when declaring a dividend, took into account profits shown on the books of its subsidiary company. It argued that the subsidiary's profits were within its disposition, given that it could ensure the distribution to it of those profits through its control of the subsidiary's general meeting. The High Court rejected the argument. Each company was separate and had its own accounts for the information of its creditors, notwithstanding that the holding company had to prepare consolidated group accounts.

- *related party transactions.* A public company is prohibited from giving a financial benefit (including any intra-group loan, guarantee, indemnity, release of debt or asset transfer) to a related party unless that transaction has been approved by the fully-informed disinterested shareholders of the public company or is otherwise exempt.[80] These provisions are designed to protect shareholders of public companies from the possibility of their company's assets being eroded, or its financial position otherwise undermined, through undisclosed intra-group dealings.[81]

- *cross-shareholding.* Companies are generally prohibited from acquiring, or taking a security over, the shares of any controlling company or issuing or transferring their shares to any controlled company.[82] Also, there are controls over a group company providing financial assistance for the acquisition of shares in its holding company.[83] Some of these provisions are designed to prevent entrenchment of control in a holding company through indirect self-acquisitions (by a controlled company holding shares in a controlling company) or group controllers using group assets to influence the market price of shares in particular group companies.

- *insolvent trading.* The Corporations Law has sought to reduce the "moral hazard" problem of corporate group structures being used to displace entrepreneurial risks to outside creditors. It provides that a holding company which ought to suspect the insolvency of its subsidiary can be made liable for the debts of that subsidiary incurred when it was insolvent.[84] The rationale for this rule is that the ability of a holding company to control the affairs of its subsidiary should give rise to some positive duty of the holding company to prevent harm to the subsidiary's creditors.

The holding company could not take a subsidiary's profits into account until they had been formally distributed by the subsidiary.

80 Chapter 2E Related party transactions. "Related parties" and "financial benefits" are defined in ss 228 and 229, respectively. Some exceptions to this Part apply, including benefits given to or by a closely-held subsidiary of a public company (s 214) or financial benefits to members that do not discriminate unfairly and are given on arm's length terms (s 210).

81 The Companies and Securities Advisory Committee Report *Corporate Related Party Financial Transactions* (1991) set out its reasons for recommending the introduction of the related party transaction provisions: "Following the corporate group collapses of the 1980s, it has become evident that some corporate controllers abuse their positions of trust by arranging for the shifting of assets around and away from companies and corporate groups and into their own hands. They achieve this by various means, including remuneration payments, asset transfers or loan arrangements, on terms highly advantageous to themselves but to the detriment of those companies. In other instances, substantial [intra-group] loans were entered into with the apparent purpose or effect of disguising the true financial position of individual companies within a group. This was made easier by the lack of any general statutory requirement that shareholders either consent to, or be informed of, those transactions. These abuses generally involved significant losses of corporate funds, with adverse effects on investor and creditor returns and confidence."

82 ss 259B, 259C. The sections contain some exceptions. Also, ASIC may exempt a company from s 259C. There are also share disposal obligations where a company obtains control of any entity which holds its shares: s 259D.

83 ss 260A-260D.

84 ss 588V-588X.

1.74 Some transactions by group companies require the consent of the controlling company.[85] In other circumstances, directors of group companies are relieved of some reporting obligations[86] or have their involvement in a group company taken into account.[87] In the takeover context, the voting power of all group companies must be aggregated.[88] Also, ASIC has a Class Order relieving wholly-owned subsidiaries from statutory financial reporting and audit requirements if the holding company and the wholly-owned subsidiaries choose to enter into a deed giving appropriate cross-guarantees.[89] ASIC has issued a considerable number of these class orders.[90] The Australian Stock Exchange Listing Rules also regulate some intra-group transactions involving listed public companies.[91]

United States

1.75 US commercial regulatory laws affecting corporate groups increasingly employ single enterprise principles.[92] This statutory approach has sought to ensure that the policy underlying specific commercial legislation cannot be frustrated or avoided

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85 ss 200A ff, dealing with benefits for loss of, or retirement from, office. In some instances, the holding company must approve any such benefits being given by a subsidiary company.

86 The obligation of directors of a proprietary company to declare their interest in any contract with that company does not apply where the interest consists of being a director of a related company for whose benefit, or with which, the contract is made: s 191(2)(a)(viii).

87 ASIC can prohibit persons who have been involved in the failure of two or more companies from managing other companies: s 206F. In this regard, the Commission must take into account whether the failed companies are related: s 206F(2)(a).

88 s 610.

89 ASIC Class Order 98/1418, pursuant to s 341. To obtain accounting relief, the holding company must covenant with its wholly-owned subsidiaries to pay the liquidator any amount by which the liabilities of those subsidiaries exceed their assets. The subsidiaries must also provide a cross-guarantee in respect of any equivalent shortfall by the holding company. In addition, the holding company must prepare consolidated financial statements (whether or not otherwise required to under the Corporations Law).

90 IM Ramsay and GP Stapledon, *Corporate Groups in Australia* (Research Report, Centre for Corporate Law and Securities Regulation, University of Melbourne, 1998) at 10 (Table 7) indicate that almost 30% of a sample of the Top 500 listed companies, including almost 50% of the listed companies in the highest market capitalisation quartile of that sample, have sought and obtained a class order for themselves and their wholly-owned subsidiaries.

91 See, for instance, Australian Stock Exchange Listing Rules Chapter 10 - Transactions with persons in a position of influence, Chapter 11 - Significant transactions.

92 PI Blumberg, "The increasing recognition of enterprise principles in determining parent and subsidiary corporation liabilities" (1996) 28 *Connecticut Law Review* 295. This article provides a comprehensive overview of those areas of American law in which enterprise principles have superseded traditional entity concepts of corporate law. The article points out that "American statutes of specific application to corporate groups that use enterprise principles substantially now include the great federal statutes regulating the banking industry, the savings and loan industry, securities, investment companies, employer sponsored pensions, export controls and foreign trade. Enterprise concepts also play an important, though less pervasive, role in federal labor relations, employment, and anti-discrimination legislation … Through reliance on the concept of 'control' or the 'integrated enterprise' doctrine, numerous federal and state statutes of specific application regulate major industries in American society by extending the statutory program to include the corporate group as a whole rather than restricting the statutes' scope to the component corporation of the group that actually conducts the regulated activity". See also PI Blumberg, *The Multinational Challenge to Corporation Law* (Oxford University Press, 1993) at 100-107.

through the use of corporate groups. US courts have assisted this process.[93] The use of single enterprise principles also overcomes the limitations and uncertainties that would otherwise arise through reliance on lifting the corporate veil.

1.76 US courts have also selectively introduced single enterprise principles into US corporate law. This evolution has been possible primarily because US courts have held that controlling shareholders owe duties of fairness to minority shareholders.[94] The rationale for these duties is that, just as directors of a company are bound to act in the interests of the company and its shareholders collectively, any shareholder who, in effect, can control the board's actions should be subject to equitable duties.[95] Thus, for instance, in the corporate group context, a parent company which is a controlling shareholder[96] has a "fair dealing" obligation in any transactions with its controlled company or the use of its controlled company's information.

1.77 In contrast with the US approach, Australian corporate law provides that a parent company, in its capacity as a majority shareholder of a controlled company, generally owes no fiduciary or equitable duties in the exercise of its share voting power, and is subject to few other equitable limitations.[97] A parent company would only have direct duties to its controlled company if it exercised such a high degree of control that it was a shadow director of that controlled company.[98]

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93 According to PI Blumberg (1996) 28 *Connecticut Law Review* 295 at 321: "Even where statutes have not referred to groups at all, numerous courts have introduced concepts of enterprise liability … the courts generally have done so whenever enterprise treatment was required in order to implement the underlying policies and objectives of the statutory program, prevent their frustration, or to prevent evasion through the organization of a subsidiary corporation to conduct the activity in question".

94 The US case law refers to controlling shareholders owing "fiduciary duties" to minority shareholders. However, the meaning of "fiduciary" in this context is less onerous than the fiduciary concept in England or Australia and equates to equitable or general fairness principles: J Farrar, "The duties of controlling shareholders" in J Farrar, *Contemporary Issues in Company Law* (CCH New Zealand, 1987) at 195-198, R Schulte, "Corporate groups and the equitable subordination of claims in insolvency" (1997) 18 *The Company Lawyer* 2 at 5.

95 JD Cox, TL Hazen & FH O'Neal, *Corporations* (Little, Brown & Co 1995) at §11.10 (pp 11.50-11.51).

96 Under the definition of "controlling shareholder" in the American Law Institute's *Principles of Corporate Governance*, a parent company is a controlling shareholder of another group company if it either controls more than 50% of the outstanding voting shares of the latter company or otherwise exercises control over the management or policies of the latter company or the transaction in question by virtue of its position as a shareholder.

97 For instance, in *Peters' American Delicacy Company Ltd v Heath* (1939) 61 CLR 457 at 504, the High Court held that shareholders of a company "vote in respect of their shares, which are property, and the right to vote is attached to the share itself as an incident of property to be enjoyed and exercised for the owner's personal advantage".
The most common instances where the courts have held that majority shareholders are subject to overall equitable obligations to exercise their votes bona fide for the good of the company as a whole are cases on the alteration of a company's constitution. However, according to one commentator, "the instances in which the equitable limitation has been invoked to invalidate an exercise of shareholder voting power are infrequent and the principles which lend predictability to their application are elusive. That application is confined, however, to shareholder voting in general meeting and does not amount to a wider norm of fair dealing in transactions otherwise affected": P Redmond, 'Problems for insiders' in M Gillooly (ed) *The Law Relating to Corporate Groups* (The Federation Press, 1993) at 229.

98 See paras 2.145-2.147, for a discussion of the shadow director concept.

1.78 US law also provides that a parent company, in its capacity as a controlling shareholder, owes fiduciary duties to creditors of a controlled company. That duty arises where the controlled company is, or is close to being, insolvent. In these circumstances, a parent company cannot, for instance, divert corporate assets for its own benefit to the detriment of creditors of the controlled company.[99] In Australian law, it is the directors, rather than shareholders, who may need to have regard to the interests of creditors where the solvency of the company is at risk.[100] However, the result may often be the same, given that in Australian law some parent companies may be "shadow directors" of controlled companies.

1.79 Single enterprise principles have been applied to US bankruptcy legislation to strike down voidable preferences[101] and, conversely, to support intra-group guarantees.[102] In selected cases, US courts also provide a remedy of pooling (known as "substantive consolidation"), under which various group companies in liquidation may be treated as a single entity for the purpose of merging their assets and liabilities and meeting claims.[103] Also, US courts have the power to alter the priority of claims in the liquidation of a group company, either by treating some intra-group loans to

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99 The leading decision is *Federal Deposit Insurance Corporation v Sea Pines Company* 692 F.2d 973 (1982). In this case, the parent company, as the controlling shareholder, had caused a subsidiary to enter into a mortgage to secure the parent's debts. The court held that the parent company owed a fiduciary duty to the creditors of the subsidiary and was liable for that debt.

100 The obligation of directors to take into account the interests of creditors when a company is at a real, rather than merely a remote, risk of insolvency is analysed and applied in *Kinsela v Russell Kinsela* (1986) 10 ACSR 395, *Grove v Flavel* (1986) 11 ACLR 161, *Australian Growth Resources Corporation Pty Ltd v Van Reesema* (1988) 13 ACLR 261, *Jeffree v NCSC* (1989) 7 ACLC 556, *Linter Group Ltd v Goldberg* (1992) 7 ACSR 580 at 620-21, *Sydlow Pty Ltd v Melwren Pty Ltd* (1994) 13 ACSR 144, *Sycotex Pty Ltd v Baseler* (1994) 13 ACSR 766 (though note *Fitzroy Football Club Ltd v Bondboroug Pty Ltd* (1997) 23 ACSR 437 at 442). Compare *Nicholson v Permakraft (NZ) Ltd* [1985] 1 NZLR 242 at 249 where the New Zealand Court of Appeal stated:

> "… the duties of directors are owed to the company. On the facts of particular cases this may require the directors to consider inter alia the interests of creditors. For instance, creditors are entitled to consideration, in my opinion, if the company is insolvent, or near-insolvent, or of doubtful solvency, or if a contemplated payment or other course of action would jeopardise its solvency".

101 The US Bankruptcy Code §547 voids all transfers by an insolvent company, within one year prior to the filing of a bankruptcy petition, to controlling persons and other insiders or affiliates. These persons include the parent corporation: PI Blumberg, "The increasing recognition of enterprise principles in determining parent and subsidiary corporation liabilities" (1996) 28 *Connecticut Law Review* 295 at 327.

102 The US Bankruptcy Code §548 strikes down any guarantee given by an insolvent corporation "without reasonably equivalent consideration". Many corporate groups employ intra-group guarantees. According to PI Blumberg: "Under entity law analysis, looking at such transactions as arm's length transactions between separate interests, the validity of such guarantees is doubtful. However, through increasing use of enterprise analysis, courts have upheld the validity of such [intra-group] guarantees by recognizing that the affiliated parties are part of the same enterprise and that the borrowing strengthens the guarantor as well as the affiliated borrower by strengthening the financial position of the group" (id at 329).

103 "Under this form of relief, where parent and subsidiary corporations are being administered in bankruptcy, the separate proceedings of the related corporations may be consolidated and all their assets and liabilities pooled in the payment of claims. Courts apply the doctrine where such pooling would advance the interests of creditors as a whole, even though the interests of some individual creditors will be prejudiced" (PI Blumberg, id at 326). This matter is further discussed at paras 6.69-6.73.

that company as equity rather than debt, or by subordinating intra-group loans to that company to the claims of external creditors of that company (known as "equitable subordination"[104]).

New Zealand

1.80 New Zealand has introduced some single enterprise principles into its corporate legislation. In some instances, directors of wholly- or partly-owned subsidiaries may act in the interests of the holding company rather than their subsidiary company,[105] while nominee directors appointed to group companies may pass on otherwise confidential information to their nominators.[106] In addition, the New Zealand legislation provides for streamlined corporate group mergers.[107] That legislation also permits courts to make contribution orders (whereby a solvent group company can be directed to contribute towards the debts of a related insolvent group company in liquidation), or pooling orders (whereby the assets and liabilities of corporate group companies in liquidation can be pooled for the general benefit of their unsecured creditors).[108]

Future possible regulatory direction

1.81 Australia and overseas common law countries have adopted corporate law rules which apply differing mixtures of separate entity and single enterprise regulatory principles to corporate groups. Only Germany has introduced an integrated single enterprise regime for some of its corporate groups.

1.82 Australian corporate law could be reformed to better accommodate corporate groups and the interests of those who deal with them by:

- permitting wholly-owned corporate groups to choose whether to be consolidated or non-consolidated. Consolidated groups would be regulated by single enterprise principles

- leaving non-consolidated wholly-owned, and all partly-owned, corporate groups to be regulated by a mixture of separate entity and single enterprise principles, but with greater selective use of single enterprise principles where appropriate.

Consolidated corporate groups

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104 The US doctrine of equitable subordination rests on a combination of enterprise principles and fiduciary concepts. It applies where the parent company has misused its powers of control to the detriment of the controlled company in liquidation and its creditors. "Under the doctrine, where a parent corporation or other controlling shareholder has exercised inequitably its control over a bankrupt subsidiary or controlled corporation to the detriment of the corporation or its public security holders, a bankruptcy court has authority to order deferment of the payment of all claims of a parent corporation (or controlling shareholder) or other affiliate against the bankrupt debtor until the claims of all other claimants have been satisfied" (PI Blumberg, id at 328). This matter is further discussed at paras 6.99-6.102.

105 New Zealand Companies Act 1993 s 131.

106 New Zealand Companies Act 1993 s 145(2).

107 New Zealand Companies Act 1993 Part XIII, Part XV.

108 New Zealand Companies Act 1993 s 271, 272.

Method of regulation

1.83 Under this proposal, directors of the ultimate holding company of a wholly-owned corporate group[109] could choose to adopt the consolidated corporate group structure. For groups that "opt in", a term such as "consolidated corporate group company" would have to be included on all public documents of the group companies, thereby indicating to outsiders the status of that group.

1.84 These corporate groups would be regulated by single enterprise principles in the following manner:

- the Corporations Law would treat the corporate group as one legal structure
- directors of group companies could act in the overall group interest without reference to the interests of their particular group companies
- the holding company and each group company would be collectively liable for the contractual debts of all group companies, subject to any contrary agreement[110]
- group companies could merge merely at the discretion of the directors of the holding company
- ASIC would be given the power to provide appropriate relief from accounting and any other residual separate entity requirements.

Incentive to become a consolidated corporate group

1.85 Presumably, the controllers of a wholly-owned group would only favour consolidating it if there was some net gain in doing so, given that, at least for contractual purposes, the group would be taking on collective liability, contrary to common law separate entity principles. This incentive issue would arise particularly with directors' duties, tort liability, sale of individual group companies, and consolidated corporate groups seeking to "opt-out" from that status.

1.86 *Directors' duties.* One possible incentive is that the directors of each wholly-owned group company could act in the overall corporate group interest without reference to the interests of their particular group company. This would overcome the problems concerning intra-group financial dealings discussed in Chapter 2 of this Report. However, the Corporations Law already permits directors of solvent wholly-owned group companies to act solely in the interests of the holding

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[109] A wholly-owned corporate group would comprise a parent company and its wholly-owned companies, including any intermediate wholly-owned companies in a corporate chain. Where a parent company has wholly-owned and partly-owned companies, only the parent company and its wholly-owned companies would constitute a wholly-owned corporate group.

[110] This exemption would preserve private loan bargaining rights, particularly for non-recourse or limited-recourse loans under which a lender agrees to receive a higher return on funds borrowed by one group company in full or partial substitution for enforceable rights against all the group companies.
PI Blumberg points out that many US finance transactions give the lender a choice between corporate group liability at one rate or sole liability of one group company at a higher rate.

company.[111] The relevant provision eliminates these problems for all wholly-owned corporate groups, whether or not consolidated.

1.87 *Tort liability.* On one view, a consolidated corporate group should be collectively liable under single enterprise principles for the tortious, as well as the contractual, liabilities of any of its group companies. The opposite view is that, unless an exemption from collective tortious liability applied, few wholly-owned corporate groups would choose to be consolidated corporate groups, unless collective tort liability applied to all corporate groups, whether or not consolidated.[112]

1.88 This disincentive problem might be overcome by permitting selective opting in, that is, a holding company could nominate which of its wholly-owned subsidiaries to include in one or more consolidated corporate groups. Various subsidiaries could be excluded from consolidation in view of their potential tortious exposure, or to overcome any residual liability problems should they in future be sold to an outsider. However, it may sometimes be very difficult to identify in advance the potential tort liability of particular companies, and therefore the potential cost implications of any decision to form a consolidated corporate group.

1.89 *Sale of group companies.* The holding company and each group company in a consolidated corporate group would be collectively liable for the contractual debts of all group companies. This raises the question of whether any wholly-owned company in a consolidated corporate group could be sold to an outside party and, if so, what, if any, residual rights should existing creditors of that company have against the corporate group under the collective liability principle.

1.90 On one view, any prohibition on selling off a wholly-owned group company in a consolidated corporate group would be a considerable disincentive to opting in. However, without some residual group liability, the creditors of that group company could be seriously disadvantaged by the sale. This would particularly affect those creditors who had originally contracted with a particular group company in reliance on collective group liability of the consolidated corporate group, rather than the assets of that company.

1.91 *Consolidated corporate groups "opting-out" from that status.* A consolidated corporate group may wish to deconsolidate some or all of its group companies. Without this right, wholly-owned corporate groups might be reluctant to become consolidated, as they would be irrevocably governed by single enterprise principles, regardless of any change in the group's overall financial circumstances or internal functions. If deconsolidation is permitted, the question arises (as with the sale of group companies) of what, if any, residual rights should existing creditors have against each company in the previously consolidated corporate group.

Other corporate groups

1.92 Non-consolidated wholly-owned, and all partly-owned, corporate groups would continue to be regulated by a mixture of separate entity and single enterprise principles, both to assist the operation of these corporate groups and to better protect

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[111] s 187, as discussed at paras 2.30-2.35.

[112] See further Chapter 4 "Tort liability of group companies".

the interests of any minority shareholders and outsiders who deal with them. The remaining Chapters of this Report examine a range of areas where greater specific use of single enterprise principles may be appropriate for these groups.

Issue 2. *Should the Corporations Law provide that a wholly-owned corporate group can "opt-in" to be a consolidated corporate group governed solely by single enterprise principles (as defined in para 1.84)?*

If so:

- *should a wholly-owned corporate group be permitted to "opt-in" in relation to some only of its wholly-owned group companies*
- *should a consolidated corporate group be collectively liable for the torts of any group company*
- *should a consolidated corporate group retain a residual group liability for the debts of any group company incurred before its sale to an outsider*
- *should a deconsolidated corporate group retain a residual group liability for the debts of its group companies incurred before the deconsolidation?*

Submissions on Issue 2

Submission supporting consolidated corporate groups unless "opt-out"

1.93 One submission[113] argued that a holding company and its wholly-owned group companies should be regulated as a single entity in all instances, subject to restricted "opt-out" rights. Those rights could apply, for instance, where a wholly-owned group company is set up to start a new high risk venture.

1.94 A wholly-owned group company that lawfully "opts-out" of the corporate group should nevertheless:

- continue to be included in the consolidated financial reports of the corporate group, and
- identify to creditors and others that, other than for financial reporting purposes, it is a "stand-alone" entity and its credit risk is thus independent of the group.

Submissions supporting consolidated corporate group "opt-in" approach

113 Australian Accounting Research Foundation.

1.95 Some submissions supported a wholly-owned corporate group being permitted to “opt-in” to be a consolidated corporate group,[114] for the following reasons.

- It would bring legal requirements, particularly directors’ duties, into line with centralised management practices.[115]
- It would make the task of analysts and rating agencies easier.[116]

1.96 ASIC suggested that, where a corporate group opts to be consolidated, that information should appear on the ASIC database for the holding company and each of the other consolidated group companies. Another respondent suggested that all companies within a consolidated corporate group should be described in a manner which makes their status readily apparent.[117]

1.97 Some of the submissions supporting the “opt-in” approach nevertheless expressed the following reservations.

- It would put Australian corporate law out of step with that in the UK and the USA.[118]
- It would require supporting changes to tax and stamp duty laws.[119]
- The prudential regulator would probably prohibit deposit-taking entities (or possibly issuers of other guaranteed financial products) from “opting-in”.[120]
- The new s 187, introduced under the CLERP amendments, which permits directors of wholly-owned subsidiaries to take into account the interests of their holding company in performing their tasks, may be an adequate solution without widening liabilities.[121]

Submissions opposing consolidated corporate groups

1.98 Some submissions opposed the concept of consolidated corporate groups,[122] for the following reasons.

- It is difficult to see why, as a matter of prudent business management, any corporate group would wish to “opt-in”, thereby voluntarily extending liabilities from individual companies within the group to other members of the group.[123]

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114 AMP (Group), AMPAM, ASIC, Australian Institute of Company Directors, Coles Myer Ltd, Law Council of Australia.
115 AMP (Group).
116 AMPAM.
117 Coles Myer Ltd.
118 AMPAM.
119 AMPAM.
120 AMP (Group).
121 AMP (Group).
122 Australian Accounting Research Foundation, Carter Holt Harvey Limited, Lend Lease.
123 Carter Holt Harvey Limited.

- The proposal is at odds with the “corporate veil” concept and the encouragement of appropriate risk-taking in business. Creditors and other people dealing with limited liability companies are aware of the risks of so dealing.[124]

- The proposed single enterprise principles do not take account of circumstances in which the interests of group companies diverge from those of their holding company. This is particularly relevant to life companies, responsible entities of managed investment schemes and other arrangements where the holding company does not have a full economic interest in the underlying assets of its controlled company.[125]

- The considerable complexities of an "opt-in" approach, particularly for sales of group companies, may outweigh any possible advantages.[126]

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[124] Carter Holt Harvey Limited.
[125] Lend Lease.
[126] Lend Lease.

Content of any "opt-in" provision

1.99 *Partial "opt-in".* Some respondents agreed with permitting a wholly-owned corporate group to "opt-in" for some only of its wholly-owned group companies.[127] This may be particularly relevant to large corporate groups that operate under different trade names. Also, some deposit-taking or other financial companies within a corporate group may in effect be prohibited from "opting-in" because of the prudential regulations applying to those companies. One of those respondents also suggested permitting sibling-sibling consolidated corporate groups that exclude the holding company.[128]

1.100 *Collective tort liability.* One respondent argued that a holding company and its wholly-owned group companies that elect to be treated as one group should be collectively liable for the torts of any group company.[129]

1.101 *Residual group liability for pre-sale debts of sold companies.* Some respondents considered that a consolidated corporate group should retain a residual group liability for the debts of any group company incurred before its sale to an outsider.[130] This would act as a counterbalance to permitting directors of consolidated group companies to act in the overall group interest.

1.102 One submission considered that the residual liability of a consolidated corporate group should be left to the terms of the sale contract.[131] Another submission argued that the principles in the ASIC Deed of Cross-Guarantee should apply in this instance.[132]

1.103 One respondent suggested that the provisions be drafted so that the undue preference provisions (Part 5.7B Div 2) apply to the sale of a group company.[133]

1.104 *Residual liability for the debts of a deconsolidated corporate group.* Some submissions considered that companies that were in a consolidated corporate group that has subsequently deconsolidated should each retain a residual liability for the debts of all the group companies incurred before the deconsolidation.[134] One of those respondents regarded residual group liability for debts as an important balance for displacing directors' duties to their separate entities.[135] However, another respondent considered that no automatic residual liability should arise and that the same principle should apply as under the ASIC Deed of Cross-Guarantee. Alternatively, all entities in a deconsolidated group should be liable on a pro rata basis unless the entities agree to fund the residual liability in a different manner.[136]

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127 Australian Credit Forum, Coles Myer Ltd.
128 Coles Myer Ltd.
129 ASIC.
130 Australian Credit Forum, Law Council of Australia.
131 Australian Accounting Research Foundation.
132 Coles Myer Ltd.
133 ASIC.
134 Australian Credit Forum, Law Council of Australia.
135 Law Council of Australia.
136 Coles Myer Ltd.

Advisory Committee response to submissions on Issue 2: Draft Recommendation 2

1.105 Wholly-owned corporate groups should have the option of operating as a consolidated corporate group under single enterprise principles (as defined in para 1.84). Accordingly:

The Corporations Law should provide that a wholly-owned corporate group can "opt-in" to be a consolidated corporate group governed solely by single enterprise principles for all or some of the group companies, by resolution of the directors of each relevant group company.

All companies that choose to be in a consolidated corporate group should be required to disclose on all public documents and on the ASIC database that they are members of that group.

A consolidated corporate group should not be collectively liable for the torts of any group company merely by virtue of the consolidation.

A consolidated corporate group may deconsolidate by resolution of the directors of all relevant group companies, but may not otherwise sell any of its group companies. Companies in a group that has deconsolidated should each retain a residual liability for the debts of all the group companies incurred before the deconsolidation.

1.106 The restriction on the sale of group companies within a consolidated corporate group would avoid the problems of whether there should be any residual group liability upon a sale and how to properly account for the sold company if the consolidated group did not keep separate accounting and other records of that company.

1.107 To impose collective tort liability on all group companies may be a fundamental disincentive to adopting the consolidated corporate group structure. However, retaining residual liability for the debts of group companies upon a deconsolidation would protect those creditors who did not obtain cross-guarantees. (The prescribed ASIC Deed of Cross-Guarantee would not assist these creditors: see paras 2.65 ff, post). Also, residual liability would avoid difficulties that may arise from any lack of separate accounts for group companies before their deconsolidation.

Submissions on Draft Recommendation 2

1.108 Some submissions supported the Draft Recommendation,[137] though one of these respondents preferred that consolidation for wholly-owned corporate groups be mandatory rather than optional.[138] Another respondent considered that, rather than the opt-in approach, wholly-owned group companies that wish to consolidate should voluntarily liquidate and operate as divisions of one company.[139] Another respondent

137 Australian Institute of Company Directors, Australian Accounting Research Foundation.

138 Australian Accounting Research Foundation.

139 Australian Society of Certified Practising Accountants.

was concerned about the practical implications of the different treatment of tortious and contractual liability of a consolidated corporate group.[140]

Advisory Committee response to submissions on Draft Recommendation 2

1.109 The Advisory Committee continues to support the Draft Recommendation. It considers that it may not always be practical for wholly-owned group companies that wish to consolidate to voluntarily liquidate and operate as divisions of one company. Wholly-owned corporate groups should have the option of opting-in to be consolidated corporate groups.

1.110 The Committee confirms its view that consolidated corporate groups should be collectively liable for contractual, but not tortious, liabilities. Distinctions are frequently drawn in practice between these types of liabilities.

Recommendation 2

The Corporations Law should provide that a wholly-owned corporate group can "opt-in" to be a consolidated corporate group for all or some of the group companies, by resolution of the directors of each relevant group company.

All companies in a consolidated corporate group should be governed by single enterprise principles in the following manner:

- the Corporations Law would treat the consolidated corporate group as one legal structure
- directors of group companies could act in the overall consolidated corporate group interest without reference to the interests of their particular group companies (cf s 187)
- the parent company and each group company would be collectively liable for the contractual debts of all group companies, subject to any contrary agreement
- group companies could merge merely at the discretion of the directors of the holding company (cf Recommendation 15)
- ASIC should have the power to provide appropriate relief from accounting and any other residual separate entity requirements.

All companies that choose to be in a consolidated corporate group should be required to disclose on all public documents and on the ASIC database that they are members of that group.

A consolidated corporate group should not be collectively liable for the torts of any group company merely by virtue of the consolidation.

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140 R Schulte.

A consolidated corporate group should be permitted to deconsolidate by resolution of the directors of all relevant group companies, but not otherwise sell any of its group companies. Companies in a group that has deconsolidated should each retain a residual liability for the debts of all the group companies incurred before the deconsolidation.

Chapter 2

Directors of group companies

This Chapter examines three areas that affect the powers and duties of directors of group companies.

The Chapter first discusses the fiduciary loyalty problems that may face directors in entering into various intra-group financial transactions. It recommends giving directors of partly-owned group companies greater latitude to act in the interests of the corporate group if so authorised by minority shareholders of those companies.

The Chapter next examines the position of nominee directors. It recommends that all directors be required to disclose all situations that may put them in positions of conflict of duty and interest. This would be in lieu of any statutory provisions defining nominee directors and imposing specific disclosure obligations on them.

The Chapter also considers whether directors who resign from companies should have qualified privilege for any public statement they might make when resigning from the board.

Intra-group financial dealings

Application to wholly- and partly-owned group companies

2.1 Directors owe their fiduciary duties to their companies, not to individual shareholders. These duties apply to intra-group financial dealings, whether they involve wholly- or partly-owned group companies. Liquidators of wholly- or partly-owned companies, as well as minority shareholders of partly-owned companies, can seek remedies for any breach of those duties.

2.2 These remedial rights may be modified by shareholder ratification. The ownership structure of a group company can affect this ratification process, given the different implications of unanimous and majority ratification.

Unanimous ratification

2.3 In general, shareholders of a solvent company may unanimously ratify, either prospectively or retrospectively, particular actions of directors which could otherwise constitute a breach of fiduciary duty.[141] This ratification would cover common law

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[141] In *Pascoe Ltd v Lucas* (1999) 33 ACSR 357 at 386-387, the Court ruled that "where, as in this case, the directors have entered into a transaction the unanimous vote of the shareholders of the company, if passed before the transaction can amount to an authorisation and, if passed after the transaction, can amount to a validation. More particularly, for the purpose of this case, the shareholders may authorise or affirm a decision of the directors of the company which would otherwise be voidable because it involved a breach by those directors of their fiduciary duties to the company ... However that proposition is subject to qualification. First the company must be solvent ... Second the transaction itself must be intra vires. Third the directors must make full

and, possibly, statutory fiduciary duties.[142] This ratification process could be used to protect directors in entering into intra-group financial dealings.[143] Unanimous ratification would be a mere formality in a solvent wholly-owned group company, but could not be guaranteed for a solvent partly-owned group company.

Majority ratification

2.4 A majority of fully-informed shareholders who vote at a general meeting may, in some instances, ratify directors' actions which otherwise breach their duties. The controlling shareholders of a partly-owned group company could use this power to ratify intra-group financial transactions. However, majority ratification cannot authorise any irregular act of directors that would be oppressive or unfairly prejudicial to the minority shareholders.[144] Also (as with unanimous ratification), the company must be solvent, taking into account the transaction to be ratified, given that directors may need to have regard to the interests of creditors where the solvency of a company is at risk.[145] Shareholder ratification cannot override that separate duty to creditors.

2.5 In summary, the fiduciary duty issues concerning intra-group financial dealings, while theoretically applicable to all group companies, are more likely to arise for partly-owned group companies.

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disclosure to the shareholders. Fourth the directors must be acting in good faith. ... It is not necessary that a formal decision of the shareholders should be made; an informal consent will be sufficient. Again provided that the company was solvent when it entered into these transactions and when the authority or ratification was given by the directors a liquidator subsequently appointed to the company is in no better position than the shareholders who authorised or ratified the transaction".

142 In *Pascoe Ltd (in liq) v Lucas* (1998) 27 ACSR 737 at 772-773, the Court said: "There is, however, a nice question whether shareholders can relieve a director from a breach of his statutory duties. But, as the statutory duties reflect the duties of a director at common law and in equity, I do not think that there is any impediment to the shareholder excusing a breach of a statutory duty. If it were necessary to do so, I would invoke [the equivalent of s 1318] only for the purpose of enabling [the director] to have the benefit of the approval of [the sole shareholder] to the acts he performed at its behest". Likewise, on appeal, the Court held that, if it had been necessary, the Court would have invoked the equivalent of s 1318: *Pascoe Ltd v Lucas* (1999) 33 ACSR 357 at 389 (para [295]).
A possible contrary view is that shareholders do not have the power to override statutory duties, though the court could take this into account in determining whether to relieve a director from liability pursuant to its discretionary powers in s 1318. However, R Baxt and T Lane in "Developments in Relation to Corporate Groups and the Responsibilities of Directors - Some Insights and New Directions" (1998) 16 *Company and Securities Law Journal* 628 at 640 fn 76 argued that "this is a questionable expansion of the presently understood ambit of power conferred upon the court by s 1318 - one that would seem to render s 1317S somewhat superfluous given that it was enacted to deal specifically with the courts' ability to forgive directors for breaches of the civil regime of duties introduced into the *Corporations Law*. One wonders why Parliament would have bothered with s 1317S if it had intended s 1318 to perform the same function".

143 In *Pascoe Ltd (in liq) v Lucas* (1999) 33 ACSR 357, the Court upheld transactions under an intra-group loan arrangement.

144 *Hannes v MJH Pty Ltd* (1992) 7 ACSR 8. See further S Fridman, "Ratification of Directors' Breaches" (1992) 10 *Company and Securities Law Journal* 252, K Yeung, "Disentangling the Tangled Skein: The Ratification of Directors' Actions" (1992) 66 *Australian Law Journal* 343, HAJ Ford, RP Austin & IM Ramsay, *Ford's Principles of Corporations Law* (loose leaf, Butterworths) at [8.390].

145 See footnote 98.

Separate entity or single enterprise fiduciary loyalty

The problem in practice

2.6 Directors of group companies owe fiduciary duties of loyalty to their companies, including to act in good faith for the benefit (or in the interests) of their companies as a whole. Those directors may also wish to make decisions and act for the group's overall benefit. This may place them in the dilemma of seeking to balance their fiduciary duty of loyalty to act for the benefit of their group companies against the possibly competing economic goals or needs of the corporate group collectively.

2.7 A few examples of where this problem could arise in practice are:

- a group company providing a loan to another group company, or acting as a guarantor or itself providing a third party mortgage for a loan to be taken out by another group company
- one group company entering into an agreement with another group company to transfer its business or assets, or surrender a corporate opportunity, to the latter company, or to contract with that company on disadvantageous terms rather than contract with an outside party on much better terms
- a group company entering into cross-guarantees with its other group companies to assist the group to more effectively utilise its total assets in financing the group's operations.

2.8 Some of these transactions may be related party transactions, requiring approval by disinterested shareholders.[146] However, shareholder approval of related party transactions does not relieve directors of their fiduciary duties in entering into them.[147]

Intra-group loans and other transfers

2.9 Group controllers or group company directors cannot treat the group as a single unit for the purpose of internally transferring funds or other assets or providing security. The separate legal entity of each group company must be respected.

2.10 These general common law principles are set out in the leading High Court decision of *Walker v Wimborne*.[148] In that case, the directors of a group company authorised it to lend funds to various other group companies. In determining whether the directors had breached their fiduciary duty to act in good faith for the benefit of the lending company, the High Court stated that:

> "… the emphasis given by the primary judge to the circumstance that the group derived a benefit from the transaction tended to obscure the fundamental principle that each of the companies [within the corporate group] was a separate and independent legal entity, and that it was the duty of the directors

146 See para 1.73: *related party transactions*.
147 s 230.
148 (1976) 137 CLR 1.

> of [one of the companies within the corporate group] to consult its interests and its interests alone in deciding whether payments should be made to other companies [within the group]. In this respect it should be emphasised that the directors of the company in discharging their duty to the company must take account of the interests of its shareholders and [where the solvency of the company is an issue] its creditors."[149]

2.11 The High Court held that the directors of the lending company had breached their fiduciary duty of loyalty to that company, given that it did not receive any commercial benefit or advantage from advancing the funds. It did not suffice that the payment could have been for the benefit of the corporate group collectively. The directors were not entitled to sacrifice the interests of their company for the overall benefit of the group.[150]

2.12 The High Court nevertheless gave a degree of recognition to the way in which corporate groups operate. Directors would not be obliged to ignore that group structure. The interests of the group may be relevant in determining the interests of a particular company. For instance, 'downstream' loans or other intra-group financial transactions[151] are permitted if the parent company acquires a direct or derivative commercial benefit from them (for instance, an eventual enhanced dividend return):

> "… the payment of money by company A to company B to enable company B to carry on its business may have derivative benefits for company A *as a shareholder* in company B if that company is enabled to trade profitably or realize its assets to advantage. Even so, the transaction is one which must be viewed from the standpoint of company A and judged according to the criterion of the interests of that company." [italics added].[152]

Therefore, directors of a parent company may take into account a subsidiary's interests, to the extent that their own company will receive such benefits.

2.13 The more difficult issue is whether directors of a group company can take into account the overall interests of that group in entering into 'upstream'[153] or 'lateral'[154] intra-group transactions, for instance by mortgaging its assets as a security to support

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149 At 6-7.

150 As stated in the subsequent case of *Parker v NRMA* (1993) 11 ACSR 370 at 376 (per Kirby P):

> "The directors of each company [in a corporate group] owed separate duties to each [company]. It was not open to the directors to ignore these separate duties or to conceive of themselves as owing a higher, larger or broader duty to the group."

The same principle was applied in Canada, where the Superior Court of Quebec in *Peoples Department Stores Inc v Lionel Wise et al* (1998) Q.J. No. 3571 confirmed that each company in a group is a separate legal entity. As a result, the directors of a particular group company are not entitled to sacrifice the interests of that company in favour of the interests of the group.

151 A 'downstream' transaction is one involving a parent company passing a financial benefit to a company that it controls.

152 *Walker v Wimborne* (1976) 137 CLR 1 at 6.

153 An 'upstream' transaction is one involving a controlled company passing a financial benefit to its parent company.

154 A 'lateral' transaction involves benefits passing between controlled companies within the same corporate group.

borrowing by a parent or sibling group company (a third party mortgage) or itself providing a loan to that company.

2.14 The test employed in the UK case law (known as the *Charterbridge* principle[155]) is:

> "whether an intelligent and honest man in the position of a director of the company concerned, could in the whole of the existing circumstances, have reasonably believed that the transactions were for the benefit of the company."

2.15 Applying that principle, the UK courts have upheld upstream or lateral security transactions where the past and continuing stability of the group company providing the security depended on the continuing survival of the recipient group company.[156] However, directors of a group company providing an intra-group security would breach their fiduciary duty to act in good faith for the benefit of that company if it received no real commercial benefit from that transaction and undertook security obligations which those directors knew (at the time of providing the security) would be enforced, thereby stripping the company of its assets.[157]

2.16 The *Charterbridge* principle has been applied in Australian case law.[158] Directors must exercise their powers for the benefit of the company they direct. Nevertheless, in determining whether to enter into an upstream or lateral intra-group loan or security transaction, directors of group companies may have regard to any direct or derivative commercial benefits to be derived by their company, and the extent to which their company's prosperity or continued existence depends on the well-being of the group as a whole. To that limited extent, directors may consider the wider interests of the group. Therefore:

> "…actions carried out for the benefit of the group as a whole may, in particular circumstances, be regarded as benefiting as well one or more companies in a group."[159]

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155 *Charterbridge Corporation Ltd v Lloyds Bank Ltd* [1970] 1 Ch 62 at 74.

156 In *Charterbridge Corporation Ltd v Lloyds Bank Ltd* [1970] 1 Ch 62, one group company provided a charge over its property as security for loans to a related group company. The Court upheld the validity of the charge as being for the benefit of the company that provided it. The related company provided rental payments, expertise and other necessary commercial assistance to the company which gave the charge. The failure of that related company may have undermined the stability of the company providing the charge.
In *Nicholas v Soundcraft Electronics* [1993] BCLC 360, the Court held that it was legitimate for the directors of the group company to have regard to the interests of the group and not just the interests of the partly-owned subsidiary. However, it would be necessary to show that sacrificing the interests of the subsidiary in the short term was for its benefit in the longer term, for instance where action detrimental to the subsidiary is taken to avoid the failure of the parent company where such failure would gravely harm the subsidiary.

157 *Rolled Steel Products (Holdings) Ltd v British Steel Corporation* [1986] 1 Ch 246.

158 The *Charterbridge* test was applied in *Reid Murray Holdings Ltd (in liq) v David Murray Holdings Ltd* (1972) 5 SASR 386, *Farrow Finance Co Ltd (in liq) v Farrow Properties Pty Ltd* (1997) 26 ACSR 544 at 581 and *Japan Abrasive Materials Pty Ltd v Australian Fused Materials* (1998) 16 ACLC 1,172 at 1,180.

159 In the leading case of *Equiticorp Financial Services Ltd v Bank of New Zealand* (1993) 11 ACSR 642, the New South Wales Court of Appeal upheld a decision by directors of two subsidiary group companies to give a bank a charge over the liquidity reserves held by those companies, as

2.17 The test is whether an intelligent and honest person in the position of a director of the particular company could have reasonably believed that the intra-group transaction was for the commercial benefit of that company, not merely the corporate group collectively.[160] In applying this test, directors of group companies should also take into account any reasonably foreseeable detriments to the company from entering into the intra-group financial transaction.[161]

2.18 The same fiduciary duty test applies to intra-group asset or opportunity transfers. Directors should determine whether their group company would receive any direct or derivative commercial benefit from transferring a company asset to another group company.[162] Directors have a similar duty in considering whether their company should surrender a corporate opportunity to another group company, or

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being in the best interests of the mortgagor companies. The directors considered that unless the bank was granted these charges, it might "pull the plug" on the whole corporate group.

The Court ruled that use of the liquidity reserve was for the benefit of the two subsidiary companies. Loss of the bank's support would have created a financial disaster for the whole corporate group. Both subsidiary companies therefore had a direct interest in maintaining the bank's support. These derivative benefits to the two subsidiary companies providing the charge justified the directors' action.

160 In *Spedley Securities Ltd v Greater Pacific* (1992) 7 ACSR 155 at 164, Cole J interpreted the *Charterbridge* test as meaning whether an intelligent and honest man in the position of *that* director could reasonably believe that the transactions were for the benefit of *that* company. This interpretation arguably shifts the inquiry from a largely objective one about what a director in such circumstances should do to a more subjective inquiry into the intention of the director concerned.

RP Austin, in 'Problems for directors within corporate groups' in M Gillooly (ed), *The Law Relating to Corporate Groups* (The Federation Press, 1993) at 143, has criticised this modification to the *Charterbridge* test on the basis that it requires directors to specifically turn their minds to the question of whether a proposed step is in the interests of their company. He suggests that it would be difficult for corporate group directors to prove they had specific regard for the interests of individual companies in conducting the affairs of a group. He argues that the *Charterbridge* test is more realistic, since it focuses less on the actual decision of a director and more on whether a reasonable director could believe a group transaction to be in the company's interest. It does not require actual separate consideration of an individual company's interests.

The *Charterbridge* test was applied in *Farrow Finance Co Ltd (in liq) v Farrow Properties Pty Ltd* (1997) 26 ACSR 544 at 581 and *Japan Abrasive Materials Pty Ltd v Australian Fused Materials* (1998) 16 ACLC 1,172 at 1,180.

161 In *Gamble v Hoffman* (1997) 24 ACSR 369 at 374, the Federal Court considered whether directors of a company who authorised a loan to a related company had breached their fiduciary duty to the lending company. The Federal Court held that the directors' duty of care required them to take the following steps:

- "assess what benefits, if any, [the lending company] would derive from making those payments
- "if there were any benefits so to be derived by [the lending company], to assess whether there was any reasonably foreseeable prospect of detriment to [that company]."

Applying these tests, the Court ruled that the directors of the lending company had breached their fiduciary duty to that company. The loan was irrecoverable due to the poor financial position of the borrowing company, as known to those directors, at the time of making the loan.

162 For instance, in *Sydlow v Melwren* (1994) 13 ACSR 144, the directors of various companies in a corporate group laterally transferred assets from one company to another company within the group, when faced with the pending insolvency of the transferor company. No adequate consideration was provided by the transferee company. In ruling that the directors had breached their fiduciary duties to the transferor company, the Court concluded that:

"The benefit to [the transferor company] was not a consideration in the minds of either [director] - the dominant consideration appears to have been to preserve the continuing viability of the total business operation in the hands of [the recipient company]" (at 147).

contract with that other group company on terms that are disadvantageous to their own group company, rather than contract with an outside party on much better terms.

2.19 In addition to these fiduciary duty principles, directors may have a duty to consider the position of the company's unsecured creditors. This obligation arises if entry into these transactions could affect the solvency of the company providing the intra-group benefits.[163]

Intra-group guarantees

2.20 It is relatively common for corporate groups to have a system of intra-group guarantees. For instance, group cross-guarantees typically contain "cross-default" provisions which render all the companies who are party to the cross-guarantees liable if any one of those companies defaults in its obligations as a borrower or as a guarantor. These cross-guarantees may also provide that events of default include any of the borrowers or guarantors in the corporate group being placed in receivership, voluntary administration or liquidation.

2.21 Cross-guarantees allow corporate groups to employ their total assets more effectively in financing the overall group operations. They also overcome some of the problems faced by creditors in dealing with corporate groups by ensuring that, irrespective of the identity or financial position of the contracting company, the creditor can also prove against the assets of guarantor group companies. ASIC also provides some accounting relief where holding companies and their wholly-owned subsidiaries enter into prescribed cross-guarantees.[164]

2.22 US corporate law recognises the role of intra-group guarantees, whether they be downstream, upstream or lateral.[165] Downstream guarantees may enhance the financial position of a controlled company, and therefore the parent company's investment in it. Upstream guarantees are recognised where there is some economic integration of the business of the two companies and the guarantee may further the long-term interests of the controlled company. Likewise, cross-guarantees between sibling group companies are valid where there is a business relationship between these companies and the financing is related to the business interests of both of them. However, a guarantee granted by a controlled company may be invalid if it furthers only the interests of the parent company or the personal interests of a common controlling shareholder that are unrelated to the business of the group.

2.23 Australian corporate law does not prohibit intra-group guarantees. However, directors of a group company may sometimes risk breaching their fiduciary duty to act for the benefit of their company as a whole in entering into these guarantees. An upstream or lateral guarantee should promote the group company's own corporate

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163 See footnote 98.

164 ASIC Class Order 98/1418; Pro Forma 24: Deed of cross-guarantee. To obtain accounting relief, the holding company must covenant with its wholly-owned subsidiaries to pay the liquidator any amount by which the liabilities of those subsidiaries exceed their assets. The subsidiaries must also provide a cross-guarantee in respect of any equivalent shortfall by the holding company.

165 PI Blumberg, *The Law of Corporate Groups: Bankruptcy Law* (Little, Brown & Co, 1985) at §2.05; PI Blumberg, "Intragroup (Upstream, Cross-stream, and Downstream) Guaranties under the Uniform Fraudulent Transfer Act" 9 *Cardozo Law Review* 685 (1987).

purposes and be issued in consideration of some commercial benefit to it. Also, entry into a guarantee may constitute oppressive conduct, particularly if the interests of majority and minority shareholders of the group company diverge.[166] For instance, if the financial circumstances of the principal debtor company, or a would-be guarantor group company, are in a poor state, a guarantor may gain no commercial benefit. Entry into that guarantee would not be for a proper corporate purpose. Any attempt by a holding company to have a wholly- or partly-owned group company enter into such guarantees in these circumstances may be invalid.[167]

2.24 The effect of a cross-guarantee is to make the assets of the guarantor company available for distribution to the creditors of another group company, to the possible detriment of the unsecured creditors of that guarantor. Entry into a particular cross-guarantee may therefore breach the requirement that arises when a company is insolvent or nearly insolvent, that the directors must take into account the interests of the company's creditors.[168] This obligation might therefore be breached if entering into a guarantee threatened the company's solvency or impaired its practical ability to discharge its own debts as they fell due.

2.25 An intra-group guarantee entered into by directors in breach of any of their fiduciary duties is voidable against any party seeking to enforce it who had actual knowledge of the breach.[169]

2.26 In some circumstances, a cross-guarantee given by a company that subsequently goes into liquidation may be set aside as an "uncommercial transaction".[170] Also, entry into some cross-guarantees may create a "debt", thereby exposing directors to potential personal liability if the company is already insolvent or becomes insolvent by entry into that guarantee.[171]

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166 J Hill, "Corporate Groups, Creditor Protection and Cross Guarantees: Australian Perspectives" in *The Canadian Business Law Journal* Vol 24 No 3 (February 1995) 321 at 352.

167 In *ANZ Executors and Trustee Co Ltd v Qintex Ltd* (1990) 8 ACLC 980, a parent company covenanted with a financier to procure guarantees from its wholly-owned subsidiaries for its borrowings. The parent company defaulted in payment and the financier sought specific performance of the covenant. The subsidiaries were insolvent and their directors maintained that the giving of a guarantee would be a breach of their fiduciary duty to consider the interest of the subsidiaries' creditors. The financier contended that the parent could use its power as the controlling shareholder of each of the subsidiaries to pass resolutions approving the guarantees. The Queensland Full Court declined to order specific performance, holding that the court cannot order a shareholder to require a company to execute a guarantee if to do so would infringe the principle that corporate powers and funds may be used only for corporate purposes. In this case, the subsidiaries' power to guarantee a corporate loan was to be exercised solely for the benefit of the parent company, not the subsidiaries.

168 See footnote 98.

169 In *Rolled Steel Products (Holdings) Ltd v British Steel Corporation* [1986] Ch 246, the UK Court of Appeal held that an instrument of guarantee and debenture executed by one company to secure the debts of another were unenforceable by the creditor in whose favour it had been created because that creditor "had actual knowledge of the facts which showed that the giving of the guarantee and the debenture was an abuse of powers by the directors" (at 307). Compare *Seabird Corporation Ltd v Sherlock* (1990) 2 ACSR 111. See also para 6.22.

170 s 588FB.

171 s 588G. See further J Hill, "Corporate Groups, Creditor Protection and Cross Guarantees: Australian Perspectives" in *The Canadian Business Law Journal* Vol 24 No 3 (February 1995) 321 at 353-355, discussing the implications of *Hawkins v Bank of China* (1992) 10 ACLC 588.

Law reform options

2.27 Australian corporate law may not fully resolve the difficulties facing directors of a group company, in their intra-group financial dealings, in balancing their fiduciary duty to act in good faith for the benefit of that group company against the economic necessity of considering the group's overall financial interests. It seems commercially unrealistic to require these directors in these dealings to ignore the organisational structure within which the group company operates. However, this may leave directors of a group company in a difficult legal position, particularly if they consider that to preserve the overall group interests requires a considerable degree of financial support or sacrifice by their group company. An intra-group financial transaction which may be sensible commercially from an overall group perspective may not necessarily be consistent with the legal obligation of directors to consider the interests of their individual group company. The problem arises where there is no immediately ascertainable direct or derivative commercial benefit to the group company in entering into these transactions.

2.28 Any law reform should ideally provide greater flexibility for directors to take into account the overall group interest, while ensuring that creditors and any minority shareholders do not suffer undue detriment from intra-group financial dealings.[172]

2.29 There are various possible approaches for achieving a proper balance of interest. One approach, as found in European proposals, is to adopt the principles in the French Cour de Cassation "Rozenblum" decision whereby the directors of a group company can act in the interests of the overall corporate group, and subordinate or sacrifice the interests of their own company, if:

- the corporate group has a balanced and firmly established structure
- the company took part in a long-term and coherent group policy, and
- the directors in good faith reasonably assumed that any detriment suffered by their company would in due course be made good by other advantages.[173]

Another approach is to permit directors of a group company to act in the interests of a holding company provided this does not prejudice the group company's ability to pay its creditors and the directors are authorised, either under the constitution (for wholly-owned group companies) or by minority shareholders (for partly-owned group companies).

Wholly-owned group companies

That case examines the circumstance whereby the giving of a guarantee may constitute the incurring of a debt. See also A Brown, "Does s 592 [s 588G] apply to Guarantees? The risks increase after the Hawkins case" (1993) 11 *Company and Securities Law Journal* 34.

172 The same problem has been identified in the United Kingdom. M Lower in "Good Faith and the Partly-Owned Subsidiary" [2000] *Journal of Business Law* 232 at 233 said: "In an ideal world, company law rules would allow those controlling a group of companies to take the fullest possible advantage of efficiencies available to the group while ensuring that those efficiencies are shared with, and certainly not achieved at the expense of, minority shareholders and creditors."

173 Forum Europaeum Konzernrecht, "Corporate Group Law for Europe" 1 *European Business Organization Law Review* (2000).

2.30 The Corporations Law s 187, introduced in March 2000, permits directors of wholly-owned subsidiaries in some circumstances to take into account the interest of the holding company in performing their tasks. It provides as follows:

> "*A director of a corporation that is a wholly-owned subsidiary of a body corporate is to be taken to act in good faith in the best interests of the subsidiary if:*
>
> *(a) the constitution of the subsidiary expressly authorises the director to act in the best interests of the holding company; and*
>
> *(b) the director acts in good faith in the best interests of the holding company; and*
>
> *(c) the subsidiary is not insolvent at the time the director acts and does not become insolvent because of the director's act.*"[174]

2.31 Use of this provision might assist external lenders to wholly-owned corporate groups. At common law, any guarantee or third party mortgage that is not in the interests of a wholly-owned subsidiary providing it may be unenforceable, and the lender may be a constructive trustee for any benefit it has obtained from that guarantee or mortgage, if the directors of that subsidiary have breached any of their fiduciary duties in entering into it (for instance, the transaction provided no direct or derivative commercial benefit for that company) and this breach was known or suspected by the lender.[175]

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174 This draft provision is based on the New Zealand Companies Act 1993 s 131(2), with various amendments.

175 Subsection 129(4) provides that a person dealing with a company "may assume that the officers and agents of the company properly perform their duties to the company" (one aspect of the indoor management rule). A company (or its liquidator) is not generally entitled to assert in proceedings in relation to the dealings that this assumption is incorrect (s 128(1)). However, by virtue of s 128(4) a person is not entitled to make this assumption "if at the time of the dealings they knew or suspected that the assumption was incorrect" (the knowledge or suspicion exception).

The competing policy considerations that lie behind the indoor management rule and its exceptions were summarised by Mason J of the High Court in *Northside Developments Pty Ltd v Registrar-General* (1990) 93 ALR 385 at 395-396:

> "What is important is that the principle and the criterion which the rule in *Turquand's* case [the indoor management rule] presents for application give sufficient protection to innocent lenders and other persons dealing with companies, thereby promoting business convenience and leading to just outcomes. The precise formulation and application of that rule call for a fine balance between competing interests. On the one hand, the rule has been developed to protect and promote business convenience which would be at hazard if persons dealing with companies were under the necessity of investigating their internal proceedings in order to satisfy themselves about the actual authority of officers and the validity of instruments. On the other hand, an over-extensive application of the rule may facilitate the commission of fraud and unjustly favour those who deal with companies at the expense of innocent creditors and shareholders who are the victims of unscrupulous persons acting or purporting to act on behalf of companies. Agency principles aside, to hold that a person dealing with a company is put upon inquiry when that company enters into a transaction which appears to be unrelated to the purposes of its business and from which it appears to gain no benefit is, in my opinion, to strike a fair balance between the competing interests. Indeed there is much to be said for the view that the adoption of such a principle will compel lending

2.32 The effect of s 187 is to reduce the likelihood of a challenge to the enforceability of a guarantee or third party mortgage given by a wholly-owned subsidiary, by deeming the directors of that subsidiary to have acted in its best interests, notwithstanding that the mortgage or guarantee was provided solely or primarily to assist the holding company. However, the provision would not overcome the possibility that the guarantee or third party mortgage could be set aside as an insolvent transaction in the event of the subsequent liquidation of the subsidiary.[176]

2.33 Section 187 requires that the wholly-owned subsidiary be solvent at the time the director acts and "does not become insolvent because of the director's act".[177] This differs from the predecessor initial provision in the Corporate Law Economic Reform Draft Bill (1998) which referred to the subsidiary not being insolvent "at the time, or immediately after, the director acts".[178] The requirement in the Corporations Law is intended to avoid protecting a director whose actions do not precipitate an immediate insolvency but instead lead to a protracted insolvency, that is, the director acts in a way that, while it may be in the interests of the holding company, effectively runs the subsidiary down, leading to its eventual insolvency.

> institutions to act prudently and by so doing enhance the integrity of commercial transactions and commercial morality."

In the context of external lenders requiring guarantees or third party mortgages from one group company to support a loan to another group company, the exception to the indoor management rule may apply where there is no discernible direct or derivative benefit to the guarantor or mortgagor.

According to the Explanatory Memorandum to the Corporate Law Reform Act 1998 which introduced ss 128 and 129, the knowledge or suspicion exception is stricter than the common law "put on inquiry" test. However, according to L Shervington, "Signing and execution of documents on behalf of corporations" *Law Council of Australia Corporate Law Workshop, September 1998*: "It is arguable that in practice the tests will be indistinguishable because it seems likely that in order for a person to know or suspect that an assumption is incorrect they will have had to have been put upon inquiry that it is incorrect. That is, a person cannot 'suspect' an assumption to be incorrect unless they have been put upon inquiry that the assumption was incorrect." A similar view is expressed by C Hammond in (1998) 16 *Company and Securities Law Journal* 562 at 564 who argues that "it is not clear that the application of the new test to factual scenarios will produce results which are any different from the earlier cases dealing with 'ought to know' and 'put upon inquiry'".

The relevant case law affecting lenders to corporate groups under the forerunner of ss 128 and 129 and the related principles of constructive trust are discussed by J O'Donovan, "Corporate Benefit in relation to Guarantees and Third Party Mortgages" (1996) 24 *Australian Business Law Review* 126 at 128-132, C Hammond, "Section 164(4)(b) of the Corporations Law: 'To be put upon inquiry or not to be put upon inquiry: is that the question?' A problem of statutory interpretation" (1998) 16 *Company and Securities Law Journal* 93. See also R Carroll, "Proper performance of duties by company officers: the statutory assumption in s 164(3)(f) of the Corporations Law" (1995) 69 *Australian Law Journal* 200, which analyses the equivalent of s 129(4) (proper performance of duties), which superseded s 164(3)(f).

176 See further paras 6.19-6.21.

177 Section 95A of the Corporations Law provides that "a person is solvent if, and only if, the person is able to pay all the person's debts, as and when they become due and payable. A person who is not solvent is insolvent." Section 588E contains rebuttable presumptions to assist in establishing insolvency.

178 Corporate Law Economic Reform Draft Bill: New Directors' Duties and Corporate Governance Provisions s 8(1).

2.34 A remaining question is whether s 187 is necessary, given the power of shareholders to unanimously ratify the actions of directors (the *Pascoe* principle).[179] There are some differences between s 187 and the *Pascoe* principle, though they may have little effect in practice. For instance, the *Pascoe* principle requires unanimous shareholder ratification, whereas this is not necessary in s 187. Conversely, s 187, but not the *Pascoe* principle, requires that an express permissive power be included in the constitution of the wholly-owned subsidiary permitting the directors to act in the best interests of the holding company. However, each of these prerequisites should merely be a formality in a solvent wholly-owned group company.

2.35 Possibly the strongest argument for s 187 having a role independent of the common law turns on the possible inherent limitations on common law unanimous shareholder ratification. There is strong authority for the proposition that shareholders, at common law, can ratify any breach of common law duty. Less certain is whether shareholders can ratify any breach of statutory duty.[180] By contrast, s 187 applies to the directors' statutory as well as common law duties to act in good faith in the best interests of their company as a whole, thereby avoiding the uncertainty whether common law ratification covers statutory duties.

Partly-owned group companies

2.36 The New Zealand Companies Act contains an additional provision which could be applied to "upstream" financial transactions within a partly-owned corporate group.[181] A modified version of that provision was contained in the initial Corporate Law Economic Reform Draft Bill (1998), but was subsequently omitted, for further review by the Advisory Committee. This draft provision is as follows:

> "*A director of a corporation that is a subsidiary, but not a wholly-owned subsidiary, of a body corporate is to be taken to act in good faith in the best interests of the subsidiary if:*
>
> *(a) the constitution of the subsidiary expressly authorises the director to act in the best interests of the holding company; and*
>
> *(b) a resolution passed at a general meeting of the subsidiary authorises the director to act in the best interests of the holding company (no votes being cast in favour of the resolution by the holding company or an associate); and*
>
> *(c) the director acts in good faith in the best interests of the holding company; and*

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179 See para 2.3.

180 Refer to footnote 140. The statutory duties of directors are found principally in ss 180 ff.

181 New Zealand Companies Act 1993 s 131(3) provides: "A director of a company that is a subsidiary (but not a wholly-owned subsidiary) may, when exercising powers or performing duties as a director, if expressly permitted to do so by the constitution of the company and with the prior agreement of the shareholders (other than its holding company) act in a manner which he or she believes is in the best interest of that company's holding company even though it may not be in the best interests of the [subsidiary] company".

(d) *the subsidiary is not insolvent at the time, or immediately after, the director acts.*"[182]

2.37 In effect, this draft provision would allow a director of a partly-owned group company to act in the interests of the holding company, provided the stipulated conditions were met. The requirements for independent shareholder approval and that the company be solvent at the time the director acts are intended to protect its minority shareholders and any unsecured creditors.

2.38 The possible benefits of the draft provision would include:

- protecting directors of a subsidiary group company who wish to act in the interests of the holding company but without any clearly discernible direct or derivative net commercial benefit to their own company.[183] Theoretically, under the existing law, they could seek prospective or retrospective shareholder ratification of their actions, though there are significant restrictions on this right of ratification.[184] This draft provision resolves these ratification problems

- improving financial efficiency in some corporate groups by overcoming some of the possible legal restrictions on intra-group financial transactions

- better protecting lenders to a corporate group, particularly where they seek guarantees or third party mortgages from partly-owned group companies.[185]

2.39 The possible detriments of the draft provision would include:

- eliminating the need for directors of partly-owned group companies to consider whether their company will receive any benefit from entering into the transaction. This could provide too much protection for these directors, compared with the possible detriment to the group company and its minority shareholders

- permitting those directors to act even when they had a personal interest in the holding company, given that the test of good faith in the draft provision only refers to acting in the best interests of the holding company

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182 Corporate Law Economic Reform Draft Bill: New Directors' Duties and Corporate Governance Provisions s 8(2). There is no equivalent of s 8(2)(d) of the Draft Bill in the New Zealand legislation.

183 As outlined earlier in this Chapter, directors of group companies are not precluded under the current law from taking into account the interests of the holding company (or any other group company) provided their company receives some net direct or derivative commercial benefit. New legislation is not needed to protect them in these circumstances (apart possibly from its comfort effect), nor has it been suggested that the draft provision should substitute for this common law principle.

184 See para 2.4.

185 See further paras 2.23-2.26. The draft provision requires, inter alia, that the non-aligned shareholders have passed a resolution at a general meeting authorising the director to act. It is questionable whether the assumptions in s 129 would cover that matter. Therefore, if the draft provision were introduced in its current form, it may be necessary for lenders to obtain confirmation that the resolution was so passed.

- reducing the rights of minority shareholders. It would be doubtful whether dissenting minority shareholders would still be eligible to initiate an oppression action concerning a resolution under the draft provision that was approved by a majority of that minority.[186]

2.40 The draft provision also raises a series of further policy issues that would need to be considered.

- *Information to minority shareholders.* The draft provision would permit only the minority shareholders of the subsidiary to vote on the resolution (given the exclusion of the holding company and its associates). At common law, shareholders are entitled to such information as is necessary for them to make an informed judgment on any proposal requiring their consent.[187] What constitutes full disclosure under this draft provision may not always be clear, particularly the extent to which directors should inform shareholders of the anticipated consequences for the company of approving any resolution permitting the directors to act in the interests of another company. This problem of shareholders understanding the full ramifications of a proposed resolution could particularly arise if general prospective approvals were permitted (see below).

- *Prior or retrospective approval.* The New Zealand legislation, on which the draft provision is based, expressly stipulates that directors may only act with the "prior agreement" of the minority shareholders.[188] By contrast, the draft provision does not make clear whether retrospective, as well as prior, approval is permitted. It may be preferable that this matter be expressly clarified, one way or the other.

- *Approval of each action or a general approval.* The draft provision does not indicate whether shareholders must approve each specific act of the directors, or whether a general approval for all the directors' actions is permissible. If the former interpretation is correct, the provision may be largely unworkable, as it could require constant shareholder meetings. However, if general prospective approval is permitted, minority shareholders may be asked, in effect, to surrender, or place in jeopardy, many of their future interests, both foreseeable and unforeseeable (for instance, directors of the subsidiary may determine that it is in the interests

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186 For instance, in *Re G Jeffrey (Mens Store) Pty Ltd* (1984) 9 ACLR 193, the Court held that a shareholder cannot have recourse to the oppression remedy merely because a majority of shareholders vote contrary to the views of that particular shareholder. It applied the decision in *Re HW Thomas Limited* (1983) 1 ACLC 1256, where the Court ruled that the test of fairness, for the purpose of determining oppression, should be assessed according to fairness to the whole body of shareholders, not merely an individual shareholder. An individual is not oppressed merely because that shareholder must abide by the decisions of a majority of shareholders.

187 *Winthrop v Winns* [1975] 2 NSWLR 666.

188 The New Zealand Companies Act 1993 s 131(3) provides: "A director of a company that is a subsidiary (but not a wholly-owned subsidiary) may, when exercising powers or performing duties as a director, if expressly permitted to do so by the constitution of the company and with the prior agreement of the shareholders (other than its holding company), act in a manner which he or she believes is in the best interest of that company's holding company even though it may not be in the best interests of the [subsidiary] company".

of the holding company to fundamentally change or run down the business of the subsidiary company or sell off its key assets). The information on which shareholders should base their decision may need to fully explain and emphasise the potential implications of any approval.

- *Implications of a "no" resolution.* On one view, the directors could still proceed with intra-group financial transactions, taking into account the interests of the holding company, provided that there was some direct or derivative benefit to their own partly-owned group company. However, another possible view is that the draft provision, if enacted, would constitute an exhaustive code and the directors could only act in the interests of the holding company (notwithstanding that there may be some benefit to the subsidiary company) if they received shareholder approval. The draft provision would need to make clear whether or not it is an exhaustive code.

- *Implications of a "yes" resolution.* A related concern is whether the draft provision might be interpreted as the only way that directors could take into account the interests of another group company, thereby putting in doubt the current legal principles regulating nominee directors.[189] One suggestion is that any legislation should put beyond doubt that the current rights of nominee directors to take into account the interests of their nominators without further authorisation by their group company remain in force.[190]

- *Withdrawal of consent.* The draft provision makes no reference to how a consent, once given, may be withdrawn. The general common law principle is that any shareholder resolution can only be overturned by a further shareholder resolution. If the principle were applied in this context, shareholder approval may give directors the power for an indefinite future time to act in the interests of the holding company, rather than their own company. One possible control might be to introduce a statutory "sunset" limitation on any resolution (say one year), with directors having to obtain a further resolution from minority shareholders to continue to act in the interests of the holding company. In seeking any further approval, a statutory obligation could be placed on directors to report to shareholders on how they have previously exercised their power to act in the interests of the holding company and its financial and other material implications for the subsidiary company.[191]

- *Good faith in the best interests.* The draft provision refers to the directors acting "in good faith in the best interests of the holding company". It is not clear whether this constitutes one or two requirements. On one view, directors should be required to act both bona fide and in the interests of the holding company. Also, the reference to the "best" interests of the holding company might suggest that the provision only applies to decisions that are

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189 These nominee director principles are discussed at paras 2.74 ff.

190 R Baxt and T Lane, "Developments in Relation to Corporate Groups and the Responsibilities of Directors - Some Insights and New Directions" (1998) 16 *Company and Securities Law Journal* 628 at 644.

191 Compare the requirements for German de facto groups: para 1.70.

the best possible for the holding company. By contrast, the usual formulation is that directors must act in the interests of their company.[192]

- *Solvency of the subsidiary.* The solvency requirement in the draft provision looks at the circumstances of the partly-owned group company at the time that its directors act, not necessarily when the resolution was passed. This solvency obligation is designed to protect the company's unsecured creditors. However, the requirement in the draft provision that the company be insolvent "at the time, or immediately after, the director acts" would not cover financial transactions or other decisions (for instance, a decision to transfer assets or a corporate opportunity to another group company) which may eventually, but not immediately, lead to the subsidiary company's insolvency (the "run down" problem). These transactions can be set aside in the liquidation of the subsidiary company in only limited circumstances.[193]

  A number of alternative policy options could be employed to deal with this problem. One policy option would be to replace the solvency requirement with a test found in the share capital reduction provisions, namely that any transaction entered into under the draft provision "does not materially prejudice the company's ability to pay its creditors".[194] An alternative approach would be to adopt the language in s 187 (dealing with wholly-owned subsidiaries) which requires that the subsidiary be solvent at the time the director acts and "does not become insolvent because of the director's act".[195] Another, or additional, approach, which is applied in New Zealand, would be to empower the courts to make mandatory contribution or pooling orders, each of which could deal with the types of transactions that are permitted by the draft provision but nevertheless lead to the eventual, though not immediate, insolvency of the company. The merits of these additional powers are discussed elsewhere in this Report.[196]

- *Protection of minority shareholders.* The draft provision does not prevent the holding company and its associates from voting on any proposal to include the permissive power in the subsidiary company's constitution. However, they are excluded from voting in support of any shareholder resolution authorising directors to exercise that power. The possibility remains, however, that the long-term interests of minority shareholders of the partly-owned group company could be sacrificed through this procedure.

  One response to these concerns may be that the related party provisions[197] protect minority shareholders of partly-owned group companies. Certainly, directors of some group companies would have to obtain minority shareholder approval under those provisions for intra-group financial dealings, in addition to any approval they may have to act in the interests of the holding company (if the draft provision were introduced). However, the

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192 *Russell Kinsela Pty Ltd v Kinsela* (1983) 8 ACLR 384 at 403.

193 For instance, under s 267 (void charges) or Part 5.7B Div 2 (Voidable transactions).

194 s 256B(1)(b).

195 Refer to para 2.30.

196 See Chapter 6.

197 See para 1.73: *related party transactions*.

related party provisions would not cover decisions by directors either not to act (for instance, not to compete with another group company for a corporate opportunity), or to change the role of the company (for instance, by selling the company's assets externally either to run it down or to convert it into a "cashbox" for the group). Also, the related party provisions do not require that shareholders consider the interests of creditors.

Consideration of the position of minority shareholders raises the question whether all, or at least the non-assenting, minority shareholders should have buy-out rights where a resolution is passed.

An argument against any buy-out right would be that its exercise could create financial disincentives to using the provision, given that dissenting minorities could require a buy-out once a resolution was passed. A contrary argument is that a buy-out right could act as a discipline on directors of a partly-owned group company to seek a minority shareholder resolution only where there was clearly no direct or derivative benefit to that group company from a proposed transaction. The buy-out right would therefore only apply where the minority shareholders approved the directors acting against the interests of their own company.

The recommended buy-out procedure is discussed elsewhere in this Report.[198]

- *Liability of the holding company.* The draft provision does not discuss the circumstances, if any, in which a holding company should be liable for the actions of a director of a partly-owned group company who has acted in the interests of the holding company, to the financial detriment of the group company.

  On one argument, the attraction of this provision for corporate groups could be seriously undermined if the courts interpreted it as giving them a direct or indirect power to lift the corporate veil and give creditors of the subsidiary access to the assets of the holding company.[199] The contrary argument is that, where a power is exercised for the benefit of a holding company, that company should be prepared to carry some of the financial consequences of this action. Similar matters are discussed elsewhere in this Report.[200]

- *Upstream and lateral group transactions.* The draft provision refers to a director of the subsidiary acting in the best interests of the holding company. This would clearly cover "upstream transactions" such as a subsidiary lending money to, or providing a guarantee for the benefit of, the holding company. What is less certain is whether the provision does, or indeed

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198 paras 3.10 ff and Recommendation 10.

199 This concern was raised by R Baxt and T Lane in "Developments in Relation to Corporate Groups and the Responsibilities of Directors - Some Insights and New Directions" (1998) 16 *Company and Securities Law Journal* 628 at 644, 646 & 649.

200 See paras 2.144 ff which deal with the comparable matter of the possible liability of nominators for the actions of their nominee directors.

should, cover "lateral" transactions, such as loans, guarantees or the provision of securities between sibling group companies.

On one view, the draft provision should apply to all intra-group dealings, whether or not the holding company is a party. To restrict the provision to upstream transactions could undermine its usefulness to corporate groups. However, to include all lateral transactions raises the issue of whether, or in what circumstances, a sibling group company that has benefited from a transaction to which the draft provision applies should also assume some financial responsibility for its consequences.

Issue 3. *Should a provision similar to that found in the New Zealand Companies Act be introduced to permit directors of a solvent partly-owned group company to act in the interests of the parent company where the minority shareholders of the former company pass a resolution, in accordance with its constitution, that approves the directors so acting?*

If so, should the provision, or other related provisions:

- *stipulate what information is necessary for minority shareholders to make a fully informed decision*
- *permit minority shareholders to give retrospective, as well as prior, approval to the directors' actions*
- *only permit approval to be given for specific actions of directors or, alternatively, allow for minority shareholders to give a general approval*
- *make it clear whether the proposed procedure sets out the only circumstances in which directors can act in the interests of the parent company*
- *stipulate a time limit on the operation of any minority shareholder resolution? If so, should directors who seek further minority shareholder approval be required to report to shareholders on how they have previously exercised their power under the provision*
- *refer to directors acting "in good faith and in the interests of the holding company" rather than "in good faith in the best interests of the holding company"*
- *cover actions that would eventually, but not immediately, lead to the insolvency of the partly-owned group company? If so, should the provision require that any relevant transaction not materially prejudice the company's ability to pay its creditors or, alternatively, that the subsidiary be solvent at the time the director acts and not become insolvent because of the director's act*

- *give all, or at least the non-assenting, minority shareholders buy-out rights where a resolution is passed*
- *set out the circumstances, if any, in which a parent company should be liable for the actions of a director of a partly-owned group company who has acted in the interests of the parent company, to the financial detriment of the group company*
- *extend to transactions for the benefit of sibling group companies and, if so, provide for the circumstances in which those sibling companies should accept liability for those transactions?*

Submissions on Issue 3

Should there be a statutory provision based on the New Zealand Act?

2.41 The submissions were divided.

2.42 Some submissions supported permitting directors of solvent partly-owned group companies to act in the interests of the parent company with minority shareholder approval.[201] One of those respondents[202] favoured extending the proposed provision to joint venture companies, as under the New Zealand legislation.[203]

201 Australian Accounting Research Foundation, Australian Institute of Company Directors, AMP (Group), AMPAM, Carter Holt Harvey Limited, QBE Insurance Group Ltd.

202 Australian Institute of Company Directors.

203 New Zealand Companies Act 1993 s 131(4) states: "A director of a company that is carrying out a joint venture between the shareholders may, when exercising powers or performing duties as director in connection with the carrying out of the joint venture, if expressly permitted to do so by the constitution of the company, act in a manner which he or she believes is in the best interests of a shareholder or shareholders, even though it may not be in the best interests of the company".

2.43 Submissions that opposed a statutory provision argued that:

- there is no strong case that the present law is unduly restrictive[204]
- there is a risk that such a provision may be abused, which outweighs its potential benefits to business. A parent company that wants the directors of a partly-owned group company to act in its interests should seek to compulsorily acquire the shares of the minority shareholders.[205]

Content of any statutory provision

2.44 *Information.* Several submissions favoured the provision specifying the information that should be provided to minority shareholders before they vote on a resolution.[206]

2.45 One submission suggested that the legislation should state that the relevant notice of meeting should contain whatever information is necessary to enable minority shareholders to make an informed decision on the matter.[207] Another submission considered that minority shareholders should receive "all information known to the company that is material to the decision on how to vote on the resolution" (cf s 256C(4), the equivalent provision for capital reductions), though information previously disclosed to shareholders should not have to be included.[208]

2.46 *Retrospective, as well as prior, approval.* One submission approved shareholders being able to give retrospective as well as prior approval.[209] However, another submission opposed retrospective approval.[210]

2.47 *Specific or general approval.* One submission agreed with providing for general approval, arguing that requiring specific approval for every action would be impractical, given the number of matters which directors of some companies may have to deal with in practice.[211]

2.48 However, another submission, while acknowledging that a requirement for specific approval may lead to repeated requests to conduct the same activity, opposed any provision for general approval, arguing the potential for abuse and lack of recourse for aggrieved shareholders if general approval were permitted.[212]

2.49 *Exhaustive or non-exhaustive provision.* Some submissions considered that the provision should be exhaustive, for the sake of certainty.[213]

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204 Law Council of Australia.
205 ASIC.
206 Australian Accounting Research Foundation, Carter Holt Harvey Limited, Chris Sotiropoulos.
207 Carter Holt Harvey Limited.
208 Australian Accounting Research Foundation.
209 Carter Holt Harvey Limited.
210 Chris Sotiropoulos.
211 Carter Holt Harvey Limited.
212 Chris Sotiropoulos.
213 Carter Holt Harvey Limited, Chris Sotiropoulos.

2.50 *Time limit.* One submission considered that there was no need for a sunset clause, given the requirement that the partly-owned group company not become insolvent because of the directors' acts (see para 2.52), provided all minority shareholders are:

- given the opportunity to vote on the proposal at the outset, and
- subsequently kept aware that the approval has been given (for instance, by disclosure in the company's annual report).[214]

2.51 *"In good faith and in the interests of the holding company" or "in good faith in the best interests of the holding company".* One submission approved the wording "in good faith and in the interests of the holding company".[215]

2.52 *Actions leading to insolvency.* Some submissions considered that the protection in the provision should not extend to actions that would eventually, but not immediately, lead to the insolvency of the partly-owned group company.[216] One of these respondents favoured the requirement in s 187(c) that "the subsidiary is not insolvent at the time the director acts and does not become insolvent because of the director's act".[217]

2.53 *Buy-out rights.* Some submissions favoured buy-out rights for minority shareholders. This matter is discussed in Chapter 3.

2.54 One submission opposed any buy-out right for minority shareholders, as a resolution can only be put if authorised by the company's constitution and shareholders in all companies take the risk that they will be outvoted on particular matters by other shareholders who are eligible to vote.[218]

2.55 *Parent company liability.* One respondent argued that a parent company that has the capacity to control a group company should be liable for all that company's debts.[219]

2.56 One submission opposed any automatic parent company liability for the actions of directors of partly-owned group companies.[220] It was also suggested in submissions that the legislation should specifically state that minority shareholder authorisation for directors to act in the interests of the parent company should not by itself make the parent company liable for the debts or actions of the group company.

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214 Carter Holt Harvey Limited.

215 Carter Holt Harvey Limited.

216 Australian Credit Forum, Australian Accounting Research Foundation, Carter Holt Harvey Limited, Chris Sotiropoulos.

217 Chris Sotiropoulos.

218 Carter Holt Harvey Limited.

219 Australian Accounting Research Foundation.

220 Carter Holt Harvey Limited.

2.57 *Transactions for the benefit of sibling group companies.* One submission supported the provision extending to sibling group companies, as the interests of the sibling companies are likely to coincide with those of the parent company.[221]

2.58 *Other matters.* One submission suggested that minority shareholders should retain the ability to initiate an oppression action under s 232 for an authorisation resolution that was approved by a majority of that minority.[222]

Advisory Committee response to submissions on Issue 3: Draft Recommendation 3

2.59 The Advisory Committee sought public comment on a provision based on the New Zealand legislation. The Committee expressed reservations about the provision, in particular whether minority shareholders would ever wish to approve a resolution of this nature. However, the Committee proposed that any provision, if introduced, should deal with the matters raised in the discussion of Issue 3 in the manner set out in the following Draft Recommendation.

A provision should be introduced to permit directors of a solvent partly-owned group company to act in good faith and in the interests of the parent company where the minority shareholders of the former company pass an ordinary resolution, in accordance with its constitution, that approves the directors so acting.

That provision should:

- *not stipulate what information is necessary for minority shareholders to make a fully-informed decision* (given that there are adequate common law principles)
- *permit minority shareholders to give retrospective, as well as prior, approval to the directors' actions*
- *permit minority shareholders to give a general approval*
- *make it clear that the proposal is additional to, not in substitution for, the current common law principles permitting directors to act in the interests of their company and permitting shareholder ratification*
- *not stipulate a statutory time limit on the operation of any minority shareholder resolution, but leave that to the terms of the resolution*
- *apply the principle, found in the capital reduction provision (s 256B(1)(b)), that the action of directors in exercising the power should not materially prejudice the company's ability to pay its creditors* (this formulation may be preferable to the s 187(c) formulation)

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221 Carter Holt Harvey Limited.

222 Chris Sotiropoulos.

- *permit all minority shareholders who have not voted in favour of the resolution (that is, dissenting shareholders and shareholders who failed to vote) to exercise buy-out rights* (see further Recommendation 10)

- *not impose any additional liability on a parent company for the actions of the directors of a partly-owned group company*

- *not extend to sibling group companies* (this appears to be unnecessary, as transactions between sibling companies would nevertheless directly or indirectly benefit the parent company and therefore be covered by the provision)

- *stipulate that the oppression remedy should not apply to any resolution passed in accordance with this proposal* (given that any non-approving shareholders would have buy-out rights).

Submissions on Draft Recommendation 3

2.60 Some submissions agreed with the Draft Recommendation.[223] However, one of these respondents considered that minority shareholders should not be able to give retrospective approval and was uncertain whether the rule should apply to sibling companies.[224]

2.61 Another submission[225] opposed the Draft Recommendation, arguing that minority shareholders purchasing shares in the group company should already have taken into account, in determining the price, the possibility of their directors acting in the interests of the parent company. Also, the Draft Recommendation takes no account of the effect it would have on creditors.

Advisory Committee response to submissions on Draft Recommendation 3

2.62 The Advisory Committee continues to support the Draft Recommendation, albeit that minority shareholders may not often wish to approve a resolution of this nature.

2.63 The Committee maintains its view that, in accordance with common law principles, minority shareholders should be able to give retrospective as well as prospective approval. It also confirms that the provision need not expressly extend to sibling group companies, as transactions between sibling companies would nevertheless directly or indirectly benefit the parent company and would therefore come within the provision.

2.64 The purpose of the Draft Recommendation is to permit directors of partly-owned group companies to act in the interests of the holding company without this constituting a breach of their fiduciary duties. This is a separate issue from the price of minority shares. Also, the interests of creditors would be protected by

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223 Australian Institute of Company Directors, Australian Society of Certified Practising Accountants.

224 Australian Institute of Company Directors.

225 R Schulte.

applying the principle that exercise of the power "should not materially prejudice the company's ability to pay its creditors".

Recommendation 3

The Corporations Law should permit directors of a solvent partly-owned group company to act in good faith and in the interests of the parent company where the minority shareholders of the former company pass an ordinary resolution, in accordance with its constitution, that approves the directors so acting.

That provision should:

- not stipulate what information is necessary for minority shareholders to make a fully-informed decision
- permit minority shareholders to give retrospective, as well as prior, approval to the directors' actions
- permit minority shareholders to give a general approval
- make it clear that the proposal is additional to, not in substitution for, the current common law principles permitting directors to act in the interests of their company and permitting shareholder ratification
- not stipulate a statutory time limit on the operation of any minority shareholder resolution, but leave that to the terms of the resolution
- apply the principle, found in the capital reduction provision (s 256B(1)(b)), that the action of directors in exercising the power should not materially prejudice the company's ability to pay its creditors
- permit all minority shareholders who have not voted in favour of the resolution (that is, dissenting shareholders and shareholders who failed to vote) to exercise buy-out rights
- not impose any additional liability on a parent company for the actions of the directors of a partly-owned group company
- not extend to sibling group companies
- stipulate that the oppression remedy should not apply to any resolution passed in accordance with this proposal.

Sale of a group company subject to an ASIC Deed of Cross-Guarantee

Current law

2.65 From the perspective of creditors, intra-group cross-guarantees allow them to advance funds or credit against the assets of the corporate group, not just the assets of the contracting group company. However, the interests of these creditors may be affected where the group wishes to sell the debtor group company to an outsider.

2.66 Currently, the prescribed Deed of Cross-Guarantee under the ASIC Class Order for wholly-owned corporate groups permits the sale of group companies.[226] The corporate group may sell its shares in a group company to an outside party, provided that "the directors of the Holding Entity upon disposal certify in writing that the disposal is a bona fide sale and that the consideration for the sale is fair and reasonable". In that case, the Deed of Cross-Guarantee ceases to apply to the group company sold. The Holding Entity and all other group companies will be released from all liability concerning the sold company under the Deed of Cross-Guarantee, whether arising or accruing prior to or after the disposal.[227] The overall effect of these provisions is that the sale could disadvantage those creditors who have contracted with a particular group company in reliance on their having access to the total group assets under the group cross-guarantee, not merely to the assets of that company.

2.67 In some instances, the parties to the sale transaction may voluntarily pay out the creditors of the debtor group company. However, if this does not occur, these creditors may need some other form of protection. Options include:

- to require that creditors receive reasonable notice of the sale, thereby giving them an opportunity to exercise their existing rights to payment prior to the share transfer. This option would not protect those creditors having no immediate right to payment

- to retain an obligation on the corporate group to honour the liabilities of the group company incurred prior to its sale. This raises the questions of how long those residual group liabilities should remain (indefinitely or for a limited period) and whether those residual liabilities should substitute for the right to recover from the company after its sale.

2.68 Any move to increase the protection for creditors of the group company to be sold (the sale creditors) also raises the question of the position of the remaining group creditors (the remaining creditors). The requirement that the directors of the holding entity must certify that the sale price is fair and reasonable is designed to stop the corporate group selling off a group company at an undervalue. This protects the interests of the remaining creditors. However, these creditors might still be

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[226] For background information on this prescribed Deed, see G Dean, F Clarke and E Houghton, "Corporate restructuring, creditors' rights, cross-guarantees and group behaviour" (1999) 17 *Company and Securities Law Journal* 85.

[227] ASIC Pro Forma 24: Deed of cross-guarantee cl 4.2.

disadvantaged vis-à-vis the fully-paid sale creditors if the corporate group subsequently goes into insolvent liquidation.[228]

Issue 4. *What residual liability, if any, should a non-consolidated wholly-owned corporate group that has adopted a prescribed Deed of Cross-Guarantee retain for the debts of one of its group companies incurred before that group company was sold to an outsider? (The Advisory Committee Recommendation 2 would not permit a consolidated wholly-owned corporate groups to sell any of its group companies while it remains consolidated.)*

Submissions on Issue 4

2.69 The submissions were divided between those that considered that a wholly-owned corporate group should have residual liability[229] and those that considered that this matter should be left to the parties to the relevant contract to determine.[230]

2.70 One respondent pointed out that any unpaid creditors of a wholly-owned group company that is sold may still have the protection of s 588V and the undue preference provisions, notwithstanding that they will no longer have recourse to the assets of other wholly-owned group companies after the sale.[231]

Advisory Committee response to submissions on Issue 4: Draft Recommendation 4

2.71 The primary purpose of the ASIC Deed of Cross-Guarantee is to permit consolidated accounting. That deed ceases to apply to any group company that has been sold for fair value. The question of any residual liability of the remaining group companies in the event of a sell-off should be left to existing corporate law principles and any private arrangement between a creditor and the corporate group. Accordingly:

A non-consolidated wholly-owned corporate group that has adopted a prescribed ASIC Deed of Cross-Guarantee should not retain liability under that Deed for the debts of one of its group companies incurred before that group company was sold to an outsider. However, the prescribed Deed of Cross-Guarantee should be redrafted to indicate more clearly this limitation on its application.

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228 See D Murphy's critique of the ASIC deed of cross-guarantee, as noted in J Farrar, "Legal Issues Involving Corporate Groups" (1998) 16 *Company and Securities Law Journal* 184 at 193.

229 Australian Credit Forum.

230 Carter Holt Harvey Limited, Coles Myer Ltd, Law Council of Australia.

231 ASIC.

Submissions on Draft Recommendation 4

2.72 Submissions supported the Draft Recommendation, including that the Deed of Cross-Guarantee be redrafted to expressly point out in plain English that it does not apply to any group company that has been sold.[232]

Advisory Committee response to submissions on Draft Recommendation 4

2.73 The Advisory Committee maintains the approach in the Draft Recommendation.

Recommendation 4

There should be no change to the current provision in the prescribed ASIC Deed of Cross-Guarantee whereby a non-consolidated wholly-owned corporate group has no liability under that Deed for the debts of one of its group companies incurred before that group company was sold to an outsider. However, the prescribed Deed of Cross-Guarantee should be redrafted to indicate more clearly this limitation on its application.

Nominee directors of group companies

Application only to partly-owned group companies

2.74 A nominee director is a person appointed to represent a sectional interest, rather than the company as a whole. This concept does not directly apply to wholly-owned group companies, given that there is only one shareholder. However, the concept is relevant to those partly-owned group companies where one or more directors are appointed by the controlling shareholder to represent its interests on the controlled company's board.

Role of nominee directors

2.75 Within the context of partly-owned corporate groups, a nominee director has a dual role, namely to represent the nominator and to direct the controlled company. This dual role raises four related issues:

- disclosure of nominee directors
- fiduciary duties of nominee directors
- nominee directors passing on information to their nominators
- liability of nominators.

[232] Australian Accounting Research Foundation, Australian Institute of Company Directors, Australian Society of Certified Practising Accountants.

Disclosure of nominee directors

Current law

2.76 There is no requirement that directors inform shareholders whether they are nominee directors and, if so, who are their nominators. Particular directors may be appointed to the board without shareholders being informed of whose interests they represent and whether there is any arrangement or understanding that those directors will act in the interests of particular shareholders or others.

Law reform options

2.77 Any disclosure proposal must make clear:

- who are nominee directors
- the method of disclosure.

Who are nominee directors

2.78 The Corporations Law does not define nominee directors.[233] On one view, they could be described as persons who, "independent of the method of their appointment, but in the performance of their office, act in accordance with some understanding, arrangement or status which gives rise to an obligation (in the wide sense) to the appointor".[234] The Corporations Law already recognises these types of formal or informal arrangements for other purposes.[235] A similar approach could be adopted in defining nominee directors.

Method of disclosure

2.79 There are various possible means of disclosure. For instance, nominee directors could be required to disclose on the ASIC database their status and the identity of their nominators upon their appointment as directors. In addition, these details could be included in the corporate governance section of companies' annual reports.

Issue 5. *Should nominee directors be required to disclose their status and the identity of their nominators?*

If so, should that disclosure be through the ASIC database and in the annual report?

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233 Nominee directors are indirectly recognised in s 203D(1) which refers to a director who "was appointed to represent the interests of particular shareholders or debenture holders".

234 Companies and Securities Law Review Committee Discussion Paper No 7 *Nominee and Alternative Directors* (1987) at 2.

235 For instance, ss 608, 609.

Submissions on Issue 5

Definition of nominee director

2.80 Some submissions noted that an obligation for nominee directors to disclose would require a statutory definition of "nominee director".[236]

2.81 One respondent[237] suggested that the following should fall within a statutory definition of nominee director:

- a director appointed pursuant to a provision in a company's constitution permitting a specified person or a class of shareholders to appoint a certain number of directors
- a person appointed to represent the interests of employees or a creditor
- 'associates' of a significant shareholder (say, a shareholder who holds 20% or more of the voting shares)
- employees or former employees (say, during the last 6 months) of such a shareholder
- persons accustomed or under an obligation to act in accordance with the directions of such a shareholder
- the holders of, say, more than 20% of the voting shares of such a shareholder.

2.82 Another respondent pointed out that many representatives of majority shareholders are not appointed solely by the parent company or by the application of its votes alone, but are elected by a majority of all the shareholders.[238] Another respondent[239] pointed out that:

- directors are generally elected to a board by the shareholders in general meeting. A parent company could thus, if it wished, control the composition of the entire board. However, consistent with current corporate governance principles, ASX-listed subsidiary boards generally have independent non-executive directors as well as directors connected with the parent company (including, in many cases, executives of the parent company)
- it would be inappropriate to treat all directors who were connected with a parent company as nominee directors. Unless a parent company has obtained a constitutional amendment, authorised by the minority shareholders, allowing a particular director to give priority to the parent company's interests, no additional responsibilities should be imposed on either the parent corporation or the relevant director.

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236 Australian Institute of Company Directors, Law Council of Australia, Jon Webster.
237 Law Council of Australia.
238 ASIC.
239 Australian Institute of Company Directors.

Disclosure of status

2.83 *Support.* Some submissions considered that nominee directors should be required to disclose their status and the identity of their nominators.[240] One of those respondents[241] argued that any disclosure obligation should not disqualify nominees from voting on any issue once they have disclosed their status, subject to the requirements of the Corporations Law and any constitutional provisions.

2.84 Another respondent,[242] in arguing that specific provision for this disclosure was necessary, suggested that current disclosure requirements may not be adequate, as:

- the disclosure requirements for public company directors are limited to material personal interests and are generally confined to disclosure of the interest to the board, not to the shareholders[243]
- the relevant time for disclosure should be when the nominee's election to office is first under consideration, not when a particular issue of interest to the nominator is due for review by the board.

2.85 *Qualified support.* One submission supported disclosure if it would assist in resolving difficulties concerning liability and related issues.[244] However, that respondent considered that the details of disclosure should be kept to a minimum and confidentiality protected.

2.86 Another respondent only supported a disclosure obligation where the nominee directors can act in the interests of the parent company.[245] The obligation would be unnecessary in other cases, as nominee directors have the same duties as all other directors.

2.87 *Opposed.* One submission opposed a statutory requirement that nominee directors disclose their status and the identity of their nominators.[246] That respondent pointed out that to some extent best practice already requires some level of disclosure at least for executive directors. For instance, the ASX Listing Rules require a statement of corporate governance practices and promote disclosure of the directors' status as executive or non-executive.[247]

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240 Australian Accounting Research Foundation, Australian Credit Forum, AMP (Group), AMPAM, Australian Corporate Lawyers Association, Law Council of Australia.

241 Law Council of Australia.

242 Australian Corporate Lawyers Association.

243 s 232A.

244 Australian Institute of Company Directors.

245 Carter Holt Harvey Limited.

246 ASIC.

247 Listing Rule 4.10.3 and Appendix 4A.

Where should the disclosure take place?

2.88 Some submissions considered that this information should be disclosed on the ASIC database,[248] for the following reasons.

- It would ensure that the information is current.[249]
- It would ensure that all users have equal access to the information, given that not all companies are required to issue an annual report (incorporating the directors' report).[250]

Advisory Committee response to submissions on Issue 5: Draft Recommendation 5

2.89 The submissions point to the difficulties in attempting to clearly define nominee directors. They also raise the issue of whether nominee directors should be subject to different disclosure rules from those that apply to other directors. It would be inappropriate to create a separate legal disclosure regime for nominee directors. A better approach would be to consider the more general issue of the disclosure obligations of directors generally.

2.90 Section 191 obliges directors of any company to disclose their material *personal* interests. This contrasts with the predecessor disclosure obligation for directors of proprietary companies which was not confined to personal interests.[251] The current provision appears to have a narrower disclosure obligation. For instance, material personal interests may not cover fiduciary duties owed by a director to some other entity.

2.91 In light of these considerations, the Corporations Law should be amended in the following manner.

In lieu of any statutory provisions defining nominee directors and imposing specific disclosure obligations on them, the Corporations Law should require directors of all companies, whether or not in a corporate group, to disclose all situations that may put them in positions of conflict of duty or interest, in particular their directorships of any other board and their employment by any other person. That disclosure should be in the same manner as disclosure of all other interests, namely disclosure to fellow directors at the next directors' meeting.

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248 Australian Accounting Research Foundation, Australian Credit Forum, Australian Corporate Lawyers Association, Carter Holt Harvey Limited.

249 Carter Holt Harvey Limited.

250 Australian Accounting Research Foundation.

251 Section 231 of the Corporations Law before 13 March 2000.

Submissions on Draft Recommendation 5

2.92 The submissions agreed with the policy of disclosure,[252] though one respondent preferred a specific requirement that nominee directors disclose their status and their appointor.[253]

Advisory Committee response to submissions on Draft Recommendation 5

2.93 The Advisory Committee confirms the view in the Draft Recommendation that there should not be specific provisions for nominee directors, given the difficulty of defining these directors. Instead, all directors should be obliged to disclose conflicts of duty or interest.

Recommendation 5

In lieu of any statutory provisions defining nominee directors and imposing specific disclosure obligations on them, the Corporations Law should require directors of all companies, whether or not in a corporate group, to disclose all situations that may put them in positions of conflict of duty or interest, in particular their directorships of any other board and their employment by any other person. That disclosure should be in the same manner as disclosure of all other interests, namely disclosure to fellow directors at the next directors' meeting.

Fiduciary duties of nominee directors

Current law

2.94 Nominee directors appointed to a group company by a parent company owe fiduciary duties to the group company. These fiduciary duties include not fettering their discretion, avoiding conflicts of interest, and acting in good faith for the benefit of their company as a whole. For instance, nominee directors of a group company may breach their duty to actively exercise their discretion if they undertake to follow their nominator's instructions or wishes on all matters to be considered by the group company's board.[254] However, a company's constitution or a shareholders' agreement may define or modify the scope and nature of the fiduciary duty owed by nominee directors of that company.[255]

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252 Australian Accounting Research Foundation, Australian Institute of Company Directors, Australian Society of Certified Practising Accountants.

253 Australian Accounting Research Foundation.

254 Likewise, subject to the terms of a company's constitution, a majority shareholder cannot control directors in the exercise of their powers: *Automatic Self-Cleansing Filter Syndicate Co Ltd v Cuninghame* [1906] 2 Ch 34, *Howard Smith Ltd v Ampol Petroleum Ltd* (1974) 3 ALR 448 at 457.

255 *Levin v Clark* [1962] NSWLR 686. In *Whitehouse v Carlton Hotel Pty Ltd* (1987) 162 CLR 285 at 291, the High Court affirmed that a company's constitution may expressly or impliedly authorise directors to exercise corporate powers in a manner that would otherwise constitute an improper purpose. In *Japan Abrasive Materials Pty Ltd v Australian Fused Materials* (1998) 16 ACLC 1,172, the Court held that a nominee director could vote in accordance with the wishes of the nominator where that was permitted under the terms of the shareholder agreement binding the

2.95 Subject to these principles, there is case law authority that nominee directors can advance their nominator's interests provided that in so doing they have an honest and reasonable belief that they are acting consistently with the interest of their group company.[256] Nominee directors would breach their duty only if, when faced with a conflict of interest, they knowingly sacrificed their company's interests for those of their appointor.[257] The actions of nominee directors are "not reprehensible unless it can also be inferred that the directors so nominated would so act even if they were of the view that their acts were not in the best interest of the company".[258]

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relevant shareholders. Shareholders could, through unanimous consent under a shareholder agreement, attenuate the fiduciary duties that nominee or other directors of the company would otherwise owe to that company. For shareholder agreements, see also *Russell v Northern Bank Development Corp Ltd* [1992] BCC 578.

In *Berlei Hestia (NZ) Ltd v Fernyhough* [1980] 2 NZLR 150 at 165-66, Mahon J referred to attempts to bring the theoretical doctrine that directors have an undivided loyalty to their companies into harmony with commercial reality by taking the view that: "When Articles are agreed upon whereby a specified shareholder or group of shareholders is empowered to nominate its directors, then there may be grounds for saying that in addition to the responsibility which such directors have to all shareholders as represented by the corporate entity, they may have a special responsibility to those who nominated them. Such a view proceeds on the basis that the Articles were so constructed with the intent and belief that the institution of such a special responsibility towards one class of shareholders was conducive to the interests of the company as a whole.... As a matter of legal theory, as opposed to judicial precedent, it seems not unreasonable for all the corporators to be able to agree upon an adjusted form of fiduciary liability, limited to circumstances where the rights of third parties vis-à-vis the company will not be prejudiced".

256 In *Levin v Clark* [1962] NSWLR 686, Jacobs J considered that it may be in the interests of a company to have a director on the board who is nominated by, and acts in the interests of, a particular shareholder, mortgagee or creditor. The board as a whole could then arrive at decisions which may be in the company's interests through recognition of the interests of these disparate groups:

> "It is of course correct to state as a general principle that directors must act in the interests of the company … However, that leaves open the question in each case - what is the interest of the company? It is not uncommon for a director to be appointed to a board of directors in order to represent an interest outside the company, a mortgagee or other trader or a particular shareholder. It may be in the interests of the company that there will be upon its board of directors one who will represent these other interests and who will be acting solely in the interest of such a third party and who may in that way be properly regarded as acting in the interests of the company as a whole. To argue that a director particularly appointed for the purpose of representing the interests of a third party, cannot lawfully act solely in the interests of that third party, is in my view to apply the broad principle, governing the fiduciary duty of directors, to a particular situation, where the breadth of the fiduciary duty has been narrowed, by agreement amongst the body of shareholders."

In *Berlei Hestia (NZ) Ltd v Fernyhough* [1980] 2 NZLR 150 at 166, Mahon J said: "The stage has already been reached, according to some commentators, where nominee directors will be absolved from suggested breach of duty to the company merely because they act in furtherance of the interests of their appointors, provided that their conduct accords with bona fide belief that the interests of the corporate entity are likewise being advanced."

257 cf *Re Spargos Mining NL* (1991) 3 ACSR 1 and *Re Enterprise Gold Mines NL* (1991) 3 ACSR 531 where the Court held that the directors of group companies had subordinated the interests of those individual companies to the interests of the overall group. The Court reaffirmed the view that directors owed their duties to their individual companies and where there is a conflict, the interest of the individual companies must be preferred to the interest of the corporate group.

258 *Re Broadcasting Station 2GB Ltd* [1964-65] NSWLR 1648 at 1662-3.

2.96 While the above formulation probably represents the predominant view, the legal position of nominee directors is not beyond doubt, given some contradictory case law in Australia, as well as in the UK and Canada.[259] For instance, some courts have adopted strict separate legal entity principles to conclude that the overriding duty of nominee directors is to the company, not to their nominators. In the event of any conflict of interest between the company and those nominators, the nominee directors are "bound to ignore the interests and wishes of their [nominators]".[260]

Law reform options

2.97 On one view, the role of nominee directors contradicts the undivided fiduciary loyalty owed by directors to their company. The ability of nominee directors to carry out their duties in the interests of the company as a whole might be compromised by this divided loyalty. The contrary view, in the corporate group context, is that it may be in the interests of a group company to have one or more directors on the board nominated by, and acting in the interests of, the controlling, or another, group company.

2.98 Some common law countries give express legislative recognition to the dual loyalties of nominee directors. An early model, drafted by Professor Gower, a leading UK commentator on company law, states:

> "In considering whether a particular transaction or course of action is in the best interests of the company as a whole, a director, when appointed by, or as a representative of, a particular class of members, employees or creditors, may give special, but not exclusive, consideration to the interests of that class."[261]

2.99 In Australia, the dual loyalty issue was considered by the Companies and Securities Law Review Committee, which recommended legislation to clarify that in certain circumstances nominee directors may expressly have regard to the interests of their nominators without breaching their duty to the company.[262] This would reflect the commercial *raison d'être* of nominee directors, namely to protect the interests of the appointor. The proposal was relatively narrow. The protection would only apply to companies administered under a relevant shareholders' agreement or where all the shareholders of the company had given their prior informed consent. Also, that

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259 P Redmond, 'Problems for insiders' in M Gillooly (ed) *The Law Relating to Corporate Groups* (The Federation Press, 1993) 218-221, RJ Austin, 'Problems for directors within corporate groups' in M Gillooly (ed) *The Law Relating to Corporate Groups* (The Federation Press, 1993) 140 at 146, K Yeung, "Corporate groups: legal aspects of the management dilemma" [1997] *Lloyd's Maritime and Commercial Law Quarterly* 208 at 216-220.
PI Blumberg points out that US corporate law relies on the distinction between the "independent" and the "management" directors. The "independent" directors, whether or not nominee directors, have special responsibilities, particularly in cases of conflict of interest, such as takeovers. US courts have emphasised these special duties, which may include the retention of "independent" legal counsel and investment bankers at the expense of the corporation to advise and represent the "independent" directors.

260 *Bennetts v Board of Fire Commissioners of NSW* (1967) 87 WN (NSW) 307, *Kuwait Asia Bank EC v National Mutual Life Nominees* [1991] 1 AC 187 at 319-320.

261 Ghana Companies Code 1973.

262 Companies and Securities Law Review Committee Report No.8 *Nominee Directors and Alternate Directors* (1989) at 28.

protection would only extend to decisions made by directors whilst a company was solvent.

2.100 The New Zealand Companies Act gives broader protection to nominee directors by permitting the directors of a partly-owned group company to act in the interests of the controlling company where this is authorised by the company's constitution and a resolution to that effect has been passed by the shareholders.[263] Particulars of the nominee director's appointment and the extent of the interests of the nominator must be publicly disclosed.[264] This disclosure is designed for the benefit of other directors, shareholders trading in the company's shares and creditors and other persons dealing with the company.

2.101 A similar provision was contained in the initial Corporate Law Economic Reform Draft Bill (1998), with the additional requirement that the subsidiary be solvent at the time, or immediately after, the director acts. It was subsequently omitted, for further review in this Report. The provision is discussed in detail elsewhere in this Report.[265]

2.102 Another policy option would be for the Corporations Law to state specifically that nominee directors would breach their fiduciary duties to their group company by taking into account the interests of their nominators, or acting in accordance with their instructions, only where:

- in so doing they did not have a bona fide belief that they were also promoting, or acting consistently with, the interests of the group company as a whole, or
- no honest and reasonable director could have formed that belief.[266]

This would recognise and clarify the prevailing view in Australian case law, thereby overcoming residual uncertainty. It would also go further than the Companies and Securities Law Review Committee recommendations or the New Zealand provisions, to cover circumstances where there was no express provision in the company's constitution, or any relevant shareholder approval.

2.103 In US law, controlling shareholders of a company owe equitable fairness duties to minority shareholders. In the corporate group context, a parent company which is a controlling shareholder owes these duties to minority shareholders of a controlled company. If that approach were adopted in Australian law, the problem of the possible divided loyalty of nominee directors appointed by a controlling company could be resolved by permitting them to act in the interests of that controlling company, which in turn would have a "fair dealing" obligation to the minority shareholders of the group company.[267]

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263 See footnote 179.

264 New Zealand Companies Act 1993 s 140.

265 paras 2.36 ff.

266 P Crutchfield, "Nominee Directors: The Law and Commercial Reality" (1992) 20 *Australian Business Law Review* 109 at 122.

267 These "fair dealing" obligations are further discussed at paras 2.132-2.133, 3.46-3.48.

Issue 6. *Should the law be amended to clarify the fiduciary duties of nominee directors of partly-owned group companies?*

If so, should it:

- *permit nominee directors to give special, but not exclusive, consideration to the interests of the class they represent (Option A), or*
- *permit nominee directors to act in the interests of their nominators where this is authorised by the company's constitution and a resolution to that effect has been passed by the shareholders (Option B), or*
- *provide that nominee directors would breach their fiduciary duties by taking into account the interests of their nominators, or acting in accordance with their instructions, only where in so doing they do not have a bona fide belief that they are also promoting, or acting consistently with, the interests of the company as a whole, or no honest and reasonable director could have formed that belief (Option C), or*
- *impose on a parent company a fair dealing obligation to minority shareholders of a partly-owned group company in lieu of any controls over a nominee director acting in the interests of the parent company (Option D), or*
- *adopt some other approach (Option E)?*

Submissions on Issue 6

Should there be a statutory amendment?

2.104 Some submissions favoured amending the Corporations Law to clarify the fiduciary duties of nominee directors of partly-owned group companies.[268]

2.105 One respondent considered that nominee directors in joint venture companies should be required to act in the interests of the joint venture company.[269]

Terms of any statutory amendment

2.106 *Submissions supporting Option A.* One submission supported Option A.[270]

2.107 *Submissions supporting Option B.* One submission supported Option B, with the clarification, as found in the New Zealand legislation, that the parent company cannot vote on the shareholder resolution.[271]

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268 Australian Accounting Research Foundation, AMP (Group), AMPAM, Australian Corporate Lawyers Association, Australian Institute of Company Directors, QBE Insurance Group Ltd, Chris Sotiropoulos.

269 Lend Lease.

270 Chris Sotiropoulos.

2.108 Another submission considered that Option A seems to erode the fundamental features of corporate structure and governance, namely the distinction between shareholders and management.[272] That respondent also said that any provision pursuant to Option C would need to take into account the proposed business judgment rule, which should apply consistently to all directors, whether nominee or independent. The respondent therefore favoured Option B, provided that particulars of each nominee director's appointment and the extent of the interests of the nominator are publicly disclosed. This disclosure would benefit fellow directors, current and prospective shareholders, creditors, co-venturers and others dealing with the company in any relevant capacity.

2.109 *Submissions supporting Option C.* Various submissions supported Option C.[273] However, some of these respondents,[274] while taking the view that Option C was the best approach if it was thought necessary to clarify the law, nevertheless considered reform unnecessary, arguing that:

- the courts have generally been able to apply the existing law to produce the right result
- the contrasting authorities cited in the *Corporate Groups Discussion Paper* appear to go to matters of emphasis
- a statutory provision would inject a new element of uncertainty, no matter how carefully it is drafted
- it is not clear that any uncertainty is causing difficulty in business life, especially in view of the ability of companies to vary the duties by amending their constitution or by unanimous shareholder agreement.

2.110 Another submission that favoured Option C considered Option B too limiting and the US law (Option D) too incompatible with Australian law.[275]

2.111 One of the submissions supporting Option C suggested that the option might be stated as a replaceable rule, to allow shareholders to place additional restrictions on how a nominee director discharges his or her responsibilities.[276]

2.112 *Submissions supporting Option D.* No submissions supported Option D.

2.113 *Submissions supporting Option E.* No submissions suggested any alternative approach.

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271 Australian Institute of Company Directors.

272 Australian Corporate Lawyers Association.

273 Australian Accounting Research Foundation, AMPAM, Law Council of Australia, QBE Insurance Group Ltd, Jon Webster.

274 Law Council of Australia, Jon Webster.

275 QBE Insurance.

276 Australian Accounting Research Foundation.

Advisory Committee response to submissions on Issue 6: Draft Recommendation 6

2.114 Consistently with the Advisory Committee's views expressed in the discussion leading up to Recommendation 5, there should be no separate codification of the fiduciary duties of nominee directors. The fiduciary duties of these directors should not differ from those of other directors. Any modification of the fiduciary duties of nominee directors may also give them a legal advantage over other directors. Furthermore, to create a statutory "safe harbour" under any of the options set out in Issue 6 may be inappropriate in particular cases. Accordingly:

The Corporations Law should not contain specific provisions dealing with the fiduciary duties of nominee directors of partly-owned group companies. These directors should be subject to the same fiduciary duties as all other company directors.

Submissions on Draft Recommendation 6

2.115 Respondents supported the Draft Recommendation.[277]

Advisory Committee response to submissions on Draft Recommendation 6

2.116 The Advisory Committee maintains the approach in the Draft Recommendation.

Recommendation 6

The Corporations Law should not contain specific provisions dealing with the fiduciary duties of nominee directors of partly-owned group companies. These directors should be subject to the same fiduciary duties as all other company directors.

Nominee directors passing on information

Current law

2.117 The Corporations Law and the common law prohibit directors from improperly using information acquired by virtue of their position to "gain an advantage for themselves or someone else or cause detriment to the corporation".[278] The prohibition raises the issue of what restrictions are imposed on nominee directors, or persons who are directors of more than one group company, in passing information that they have received as directors of one group company to another group company.

2.118 Disclosure of corporate information to another group company may be permitted by express agreement. A company's constitution or specific shareholder approval (for instance, through a separate shareholders' agreement involving all shareholders) could define or modify the scope and nature of the fiduciary duties

277 Australian Institute of Company Directors, Australian Society of Certified Practising Accountants.

278 s 183.

owed by particular directors, including permitting them to disclose information to another group company.[279]

2.119 Under current law, a board of directors may lawfully authorise a director to disclose confidential information to another company provided it does so on a case by case basis.[280] Conversely, a board may withhold certain information from a particular director if that director would use that information in a manner contrary to the interests of the company, for instance, by passing it to a nominator who is a direct competitor.[281]

2.120 In the absence of express agreement or authorisation, the problem remains of whether it is appropriate for nominee directors or other directors of more than one group company to disclose information. In many instances, it may be in the commercial interests of a group company that its directors pass on relevant information to another group company. That information may enable the latter group company to provide appropriate advice and financial support to the first group company. However, a conflict of interest issue may arise where, for instance, a director of one group company proposes to pass on confidential price-sensitive information or commercial opportunity information, with the intention or knowledge that the recipient group company or some other group company, rather than the first group company, will utilise that price-sensitive information or opportunity.

2.121 In determining the current legal position of these directors, a distinction might be drawn between a director who is also a director of the group company that would receive the information (director of both group companies) and a nominee director who is not a director of the recipient group company (director of one group company). An example of the latter would be an employee of a holding company who is nominated to the board of a partly-owned group company.

Director of both group companies

2.122 These directors may be faced with conflicting fiduciary duties, namely a duty of confidentiality to the first group company and a duty of disclosure to the second group company.

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279 See para 2.94.

280 A blanket authorisation by the board permitting disclosure could constitute an improper exercise of that board's power by unduly fettering the proper exercise of its discretion.

281 In *Berlei Hestia (NZ) Ltd v Fernyhough* [1980] 2 NZLR 150, the Court held that the board of directors could exclude a nominee director appointed by a direct competitor from access to corporate information only where it could be proved that the nominee director intended to pass that information to that competitor.
In *Bennetts v Board of Fire Commissioners of NSW* (1967) 87 WN (NSW) 307, the Court held that the board could refuse to disclose corporate information to a particular nominee director, given that the nominee had admitted his intention to pass the information on to his nominator, and that disclosure would be detrimental to the community interest which the board was established to serve.
The general principles governing a director's right of access to corporate information, including the director's right of access to financial records under s 290, and the restrictions that might apply where conflicts of interest arise, are further discussed in HAJ Ford, RP Austin & IM Ramsay, *Ford's Principles of Corporations Law* (loose leaf, Butterworths) at [10.410]. Section 198F gives directors enhanced rights of access to the books of a company in the context of litigation involving that director.

2.123 One view is that the duty to keep information of the first group company confidential overrides any duty to communicate information to the second group company.[282]

2.124 A contrary view is that both a duty of confidentiality and a duty to communicate should remain, notwithstanding that this may create conflicting obligations for a director.[283] The relevant case law does not deal explicitly with the

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282 In *Bennetts v Board of Fire Commissioners of NSW* (1967) 87 WN (Pt 1) (NSW) 307 at 310, the Court stated: "In particular, a Board member must not allow himself to be compromised by looking to the interests of the group which appointed him rather than to the interests for which the Board exists. He is most certainly not a mere channel of communication or listening post on behalf of the group which elected him. There is cast upon him the ordinary obligation of respecting the confidential nature of Board affairs where the interests of the Board itself so require."

Likewise, in *Harkness v Commonwealth Bank of Australia Ltd* (1993) 12 ACSR 165 at 177, the Court said: "While ordinarily there will be a duty to communicate knowledge received, where the director is functioning within another corporate organisation and information comes to the director in the course of that work with the other organisation, his duty of confidentiality to that other organisation will subsume any duty he might otherwise owe to the company which appointed him to that organisation."

283 In *Byrnes v The Queen* (1995) 17 ACSR 551, the High Court was unwilling to relieve directors of one of their fiduciary duties merely because they were in a position of conflict in relation to another fiduciary duty. The Court stated that: "a company is entitled to the unbiased and independent judgment of each of its directors. A director of a company who is also a director of another company may owe conflicting fiduciary duties" (at 562).

In *Fitzsimmons v R* (1997) 23 ACSR 355, a director of two arm's length companies held information as a director of the first company, which was material to a proposed transaction with the second company. The other directors of the second company were not given that information by the director. The Court held that the director was not relieved from his fiduciary duty of honesty to the second company by the duty of confidentiality that he owed to the first company. The Court did not determine how a director could resolve these conflicting fiduciary duties. It merely concluded (at 359) that:

> "It may not be enough for the director simply to refrain from voting or even to absent himself or herself from the meeting during discussion of the impugned business. The circumstances may require the director to take some positive action to identify clearly the perceived conflict and to suggest courses of action to limit the possible damage.
>
> It is not for [the Court] to say what [the defendant director] should have done to avoid a breach of duty. There may have been some disclosure or recommendation that he could have made, short of resignation, that might have complied with his obligations to [the second company] without infringing the duty of confidentiality that he owed to [the first company]. … The mere fact that he owed conflicting duties did not render him immune from the consequences of breach of those duties to one or other of the companies."

The Court noted (at 364) that the director's difficulty arose when he was also appointed a director of the second company shortly before the transaction was entered into and that he "could have avoided it entirely by refusing appointment [to the second board] when it must have been obvious that the conflict of interest loomed".

Professor R Baxt in his Paper for a CLERP Conference (9 September 1997) was critical of this approach:

> "The solutions provided by the courts in this context are not always commercial in my view. It would be ridiculous if all directors who faced a potential conflict [had] to resign and yet, that may be the only solution in some of those situations. Even full disclosure may not be enough. … It was suggested … that the director may be faced with a decision of whether he should have accepted the position in the first place! That again would result in an almost impossible position for commerce."

passage of information within corporate groups. It therefore remains uncertain how these conflicting duties will be resolved for directors of various group companies.

Director of one group company

2.125 In this situation, the director is under a duty of confidentiality to the first group company, but, at most, would be subject to an expectation (or private arrangement) concerning the passing of information to the second group company. In principle, the duty of confidentiality should override that expectation. However, there is no case law directly on the point.

Law reform options

2.126 The current law may pose some impediments to the flow of information within partly-owned corporate groups, though it is unclear how often this problem of conflicting fiduciary duties has arisen in practice. Any law reform proposal would need to balance the benefits to the corporate group collectively of unimpeded internal disclosure against the detriment that might be suffered by minority shareholders of a partly-owned group company in having its confidential or otherwise commercially valuable information made available to another group company.

2.127 There are various ways that the Corporations Law might ensure that nominee directors or directors of more than one group company are not faced with irreconcilable legal or practical conflicts. In principle, it could provide that:

- the duty or expectation to disclose overrides the duty of confidentiality, or conversely
- the duty of confidentiality overrides the duty or expectation to disclose.

Within that context, the legislation could permit the board of directors of the company holding the information either to prohibit the disclosure (in the first instance) or permit the disclosure (in the second instance). Prohibiting disclosure in any of these circumstances also raises the prospect of the recipient group company being potentially liable as a constructive trustee if it receives and acts on information that it knows is provided by the director in breach of an overriding duty of confidentiality.[284]

2.128 The New Zealand Companies Act 1993 permits a nominee director to pass on corporate information to the nominator in some circumstances. It states:

> "145(1) A director of a company who has information in his or her capacity as a director or employee of the company, being information that would not otherwise be available to him or her, must not disclose that information to any person, or make use of or act on the information, except -
>
> (a) for the purpose of the company; or
>
> (b) as required by law; or

[284] Compare footnote 533.

(c) in accordance with subsection (2) or subsection (3) of this section".

"145(2) A director of a company may, unless prohibited by the board, disclose information to -

(a) a person whose interests the director represents; or

(b) a person in accordance with whose directions or instructions the director may be required or is accustomed to act in relation to the director's powers and duties and, if the director discloses the information, the name of the person to whom it is disclosed must be entered in the interests register."

"145(3) A director of a company may disclose, make use of, or act on the information if -

(a) particulars of the disclosure, use, or the act in question are entered in the interests register; and

(b) the director is first authorised to do so by the board; and

(c) the disclosure, use, or act in question will not, or will not be likely to, prejudice the company."

2.129 The effect of s 145(2) is that it permits a nominee director to disclose information to the nominator, unless prohibited by the nominee director's board. However, the wording of s 145(2)(a) may cover a much broader range of persons than a director's nominator. In all other circumstances, s 145(3) applies.[285]

2.130 The New Zealand provision does not explicitly resolve the problem of competing duties if the board of the nominee director's company prohibits the disclosure. One possibility would be to state explicitly that the prohibition extinguishes any right or duty to communicate the information to the nominee director's nominator.

2.131 An alternative, and less prescriptive, approach than the New Zealand legislation might be to permit a director of a subsidiary company to disclose confidential information of that company to the parent company and to permit the latter company to act on that information where that disclosure and response would not be likely to cause material prejudice to the subsidiary company.

2.132 Another policy option would be to focus on the relationship between partly-owned group companies and their controlling shareholders, rather than on the fiduciary duties of nominee directors. This approach could be derived from the *Principles of Corporate Governance* of the American Law Institute (ALI), which provide that a controlling shareholder (a parent company in the context of corporate groups) may not use corporate information of a partly-owned group company unless:

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[285] This interpretation is based on the terms of s 145(1)(c) which refers to disclosure "in accordance with subsection (2) *or* subsection (3) of this section".

- value is given for the use and the transaction meets standards of fair dealing,[286] or
- any resulting benefit to the parent company is made proportionately available to minority shareholders of that partly-owned group company or is not otherwise unfair to those shareholders.[287]

2.133 The principle underlying the ALI's approach is that the sharing of confidential corporate information within a corporate group should not create a conflict of interest between the controlling company and the controlled company, provided any benefits flowing to the controlling company are either properly compensated for, or shared proportionately with, the minority shareholders of the controlled company. This approach recognises both the community of interests between companies within a corporate group and also the rights of minority shareholders within that group.

2.134 Another view is that the problem of conflicting fiduciary duties can best be dealt with, not by legislative amendment, or adoption of the ALI's *Principles of Corporate Governance*, but by leaving it to directors to avoid placing themselves in this position of conflict.

Issue 7. *Should the Corporations Law be amended to provide specifically that:*

- *a duty of a nominee director of a company to disclose information to the director's nominator overrides the director's duty of confidentiality to the company (option A), or conversely*
- *the director's duty of confidentiality overrides the duty to disclose (option B)?*

If option A is adopted, should the board of directors of the company holding the information have the right to prohibit the disclosure? Should the provision be based on the New Zealand Companies Act 1993 s 145 or a less prescriptive approach?

If option B is adopted, should the board of directors of the company holding the information have the power to permit the disclosure?

What rule should apply where there is merely an expectation that the nominee director will disclose information to the director's nominator, but no duty to disclose?

As an alternative to either option A or option B:

- *should a director of a subsidiary company be entitled to disclose confidential information to the parent company, and the parent company be permitted to act on that information, where to do so*

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286 See paras 3.46-3.48.

287 American Law Institute, *Principles of Corporate Governance* (ALI, 1994), §5.11 at 333.

would not be likely to cause material prejudice to the subsidiary company, or

- *should a parent company be subject to a fair dealing obligation to minority shareholders of a partly-owned group company, in lieu of any other controls over its use of information held by that group company?*

Submissions on Issue 7

Support for Option A

2.135 Some submissions supported Option A.[288] The duty to disclose should be balanced by a clear obligation on the parent company not to disclose the information that it has received.

Support for Option B

2.136 Some submissions supported Option B,[289] as:

- it would avoid problems with disclosure issues[290]
- Option A could prejudice the interests of the company holding the confidential information.[291]

2.137 One respondent considered that those members of the board of directors of the company holding the information who are not associated with the nominator should have the power to permit disclosure.[292]

Alternatives to Option A or Option B

2.138 Some other submissions preferred that this matter be dealt with by the courts rather than by legislative amendment.[293] One of these submissions preferred Option A if there were to be legislative amendment, provided the company has a right to prohibit disclosure to the nominator either generally or specifically.[294] This respondent said that this is very similar to the current law, once account is taken of the ability to modify the fiduciary duties.

2.139 Another respondent preferred the American Law Institute's fair dealing obligation to either Option A or Option B, as the law should place few restrictions on

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288 Australian Institute of Company Directors, Lend Lease (at least in relation to joint venture companies), QBE Insurance Group Ltd (however, this submission considered the New Zealand approach too prescriptive).

289 AMP (Group), AMPAM.

290 AMP (Group).

291 AMPAM.

292 Carter Holt Harvey Limited.

293 Law Council of Australia, Jon Webster.

294 Law Council of Australia.

directors of intra-group controlled companies passing on information if a single enterprise approach is adopted.[295]

Advisory Committee response to submissions on Issue 7: Draft Recommendation 7

2.140 Neither Option A nor Option B, nor any of the other alternatives to which Issue 7 refers, may be suitable as a general rule for all circumstances.

2.141 The current fiduciary principles, as analysed in the *Fitzsimmons* case,[296] are designed to deter directors from putting themselves in a position of conflict of interest in the first place. The law should not be changed to try to assist those directors who nevertheless put themselves in that position. Accordingly:

All directors should remain subject to fiduciary duties both of confidentiality and of disclosure. The Corporations Law should not attempt to resolve the conflict that a director of two or more companies might face between the fiduciary duty of confidentiality to one company and the fiduciary duty of disclosure to another company.

Submissions on Draft Recommendation 7

2.142 Respondents supported the Draft Recommendation.[297]

Advisory Committee response to submissions on Draft Recommendation 7

2.143 The Advisory Committee maintains the approach in the Draft Recommendation.

Recommendation 7

All directors should remain subject to fiduciary duties both of confidentiality and of disclosure. The Corporations Law should not attempt to resolve the conflict that a director of two or more companies might face between the fiduciary duty of confidentiality to one company and the fiduciary duty of disclosure to another company.

Liability of nominators

Current law

2.144 A nominator may be held liable for the acts of nominee directors that are detrimental to either the company or an outside third party on a number of grounds, including:

- liability as a shadow director

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295 Australian Accounting Research Foundation.

296 *Fitzsimmons v R* (1997) 23 ACSR 355.

297 Australian Institute of Company Directors, Australian Society of Certified Practising Accountants.

- vicarious liability
- accessorial liability.

Liability as a shadow director

2.145 A nominator may be a "shadow director" of a company to which it has appointed nominee directors, and therefore itself be liable as a director.[298] A shadow director is any person in accordance with whose "instructions or wishes" the directors of the body are accustomed to act.[299]

2.146 The UK Cork Committee considered difficulties in applying a shadow director test to groups of companies.[300] It noted that the usual test does not state the frequency with which instructions must be provided. Also, it may be difficult to prove that instructions had been given or other means used to ensure the compliance of the company. The Committee recommended that a parent company should be presumed, in the absence of evidence to the contrary, to be a shadow director of any company where a majority of directors were its nominees, or the boards of the two companies consisted substantially of the same persons.[301] This proposal was not implemented in the UK legislation.

2.147 In Australian corporate law, the mere fact that a person appoints one or more nominee directors is not enough to make that person a shadow director. Rather, the nominator must have exercised influence over at least a majority of the board or the director to whom the board has delegated the relevant power. It must be established that the board or the delegated member regularly (though not invariably) acted in accordance with the nominator's instructions or wishes, although these need not take the form of express or formal instructions, or embrace all matters involving the board.[302]

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298 For instance, under s 180 or s 588G.

299 s 9 definition of "director".

300 *Insolvency Law and Practice: Report of the Review Committee*, Cmnd 8558 (HMSO 1982) (the Cork Committee Report).

301 Id at Chapter 52, para [1937].

302 In *Standard Chartered Bank of Australia Limited v Antico* (1995) 18 ACSR 1, the Supreme Court of New South Wales held that the mere fact that the first company held, through two of its wholly-owned subsidiaries, 42% of the voting shares of the second company and also had three nominee directors out of a total of 11 board members of the second company did not suffice to make the first company a shadow director of the second company. However, the Court noted additional factors, such as the high degree of management and financial control exercised by the first company over the second company, which did indicate that the first company effectively controlled the second company and could therefore be regarded as its shadow director. All of these factors showed a "willingness and ability to exercise control, and an actuality of control, over the management and financial affairs of [the second company]" (at 70).
In *ASC v AS Nominees Ltd* (1995) 18 ACSR 459 at 509, Finn J held that the statutory reference to a person in accordance with whose directions or instructions the directors are accustomed to act, "does not … require that there be directions or instructions embracing all matters involving the board. Rather it only requires that, as and when the directors are directed or instructed, they are accustomed to act as the section requires". [See now s 9 definition of "director" which refers to instructions or wishes.]
For further discussion of these cases and other cases relevant to corporate groups, including *Harris v S* (1976) 2 ACLR 51, *Kuwait Asia Bank EC v National Mutual Life Nominees* [1991]

Vicarious liability

2.148 Some recent UK and New Zealand case law supports the principle that a parent company can be vicariously liable for the negligence of its nominee directors whom it has appointed to its group companies.[303] This matter has not been directly decided by

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1 AC 187, *Re Hydrodam (Corby) Limited* [1994] BCC 161, *Bluecorp Pty Ltd (in liq) v ANZ Executors and Trustee Company Ltd* (1994) 13 ACSR 386 and *Dairy Containers Ltd v NZI Bank Ltd* (1995) 13 ACLC 3,211, and some remaining issues on the interpretation of the shadow director provision, see P Koh, "Shadow Director, Shadow Director, Who Art Thou?" (1996) 14 *Company and Securities Law Journal* 340, M Markovic, "The Law of Shadow Directorships" (1996) 6 *Australian Journal of Corporate Law* 323, K Yeung, "Corporate groups: legal aspects of the management dilemma" [1997] *Lloyd's Maritime and Commercial Law Quarterly* 208 at 228-233, R Carroll, "Shadow Director and Other Third Party Liability for Corporate Activity" in I Ramsay, *Corporate Governance and the Duties of Company Directors* (Centre for Corporate Law and Securities Regulation, 1997) 162 at 174-183, M Hobson, "The Law of Shadow Directorships" (1998) *Bond Law Review* vol 10 No 2 184. Note, however, that all these articles refer to the pre-March 2000 test of shadow directors, which referred to a person acting under "instructions or directions", rather than "instructions or wishes".

J Farrar, "Legal Issues Involving Corporate Groups" (1998) 16 *Company and Securities Law Journal* 184 at 188 provides the following summary of the relevant principles concerning the test of shadow director:

- "there must be some intention by the shadow director to exert control, although it is unnecessary to establish actual directions issued to the board
- it will probably be sufficient if a majority of the board are accustomed to act in accordance with the directions or instructions
- the fact that the directors follow the advice of a person does not necessarily establish a shadow directorship if the advice is given by the person in the proper performance of the functions attaining to a professional capacity or to the person's business relationship with the directors of the company. The scope of the latter is uncertain, especially in relation to group management arrangements."

303 In *Dairy Containers Ltd v NZI Bank Ltd* (1995) 13 ACLC 3,211, Thomas J (although he felt bound by the decision of the Privy Council in *Kuwait Asia Bank EC v National Mutual Life Nominees Ltd* [1991] 1 AC 187 that a nominator was not vicariously liable for the acts of its nominee directors) considered that the recognition in the case law that nominee directors owe loyalty to their nominator as well as their company supports imposing vicarious liability on the nominator. He referred (at 3244) to "the commercial futility of endeavouring to construct a company structure divorced from the underlying economic reality of nominee or employee-directors and their principals or employers. Recognising the economic reality of employee-directors and their employers requires that those who employ employees as directors to represent their interests accept responsibility for their resulting conduct. …There is no reason in principle why employers should be exempt from liability for the negligent acts of their employees whom they have required to act as directors to protect and promote their interests. The measure of real control exercised by the employer should be recognised in law. It carries with it a responsibility and that responsibility should, in the event of a default on the part of the company they control through their employees, be exposed to the potential of vicarious liability.'

Virtually contemporaneously (11 days) with the decision in *Dairy Containers Ltd v NZI Bank Ltd* (1995) 13 ACLC 3,211, the Privy Council in *New Zealand Guardian Trust Co Ltd v Brooks* [1995] BCC 407 at 410 ruled that a company may be vicariously liable for the negligence of its directors. The case did not deal specifically with the position of nominee directors. However, the Privy Council sought to read down its earlier decision in *Kuwait Asia Bank EC v National Mutual Life Nominees Ltd* [1991] 1 AC 187, stating that '…in the present case the fact that [the nominator] may not itself have owed any duty of care to [the company to which the nominee directors had been appointed] in relation to the preparation of the certificates does not necessarily mean that it cannot be liable for the negligence of its directors acting within the scope of their authority'.

an Australian court, and relevant case law is divided.[304] However, according to one commentator, “There is no compelling reason in principle for excluding adoption of vicarious liability in the context of nominee directors.”[305] A nominator could be fixed with liability for the negligence or other wrongful act of its nominee director if that wrongdoing occurred within the course of the nominee director’s employment by the nominator.[306]

2.149 A nominator may be vicariously liable for a single breach by a nominee director, whereas under shadow director liability (see above) there must be evidence that the board has acted regularly in accordance with the nominator’s directions.

Accessorial liability

2.150 The Corporations Law sets out the circumstances in which any person (including a nominator) will be held to have been involved in a contravention.[307] In addition, in the context of corporate groups, a nominator (and possibly the directors of that nominator) may be liable as an accessory for breach of fiduciary duty if that person knowingly or recklessly assists in or procures a breach of trust or fiduciary duty by a nominee or other director of a group company.[308] Also, “the liability attaching to persons who knowingly assist in a breach of fiduciary duty should be of particular concern to companies where their directors are capable of being attributed with knowledge about the affairs of one company by virtue of their directorship in another company; that is, their common directorship”.[309]

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304 In *Young v Murphy* (1994) 13 ACSR 722 at 749-750, the Court assumed, without discussion, that an appointor may be vicariously liable for the wrongdoing of its nominee directors. Compare *Standard Chartered Bank of Australia Ltd v Antico* (1995) 131 ALR 1 and *Schwarz v South Australia Public Service Savings and Loans Society Ltd* (Federal Court 16 September 1994). These cases are discussed in J Pizer, “Holding an Appointor Vicariously Liable for its Nominee Director’s Wrongdoing - an Australian Roadmap” (1997) 15 *Company and Securities Law Journal* 81 at 87-88.

305 J Pizer, id at 94. A more critical view is taken by K Yeung, “Corporate groups: legal aspects of the management dilemma” [1997] *Lloyd’s Maritime and Commercial Law Quarterly* 208 at 250 who argues that “nevertheless, *Kuwait* remains authoritative: nominee status alone will not be sufficient to render the appointor of a nominee director liable for the latter’s negligence. If a parent company could be vicariously liable for the negligence of its employee directors, the consequences would be far-reaching. This would cut across the limited liability principle, hitherto regarded as fundamental”.

306 The elements necessary to establish vicarious liability are discussed in detail by J Pizer, id.

307 s 79.

308 *ASC v AS Nominees* (1995) 18 ACSR 459 at 475-476. In that case, the Court held that the directors of a parent company may be liable to investors in relation to the products marketed by a group company (in this case unit trust and superannuation products) if the directors of the parent company knowingly or recklessly assisted the group company to breach its duty.

309 R Carroll, “Shadow Director and Other Third Party Liability for Corporate Activity” in I Ramsay, *Corporate Governance and the Duties of Company Directors* (Centre for Corporate Law and Securities Regulation, 1997) 162 at 173.

Law reform options

2.151 This Report has elsewhere discussed the dual loyalties of nominee directors and whether any change to the existing law is necessary.[310] The appropriate basis of liability of nominators for the actions of their nominees is a related issue.

2.152 One option would be to rely solely on the current grounds of liability, regardless of any change to the law regulating the duties of nominee directors.

2.153 Another possibility would be to provide that, in return for permitting nominee directors to have greater regard to the interests of their nominators, those nominators should be subject to vicarious civil liability.[311] That civil liability could apply for any action of a nominee director in conducting the company's affairs, on the reasoning that the nominee is, in effect, in a similar position to an agent. This option would impose automatic vicarious liability but might be criticised as being too wide.

2.154 Another approach would be to impose vicarious civil liability only for some actions of a nominee director, for instance where:

- the director acted in accordance with any instructions or wishes of the nominator, whether or not this satisfied the shadow director test. This option would limit vicarious liability, but could raise difficulties in proving the existence of instruction or wishes, and/or

- the director acted pursuant to the proposal that a director of a partly-owned group company may act in the interests of the holding company.[312]

2.155 Another policy option would be to adopt the US approach of imposing a direct "fair dealing" obligation on a controlling company, rather than seeking to impose liability indirectly on that company through the actions of any of its nominee directors.[313] The content of this "fair dealing" obligation is outlined elsewhere in this Report.[314]

Issue 8. *Should the nominators of nominee directors have vicarious civil liability for all the actions of those directors?*

Alternatively, should those nominators have vicarious civil liability for some actions of their nominee director, for instance where:

- *the director acted in accordance with any instructions or wishes of the nominator and/or*

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310 paras 2.94 ff.

311 An argument for imposing vicarious liability on nominators of nominee directors was put forward by Thomas J (the judge in *Dairy Containers Ltd v NZI Bank Ltd* (1995) 13 ACLC 3,211) in "The Role of Nominee Directors and the Liability of their Appointors" in I Ramsay, *Corporate Governance and the Duties of Company Directors* (Centre for Corporate Law and Securities Regulation, 1997) 148 ff.

312 See Recommendation 3.

313 Refer to para 2.103.

314 paras 3.46-3.48.

- *the director acted pursuant to the proposal that a director of a partly-owned group company may act in the interests of the holding company?*

Alternatively, should a parent company have a fair dealing obligation to minority shareholders of a partly-owned group company in lieu of imposing any civil liability on that parent company for the actions of any of its nominee directors?

Submissions on Issue 8

Imposing vicarious civil liability on nominators

2.156 *Support.* One submission supported liability of appointors for acts of their nominee directors.[315]

2.157 *Opposed.* Most submissions opposed any vicarious civil liability for nominators.[316] One respondent argued that the law should not be amended in the absence of any case law on the matter.[317]

Fair dealing obligation

2.158 *Support.* One submission tentatively favoured a fair dealing obligation on a parent company rather than that company being exposed to vicarious civil liability for the actions of any of its nominee directors.[318] However, that respondent expressed reservations even about a fair dealing obligation.

2.159 *Opposed.* Some submissions opposed a fair dealing obligation,[319] for the following reasons.

- It would be likely to lead to complexity and litigation. "There is a risk that a liquidator of a company will, as a matter of course, and irrespective of the merits of the claim, attempt to assert that the actions of a nominee director have contributed to the liquidation of the company and that therefore the nominating shareholder should be liable to some degree."[320]

- The existing oppression remedy is sufficient.[321]

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[315] QBE Insurance.

[316] AMP (Group), AMPAM, Australian Institute of Company Directors, Carter Holt Harvey Limited, Law Council of Australia, Lend Lease, Jon Webster (though the Law Council and Jon Webster said that vicarious liability of nominators may need to be considered if there is any change to the law relating to the duties of nominee directors).

[317] Law Council of Australia.

[318] Australian Institute of Company Directors.

[319] Carter Holt Harvey Limited, Law Council of Australia.

[320] Carter Holt Harvey Limited.

[321] ss 232-235. The Law Council of Australia referred to the decision in *Scottish Co-Operative Wholesale Society Ltd v Meyer* [1959] AC 327, where Viscount Simonds stated that when a subsidiary company is formed with an independent minority of shareholders, the parent company is obliged so to conduct its own affairs as to deal fairly with its subsidiary. The statutory

Advisory Committee response to submissions on Issue 8: Draft Recommendation 8

2.160 The submissions put forward strong reasons why there should be no vicarious civil liability on nominators or fair dealing obligation on parent companies. Accordingly:

Nominators of directors of group companies should not be vicariously liable for the actions of their nominees, except under existing principles, including any liability as "shadow directors". Also, a parent company should not have a fair dealing obligation to minority shareholders of a partly-owned group company.

Submissions on Draft Recommendation 8

2.161 Respondents supported the Draft Recommendation.[322]

Advisory Committee response to submissions on Draft Recommendation 8

2.162 The Advisory Committee maintains the approach in the Draft Recommendation.

Recommendation 8

Nominators of directors of group companies should not be vicariously liable for the actions of their nominees, except under existing principles, including any liability as "shadow directors". Also, a parent company should not have a fair dealing obligation to minority shareholders of a partly-owned group company.

Dissenting directors

Current law

2.163 The previous sections of this Chapter have focused on various problems that directors of group companies may encounter in balancing their fiduciary loyalty obligations to their group companies against the commercial and financial interests of the group collectively and their group nominators.

2.164 A different problem concerns the limited options available to company directors to explain why they dissent from board decisions. In the context of corporate groups, this problem could arise, for instance, for directors of group companies who dissent from board decisions to enter into intra-group financial transactions which they consider provide little or no direct or derivative benefit to those group companies.

derivative action in the Corporations Law will also provide further protection for minority shareholders.

322 Australian Institute of Company Directors, Australian Society of Certified Practising Accountants.

2.165 Company directors owe duties of confidentiality to their company. They are under an obligation of confidence concerning any information they obtain in their position as director. That obligation remains whether or not they resign from that position.[323]

2.166 Given these duties of confidentiality, dissenting directors are restricted in their ability to publicly disclose the nature of, and reasons for, their concerns, whether or not they resign from the board. They may provide ASIC with information about any perceived fraud or other wrongdoing, though these details are not publicly available.[324] Alternatively, or additionally, dissenting directors could specify their concerns in the directors' minutes. These minutes are not available for inspection by shareholders as of right, though individual shareholders could seek a court order for access to them, provided they act in good faith and for a proper purpose.[325] In other circumstances, dissenting directors may be unwilling to disclose to shareholders the reasons for their concern or resignation, given their confidentiality obligation and the possibility of being sued for defamation. This lack of explanation could adversely affect the interests of some shareholders, for instance minority shareholders of a partly-owned group company.

Law reform options

2.167 Any reform initiative in the context of corporate groups, or companies generally, must seek to balance two competing objectives, namely:

- to appropriately protect corporate information and the reputation of directors, and
- to properly inform shareholders about the possible implications for them of particular board decisions.

2.168 One policy option would be to provide directors with qualified privilege for any public statement they might make in resigning from the board, given the

323 See generally HAJ Ford, RP Austin & IM Ramsay, *Ford's Principles of Corporations Law* (loose leaf, Butterworths) at [9.210].

324 ASIC Policy Statements 47 and 103. Any person who provides information to ASIC pursuant to the Commission's exercise of its statutory investigative powers is protected from any consequential civil liability in making that disclosure: Australian Securities and Investments Commission Act 1989 s 92.

325 s 247A. Applicants do not lack good faith and a proper purpose merely because they are hostile to the directors. An example of a proper purpose is where the inspection is sought pursuant to a reasonable suspicion that directors have breached their duties: *Humes Ltd v Unity APA Ltd* (1987) 11 ACLR 641, *Barrack Mines Ltd v Grants Patch Mining Ltd (No 2)* (1987) 12 ACLR 630.
A court has powers under s 247B to make various orders, including limiting the use that a person who inspects books may make of information obtained during that inspection.
The general principles applicable to a court order for inspection under those provisions are further discussed in HAJ Ford, RP Austin & IM Ramsay, *Ford's Principles of Corporations Law* (loose leaf, Butterworths) at [10.420]-[10.440]. In addition, under s 247A(3)-(5), any person who has applied, or is eligible to apply, for leave, or who has been granted leave, to bring or intervene in derivative proceedings under ss 236-242 (Proceedings on behalf of a company by members and others) may apply to the court to inspect company records. Those records could include the directors' minutes.

significance of that decision. The legislation could specify that qualified privilege in this context protects a director from breach of confidentiality or liability in defamation, in the absence of malice.[326] A similar qualified privilege could be extended to the remaining directors in any public response they might provide to the dissenting directors' statement.

2.169 An argument for granting qualified privilege is that shareholders may be better informed and therefore better able to protect their interests. The contrary argument is that a company's commercial reputation and share price could unduly suffer as a result of incorrect allegations of a dissenting director, even though they might be reasonably and honestly believed.

Issue 9. *Should directors have qualified privilege for any public statement they might make in resigning from the board? Also, should the remaining directors have a similar qualified privilege in any public response they might provide to the dissenting directors' statement?*

Submissions on Issue 9

Support

2.170 Some submissions supported qualified privilege for both resigning directors and remaining directors,[327] for the following reasons.

- Given the responsibility of corporate institutions to contribute to social and economic cohesion and development within the broader community, robust debate on matters of corporate governance and strategies should be allowed, without the threat of legal sanctions stifling discussion or opposition around the board table.[328]

- Qualified privilege would benefit shareholders, for instance by permitting a director who honestly believes that a majority of the board has clearly acted beyond its powers or against shareholders' interests to disclose that fact without exposure to personal liability.[329]

- The fact that the privilege will not be absolute should limit false or reckless statements.[330]

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326 Compare s 89. That section defines malice as including ill will to the person concerned or any other improper motive. A lack of honest belief in the truth of what is disclosed, or recklessness as to its truth, is generally conclusive evidence of malice. At common law, a party claiming malice must lead evidence capable of giving rise to a reasonable and definite inference of malice: see further *Australian Corporation Law: Principles and Practice* (loose leaf, Butterworths) Vol 3 [15.1.0025] Annotation 20.

327 Australian Accounting Research Foundation, Australian Corporate Lawyers Association, Australian Institute of Company Directors, Australian Shareholders' Association Ltd Melbourne, QBE Insurance Group Ltd.

328 Australian Corporate Lawyers Association.

329 Australian Shareholders' Association Ltd Melbourne, QBE Insurance Group Ltd.

330 QBE Insurance Group Ltd.

- Given that the resignation of a director might be expected to have a material effect on the price or value of securities, wider public disclosure of the reasons for resignation is justified.[331]

Opposed

2.171 Some submissions opposed any qualified privilege,[332] for the following reasons.

- The confidentiality of the company's information and the reputation of the other directors could be unjustly put at risk where a director objects to a transaction for irrational reasons.[333]
- If the director is sufficiently well-respected, resignation of itself usually sends a strong message to the market and shareholders.[334]
- The current law does not prevent a director from making general public statements indicating his or her reasons for dissent and resignation, provided those statements do not breach any confidence or defame.[335]
- A dissenting director may have his or her dissenting view recorded in the minutes of the directors' meetings.[336]

Undecided

2.172 Some submissions were undecided.[337] One respondent referred to:

- the need to balance abuse of qualified privilege with a director's ability to act in the company's best interests by making a public statement
- the unsatisfactory nature of the present law, which does not provide a workable avenue for resigning directors to make known their reason for resigning, even where that would be in the interests of the company.[338]

2.173 Another respondent[339] argued that, while it did not oppose giving departing directors qualified privilege, there were a number of problems associated with the proposal:

- departing directors may well have grievances against the company which are not soundly based. Provisions designed to ventilate those grievances could conceivably harm the company and its shareholders rather than promote their interests

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331 Australian Accounting Research Foundation.
332 AMP (Group), Carter Holt Harvey Limited, Coles Myer Ltd.
333 Carter Holt Harvey Limited.
334 Carter Holt Harvey Limited.
335 Coles Myer Limited.
336 Coles Myer Ltd.
337 AMPAM, ASIC.
338 AMPAM.
339 ASIC.

- as a matter of fairness, if qualified privilege is allowed to the departing director then it should also be allowed to the continuing directors. Any public dispute which was thereby promoted might not be productive

- the value of qualified privilege is itself often debated. It may not necessarily promote openness. Qualified privilege does not protect anyone acting from malice. Persons seeking to rely on the privilege may find that they have, in effect, invited an allegation that they are acting maliciously. It is therefore arguable that qualified privilege can be counterproductive by actually "raising the stakes" and thereby intimidating the party who might otherwise have wished to make some disclosure.[340]

Advisory Committee response to submissions on Issue 9: Draft Recommendation 9

2.174 This matter involves competing interests, including ensuring an informed market and protecting the reputation of individuals and the company.

2.175 On balance, directors should not have qualified privilege when resigning from the board, for the following reasons.

- There is a common law qualified privilege for any communications between directors and shareholders relating to a shareholder meeting and matters which are to be dealt with at that meeting.[341]

- Qualified privilege would be an exception to the defamation laws. It might reasonably be questioned why company directors should be favoured in this regard over other persons by receiving qualified privilege.

- Directors can require that the reasons for their dissent be minuted in the directors' minutes.

- The current law does not preclude directors from making public statements, though those persons are subject to the laws of defamation and fiduciary duties (including to keep confidential non-public information obtained in the course of their duties).

- Any director who is concerned about possible illegality can approach ASIC, though the director's concerns may not become public at any stage, given the Commission's policy not to make any public statement about a possible or actual investigation and not to make a public statement where the Commission decides that no action is warranted.

Accordingly:

Directors should not have qualified privilege for any public statement they might make in resigning from the board.

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340 ASIC.

341 *Gabriel v Lobban* [1976] VR 689.

Submissions on Draft Recommendation 9

2.176 Some submissions supported the Draft Recommendation,[342] while another respondent considered that directors should be at liberty to make public the reasons for their resignation.[343]

Advisory Committee response to submissions on Draft Recommendation 9

2.177 The case for introducing statutory qualified privilege for resigning directors has not been sufficiently made out. The matter should be left to the general law of defamation.

Recommendation 9

Directors should not have qualified privilege for any public statement they might make in resigning from the board.

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342 Australian Institute of Company Directors, Australian Society of Certified Practising Accountants.

343 Australian Accounting Research Foundation.

Chapter 3

Minority shareholders of group companies

This Chapter reviews the position of minority shareholders of partly-owned group companies. It recommends buy-out rights for non-assenting minority shareholders of group companies whose directors are permitted to act in the overall group interest. Buy-out rights would further protect those minority shareholders, without unduly impeding the ability of corporate group controllers to achieve their collective goals.

Application only to partly-owned group companies

3.1 Minority shareholder rights and remedies are relevant only to partly-owned group companies.

Current law

3.2 Minority shareholders in a partly-owned group company may be in a particularly vulnerable position. The parent company may exercise its controlling power in that group company in a way that is detrimental to the interests of those shareholders. For instance, the parent company may prefer that, for overall group purposes, the profits of a partly-owned group company be capitalised, rather than distributed as dividends, thereby providing little or no return to the minority shareholders. Conversely, a parent company suffering liquidity problems may prefer that the group company pay a very high dividend, notwithstanding that this may be detrimental to the future growth and profitability of the group company, thereby diminishing the long-term value of the minority shareholders' investment. In other instances, the parent company may prefer, for group economic or managerial reasons, that assets of the group company be transferred to another group company, that a corporate opportunity available to the group company (and in this sense an asset of that company) be taken up by either the parent company or some other group company, or that, for fiscal or transfer pricing reasons, a particular group company be run at a loss or on a break-even only basis.

3.3 The remedies available to shareholders of Australian companies are predominantly based on the separate entity approach. Minority shareholders of one corporate group company usually lack the standing at common law to enforce the rights, or challenge the actions, of other companies within that group.[344] However, they have some statutory remedies for actions of other group companies, or actions of their own directors in advancing the corporate group interest, that are detrimental to their own interests, namely:

- an injunction

[344] The exceptions to the "proper plaintiff" rule in *Foss v Harbottle* (1843) do not permit a member of one company in a corporate group to commence an action on behalf of another company in that group.

- an oppression action.

In addition, various intra-group transactions that provide a financial benefit would be related party transactions that require the approval of the fully-informed disinterested shareholders.[345]

Injunction

3.4 In limited situations, minority shareholders may have a statutory right to seek an injunction for contraventions of the Corporations Law.[346] Any person "whose interests have been, are or would be affected" by the conduct complained of may be an applicant.[347] A minority shareholder in one partly-owned group company could seek an appropriate remedy on the basis that its interests have been, or could be, affected by the actions of another company in that group.[348]

Oppression

3.5 The actions of directors of a partly-owned group company in subordinating the interests of that company to those of the controlling company or the corporate group generally could amount to minority oppression.[349] It is less certain whether minority shareholders in one group company could claim oppression for the actions of another group company allegedly detrimental to the first group company. In some cases of

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[345] See para 1.73: *related party transactions*.

[346] s 1324.

[347] s 1324(1).

[348] An unsuccessful injunction application was made in *Re Claremont Petroleum NL* (1991) 6 ACSR 205. The Court ruled that it was inappropriate to grant interlocutory relief in the circumstances. There were many complex issues of fact and law, which could be effectively and justly determined only in a final hearing. To grant an interlocutory injunction may cause irreparable damage to the defendants, notwithstanding any undertaking as to damages that might be given by the applicants.

[349] ss 232 ff.

In *Re Spargos Mining NL* (1991) 3 ACSR 1 (a successful oppression action commenced by a minority shareholder of a subsidiary company within a corporate group), the Court said:

> "One can understand that philosophy [of a subsidiary entering into transactions that appear to be for the benefit of other members of the group, rather than the subsidiary] within a group of corporate entities where there is a unity of control in the form of major shareholdings and representation upon various boards, but it is an approach which tends to take little account of the particular interests of individual companies and therefore of individual small shareholders in those corporate entities" (at 33).

In *Re Spargos*, the directors of the subsidiary company had entered into a number of transactions which channelled funds to the controlling shareholders in a manner which caused substantial loss to the subsidiary company and was otherwise "almost entirely devoid of any discernible commercial benefit" for the subsidiary company.

In *Jenkins v Enterprise Gold Mines NL* (1992) 6 ACSR 539 at 550, the Court held that, where the facts demonstrate that a group company received no apparent commercial benefit from a transaction and the directors of that company had an apparent conflict of interest, the evidentiary burden shifts to the company in an oppression action to establish the commercial basis and benefit of the transaction to the company and the manner in which the directors resolved the conflict of interest.

this nature, an oppression action is available, though attempts to invoke the remedy have not necessarily been successful.[350]

3.6 The Corporations Law contains two other powers which affect the position of minority shareholders in corporate groups, namely:

- statutory derivative actions
- compulsory acquisitions.

Statutory derivative actions

3.7 Individual shareholders, with court approval, may litigate on behalf of a company for a wrong done to that company, where the company is unwilling or unable to do so.[351] Members of related companies would be eligible applicants to commence a statutory derivative action.[352] Shareholders of a group company could

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350 Part 2F.1 (Oppressive conduct of affairs) applies, inter alia, to "a company's affairs" or "an actual or proposed act or omission by or on behalf of a company".

In *Re Dernacourt Investment Pty Ltd* (1990) 20 NSWLR 588 and *Re Norvabron Pty Ltd (No 2)* (1986) 11 ACLR 279, the Court held that the affairs of a parent company include the business of a subsidiary. On this basis, minority shareholders of a parent company could claim oppression regarding the manner in which the business of a subsidiary was conducted, as it affected their interests. By contrast, in *Morgan v 45 Fleurs Avenue Pty Ltd* (1986) 10 ACLR 692, the Court was unprepared to hold that the conduct of a director of a subsidiary could be construed as conduct in the affairs of the parent company, despite the parent company having appointed the director.

In *Nicholas v Soundcraft Electronics Ltd* [1993] BCLC 360, the minority shareholders of a subsidiary company alleged that by withholding payment of debts due to the subsidiary, the parent company had acted in the affairs of the subsidiary in an unfairly prejudicial manner. The UK Court of Appeal held that the mere withholding of payment would not amount to conduct in the affairs of the subsidiary company. However, because the parent company closely controlled the subsidiary's finances and handled its sales, its actions in withholding payment from the company were part of the parent company's general control of the financial affairs of the subsidiary company. Accordingly, the actions of the holding company did relate to the affairs of the subsidiary company. However, while the Court had jurisdiction to entertain an oppression action, it held that the withholding of debts by the parent company, which deprived the subsidiary company of much-needed funds, did not constitute unfair prejudice, because if the parent company failed to hold off its creditors, the subsidiary company would also suffer. The Court stated (at 366):

> "It was in the interests of the [subsidiary] company that the parent should not go into liquidation. The [subsidiary] company had to pay a price to help secure that. It is the fact that the price - the withholding of debts - left the [subsidiary] company critically short of money. But the attempt to keep the group afloat by recourse to the assets of both companies was a reasonable commercial judgment in the circumstances which existed and was not unfair. It no doubt harmed the [subsidiary] company but worse harm [to the subsidiary company] would probably have followed from the liquidation of [the parent]."

Contrast, however, *Re Blackwood Hodge plc* [1997] 2 BCLC 650 where the Court held that the conduct of a parent company did not amount to conduct of the affairs of the subsidiary. See further M Lower in "Good faith and the partly-owned subsidiary" [2000] *Journal of Business Law* 232 at 242 ff.

351 ss 236-242.

352 s 236(1)(a)(i). This overcomes the problem that arises with oppression actions of whether they may be commenced by shareholders of related companies: *Claremont Petroleum NL v AGL* (1990) 1 ACSR 504, *Re Dernacourt Investments Pty Ltd* (1990) 2 ACSR 553.

use this mechanism to assert the rights of their own company or other related group companies. To assist in an application, a shareholder could apply for court approval to inspect the records of the relevant group company.[353] These provisions may assist minority shareholders in corporate groups to enforce any individual company rights which had been improperly subsumed by the group interest.

Compulsory acquisitions

3.8 Persons holding 90% or more of the shares in a company may compulsorily acquire the remaining shares, thereby obtaining complete control.[354] This power may be exercised without having to conduct a takeover bid. Minority shareholders are protected by a requirement that they be given information concerning the value of their shares, with court approval of the compulsory acquisition being required if a sufficient number of minority shareholders dissent. These provisions enable corporate groups to more easily convert some of their closely-held group companies into wholly-owned subsidiaries, thereby avoiding some of the potential minority shareholder issues that may otherwise arise.

Buy-outs following a shareholder authorisation

The issue

3.9 Any consideration of additional provisions affecting minority shareholders of group companies needs to aim at protecting the legitimate interests of these shareholders without giving them a disproportionate influence over the affairs of their group company, or the corporate group collectively.

3.10 The compulsory acquisition provisions, while allowing some rationalisation of corporate group structures, do not deal with minority shareholders in less than 90% controlled group companies, nor do they oblige the controllers of closely-held group companies to exercise the compulsory acquisition powers. Only limited buy-out rights apply.[355]

US derivative actions have a similar extended application. PI Blumberg, "The increasing recognition of enterprise principles in determining parent and subsidiary corporation liabilities" (1996) 28 *Connecticut Law Review* 295 at 340 states: "Under the [US] multiple derivative action doctrine, the derivative remedy has been broadened to authorize a derivative action by a shareholder of a parent corporation in the name and on behalf of a subsidiary corporation (or even a second-tier subsidiary corporation), although the shareholder of the parent corporation does not hold directly any shares in the subsidiary. This includes majority-owned and sister subsidiaries as well as wholly-owned subsidiaries. Apparently, no American court has considered this question with respect to minority-owned controlled subsidiaries of a corporate group, though the result should be the same. This is particularly true in the case of an action against the parent or its officers or directors for alleged breach of fiduciary duty where the parent board of directors may not be expected to act."

353 s 247A(3). The court could order an inspection if satisfied that the applicant was acting in good faith and for a purpose connected with the bringing of the derivative action.

354 ss 664A-664G.

355 ss 662A-663C; ss 665A-665C. Buy-out rights may also be available under a s 414 share acquisition scheme. The Report of the Legal Committee of the Advisory Committee *Compulsory Acquisitions* (January 1996) recommended the repeal of s 414.

3.11 One possibility would be to extend the circumstances where minority shareholders in a group company have buy-out rights, thereby enabling them to invest their resources elsewhere.[356] A buy-out right might be appropriate if minority shareholders of a partly-owned group company were given, and exercised, the power recommended elsewhere in this Report to permit directors to act in the interests of a holding company rather than the group company.[357] The need for such rights might be reinforced by the apparent lack of alternative oppression remedies in that context.[358]

3.12 Consideration of any buy-out right linked to a shareholder resolution permitting directors of a partly-owned group company to act in the interests of the holding company raises the following policy and procedural issues.

- *Eligible shareholders.* Should all minority shareholders, or only those who did not vote in favour of the resolution, be given buy-out rights? If all the minority shareholders could exercise the buy-out right, they may vote in favour of the resolution simply for that purpose. However, to exclude assenting shareholders from the buy-out right may discourage them from supporting the shareholder resolution. Also, should buy-out rights extend to minority holders of equity options or other securities convertible into equity?

- *Time for exercise.* Should the buy-out right apply only at the time the resolution is passed or at any subsequent time? To permit eligible shareholders to exercise their buy-out right at any subsequent time could create a long-term contingent liability for the company.

- *Buy-out obligation.* Should the holding company as well as the group company have to meet some or all of the costs of the buy-out, given that the resolution permits the group company to act in the interests of the holding company and the exercise of any buy-out right could affect the solvency of the group company? One possibility would be to require the holding company to meet all or part of those costs if the solvency of the group company would otherwise be at risk.

  A related question is whether the group company or the holding company should be entitled to seek an exemption from a buy-out obligation. New Zealand courts may exempt a company from a buy-out obligation on various financial and equitable grounds.[359]

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356 T Hadden, "The Regulation of Corporate Groups in Australia" (1992) 15 *University of New South Wales Law Journal* 61 at 76-77.

357 Recommendation 3. The arguments for and against the introduction of buy-out rights in this context are discussed at para 2.40: *Protection of minority shareholders*.

358 As noted in para 2.39, it is doubtful whether dissenting minority shareholders would be eligible to initiate an oppression action concerning a resolution that was approved by a majority of that minority.

359 New Zealand Companies Act 1993 s 114(1) provides that a court may exempt a company from a buy-out obligation on any of the following grounds:
- the purchase would be disproportionately damaging to the company, or
- the company cannot reasonably be required to finance the purchase, or
- it would not be just and equitable to require the company to purchase the shares.

- *Valuation of shares.* Minority shareholders exercising buy-out rights should receive fair value for their shares. North American corporate law has employed various tests to determine fair value, including a combination of market value, asset value and earnings value.[360] The US Model Business Corporation Act states that "fair value" of a minority shareholding means:

  > "the value of the shares immediately before the effectuation of the corporate action to which the [minority shareholder] objects, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable".[361]

  The reference to evaluation before the relevant corporate action is to ensure that minority shareholders neither benefit from, nor are disadvantaged by, that action. If applied in the Australian context, this would mean that the shares of a minority would generally be evaluated prior to any shareholder approval for directors of a partly-owned group company to act in the interests of the holding company, rather than the group company.

  In Australia, fair value in the context of buy-outs following a successful takeover bid is determined as follows:

  "(a) first, assess the value of the company as a whole; and

  (b) then allocate that value among the classes of issued securities in the company (taking into account the relative financial risk, and voting and distribution rights, of the classes); and

  (c) then allocate the value of each class pro rata among the securities in that class (without allowing a premium or applying a discount for particular securities in that class)".[362]

  A related issue is whether any share valuation disputes should be determined by a court or by arbitration. Most jurisdictions provide that a court should resolve any such dispute, though New Zealand requires that this matter be referred to arbitration, with a right to receive provisional consideration in the meantime.[363] In Australia, a court, rather than an administrative body, must conduct any share valuation appraisal.

A court may also grant an exemption from a buy-out obligation if the company would thereby become insolvent: s 115.

360 The fair value tests are particularly relevant to buy-outs under "short-form" mergers: para 5.17, post. A useful summary of the fair value tests is found in V Mitchell, "The US Approach Towards the Acquisition of Minority Shares: Have We Anything to Learn?" (1996) 14 *Company and Securities Law Journal* 283 at 291-292 & 297.

361 Model Business Corporation Act Annotated 3rd edition, Vol 3 (Prentice Hall Law and Business) §13.01(3) (p 1356).

362 s 667C.

363 New Zealand Companies Act 1993 s 112(4). The New Zealand Companies Act s 112(4), (7), (8) provides that, where there is a dispute over valuation, the company subject to the buy-out obligation must nevertheless pay a provisional price equal to the price it nominated. Following the arbitration, the shareholder would either receive, or return, the appropriate balance. This

Issue 10. *Should there be any buy-out rights for minority shareholders in group companies if minority shareholders are given, and exercise, the right to authorise their directors to act in the interests of the holding company (Issue 3)?*

If so:

- *should all minority shareholders, or only those who did not vote in favour of the resolution, have those rights*
- *should those rights extend to minority holders of equity options or other securities convertible into equity*
- *should those rights apply only at the time the resolution is passed or at any subsequent time*
- *should the parent company as well as the group company have to meet some or all of the costs of the buy-out*
- *should the group company or the parent company be entitled to seek an exemption from a buy-out obligation*
- *what tests should apply for determining fair value*
- *should share valuation disputes be determined by a court or by arbitration*
- *should minority shareholders be entitled to receive provisional consideration until any dispute is settled?*

Submissions on Issue 10

Whether there should be buy-out rights

3.13 Some submissions supported buy-out rights for minority shareholders in the event of their passing a resolution to permit directors of partly-owned group companies to act in the interests of the parent company (shareholder authorisation),[364] for the following reasons.

- If directors of a controlled partly-owned entity are permitted to consider the interests of the parent, the parent entity would in most instances want to acquire full ownership.[365]
- Buy-out rights would provide an additional mechanism, especially where the parent has less than a 90% beneficial interest, for facilitating the

ensures that any shareholder is not precluded from receiving funds until any dispute over share valuation is resolved.

364 Australian Accounting Research Foundation, AMP (Group), AMPAM, Australian Institute of Company Directors, Coles Myer Ltd.

365 Australian Accounting Research Foundation.

rationalisation of corporate group structures as single economic entities, while ensuring minorities are not unfairly treated.[366]

- Minority shareholders feel less aggrieved under a buy-out than if their shares are compulsorily acquired.[367]

- Minorities may otherwise be locked in.[368]

3.14 One submission opposed any buy-out right, whether it was one related to a shareholder authorisation or a more general buy-out right,[369] for the following reasons.

- Most minority shareholders invest in companies in the knowledge that they are minority shareholders. This is a risk which they must take into account when investing.

- Allowing minority shareholders to be bought out of a company simply because they disagree with the view of the majority shareholder in any number of circumstances is likely to lead to unfairness and commercial uncertainty.

- The proposal assumes that majority shareholders act to the disadvantage of minorities. In fact, many larger shareholders add significantly to the value of the company, to the benefit of all shareholders.

3.15 Another submission did not consider that the right to request a buy-out is important for minority shareholders, as a small shareholding can always be sold on the market.[370]

Subsidiary questions

3.16 Submissions that supported the buy-out right in the context of shareholder authorisations made the following comments on the subsidiary questions.

3.17 *All minority shareholders or only those not voting in favour.* Two submissions considered that all minority shareholders should have the buy-out right, regardless of how they voted on the authorisation resolution.[371] Some other submissions considered that only those who did not vote in favour of the authorisation resolution should have a buy-out right.[372]

366 Australian Accounting Research Foundation.
367 Australian Accounting Research Foundation.
368 AMPAM.
369 Carter Holt Harvey Limited.
370 John Fielding.
371 Australian Institute of Company Directors, Coles Myer Ltd.
372 AMP (Group), AMPAM.

3.18 *Extension of rights to minority holders of securities convertible into equity.* Some submissions considered that the buy-out right should also extend to minority holders of equity options or other securities convertible into equity.[373]

3.19 *Once-only or continuing rights.* Some submissions considered that the buy-out rights should only apply within a certain time after the shareholder authorisation.[374] One respondent suggested that the buy-out rights should exist at the time of the resolution or for, say, another three months.[375] The other submissions did not specify what the period should be.

3.20 *Who meets the costs of the buy-out.* One respondent said that the parent company should not have to meet any of the costs of the buy-out.[376] Similarly, other submissions said that this matter should be left to the discretion of the parent company.[377]

3.21 *Exemption from the buy-out obligation.* Some submissions supported a right for the group company or the parent company to seek an exemption from the buy-out obligation.[378]

3.22 *Tests for determining fair value.* One respondent said that the criteria for determining fair value should be those set out in s 667C,[379] namely:

- first, assess the value of the company as a whole; and
- then allocate that value among the classes of issued securities in the company (taking into account the relative financial risk, and voting and distribution rights, of the classes); and
- then allocate the value of each class pro rata among the securities in that class (without allowing a premium or applying a discount for particular securities in that class).

3.23 Other submissions supported applying only common law rules for determining fair value in buy-outs.[380] One of those submissions specifically opposed the criteria in s 667C.[381]

3.24 Another submission said that the fair value of securities of a listed entity should be the quoted market price of those securities.[382] Where an entity is not listed and an authorisation resolution is passed, that entity should arrange for an independent expert's report stating whether, in the expert's opinion, the terms under which the company will agree to buy out any minority shares represent fair value.

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373 AMP (Group), AMPAM, Australian Institute of Company Directors.
374 AMP (Group), AMPAM, Australian Institute of Company Directors, Coles Myer Ltd.
375 Australian Institute of Company Directors.
376 Australian Institute of Company Directors.
377 AMP (Group), AMPAM.
378 AMP (Group), AMPAM, Australian Institute of Company Directors.
379 AMP (Group).
380 Australian Institute of Company Directors, John Fielding.
381 John Fielding.
382 Australian Accounting Research Foundation.

3.25 *Share valuation disputes.* One submission considered arbitration the preferable method for resolving disputes about share valuation, as it is speedier and cheaper.[383]

3.26 Another submission considered that the court should determine share valuation disputes.[384] This respondent was also concerned to protect minority shareholders from having to bear the costs of obtaining a valuation.

3.27 Another submission considered that share valuation disputes should be determined by an independent expert or by the court.[385]

3.28 Some submissions opposed minority shareholders receiving provisional consideration before any dispute is settled.[386]

Advisory Committee response to submissions on Issue 10: Draft Recommendation 10

3.29 The arguments put forward in submissions for introducing a buy-out right in the context of minority shareholders authorising the directors to act in the interests of a holding company outweigh the arguments against introducing that right. All minority shareholders who do not vote in favour of a successful authorisation resolution should for a limited time have the right to be bought out at fair value. Accordingly:

If the minority shareholders of a solvent partly-owned group company are given, and exercise, the power to resolve that the directors may act in the interests of the parent company (Recommendation 3):

- *all minority shareholders, except those who voted in favour of the resolution, should have a buy-out right*
- *the right should extend to holders of equity options and other convertible securities*
- *the right should only apply for three months after the resolution is passed* (this would minimise the uncertainty for the parent company in funding the buy-out)
- *the parent company should have to meet the cost of the buy-out*
- *there should be no statutory right to seek an exemption from the buy-out obligation* (given that the parent company or the directors of the partly-owned group company would be sponsoring the authorisation resolution)
- *the test of fair value should be the same as that for determining the value of securities in a compulsory acquisition* (s 667C)

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383 AMPAM.

384 John Fielding. However, this respondent did not consider that a buy-out right is important for minority shareholders, arguing that they can sell their shares on the market.

385 AMP (Group).

386 AMP (Group), AMPAM, Australian Institute of Company Directors.

- *share valuation disputes should be determined by the courts in a comparable manner to compulsory acquisition disputes (in particular, s 664F(4) dealing with costs), and*

- *minority shareholders should not be entitled to receive provisional consideration pending the determination of any dispute* (given the administrative complexities that could arise).

Submissions on Draft Recommendation 10

3.30 The respondents agreed with the Draft Recommendation.[387]

Advisory Committee response to submissions on Draft Recommendation 10

3.31 The Advisory Committee maintains the approach in the Draft Recommendation.

Recommendation 10

If the minority shareholders of a solvent partly-owned group company are given, and exercise, the power to resolve that the directors may act in the interests of the parent company (Recommendation 3):

- all minority shareholders, except those who voted in favour of the resolution, should have a buy-out right

- the right should extend to holders of equity options and other convertible securities

- the right should only apply for three months after the resolution is passed

- the parent company should have to meet the cost of the buy-out

- there should be no statutory right to seek an exemption from the buy-out obligation

- the test of fair value should be the same as that for determining the value of securities in a compulsory acquisition (s 667C)

- share valuation disputes should be determined by the courts in a comparable manner to compulsory acquisition disputes (in particular, s 664F(4) dealing with costs), and

- minority shareholders should not be entitled to receive provisional consideration pending the determination of any dispute.

General buy-out rights

387 Australian Institute of Company Directors, Australian Society of Certified Practising Accountants.

The issue

3.32 In addition to buy-out rights following a shareholder authorisation, the question arises whether there should be a de minimis and unconditional buy-out right where, for instance, the total minority shareholding of a group company constitutes no more than, say, 1% of the company's total issued shares, by value. A recent European proposal is to permit this buy-out right where the total minority shareholding is up to 5%, or possibly even 10%, of the company's issued shares.[388]

Issue 11. *Should there be a de minimis and unconditional buy-out right whenever the total minority shareholding of a group company constitutes no more than a specified small percentage of the company's issued share capital?*

Submissions on Issue 11

3.33 Some submissions favoured this right, arguing that it would provide greater efficiency.[389]

3.34 Some submissions opposed this right.[390] One respondent argued that the proposed right would increase the propensity to greenmail by "reducing the size of the rump of shareholders that are left and making them more difficult to deal with".[391] This respondent considered selective capital reductions at a fair price nominated by the majority shareholder and accepted by 75% of the exiting shareholders as the best option for dealing with small remaining minorities.

Advisory Committee response to submissions on Issue 11: Draft Recommendation 11

3.35 A de minimis and unconditional buy-out right is unnecessary, as:

- there is no evidence of minority shareholders complaining that they are locked into a company
- minorities are protected by the statutory oppression remedy.

3.36 In addition, a general buy-out right could be undesirable. Some companies need to maintain a certain number of minority shareholders. For instance, in backdoor listings, a spread of shareholders is necessary to maintain listing. Also, the cost of a general buy-out right could be considerable and, if paid for by the company, could weaken its capital base, market competitiveness or even solvency. Accordingly:

There should be no additional buy-out right for minority shareholders in corporate groups.

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388 Forum Europaeum Konzernrecht, "Corporate Group Law for Europe" 1 *European Business Organization Law Review* (2000). This proposal recognises that a general buy-out right could constitute a serious financial burden for a company. The Forum Europaeum therefore recommends that each European State should consider whether to introduce a mandatory buy-out right.

389 AMP (Group), AMPAM, Coles Myer Ltd.

390 Carter Holt Harvey Limited, John Fielding.

391 John Fielding.

Submissions on Draft Recommendation 11

3.37 The respondents agreed with the Draft Recommendation.[392]

Advisory Committee response to submissions on Draft Recommendation 11

3.38 The Advisory Committee maintains the approach in the Draft Recommendation.

Recommendation 11

There should be no additional buy-out right for minority shareholders in corporate groups.

Further disclosure

The issue

3.39 Minority shareholders of a partly-owned group company may suffer detriment if the opportunities or contractual rights of their company are diverted to, or not enforced against, another group company. However, related party transactions require prior shareholder approval.[393] Also, individual shareholders may have a remedy in oppression.[394] The question is whether directors of partly-owned group companies should be required to report periodically (annually or more often) on any intra-group dealings that are not regulated related party transactions.

Issue 12. *Should directors of partly-owned group companies be required to report periodically on any intra-group dealings that are not regulated related party transactions?*

Submissions on Issue 12

3.40 All submissions that commented on this Issue opposed the suggested additional reporting requirement,[395] for the following reasons.

- Current related party transactions regulation is sufficient.[396]

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392 Australian Institute of Company Directors, Australian Society of Certified Practising Accountants.

393 Under Chapter 2E (Related party transactions), these transactions must be approved by the disinterested shareholders: see para 1.73: *related party transactions*.

394 In *Scottish Co-operative Wholesale Society Ltd v Meyer* [1959] AC 327, an oppression action was successful where a holding company deliberately diverted business away from a subsidiary, which had been set up as a joint venture with the holding company, to deprive minority shareholders in the subsidiary of a share of the joint venture's profits.
In *Re Bright Pine Mills* [1969] VR 1002, a minority shareholder claimed that the controlling shareholder had acted in an oppressive manner by setting up another company to exploit an opportunity available to the first company. In finding oppression, the Court ruled that the real purpose of the controlling shareholder's action in setting up the second company was to prevent the minority shareholder from participating in the profits from the commercial opportunity and this amounted to minority oppression.

395 AMP (Group), AMPAM, Australian Institute of Company Directors, Carter Holt Harvey Limited.

396 AMP (Group).

- Increased reporting would not be sufficiently beneficial to justify the costs.[397]

- Given the number of possible transactions between partly-owned group companies and majority shareholders, disclosure could be unduly onerous and impractical, and may become meaningless.[398]

3.41 One of those respondents, while opposing any such requirement, said that if one were introduced, it should be limited to material matters.[399]

3.42 Another respondent considered that the better approach would be to rely on the directors' duties and interested director voting requirements to deal with any matters not covered by the related party transaction provisions.[400]

Advisory Committee response to submissions on Issue 12: Draft Recommendation 12

3.43 Submissions did not identify any material gaps in the related party or other disclosure provisions. Accordingly:

Directors of partly-owned group companies should not be required to report periodically on any intra-group dealings that are not regulated related party transactions.

Submissions on Draft Recommendation 12

3.44 The respondents agreed with the Draft Recommendation.[401]

Advisory Committee response to submissions on Draft Recommendation 12

3.45 The Advisory Committee maintains the approach in the Draft Recommendation.

397 AMP (Group). AMPAM also questioned the benefits.

398 Carter Holt Harvey Limited.

399 Australian Institute of Company Directors.

400 Carter Holt Harvey Limited.

401 Australian Institute of Company Directors, Australian Society of Certified Practising Accountants.

Recommendation 12

Directors of partly-owned group companies should not be required to report periodically on any intra-group dealings that are not regulated related party transactions.

Intra-group fair dealing

The issue

3.46 A different, or additional, approach might be to impose a "fair dealing" or "fair price" (fair dealing) obligation on any parent company in all of its dealings with a partly-controlled group company, or where the parent company appoints nominee directors to its board.[402] The American Law Institute *Principles of Corporate Governance* contain guidelines on how a parent company must conform with a duty of fair dealing. This duty applies to:

- dealings between a parent company and its controlled company
- the use by a parent company of its controlled company's corporate property, material non-public information or position
- the taking of a controlled company's corporate opportunities[403] by its parent company, or
- competition by a parent with its controlled company.[404]

3.47 In cases of dispute, the parent company generally has the burden of proving either that these actions are fair to the controlled company under an arm's length test or that they have been approved in advance, or subsequently ratified, by the fully-informed independent directors of the controlled company or, if there are no such directors, by its minority shareholders. A controlling company is liable for any loss incurred by the controlled company for intra-group dealings that do not satisfy the fair dealing test and have not been appropriately approved.

3.48 The US guidelines do not specifically cover intra-group dealings where the controlling company is not a direct party. These dealings could include, for instance,

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402 In *Scottish Co-operative Wholesale Society Ltd v Meyer* [1959] AC 327 at 343, the House of Lords considered that where a subsidiary is formed with an independent minority of shareholders, the parent company, if it is engaged in the same class of business, is under an obligation to conduct its own affairs in such a way as to deal fairly with its subsidiary.

403 American Law Institute, *Principles of Corporate Governance*, 1994 § 5.12(b) define a corporate opportunity as any opportunity to engage in a business activity that:

> "(i) is developed or received by the [controlled] corporation, or comes to the controlling shareholder primarily by virtue of its relationship to the [controlled] corporation; or
>
> "(ii) is held out to shareholders of the [controlled] corporation by the controlling shareholder, or by the [controlled] corporation with the consent of the controlling shareholder, as being a type of business activity that will be within the scope of the business in which the [controlled] corporation is engaged or expects to engage and will not be within the scope of the controlling shareholder's business."

404 American Law Institute, *Principles of Corporate Governance*, 1994 §§ 5.10, 5.11, 5.12.

an agreement for one group company to surrender a corporate opportunity to a sibling group company or to contract with that sibling group company on disadvantageous terms, rather than on much more favourable "arms' length" terms with an outside party. In principle, the fair dealing requirements could be extended to all intra-group dealings.

Issue 13. *Should a parent company be subject to a fair dealing obligation in its dealings that affect controlled companies within the group?*

If so, should the obligation be based on that in the US Principles of Corporate Governance?

Submissions on Issue 13

3.49 Some submissions supported a fair dealing obligation.[405] One of these respondents argued that it would protect minorities from parent company abuse.[406] The other respondent only supported the obligation if it did not go beyond the existing duty to act in the interest of the company as a whole.[407]

3.50 Some submissions opposed any fair dealing obligation,[408] for the following reasons.

- It would be likely to lead to complexity and litigation, as well as uncertainty.[409]
- The related party benefit provisions already effectively impose a fair dealing obligation on all parent companies of Australian public companies. Under these provisions (and, in particular, the broad concept of "financial benefit"), any transaction between an Australian public company (which is not a wholly-owned group company) and its parent company must either be conducted on terms no more favourable to the parent company than would apply in an arm's length third party transaction or be authorised by the shareholders (excluding interested parties).[410]

Advisory Committee response to submissions on Issue 13: Draft Recommendation 13

3.51 The Advisory Committee considers that:

- the remedy for oppressive or unfairly prejudicial conduct[411] and common law principles[412] already cover this area

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405 AMP (Group), AMPAM. Coles Myer Limited supported a fair dealing concept if minority shareholders do not have appropriate buy-out rights.

406 AMPAM.

407 AMP (Group).

408 Australian Institute of Company Directors, Carter Holt Harvey Limited.

409 Carter Holt Harvey Limited.

410 Australian Institute of Company Directors.

411 ss 232-235.

412 For instance, *Ngurli v McCann* (1953) 90 CLR 425 at 438-439.

- the related party transaction provisions require either arm's length dealing or shareholder approval.

Accordingly:

There should be no additional fair dealing obligation on parent companies in their dealings with other group companies.

Submissions on Draft Recommendation 13

3.52 The respondents agreed with the Draft Recommendation.[413] One respondent noted that a fair dealing obligation could be subject to circumvention, impractical to implement and impossible to enforce.[414]

Advisory Committee response to submissions on Draft Recommendation 13

3.53 The Advisory Committee maintains the approach in the Draft Recommendation.

Recommendation 13

There should be no additional fair dealing obligation on parent companies in their dealings with other group companies.

[413] Australian Institute of Company Directors, Australian Society of Certified Practising Accountants.

[414] Australian Society of Certified Practising Accountants.

Chapter 4

Tort liability of group companies

This Chapter discusses the factors that differentiate the position of tort claimants from that of contract creditors of a group company. It examines the circumstances in which a controlling company might currently be liable for torts incurred by other group companies. The Chapter then raises the question of whether tort principles should be modified by adopting a single enterprise approach to make the parent company automatically liable in some circumstances for the torts of any of its group companies. It recommends that the existing principles of tort liability should not be changed for corporate groups.

Application to wholly- and partly-owned group companies

4.1 The various grounds of tortious liability of a group company are not based on any inherent distinction between a parent, partly-owned or wholly-owned group company. However, in some cases, a parent company may be liable as a principal, notwithstanding that the tort claimant has dealt with the wholly- or partly-owned group company, if the parent company has exercised a sufficient degree of control over that group company.

The position of tort claimants

4.2 Tort claimants of a group company can include a range of persons having dealings with that company, such as consumers or employees injured in the course of the company's business. Their relationship with that company may differ from that of contract creditors in various ways.

4.3 For instance, some contract creditors can contractually avoid the separate entity principle by requiring suitable intra-group securities or cross-guarantees. Potential tort claimants rarely have a similar bargaining opportunity. Also, tort claimants, unlike contract creditors, usually have no opportunity to assess the creditworthiness, or investigate the resources, of the group company prior to the action complained of.[415] Given the usually involuntary nature of the tortious relationship, mechanisms designed for contract creditors, such as enhanced financial disclosure requirements, do not assist tort claimants.

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[415] In *Briggs v James Hardie & Co Pty Ltd* (1989) 7 ACLC 841 at 863-864, Rogers AJA pointed out that:

> "Generally speaking, a person suffering injury as a result of the tortious act of a corporation has no choice in the selection of the tortfeasor. The victim of the negligent act has no choice as to the corporation which will do him harm. In contrast, a contracting party may readily choose not to enter into a contract with a subsidiary of a wealthy parent. The contracting entity may enquire as to the amount of paid-up capital and, generally speaking, as to the capacity of the other party to pay the proposed contract debt and may guard against the possibility that the subsidiary may be unable to pay. … [Where the injured party is an employee,] whilst the employee may be able to choose whether or not to be employed by the particular employer, generally speaking, he has no real input in determining how the business will be conducted and whether reasonable care will be taken for his safety".

4.4 A corporate group may have strong incentives to satisfy claims by contract creditors, either to maintain their commercial relationship with them or to preserve their overall group financial reputation and credit standing. However, some corporate groups that have no continuing commercial relationship with particular tort claimants may have less incentive to disregard the limits on liability within the corporate group structure.

Current law

4.5 Some corporate groups may be structured in a manner that seeks to isolate in one group company the possible tort liability costs for particular activities.[416] In general, a holding company and other group companies are not liable for any torts incurred by that group company, even if it is a wholly-owned subsidiary.[417] The common law exceptions are:

- agency or assumption of responsibility
- incorporation to avoid an existing tortious obligation
- where the controlling company has a direct duty of care for the activities carried out by its controlled companies.

4.6 There are also statutory exceptions, such as the product liability and misleading conduct provisions of the Trade Practices Act s 52. This Report does not discuss these provisions.

Agency or assumption of responsibility

4.7 Where an agency, partnership or trust relationship exists between a holding company and a group company, the holding company will be liable for the tortious actions of the group company.[418] However, in the absence of an express agreement, there is no presumption of that relationship, even between a holding company and its wholly-owned subsidiary.[419] In each case, it is entirely a question of fact whether the

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416 For instance, a manufacturer may decide to split up its different divisions into separate companies. In this way, the assets of the manufacturing arm would not be available to satisfy any tortious liabilities arising out of the activities of the marketing arm, or vice versa.

417 In *James Hardie & Co Pty Ltd v Hall* (1998) 43 NSWLR 554, the New South Wales Court of Appeal held that, in the absence of any evidence that a subsidiary company is a mere façade, the fact that a parent company exercises control and influence over its subsidiary does not of itself justify lifting the corporate veil so as to create a duty of care on the part of the parent company towards an employee of the subsidiary.

418 For instance, in *Spreag v Paeson Pty Ltd* (1990) 94 ALR 679 at 712, the Federal Court held that, where a subsidiary was acting as the agent of the holding company as undisclosed principal, a plaintiff who dealt with the subsidiary was entitled to recover against the holding company.

419 *Adams v Cape Industry plc* [1990] Ch 433 at 545-49. Compare *Banque Financière de la Cité v Parc (Battersea) Ltd* [1998] 1 All ER 737, where the Court held that a corporate controller did not have any agency power to bind group companies.

relationship exists.[420] Also, a holding company may be liable if it has directly assumed responsibility for the actions complained of.[421]

Incorporation to avoid an existing tortious liability

4.8 The use of separate companies within a corporate group to reduce the impact of possible future tortious liability is not, without more, an abuse of the corporate form.[422] The mere fact that a holding company has incorporated a separate group company for this purpose does not provide a ground for imposing direct liability on the holding company.[423] However, a court will overturn any attempt by a holding company to shield itself from an existing tortious liability by incorporating a separate group company to assume that current liability.[424]

Direct liability

4.9 Depending on the relationship between a controlling company, a group company and a tort claimant who dealt with that group company, the court might hold that the controlling company (as well as the group company) owed a direct duty of care to that claimant, as determined by reference to reasonable foreseeability and proximity tests.[425] The lack of a formal employment or other like relationship between

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420 *Tate v Freecorns Pty Ltd* [1972] WAR 210, *State Bank of Victoria v Parry* (1990) 2 ACSR 15, *Briggs v James Hardie & Co Pty Ltd* (1989) 7 ACLC 841 at 845-846.

421 Cf *Williams v Natural Life Health Foods Ltd* [1998] 2 All ER 577, as analysed in (1998) 16 *Company and Securities Law Journal* 663.

422 *Adams v Cape Industry plc* [1990] Ch 433. In this case, the Court declared (at 544) that it did not accept that "as a matter of law the court is entitled to lift the corporate veil as against a defendant company which is a member of a corporate group, merely because the corporate structure has been used so as to ensure that the legal liability (if any) in respect of particular future activities of the group (and correspondingly the risk of enforcement of that liability) will fall on another member of the group rather than the defendant company". The Court also observed that "Whether or not this is desirable, the right to use a corporate structure in this manner is inherent in our corporate law".

423 *Briggs v James Hardie & Co Pty Ltd* (1989) 7 ACLC 841 at 847. US case law on tort liability within corporate groups is dealt with in detail in PI Blumberg, *The Law of Corporate Groups: Substantive Law* (Little, Brown & Co, 1987) Part III. See also D DeMott, "The Mechanisms of Control" 13 *Connecticut Journal of International Law* (1999) 233 at 241 ff.

424 Compare *Green & Clara Pty Ltd v Bestobell Pty Ltd* [1982] WAR 1, *Alec Lobb (Garages) Limited v Total Oil (GB) Limited* [1985] 1 WLR 173, *Jeffree v NCSC* (1989) 15 ACLR 217. Compare *Re a Company* [1985] BCLC 333, which involved an intricate network of interlocking foreign and English companies which were formed to prevent the plaintiffs from obtaining compensation granted against the defendant for deceit and breach of trust. The Court ruled that the defendant had used this corporate group network, over which he exercised substantial or effective control, to dispose of his assets once the fraud was established.
"The timing of the switch to a different corporate entity is crucial. Where it occurs before the accrual of the cause of action, the courts will not pierce the corporate veil but it is otherwise where the switch is made after the cause of action accrued. Thus in *Adams v Cape Industries plc* [1991] 1 All ER 929, the [UK] Court of Appeal refused to pierce the corporate veil where a subsidiary company was set up to reduce potential tortious liability but this was distinguished by the judge in *Creasey v Breachwood Motors Ltd* [1993] BCLC 480, where assets had been transferred to another company owned by the same individual in order to defeat a claim for unfair dismissal after the claim had arisen.": *Farrar's Company Law* (4th edition, Butterworths, 1998) at 72.

425 These tests have been applied in a number of High Court judgments: *Jaensch v Coffey* (1984) 155 CLR 549, *San Sebastian Pty Ltd v Minister Administering the Environmental Planning and*

the controlling company and the tort claimant does not necessarily prevent a common law duty of care from arising.[426] The possibility of a holding company having a direct liability appears to depend on the level of its actual control.[427] The greater the level of day-to-day involvement, the more the possibility of direct liability.[428] Conversely, the potential direct liability of a holding company may be significantly reduced by giving the group company freedom to act without close external control.

Assessment Act (1986) 162 CLR 340, *Stevens v Brodribb Sawmilling Co Ltd* (1986) 160 CLR 16, *Hill v Van Erp* (1997) 142 ALR 687.

Compare footnote 57 which summarises the US law on a holding company owing a direct duty of care to persons affected by the actions of a controlled company.

426 *Briggs v James Hardie & Co Pty Ltd* (1989) 7 ACLC 841. A discussion of various relevant unreported cases is found in R Carroll, "Corporate parents and tort liability" in M Gillooly (ed), *The Law Relating to Corporate Groups* (Federation Press, 1993) 91 at 110-115. See also R Carroll, "Shadow Director and Other Third Party Liability for Corporate Activity" in I Ramsay, *Corporate Governance and the Duties of Company Directors* (Centre for Corporate Law and Securities Regulation, 1997) 162 at 166.

427 As summarised by R Carroll in "Corporate parents and tort liability" in M Gillooly (ed), *The Law Relating to Corporate Groups* (Federation Press, 1993) 91 at 115:

"It is evident [from the case law] that the likelihood of a duty of care being found to be owed by a holding company to a person harmed by the activities of its subsidiary is small, and will be confined to circumstances in which the holding company exercises actual control over the aspect of the subsidiary's activities out of which the tort claim arises."

R Carroll restated this view in "Shadow Director and Other Third Party Liability for Corporate Activity" in I Ramsay, *Corporate Governance and the Duties of Company Directors* (Centre for Corporate Law and Securities Regulation, 1997) 162 at 166.

At least one Court has questioned whether a holding company should be subject to a direct liability, even where that company exercises a high level of control. In *Dairy Containers Ltd v NZI Bank Ltd* (1995) 13 ACLC 3,211 at 3,237, Thomas J of the New Zealand High Court took the view that " … the general or usual control exerted by a parent company over its subsidiary [cannot of itself] be the basis for a duty of care to the subsidiary relating to the way in which the company conducts its business. To my mind, not even total control [by the parent company] over its subsidiary could give rise to that duty. The parent may hold its subsidiary accountable if it does not perform as required, but it is going too far to suggest that it must undertake the monitoring functions reposed in the directors of [the subsidiary] which it has appointed to look after its interests".

428 For instance, in *CSR Ltd v Wren* (1998) *Aust. Torts Reports* ¶81-461, the New South Wales Court of Appeal held that a holding company was primarily liable in negligence to employees of a wholly-owned subsidiary for the acts of that subsidiary in conducting asbestos mining. The Court ruled that the high level of involvement of the parent company, through its employees, in the organisation and day-to-day activities of the subsidiary caused the holding company to owe a direct duty of care to employees of the subsidiary. Similarly, in *CSR Ltd v Young* (1998) *Aust. Torts Reports* ¶81-468, a differently constituted Court of Appeal held that the holding company was liable in tort for the acts of its wholly-owned subsidiary in relation to employees of the subsidiary who had been affected by the subsidiary's asbestos activities. The holding company so controlled the activities of the subsidiary as to, in effect, itself be conducting those activities, with the subsidiary being merely its conduit. However, in *James Hardie & Co Pty Ltd v Hall* (1998) 43 NSWLR 554 at 579-584, the New South Wales Court of Appeal held that in the absence of any evidence that a subsidiary company is a mere façade, the fact that a parent company exercises control and influence over its subsidiary does not of itself justify lifting the corporate veil so as to create a duty of care on the part of the parent company towards an employee of the subsidiary. The Court distinguished *CSR Ltd v Wren*. In that case, unlike the *James Hardie* case, the parent company controlled the day-to-day operations of the subsidiary.

4.10 Section 588V (liability of a holding company for the insolvent trading of a subsidiary) provides no remedy for tort claimants. The section is premised upon a company "incurring a debt", which does not extend to tort liabilities.[429]

Law reform options

4.11 The current law may encourage some corporate groups to establish separate group companies to conduct the types of activities that involve some risk of tort liability, and to fund them with this possibility in mind, for instance, by financing them mainly through secured debt rather than equity. In the event of a company's liquidation, tort claimants rank above shareholders, but below secured creditors.

4.12 One possibility would be to impose liability on a controlling company for that part of the tortious liability of any group company that the latter company cannot meet.[430] In effect, the holding company would be automatically potentially liable for all the torts of its group companies. This would override the current law principle that, subject to some exceptions, a holding company is not liable for the torts of other group companies.

4.13 A more limited approach would be to impose a similar residual liability on a controlling company only for the torts of its controlled companies that it could have foreseen. The holding company could avoid exposure to this tort liability by ensuring that the controlled entity had sufficient continuing capital or insurance to cover this harm.[431] If particular foreseeable risks were uninsurable, or were prohibitively costly to insure against, the holding company would have to determine whether to allow the controlled company to undertake or continue with that activity, given that the holding company would be potentially liable in tort. Under this option, a holding company would not be liable for unforeseeable injury or damage arising from the activities of the controlled company.

4.14 The rationale for either approach is that corporate group controllers who receive the benefits of their controlled company's activities should be subject to a residual obligation for the injury or damage that those activities cause.[432] It would be incumbent on the controlling company to protect itself by maintaining sufficient assets or insurance to cover this liability.

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429 In *Geraldton Building Company Pty Ltd v Woodmore* (1992) 8 ACSR 585 at 590, the Court held that debt and damages are quite distinct and that incurring a liability for damages does not constitute the incurring of a debt for the purpose of s 592 (now s 588G). The same reasoning would apply to s 588V. See also A Herzberg, "Insolvent Trading" (1991) 9 *Company and Securities Law Journal* 285 at 292.

430 R Carroll, "Corporate parents and tort liability" in M Gillooly (ed), *The Law Relating to Corporate Groups* (Federation Press, 1993) 91 at 119. That author draws an analogy between this proposal and the selective withdrawal of limited liability under ss 588V-588X. For a US perspective, see R Clark, *Corporate Law* (Little, Brown & Co 1986) at 78-79.

431 RP Austin, "Corporate Groups" in C Rickett and R Grantham, *Corporate Personality in the 20th Century* (Hart Publishing, Oxford, 1998) at 88. In *Briggs v James Hardie & Co Pty Ltd* (1989) 7 ACLC 841 at 864, Rogers AJA noted the issue of whether incorporation should be available for shifting a risk of an enterprise to a company lacking sufficient capital or insurance.

432 Compare R Simmonds, "A Summing Up and a Search for Solutions" in M Gillooly (ed) *The Law Relating to Corporate Groups* (The Federation Press, 1993) at 248.

4.15 There are various legal and economic arguments against changing the existing tort liability rules. Individual companies have no general obligation under the current law to maintain their finances so that they can meet all potential tort liability. The above proposals to change the existing rules governing tort liability would create an exception for corporate groups vis-à-vis all other individuals or entities. It could expose holding companies to open-ended potential liability, given the possible difficulty of identifying in advance the potential tort liability of their group companies. Also, imposing liability on the holding company could be highly detrimental to the creditors of that company. Likewise, to impose a general or limited tortious liability on the holding company may place Australian corporate groups at a cost disadvantage to competitors regulated in other jurisdictions that do not impose this extended liability. It may also discourage corporate groups from undertaking in Australia activities involving a high risk of legal liability, or acquiring any company that undertook these activities. This may discourage development in Australia. In addition, extending tort liability to the corporate group may reduce the incentive for either party to settle tort claims, given that the assets of the whole group could be involved.

4.16 An alternative approach to changing the general tort rules for corporate groups would be to rely on specific "see through" liability legislation (for instance, environmental protection, product liability or industrial relations laws), which would "lift the corporate veil" and impose direct liability on the holding or other group companies for negligence or other tortious actions of a specific group company, where this was considered necessary in the public interest.

Issue 14. *Should the existing principles of tort liability be changed for corporate groups?*

If so, should a parent company of a corporate group be liable for:

- *that part of the tortious liability of any group company that the latter company cannot meet, or*
- *that part of the tortious liability of any group company that the latter company cannot meet and that the parent company could have foreseen?*

Submissions on Issue 14

Support

4.17 Some submissions favoured imposing greater liability on parent companies for the torts of their group companies, arguing that this would be consistent with adopting single enterprise principles for corporate groups.[433] The corporate group should be subject to both the benefits and the risks of regulation pursuant to single enterprise principles. A parent company should be liable for that part of the tortious liability of any group company that the latter company cannot meet. Alternatively, a parent

433 Australian Accounting Research Foundation, Australian Credit Forum.

company should be liable for that part of the tortious liability of any group company that the latter company cannot meet and that the parent company could have foreseen.

Opposed

4.18 Most submissions opposed increased tort liability for parent companies,[434] for the following reasons.

- It would put Australia out of step with overseas jurisdictions.[435]
- The separate entity doctrine is not only a fundamental legal principle but a commercial expectation entrenched within commercial investment practice. Coupled with limited liability, it stimulates investment. The revenue from such investment allows further research and development. Within a corporate group, the separate entity doctrine can promote the provision of diverse goods and services. This aids competition in all industries and promotes growth and development.[436]
- Making a parent company liable for the torts of a group company would commercially weaken the central economic foundation of all the other group companies. If the tort claims are large or numerous enough, they could ultimately destroy an entire corporate group comprising vastly differing interests, with negative effects on the economy.[437]
- The imposition of this tort liability may give rise to increased litigation, particularly against larger corporate groups. Settlements of actions involving these groups will be less probable, given their size and pool of funds.[438]
- The common law can accommodate the interests of individual justice. The courts can analyse the conduct of companies with common directors and differentiate between the effects of director control and control by ownership of shares by a parent company.[439]
- The interests and profiles of different group companies may differ significantly.[440]
- In relation to the second element in the stated issue, there would be difficulties in determining foreseeability.[441]

4.19 One of the submissions that opposed increased general tort liability suggested that the focus should be on specific laws on, for instance, workplace safety, product quality, production processes and the environment.[442]

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434 AMP (Group), AMPAM, Australian Institute of Company Directors, Angelo Bartzis, Carter Holt Harvey Limited, Coles Myer Ltd, Lend Lease.
435 AMPAM.
436 Angelo Bartzis.
437 Angelo Bartzis.
438 Angelo Bartzis.
439 Angelo Bartzis.
440 Lend Lease.
441 AMP (Group), AMPAM.

Advisory Committee response to submissions on Issue 14: Draft Recommendation 14

4.20 The introduction of a general tort liability for parent companies in corporate groups is undesirable, as:

- this liability would undermine the separate entity principle and could have negative consequences for the economy
- this area should be dealt with by specific legislation where the extension of liability beyond the tortfeasor company is desirable in the public interest.

Accordingly:

The existing principles of tort liability should not be changed for corporate groups. The imposition of additional tort liability on parent companies of corporate groups should be left to specific statutes and general common law principles.

Submissions on Draft Recommendation 14

4.21 The respondents agreed with the Draft Recommendation.[443] The imposition of responsibility for tortious liability of any group company would be totally contrary to the concept of the separate corporate entity. In large corporate groups with diverse interests, it is unreasonable to jeopardise the viability of every company in the group because of a major problem experienced by one company.

Advisory Committee response to submissions on Draft Recommendation 14

4.22 The Advisory Committee maintains the approach in the Draft Recommendation.

Recommendation 14

The existing principles of tort liability should not be changed for corporate groups. The imposition of additional tort liability on parent companies of corporate groups should be left to specific statutes and general common law principles.

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442 Angelo Bartzis.

443 Australian Institute of Company Directors, Australian Society of Certified Practising Accountants.

Chapter 5

Corporate group reconstructions

As the business of a corporate group expands or changes, its operators may wish to reorganise its structure to better reflect the group's current and anticipated requirements. This Chapter reviews three methods for reorganising corporate groups, namely mergers, asset transfers and voluntary administration. It recommends reforms to simplify and streamline the merger provisions, thereby permitting groups to modify their structure to better reflect and implement their overall enterprise goals. The Chapter also discusses the applicability of the asset transfer and voluntary administration provisions to corporate group reconstructions, and recommends reforms to improve those procedures.

Mergers

Application to wholly- and partly-owned group companies

5.1 In Australia, the same procedural rules apply to mergers of wholly- and partly-owned group companies through schemes of arrangement. However, the shareholder approval requirements for any merger may be more difficult to achieve for partly-owned group companies, particularly for those that have a relatively large, or dissident, minority shareholding. New Zealand has simplified "short-form" merger provisions for wholly-owned subsidiaries. The US has comparable "short-form" merger provisions, though they apply to closely-held as well as wholly-owned group companies.

External and internal mergers

5.2 A corporate group may be reconstructed through an external or internal merger. An external merger involves amalgamating one or more external companies into the corporate group. An internal merger involves merging existing group companies.

5.3 An external or internal merger may involve either:

- merging one or more internal or external companies into an existing group company (the remaining group company), or
- merging two or more internal or external companies into a new group company (the new group company).

5.4 An external merger may involve the shareholders of an external company having their shares cancelled (through a capital reduction[444]), in return for cash or

[444] ss 256B-256E.

securities in the remaining, or new, group company.[445] The assets and liabilities of the external company would be transferred to the group company.

5.5 A corporate group may merge an external company into the group for various reasons, including to expand the group's overall commercial activities or to acquire further stages in a production or distribution chain in which the group is involved, for the purpose of reducing its overall costs or dependency on suppliers or distributors.

5.6 An internal merger involves one or more group companies being merged into a remaining or new group company. The complex organisational structure of some corporate groups may reflect a history of past direct and indirect corporate acquisitions, for instance, acquiring companies which themselves may be parent companies of other companies. That structure may not necessarily meet the current functional, managerial and accounting needs of the group. These corporate groups may prefer to simplify their structure through internal mergers. As with external mergers, any minority shareholders of group companies may have their shares cancelled in return for cash or securities in the remaining or new group company.

5.7 An external or internal merger through a scheme of arrangement under Part 5.1 of the Corporations Law involves extensive disclosure, advance notification to ASIC and court supervision from the outset. In summary, the steps are as follows.

- *Explanatory statement.* The court must approve an explanatory statement which informs the shareholders about the purpose and likely effect of the proposed scheme and any material interests of directors.[446] An independent expert's report may also be required.[447]

- *Class meetings.* Where more than one class of shareholders is involved, separate meetings must be held and separate approvals obtained. The concept of class of shareholders is not defined in the legislation, but is left to

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445 See, for instance, *Re Vector Capital Ltd* (1997) 15 ACLC 421. This involved a "top hat" scheme, whereby a new company (the "top hat") was inserted at the top of an existing corporate group, with all existing shares in the merging company to be cancelled (through a capital reduction) in consideration for the issue to shareholders of the merging company of shares in the new group company. In this case: "The basic idea is for the [merging] company to become a wholly-owned subsidiary of a new entity with minimum share capital" (at 422).

446 Schedule 8 of the Corporations Regulations sets out the prescribed information referred to in s 412(1)(a)(ii). Part 3 of Schedule 8 sets out the prescribed information for a compromise or arrangement with members. The leading case on the necessary level of disclosure is *Phosphate Co-operative Co of Australia Ltd v Shears (No 3)* (1989) 14 ACLR 323, analysed in R Nicholson, "The Pivot Case - New Standards for Schemes of Arrangement" (1989) 7 *Company and Securities Law Journal* 277. In *Re W Coogan & Co Pty Ltd* (1993) 10 ACSR 461, the parties failed to seek a prior court order for calling the meetings or the approval of the explanatory statement. The court declined to cure these defects under s 1322(4)(a).

447 By virtue of Part 3 cl 3 of Schedule 8, where the other body to a proposed merger has a shareholding of not less than 30% of any class of voting shares in the affected company, or there are common directors, the explanatory statement must be accompanied by an independent expert's report that states whether the proposed scheme is in the best interests of the members of the company the subject of the scheme and sets out reasons for that opinion. See further P Crutchfield and R Rado, "The Requirement for Experts' Reports in Takeovers and Corporate Reconstructions" (1996) 14 *Company and Securities Law Journal* 489.

common law principles. Persons whose shares will be expropriated under the scheme may form a different class from remaining shareholders.

- *Requisite majorities.* The necessary majorities are 75% in value and a simple majority in number of those present and voting in person or by proxy at each class meeting.[448]

- *Non-avoidance.* The court, at the hearing that follows the shareholders' meeting, cannot approve a scheme of arrangement unless it is satisfied that the scheme has not been proposed to enable a person to avoid the operation of Chapter 6 of the Corporations Law (the takeover provisions) or unless ASIC has issued a written statement that it has no objection.[449]

5.8 Affected listed companies must also comply with the relevant Listing Rules.[450]

5.9 The court may make orders to give effect to a merger that involves transferring the assets and liabilities of a company that will cease to exist to a remaining or new group company.[451] The court can also approve a scheme which affects the rights of secured creditors of the affected companies.[452] However, a court may make special provision "for any persons who, within such time and in such manner as the court directs, dissent from the compromise or arrangement".[453]

5.10 Some mergers are also regulated by other legislation, such as the Trade Practices Act and banking legislation. This Report does not review that legislation.

5.11 Compared with some overseas countries, Australian corporate group structures appear to be unduly complex. Simplifying the merger provisions may encourage or assist groups to rationalise their structure and operations and adopt simpler, or more efficient, group structures, with consequential reduction in administrative costs.

5.12 Managers of corporate groups in New Zealand, Canada and the United States, unlike those in Australia, have a wider range of amalgamation methods at their disposal, with differing levels of shareholder and court involvement. The New

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[448] s 411. The Report of the Legal Committee of the Advisory Committee *Compulsory Acquisitions* (January 1996) recommended that there be no alteration to the current requisite majorities in s 411 for a scheme involving compulsory acquisition of securities (Recommendation 26). It also recommended that persons whose shares or other securities are not to be cancelled (remaining shareholders) should not be prohibited from voting on a compulsory acquisition scheme of arrangement, given that the cancellation of shares will constitute a reduction of capital and be regulated under ss 256B-256E (Recommendation 27).

[449] s 411(17). ASIC must be given notice of the application for approval of the shareholders' meeting: s 411(2). In *Re Advance Bank Australia Ltd (No 2)* (1997) 22 ACSR 513, Santow J stated that the disjunctive nature of s 411(17) made it clear that, once a Commission certificate had been produced, the court was unable to reject the scheme on the basis that it had been proposed for the purpose of circumventing Chapter 6 of the Corporations Law.

[450] For instance, Australian Stock Exchange Rules 7.18 - 7.22, 10.10.2.

[451] s 413.

[452] I Renard and J Santamaria, *Takeovers and Reconstructions in Australia* (loose leaf, Butterworths) para [1508] at p 15,025.

[453] s 413(1)(e). The Report of the Legal Committee of the Advisory Committee *Compulsory Acquisitions* (January 1996) considered that the current s 413 sufficiently protects dissenting minorities, and that no amendment to this provision is required (Recommendation 28).

Zealand provisions are modelled on the Canadian legislation, which is broadly similar to the US law.

Short-form amalgamations by approval of directors

Overseas precedents

New Zealand

5.13 This abbreviated procedure applies to internal mergers within wholly-owned corporate groups. It involves either wholly-owned subsidiaries being merged into a holding company or two or more wholly-owned subsidiaries being merged into one subsidiary company.[454]

5.14 The merger must be approved by each company's board. The directors voting in favour of a merger resolution must sign a certificate stating that they are satisfied on reasonable grounds that the remaining company will satisfy the solvency test immediately after the amalgamation becomes effective.

5.15 All secured creditors of the merging companies must be notified of the proposal, though they cannot vote on it. However, any secured or unsecured creditors can appeal to the court if they would be unfairly prejudiced by the merger. The court can make any order it thinks fit, including to negate or modify the proposal.

United States

5.16 The US has even more liberal short-form merger provisions than New Zealand. In Delaware, California, and other US States that have adopted the Model Business Corporation Act, the short-form merger is available for subsidiaries where at least 90% of the issued shares of each class of the subsidiary are owned by the parent.[455] Any proposal to merge a closely-held subsidiary into the parent company only requires the approval of the directors of the two companies.[456] The remaining company after the merger assumes all the liabilities of the merged company.

5.17 Approval by the minority shareholders of a less than wholly-owned subsidiary company is not required for a short-form merger, and these shareholders have only limited avenues for challenging the merger. In Delaware, there is no "proper business purpose" test. Instead, the merger must be fair.[457] Minority shareholders may be offered securities in the holding company or have their shares compulsorily acquired for cash. These shareholders may seek court appraisal of any compulsory buy-out

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454 New Zealand Companies Act 1993 ss 222-226.

455 J Cox, T Hazen, F O'Neal, *Corporations* (Little, Brown & Co 1995) at §22.14 (pp 22.44-22.46).

456 However, if a reverse short-form merger takes place, whereby the parent company is merged into a closely-held subsidiary, the shareholders of the parent company must also approve the merger.

457 Delaware courts have abandoned the business purpose test on the basis that virtually any merger proposal can meet that test. Instead, the company must show "entire fairness". A useful summary of the relevant US law is found in Q Digby, "Eliminating Minority Shareholdings" (1992) 10 *Company and Securities Law Journal* 105 at 119-120, V Mitchell, "The US Approach Towards the Acquisition of Minority Shares: Have We Anything to Learn?" (1996) 14 *Company and Securities Law Journal* 283 at 293-294.

terms under the merger. The criteria used for determining fair value are discussed elsewhere in this Report.[458]

5.18 The US short-form merger provisions are often used and work well in practice. There is no equivalent in Australia of that procedure. To achieve the same result other than through the voluntary liquidation of one or more group companies would require two steps:

- exercise the compulsory acquisition powers where the holding company owns at least 90% of the shares of the subsidiary[459]
- merge this wholly-owned subsidiary into the holding company under Part 5.1.

Issue 15. *Should Australian corporate law provide for short-form mergers by approval of directors only? If so, should that procedure apply to subsidiaries that are 90% or more owned by the holding company or only to wholly-owned subsidiaries?*

Submissions on Issue 15

5.19 Some submissions supported short-form mergers by approval of directors only.[460] One of those respondents argued that this would reduce complexity and compliance costs.[461]

5.20 Some of those respondents supported limiting the short-form merger provisions to wholly-owned group companies. To apply those provisions to less than wholly-owned group companies could lead to the abuse of minority shareholder rights.[462]

5.21 Other submissions favoured applying the short-form merger provisions to 90% or more owned group companies.[463] One of those respondents argued that minority shareholders would be protected by the oppression remedy and, where appropriate, a minority shareholder fair value appraisal right.[464]

5.22 Another respondent, while not opposing the proposal for companies in a wholly-owned group, considered that the need for such a provision had not necessarily been demonstrated.[465] That respondent pointed out that voluntary liquidation is often used as a means of undertaking an internal merger within a wholly-owned group and that the professional and compliance costs of this process are relatively low. A short-form merger power for wholly-owned groups or voluntary

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458 See para 3.12: *Valuation of shares*.

459 ss 664A-664G. Section 664AA imposes time constraints on the use of this power.

460 Australian Institute of Company Directors, Carter Holt Harvey Limited, Coles Myer Limited, Commonwealth Bank of Australia, John Fielding, Lend Lease.

461 Carter Holt Harvey Limited.

462 AMP (Group), Carter Holt Harvey Limited, John Fielding, Lend Lease.

463 Australian Institute of Company Directors, AMPAM, Commonwealth Bank of Australia.

464 Australian Institute of Company Directors.

465 ASIC.

liquidation could be used as the second stage of a corporate privatisation.[466] That respondent opposed short-form mergers for partly-owned group companies. It pointed out that there are already several ways in which minority shareholders can be expropriated, which provide adequate protection for those shareholders.

5.23 One respondent[467] argued that the simplified merger proposals are not compatible with the current "purchase method" under the Australian Accounting Standards, which require that an acquiring entity must be identified regardless of the circumstances of the merger.[468] Instead, mergers should be accounted for under the "pooling of interests" method of accounting (prohibited by Australian Accounting Standards, but permitted by the US Financial Accounting Standards Board and the International Accounting Standards Committee).[469]

Advisory Committee response to submissions on Issue 15: Draft Recommendation 15

5.24 The introduction of short-form merger provisions could simplify and expedite corporate group reconstructions. However, mergers requiring only the approval of directors of the merging companies should be limited to wholly-owned corporate groups. To extend these provisions to 90% or more owned companies would disenfranchise minority shareholders who would be forced to rely on oppression or other remedies if they opposed the merger. Accordingly:

Wholly-owned group companies should be able to merge with each other or with their parent company with the approval of the directors of all the merging companies.

The directors voting in favour of a merger resolution should sign a certificate stating that they are satisfied on reasonable grounds that the new or remaining company will be solvent immediately after the merger becomes effective.

All secured creditors of the merging companies should be notified of the proposal. Also, all creditors, whether secured or unsecured, should have a right to appeal to the court if they would be unfairly prejudiced by the merger. The court should have a power to make any order it thinks fit, including to negate or modify the proposed merger.

5.25 Accounting standards, and the issue of international harmonisation of these standards, are the province of the Australian Accounting Standards Board and the Urgent Issues Group.

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[466] The respondent pointed out that, if the Corporations Law were amended to permit short-form mergers within wholly-owned groups, a group could merge a non-wholly-owned group company through the following two-step process: (a) elimination of minority shareholdings in the partly-owned group company through a compulsory acquisition under ss 664A ff or by a capital reduction under ss 256B-256E, and (b) an internal merger either under the new short-form merger power or by means of a members' voluntary liquidation.

[467] Commonwealth Bank of Australia.

[468] This approach requires goodwill to be amortised to profit of the combined entity over several years. This significantly reduces the commercial attractiveness of any merger.

[469] This method of consolidation of two entities, provided certain criteria are met, does not result in goodwill on the balance sheet.

Submissions on Draft Recommendation 15

5.26 The respondents supported the Draft Recommendation.[470]

Advisory Committee response to submissions on Draft Recommendation 15

5.27 The Advisory Committee maintains the approach in the Draft Recommendation.

Recommendation 15

Wholly-owned group companies should be able to merge with each other or with their parent company with the approval of the directors of all the merging companies.

The directors voting in favour of a merger resolution should sign a certificate stating that they are satisfied on reasonable grounds that the new or remaining company will be solvent immediately after the merger becomes effective.

All secured creditors of the merging companies should be notified of the proposal. Also, all creditors, whether secured or unsecured, should have a right to appeal to the court if they would be unfairly prejudiced by the merger. The court should have a power to make any order it thinks fit, including to negate or modify the proposed merger.

Amalgamations by approval of shareholders and directors

Overseas precedents

New Zealand

5.28 In New Zealand, this procedure is available for external mergers or internal mergers in a partly-owned corporate group. It involves a resolution of directors of each of the merging companies and the approval of at least 75% by value of the shareholders of each of those companies who vote on the merger resolution.[471]

5.29 The approval process involves:

- preparation of an amalgamation proposal, which includes details of any proposed share for share swap or other consideration for affected shareholders
- a resolution by the board of each merging company that the proposed amalgamation is in the best interests of the company and that the directors are satisfied on reasonable grounds that the remaining or new company will be solvent immediately after the merger becomes effective

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[470] Australian Institute of Company Directors, Australian Society of Certified Practising Accountants.

[471] New Zealand Companies Act 1993 ss 221, 106, 2(1) definition of "special resolution".

- circulation of relevant information to shareholders, including a copy of the amalgamation proposal and the resolutions of the boards of each of the amalgamating companies, a statement of any material interests of the directors in the proposal, a statement setting out the buy-out rights of any dissident shareholders and such further information and explanations as may be necessary to enable a reasonable shareholder to understand the nature and implications of the proposed amalgamation

- shareholder consideration of the proposal. Shareholders can vote for or against, but cannot amend, the proposal. The proposal must be approved by the requisite majority (75% by value of shareholders who vote) of each of the amalgamating companies

- public notice to creditors. Creditors of any amalgamating company are not entitled to vote on the amalgamation but may apply to the court for relief before the amalgamation becomes effective

- registration of the amalgamation proposal, once approved.[472]

5.30 There is no requirement for court approval. However, any dissident shareholder or creditor may make a court application. The court may thereupon prevent or modify the amalgamation, if satisfied that the amalgamation would unfairly prejudice shareholders or creditors of a merging company.[473]

5.31 Any shareholder in an amalgamating company who votes against the merger has a buy-out right if the merger proceeds.[474]

5.32 The effect of an amalgamation is that the remaining or new company succeeds to all the rights, liabilities and obligations of each of the merging companies. This ensures that a company cannot avoid its liabilities to creditors by the simple expedient of being merged into another company. Also, creditors are further protected by the requirement that an amalgamation proposal, even if approved by shareholders, cannot be registered (and therefore be enforced) unless the board or proposed board of the remaining or new company has certified that no creditor will be prejudiced if that company will have a higher proportion of creditors’ claims to assets than that of any of the amalgamating companies.

5.33 If, upon amalgamation, the remaining or new company is insolvent, there are several remedies, including:

- a right for the liquidator to recover any distributions made to shareholders under the merger (subject to various defences)

- application of the voidable transaction provisions to any other benefit received by shareholders or directors of an amalgamating company

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472 ss 220-221, 223-226.

473 s 226.

474 ss 106(1)(c) (referring to an amalgamation under s 221) and 110-115.

- personal liability of any director who voted in favour of the solvency resolutions of any amalgamating company, and
- actions against directors for negligence, default or breach of duty.

United States

5.34 A controlling shareholder who controls less than 90% of the shares of a company may merge that company into another company through a long-form merger. The board of directors of each company must approve the "agreement of merger". In addition, a simple majority of the shareholders of the company that will cease to exist must approve the merger.[475] Any dissenting minority shareholders can exercise appraisal rights or challenge the merger on the basis of unfairness or improper purpose.

Current law

5.35 There is no equivalent in Australia of merger by director and shareholder approval only. However, companies may selectively reduce their share capital by special resolution of disinterested shareholders. Prior court approval is not required. The reduction must be "fair and reasonable to the company's shareholders as a whole" and must "not materially prejudice the company's ability to pay its creditors".[476] A reduction of capital is one method for eliminating, or reducing, minority shareholdings, but cannot of itself bring about a corporate merger.

Issue 16. *Should companies not covered by Recommendation 15 be permitted to merge by approval of shareholders and directors only?*

Submissions on Issue 16

Support

5.36 Some respondents supported other companies being permitted to merge by approval of shareholders and directors only.[477] One of those respondents[478] proposed an additional requirement to better protect minority shareholders, namely that the board or the majority shareholder of each merging company elect in the amalgamation proposal either that:

- minority shareholders vote as a separate class from the majority shareholder and its associates, or

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475 Q Digby, "Eliminating Minority Shareholdings" (1992) 10 *Company and Securities Law Journal* 105 at 120 points out that California, but not Delaware, requires approval by the holders of each class of share of the companies to be merged. The approval of shareholders of the remaining company is also required if the number of post-merger voting shares will exceed the number of pre-merger voting shares by more than one-sixth (California) or 20% (Delaware).

476 ss 256B-256E.

477 AMP (Group), AMPAM, Australian Institute of Company Directors, Carter Holt Harvey Limited, Coles Myer Ltd, Commonwealth Bank of Australia, Lend Lease.

478 Carter Holt Harvey Limited.

- if the merger proceeds, minority shareholders who voted against it could be bought out by their company or the majority shareholder, at the option of either the minority shareholders or the majority shareholder/company.

Opposed

5.37 One respondent did not support a new merger power by approval of shareholders and directors.[479] Such mergers can be achieved by way of a scheme of arrangement or by either a friendly takeover or capital reduction at first instance, followed by either a short-form merger (if permitted: Recommendation 15) or voluntary liquidation. One of the advantages of schemes of arrangement, from a procedural perspective, is the ability of the court to determine classes.[480]

Advisory Committee response to submissions on Issue 16: Draft Recommendation 16

5.38 There should be simplified merger provisions for companies (other than wholly-owned companies covered by Recommendation 15), based on the New Zealand provisions, subject to:

- adopting the equivalent of the reduction of capital rules that protect creditors, namely that the merger not materially prejudice the remaining or new company's ability to pay the creditors of each of the merging companies[481]
- parties having the right to seek a court determination on what constitutes a class of shares, for the purpose of holding separate class meetings.

Accordingly:

A company should be permitted to merge with another company, with the approval of the board of directors of each company and a special resolution of the shareholders (or each class of shareholders) of each company. The merger procedure should be based on the New Zealand legislation. Any merger must not materially prejudice the ability of the remaining or new company to pay the creditors of each of the merging companies. Also, any interested person should have the right to seek a court determination on what constitutes a class of shares, for the purpose of holding separate class meetings.

Submissions on Draft Recommendation 16

5.39 The respondents supported the Draft Recommendation.[482]

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479 ASIC.

480 See *Re Jax Marine Ltd & the Companies Act* (1966) 85 WN (Pt 1) (NSW) 130.

481 cf s 256B(1)(b).

482 Australian Institute of Company Directors, Australian Society of Certified Practising Accountants.

Advisory Committee response to submissions on Draft Recommendation 16

5.40 The Advisory Committee maintains the approach in the Draft Recommendation.

Recommendation 16

A company should be permitted to merge with another company, with the approval of the board of directors of each company and a special resolution of the shareholders (or each class of shareholders) of each company. The merger procedure should be based on the New Zealand legislation. Any merger must not materially prejudice the ability of the remaining or new company to pay the creditors of each of the merging companies. Also, any interested person should have the right to seek a court determination on what constitutes a class of shares, for the purpose of holding separate class meetings.

Amalgamations by court approval

Overseas precedent

5.41 Under the New Zealand legislation, a court has very broad and flexible powers to approve an amalgamation.[483] Applicants may prefer this procedure for an external or internal merger to effect more complex amalgamations, for instance those involving the compromise of debts (not provided for in shareholder approval amalgamations). This procedure is similar to Part 5.1 of the Corporations Law, though the New Zealand provisions are much less prescriptive.

5.42 Before approving an amalgamation, the court may make a number of orders including:

- requiring notice of the application to be given to such persons or classes of person as the court may specify
- requiring the holding of meetings and determining classes of shareholders and creditors for the purpose of considering whether to approve the proposed amalgamation
- requiring that a report on the proposed amalgamation be prepared and be supplied to the relevant shareholders and creditors
- requiring payment of costs incurred in the preparation of the report
- specifying those classes of persons entitled to appear and be heard by the court on the amalgamation application.[484]

5.43 The court has very broad powers (similar to those in the Australian legislation) to facilitate any merger it approves, covering such matters as:

- the transfer or vesting of any legal rights, assets or liabilities

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483 New Zealand Companies Act 1993 ss 235-239.

484 New Zealand Companies Act 1993 s 236(2).

- the issue of shares or securities
- the continuation of legal proceedings
- the liquidation of any company
- the buy-out of any dissident shareholders, and
- any other matters that are necessary or desirable to give effect to the amalgamation.[485]

Issue 17. *Should the Australian court-approved merger procedure be made less prescriptive? Would the New Zealand legislation be an appropriate model?*

Submissions on Issue 17

5.44 All the submissions that commented on this Issue supported making the Australian court-approved merger procedure less prescriptive.[486] Those submissions considered that the New Zealand legislation would be an appropriate model. One of those respondents[487] made the following comments on its experience with the New Zealand legislation.

- The New Zealand legislation is very flexible.
- The possible arrangements under this procedure are unlimited. The involvement of the court provides the necessary safeguards.
- The court has the power to determine the procedural rules for each particular merger. For instance, the court can decide whether or not a meeting of shareholders is necessary, what the necessary voting threshold/quorum requirements are to be, what experts' reports should be provided to shareholders and whether creditors should be heard.

Advisory Committee response to submissions on Issue 17: Draft Recommendation 17

5.45 Given the strong support in submissions for simplified court-approved merger procedures:

The Corporations Law should be amended to include a new provision permitting court-approved mergers, based on the New Zealand legislation. Any interested party should have the right to seek a court determination on what constitutes a class of shares, for the purpose of holding different class meetings.

5.46 These provisions would be in addition to the scheme of arrangement provisions in s 411.

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485 New Zealand Companies Act 1993 s 237(1).

486 AMP (Group), AMPAM, Australian Institute of Company Directors, Coles Myer Ltd, Commonwealth Bank of Australia, Lend Lease.

487 Carter Holt Harvey Limited.

Submission on Draft Recommendation 17

5.47 The one respondent that commented supported the Draft Recommendation.[488]

Advisory Committee response to submission on Draft Recommendation 17

5.48 The Advisory Committee maintains the approach in the Draft Recommendation.

Recommendation 17

The Corporations Law should be amended to include a new provision permitting court-approved mergers, based on the New Zealand legislation. Any interested party should have the right to seek a court determination on what constitutes a class of shares, for the purpose of holding different class meetings.

Tax implications of mergers

5.49 Current Commonwealth income tax and State stamp duty legislation can significantly affect the viability of a possible external or internal merger. For instance, the revenue and capital losses and bad debts of a merging company may not be transferable to the new or remaining group company. Also, the incidence of stamp duty under the various State Stamp Duty Acts is a disincentive to merger activity, and the potential for relief from stamp duty in the case of internal group restructures varies among the States.

5.50 The Commonwealth legislation was reviewed in the Report of the Review of Business Taxation.[489] That Report has recommended amendments to assist corporate group mergers by permitting head entities, including holding companies, and wholly-owned subsidiary entities to be treated as a single entity for taxation purposes. The Report also puts forward proposals to bring the losses of merging entities into the wholly-owned consolidated group.

Asset transfers

Application to wholly- and partly-owned group companies

5.51 Part 5.1 of the Corporations Law has specific provisions to assist asset and liability transfer schemes of arrangement involving transfers from wholly-owned subsidiaries to their holding companies. There are no comparable provisions for asset transfer schemes involving partly-owned group companies.

5.52 The provisions permitting asset transfers through a voluntary liquidation apply equally to wholly- and partly-owned group companies.

Asset and liability transfer schemes

Current law

488 Australian Society of Certified Practising Accountants.

489 *The Report of the Review of Business Taxation: A Tax System Redesigned* (July 1999).

5.53 Managers of a corporate group can use Part 5.1 to implement a scheme between a holding company, its wholly-owned subsidiaries, and the creditors of those companies, which involves transferring the assets and liabilities of the subsidiary companies to the holding company.

5.54 Prior to 1991, separate meetings of each class of creditors of each company participating in such a scheme were required. This procedure was cumbersome and expensive for creditors seeking to maximise their return.[490]

5.55 The 1991 amendments to the Corporations Law were designed to "facilitate the use of schemes of arrangement in complex corporate structures". They provided a specific procedure for a compromise or scheme of arrangement between a holding company (whether or not the ultimate holding company), its wholly-owned subsidiaries[491] and the creditors of those companies.[492] The court could order meetings of creditors of the holding company and the wholly-owned subsidiaries to be consolidated, if satisfied that the number of meetings that would otherwise be required would significantly impede the timely and effective consideration of the scheme by the creditors. These provisions also require that the scheme transfer the whole of the undertaking, property and liabilities of the wholly-owned subsidiaries to the holding company.[493] Under an approved scheme, all group creditors are treated as creditors of the holding company.

5.56 The 1991 amendments have a number of limitations which may reduce their utility for some corporate groups. These amendments:

- only apply to arrangements that would consolidate all the assets and liabilities of the wholly-owned subsidiaries into the holding company. They do not provide for partial consolidations
- do not apply to partly-owned group companies.

Issue 18. *Should the provisions regulating asset and liability transfer schemes be amended to apply to partial consolidations and/or partly-owned group companies?*

Submissions on Issue 18

5.57 Respondents generally supported the suggested extension of these provisions.[494] However, one respondent considered that the more flexible court-approved

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[490] The Harmer Insolvency Report made some general criticisms of the scheme of arrangement provisions within the context of insolvency, stating that: "The procedure for a scheme of arrangement is cumbersome, slow and costly and is particularly unsuited to the average private company which is in financial difficulties. The time taken to implement a scheme varies but in general is at least two to three months. The legal and accountancy costs of even a relatively straightforward scheme are substantial": Australian Law Reform Commission *General Insolvency Inquiry* Report (1988) (ALRC 45), vol 1, para 46.

[491] See s 9 definition of "wholly-owned subsidiary".

[492] s 411(1A), (1B), (1C).

[493] s 411(1A)(b), (1B)(a).

[494] Australian Credit Forum, Australian Institute of Company Directors, Coles Myer Ltd.

arrangement procedure referred to in the discussion leading up to Recommendation 17 would deal with this matter.[495]

Advisory Committee response to submissions on Issue 18: Draft Recommendation 18

5.58 The principles regulating asset and liability transfer schemes have equal application to whole and partial consolidations and wholly- or partly-owned group companies. Accordingly:

The Corporations Law provisions regulating asset and liability transfer schemes should be amended to apply to partial consolidations and partly-owned group companies.

Submission on Draft Recommendation 18

5.59 The one respondent that commented supported the Draft Recommendation, pointing out that the court approval process under Part 5.1 would provide the necessary safeguards for partial consolidations.[496]

Advisory Committee response to submission on Draft Recommendation 18

5.60 The Advisory Committee maintains the approach in the Draft Recommendation.

Recommendation 18

The Corporations Law provisions regulating asset and liability transfer schemes should be amended to apply to partial consolidations and partly-owned group companies.

Transfer of assets through a voluntary liquidation

Current law

5.61 An alternative route for merging the business or property of a solvent company into, or within, a corporate group is by transferring its business or property under a voluntary liquidation.

5.62 A liquidator of a company under a members' voluntary winding up may, with the approval of a special resolution of the company,[497] transfer the whole or a part of the business or property of the company to another body corporate in return for "shares, debentures, policies or other like interests in the [transferee] body

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495 Carter Holt Harvey Limited.

496 Australian Society of Certified Practising Accountants.

497 The Report of the Legal Committee of the Advisory Committee *Compulsory Acquisitions* (January 1996) recommended that there be no statutory disclosure requirements for any asset transfer resolution. This matter should be left to the common law (Recommendation 32). However, the Report recommended that the intended transferee and any associate of that transferee not be permitted to vote in favour of the resolution (Recommendation 33).

corporate".[498] No court approval is required. Creditors are protected, given that only solvent companies can be wound up voluntarily by a vote of their members alone.

5.63 Any dissenting shareholder of the transferor company may require the liquidator "either to abstain from carrying the resolution into effect or to purchase the member's interest at a price to be determined by agreement or by arbitration under this section".[499] However, it is for the liquidator to decide whether to abstain from carrying the resolution into effect or to purchase the member's interest.[500] A minority shareholder can therefore "opt-out" of the proposal, without the relevant amalgamation being defeated.

5.64 In the case of a creditors' voluntary winding up, the powers of a liquidator to transfer assets under the liquidation can only be exercised with the approval of the court or the creditors' committee of inspection.[501]

5.65 One difficulty with either form of voluntary liquidation is that the liquidator has no specific power to assign the company's liabilities to the transferee body corporate.[502] Consequently, sufficient assets must be left in the transferor company to discharge its liabilities. Alternatively, as part of the sale, transfer or other arrangement whereby the business or property of the transferor company is transferred to the transferee body corporate, the transferee may provide an indemnity to the company in respect of its pre-existing liabilities.[503]

Issue 19. *What, if any, changes should there be to the existing law regulating the transfer of assets through a voluntary liquidation? For instance, should liquidators have a specific power to assign the company's liabilities to the transferee body corporate?*

Submissions on Issue 19

5.66 All submissions that commented on this Issue supported giving the liquidator of a company a specific power to assign the company's liabilities to the transferee body corporate.[504] They endorsed any proposal which makes the provisions more flexible and easier to operate, while affording appropriate protections to minority shareholders and creditors. To protect creditors, a transfer should only be possible with their approval.

Advisory Committee response to submissions on Issue 19: Draft Recommendation 19

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498 s 507.

499 s 507(4).

500 See generally HAJ Ford, RP Austin & IM Ramsay, *Ford's Principles of Corporations Law* (loose leaf, Butterworths) at [24.180].

501 s 507(10).

502 Contrast the power of the court to effect this transfer under a Part 5.1 scheme of arrangement: s 413(1)(a).

503 I Renard and J Santamaria, *Takeovers and Reconstructions in Australia* (loose leaf, Butterworths), para [1526] at p 15,067.

504 Australian Credit Forum, Carter Holt Harvey Limited, Coles Myer Ltd.

5.67 Liquidators in a voluntary liquidation should be entitled to assign liabilities as well as transfer assets if creditors agree. Accordingly:

The Corporations Law should be amended to permit the liquidator to assign a company's liabilities with the consent of all the relevant creditors.

5.68 Creditors could ensure that no assignment of liabilities takes place unless the assignee company has assets at least equivalent to those of the assignor company.

Submissions on Draft Recommendation 19

5.69 One respondent supported the Draft Recommendation, arguing that it would permit a more efficient and cost-effective transfer of assets and liabilities than existing alternatives.[505] Another respondent was concerned about the requirement that all creditors agree. That respondent suggested that the liquidator be entitled to act with the support of 90% by value of creditors, with provision for a fall-back application to the court.[506]

Advisory Committee response to submissions on Draft Recommendation 19

5.70 Liquidators should not be given the power to assign the company's liabilities with the support of 90% by value of the relevant creditors. A better approach would be for the liquidator to have the assignment power, either with the consent of all relevant creditors or the consent of the court. Court consent would act as an independent check to prevent a very small group of creditors from automatically blocking an assignment of liabilities.

Recommendation 19

The Corporations Law should be amended to permit the liquidator to assign a company's liabilities with the consent of all the relevant creditors or the consent of the court.

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505 Australian Society of Certified Practising Accountants.

506 Law Council of Australia.

Voluntary administration

Application to wholly- and partly-owned group companies

5.71 The voluntary administration provisions apply equally to wholly- and partly-owned group companies.

Current law

5.72 The objectives of Part 5.3A of the Corporations Law are to permit an independent registered liquidator to assume control of an insolvent, or near-insolvent, company's affairs for the purpose of either:

- preparing a deed of company arrangement to revitalise the company, or
- attempting to provide the company's creditors with a better return than would result from the immediate winding up of the company.[507]

5.73 The decision to enter into a deed of company arrangement rests with the company's creditors.[508]

5.74 The voluntary administration provisions are not specifically tailored to deal with the possibility of simultaneous corporate group administrations. However, it is possible to convene a joint meeting of the creditors of various corporate group companies which are under voluntary administration, provided the creditors agree and only the creditors of each particular group company vote on any proposal for that company.[509] Also, the courts have interpreted the voluntary administration provisions so as to permit deeds of company arrangement binding two or more insolvent companies.[510]

Law reform options

5.75 Any proposal to amend the voluntary administration provisions to specifically accommodate the joint administration of two or more group companies may need to deal with the following matters:

- *creditors' meetings:* whether joint meetings of creditors would only be permissible with the unanimous consent of all creditors of all the affected

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507 s 435A.

508 The Report by the Legal Committee of the Advisory Committee *Corporate Voluntary Administration* (June 1998) examined the voluntary administration procedure in detail and recommended various amendments to enhance its operation.

509 In *Hagenvale Pty Ltd v Depela Pty Ltd* (1995) 17 ACSR 139, two related companies were in administration under the control of the same administrator. The administrator held the major meetings of the two companies simultaneously. The Court (at 147) approved that procedure, noting that the creditors had unanimously decided that the two meetings should be held simultaneously and that the chairman of the meeting was careful to point out that only the creditors of each particular company were entitled to vote on any proposal for that particular company.

510 *Mentha v GE Capital Ltd* (1997) 27 ACSR 696.

companies, with the consent of a specified minimum percentage of the creditors of all the affected companies or with the approval of the court

- *voting:* whether there should be specific voting rules, for instance, that only creditors of a particular company can vote on matters that affect that company, subject to a court discretion to make orders to cover circumstances where the affairs of companies in a corporate group have become inextricably intermingled

- *multi-company deeds:* whether the legislation should expressly provide for deeds of company arrangement that bind more than one company

- *variation, termination and avoidance:* ensuring that the provisions for variation, termination and avoidance of deeds of company arrangement cover multi-company deeds.

Issue 20. *What, if any, changes should there be to the existing law on voluntary administration to specifically accommodate corporate group reorganisations? In particular:*

- *should the circumstances for holding joint meetings of creditors of group companies under administration be clarified (for instance, only with the unanimous consent of all creditors of all the affected companies, with the consent of a specified minimum percentage of the creditors of the affected companies or with the approval of the court)*

- *should there be specific voting rules (for instance, that only creditors of a particular company can vote on matters that affect that company, subject to a court discretion to make orders to cover circumstances where the affairs of companies in a corporate group have become inextricably intermingled)*

- *should there be express provision for deeds of company arrangement that bind more than one company*

- *is it necessary to amend the provisions for variation, termination and avoidance of deeds of company arrangement to cover multi-company deeds?*

Submissions on Issue 20

5.76 All respondents that commented on this Issue generally endorsed any proposal which makes the provisions more flexible and easier to operate, while affording appropriate protections to minority shareholders and creditors.[511]

5.77 One of these respondents said that joint meetings of creditors of group companies under administration should only be held with the unanimous consent of

511 Australian Credit Forum, Carter Holt Harvey Limited. Coles Myer Ltd would limit any changes to wholly-owned group companies.

creditors of all the affected companies who attend the meeting or with the approval of the court.[512]

Advisory Committee response to submissions on Issue 20: Draft Recommendation 20

5.78 The voluntary administration provisions have proved beneficial in reorganising the affairs of individual companies. These provisions should be adjusted to deal more effectively with corporate group reorganisations. Accordingly:

The Corporations Law should be amended to permit an administrator to pool the administration of several companies, provided that no creditor who attends the creditors' meetings votes against the proposal.

The provisions regulating pooled administrations should specifically provide for:

- *joint creditors' meetings, though creditors of a particular company should only be permitted to vote on matters that affect that company, subject to a court power to make orders to cover circumstances where the affairs of the companies in the pooled administration have become inextricably intermingled*
- *deeds of company arrangement that bind more than one company*
- *the variation, termination and avoidance of multi-company deeds of company arrangement.*

Submissions on Draft Recommendation 20

5.79 One submission supported the Draft Recommendation, including the requirement that the vote of creditors be unanimous.[513] Another respondent was concerned about the requirement for unanimity of creditors and preferred that the administrator be given the power to pool with the consent of 90% of the creditors by value, with provision for a fall-back application to the court.[514]

Advisory Committee response to submissions on Draft Recommendation 20

5.80 The Advisory Committee continues to support the Draft Recommendation, subject to the court having the power to permit the administrator to pool the administration of several companies, even where one or more creditors vote against the proposal. Court approval would be preferable to a 90% of creditors test. For instance, if a 90% test were adopted, the sole creditor of, say, the only company in a group to have any substantial assets might be prejudiced by being outvoted on a proposal to pool the assets of all the various group companies under administration. A court could take this matter into account in considering whether to approve a pooling.

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512 Australian Credit Forum.

513 Australian Society of Certified Practising Accountants.

514 Law Council of Australia.

Recommendation 20

The Corporations Law should be amended to permit an administrator to pool the administration of several companies, either where no creditor who attends the creditors' meetings votes against the proposal or the court otherwise approves.

The provisions regulating pooled administrations should specifically provide for:

- joint creditors' meetings, though creditors of a particular company should only be permitted to vote on matters that affect that company, subject to a court power to make orders to cover circumstances where the affairs of the companies in the pooled administration have become inextricably intermingled
- deeds of company arrangement that bind more than one company
- the variation, termination and avoidance of multi-company deeds of company arrangement.

Chapter 6

Liquidation of group companies

This Chapter examines the various grounds under current Australian law for holding a parent company liable for the debts of an insolvent group company or for setting aside particular intra-group transactions involving an insolvent group company. It examines the possible limitations of these remedies and recommends giving liquidators (with creditor approval) and the courts the power to make pooling orders. Pooling orders would enable courts to more closely consider how particular corporate groups have conducted their affairs and thereby reduce the impediments that can arise from the application of separate entity principles to the simultaneous liquidation of group companies.

Application to wholly- and partly-owned group companies

6.1 The matters discussed in this Chapter apply equally to the liquidation of wholly- and partly-owned group companies.

6.2 At common law, the legal rights and remedies of creditors and liquidators are the same for wholly- and partly-owned group companies. Their rights of recovery are only against the debtor company, unless another group company has provided a guarantee or other security.

6.3 The common law position is subject to statutory modification. For instance, under the Corporations Law, an Australian holding company can be liable for the debts of its insolvent subsidiary on various grounds (including as a shadow director, or where it should have reasonably suspected its subsidiary was insolvent). None of these grounds distinguish between wholly- and partly-owned group companies.

6.4 The contribution and pooling powers exercisable under New Zealand and US corporate law for the benefit of creditors do not distinguish between wholly- and partly-owned group companies. Their application turns on various factors related to the overall conduct of the corporate group, not the existence or absence of minority shareholders.

Separate entity approach

6.5 An underlying common law principle of insolvency law is that each company, whether or not in a corporate group, is a separate legal entity. In consequence, when any company in a corporate group goes into liquidation:

> "the creditors of a company, whether it be a member of a 'group' of companies in the accepted sense of that term or not, must look to that company [rather than the corporate group] for payment".[515]

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[515] *Walker v Wimborne* (1976) 137 CLR 1 at 6-7.

6.6 It therefore follows at common law that:

> " … in the absence of a contract creating some additional right, the creditors of company A, a subsidiary company within a group, can look only to that company for payment of their debts. They cannot look to company B, the holding company, for payment."[516]

6.7 If applied inflexibly, the common law can have unsatisfactory consequences in the context of groups:

> "… 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 any 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."[517]

6.8 Common law countries, including Australia, have to varying degrees introduced statutory exceptions to the principle of limited liability, which acknowledge the operation of corporate groups. The Australian provisions, particularly Part 5.7B Div 5 of the Corporations Law, have gone further than comparable UK provisions, by imposing liability on holding companies, in some circumstances, for the debts of their insolvent subsidiary companies. However, Australian insolvency law does not include some other remedies available under New Zealand and US insolvency laws, such as court contribution, pooling or subordination orders.

Current law

6.9 In some instances, a holding company may deliberate very seriously and consider its commercial reputation before allowing any group company to be placed in insolvent liquidation. The group may provide additional finance to avert that insolvency, and may also voluntarily subordinate any higher priority intra-group claims to those of external creditors of that group company. However, corporate groups are not obliged to enter into funding arrangements to support a particular group company indefinitely and may lack the funds to do so without threatening the solvency of other companies in the group. Directors of a holding company may

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516 *Industrial Equity Ltd v Blackburn* (1977) 137 CLR 567 at 577.
In *Wimborne v Brien* (1997) 23 ACSR 576, one of the parties argued that the liquidator should treat various companies, because of their interlocking and related ownership, as essentially a single entity and it did not matter which assets or liabilities were in which company. In rejecting that approach, the New South Wales Court of Appeal commented (at 581):

> "However, to treat the companies as a single group without regard to their separate assets and liabilities would have breached a fundamental concept of company law - namely that except in respect of limited statutory exceptions … there is no such thing as a 'group' and each company must be treated as a separate entity … and it was the duty of the liquidator of [one group company] to have regard only to its interests being the interests of its shareholders and its creditors as such."

517 *Re Southard and Co Ltd* [1979] 1 WLR 1198 at 1208.

decide, at some point, that giving any further financial support to a group company facing insolvency would be contrary to the interests of their own shareholders.

6.10 Where a group company goes into liquidation, Australian corporate law has two types of remedy that are particularly relevant to corporate groups:

- those which impose liability on the holding company or another group company for some or all of the debts or losses of the insolvent group company, being:
  - holding company liability
  - shadow director liability
  - misfeasance
  - agency or holding out
  - letters of comfort
- those which set aside particular intra-group transactions, namely:
  - insolvent transactions
  - transactions involving knowledge of fiduciary duty breach
  - particular intra-group guarantees, charges and unfair loans.

Liability for debts or losses

Holding company liability

6.11 Under s 588V of the Corporations Law, a holding company contravenes the Corporations Law if:

- it was the holding company of a subsidiary at a time the latter incurred a debt,[518] and
- that debt caused, or was incurred during, the insolvency of the subsidiary company,[519] and

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[518] See para 1.15 on the holding/subsidiary company test. A debt would include a guarantee executed by a company to assist another group company: see further J Hill, "Corporate Groups, Creditor Protection and Cross Guarantees: Australian Perspectives" in *The Canadian Business Law Journal* Vol 24 No 3 (February 1995) 321 at 353-355, discussing the implications of *Hawkins v Bank of China* (1992) 10 ACLC 588, 7 ACSR 349. That case examines the circumstance whereby the giving of a guarantee may constitute the incurring of a debt. See also A Brown "Does s 592 [s 588G] apply to Guarantees? The risks increase after the Hawkins case" (1993) 11 *Company and Securities Law Journal* 34.

[519] Section 95A provides that "a person is solvent if, and only if, the person is able to pay all the person's debts, as and when they become due and payable. A person who is not solvent is insolvent." Section 588E contains rebuttable presumptions to assist in establishing insolvency,

- there were reasonable grounds to suspect that the subsidiary company was then insolvent or would become insolvent by incurring that debt (or debts including that debt), and either
- the holding company or any of its directors was aware of the reasonable grounds for suspecting the subsidiary's insolvency, or
- having regard to the nature of the holding company's control over the subsidiary, it was reasonable to expect that a company in the circumstances of the holding company, or any of its directors, should be aware of these grounds for suspicion.

6.12 The liquidator of the insolvent subsidiary company may seek a court order for compensation from the holding company for any loss or damage incurred by the person to whom the debt was owed if that debt was wholly or partly unsecured when the loss or damage was suffered.[520] The provisions therefore primarily protect unsecured creditors.[521] Also, the court has a discretion to order that any creditor who knew that the subsidiary company was, or would become, insolvent when the debt was incurred is not to participate in the proceeds of the compensation order until all the other unsecured debts of the insolvent subsidiary have been paid in full.[522] A recent European proposal would impose a comparable liability on parent companies of corporate groups.[523]

6.13 The holding company has various defences, including where, at the relevant time, it and its directors:

- reasonably expected that the subsidiary was solvent (taking into account the relevant debt and any other concurrent debt)[524]

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including a presumption that a corporation is insolvent during any period in which it had inadequate or no accounting records.

The relevant principles for determining insolvency, and the problems arising from their application, are discussed in detail in A Keay, "The Insolvency Factor in the Avoidance of Antecedent Transactions in Corporate Liquidations" (1995) 21 *Monash University Law Review* 305. The test of solvency within the corporate group context is also discussed in A Wyatt and R Mason, "Legal and accounting regulatory framework for corporate groups: implications for insolvency in group operations" (1998) 16 *Company and Securities Law Journal* 424, in particular at 441 ff.

520 s 588W(1)(c). These recovery rights are subject to a limitation period of six years. The civil liability falls on the corporation, rather than its directors. However, those directors could be liable as shadow directors: see further para 6.15.

521 Under s 588Y(1), amounts recovered by the liquidator are not available to pay secured debts unless all the insolvent company's unsecured debts have been paid in full.

522 s 588Y(2).

523 Forum Europaeum Konzernrecht, "Corporate Group Law for Europe" 1 *European Business Organization Law Review* (2000) proposes that, in the event of a subsidiary's insolvency, a parent company should be obliged either to help the subsidiary to regain its solvency or wind the subsidiary up. A parent company that fails to take either of these steps should be required to indemnify the subsidiary for any losses incurred as a result of the insolvency. The parent company should have a defence if it can show that it did not, and could not, foresee the subsidiary's insolvency.

524 s 588X(2).

- reasonably believed that a competent and reliable person was responsible for informing the holding company of the solvency of the subsidiary and that person was fulfilling that responsibility,[525] or

- had taken all reasonable steps to prevent insolvent trading by the subsidiary.[526]

6.14 These provisions provide an incentive for a holding company to continuously monitor the activities of its subsidiaries or delegate that task to an appropriate person. In effect, it transfers some financial risks from the unsecured creditors of the subsidiary to the holding company itself and, indirectly, the unsecured creditors of the holding company (whose chances of recovery may be reduced by the assets of the holding company being used to pay various debts of the subsidiary company). Likewise, the chances that unsecured creditors of the subsidiary will recover would be affected by the financial position of the holding company and therefore its ability to pay any relevant debts of the insolvent subsidiary, should an order be made.[527]

Shadow director liability

6.15 Directors are under a duty to prevent insolvent trading by their companies.[528] A company which controls another company in a corporate group (and possibly the directors of that controlling company[529]) may be a shadow director of the latter company.[530] The shadow director concept seeks to capture the idea of de facto control

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[525] s 588X(3)

[526] s 588X(5).

[527] See further I Ramsay, "Holding Company Liability for the Debts of an Insolvent Subsidiary: A Law and Economics Perspective" (1994) 17 *University of New South Wales Law Journal* 520 at 539-542; I Ramsay, "Allocating Liability in Corporate Groups: An Australian Perspective" 13 *Connecticut Journal of International Law* (1999) 329 at 360 ff.

[528] s 588G. A detailed analysis of the history, policy basis, statutory defences and relevant case law on this section is provided by R Langford, "The new statutory business judgment rule: should it apply to the duty to prevent insolvent trading?" (1998) 15 *Company and Securities Law Journal* 533. On the tests of solvency as they apply to this section, refer also to footnote 517.

[529] In *Re Hydrodam (Corby) Ltd* [1994] BCC 161 at 164, the Court held that the directors of a parent company would not necessarily be shadow directors of a subsidiary. For instance, if the directors of the parent company, as a collective body, gave directions to the directors of the subsidiary company, and the directors of the latter company were accustomed to act in accordance with such directions, the result would be to constitute the parent company, but not its directors, a shadow director of the subsidiary company. Conversely, if the directors of the parent company from time to time individually and personally gave directions to the directors of the subsidiary company, those individual directors of the parent company would be personally liable as shadow directors of the subsidiary company.

[530] A company cannot be formally appointed as a director of another company: s 221(3). However, it may be a shadow director by virtue of the s 9 definition of director which includes a person in accordance with whose "instructions or wishes" the directors of that body are accustomed to act. The concept of a holding company being held liable as a shadow director is recognised in European law. Under French corporate 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. 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. German case law provides that a holding company is liable to the creditors of an insolvent subsidiary for the debts of that subsidiary where the holding company was "permanently and extensively" involved in the management of the subsidiary.

within a corporate group, without becoming entangled in questions about the precise distribution of share ownership needed to establish that control.[531] Shadow directors, as well as formally appointed directors, may be liable for the insolvent trading of their companies, and could be required to pay compensation or other penalties.[532]

Misfeasance

6.16 A court may order that any person who is guilty of fraud, breach of duty or other misfeasance in relation to a company may be required to compensate the company for any consequential loss or damage.[533] This power has been invoked in a number of cases to unwind fraudulent intra-group transactions.[534] Likewise, a group company that knowingly assists another group company in breaching its fiduciary duties prior to its liquidation may be liable to account for any loss suffered by the latter group company.[535]

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531 See further paras 2.145-2.147.

532 ss 588G, 588J. Directors who breach s 588G may be subject to civil or criminal liability under the Part 9.4B civil penalty provisions: s 588G(4).

533 s 598.

534 In *Walker v Wimborne* (1976) 3 ACLR 529, a liquidator invoked the equivalent of s 598 to recover fees paid to another company in the same corporate group. In *Southern Cross Commodities Pty Ltd v Ewing* (1988) 14 ACLR 39, the Court allowed a liquidator of a company to recover property fraudulently misappropriated by the directors in favour of other companies in the same corporate group. In *Linter Group Ltd v Goldberg* (1992) 7 ACSR 580, the controller of the corporate group, in his capacity as director of a particular group company, lent over three quarters of the funds of that group company to a second group company which had no real equity or security for that loan. The purpose of that transaction was to reduce the funds available to a major creditor of the first group company. The controlling director and another director of the first group company were each held liable in damages for breach of their fiduciary duties as directors of that company.

535 Under the doctrine of *Barnes v Addy* (1874) LR 9 Ch App 244, a stranger who "knowingly receives trust property in breach of trust" or "knowingly assists" in a breach of trust by a trustee may be personally liable to account in equity to the wronged beneficiary. These limbs of *Barnes v Addy* have been applied to defaulting fiduciaries who are not trustees in the formal sense, including company directors.

In *Farrow Finance Co Ltd v Farrow Properties Pty Ltd* (1997) 26 ACSR 544, the Court said that, under the principles in *Barnes v Addy*, a holding company could be liable for the actions of its directors who had been appointed to a subsidiary company in the corporate group. The Court also discussed the principles for determining the relevant state of knowledge of a recipient company in a corporate group by means of the attribution of knowledge through common directors. The Court said that "… in a case of fraud involving two companies, both of which share a common director who is involved in the fraud, the knowledge of the director will be imputed to the company taking the benefit of the fraud if the director was acting within the scope of his or her actual or apparent authority as a director of the benefiting company. In my opinion, that criterion applies equally to a case not of fraud but of breach of fiduciary duty" (at 587). The Court also ruled that, where the appropriate elements of knowledge are satisfied, a claim under *Barnes v Addy* was not precluded merely because the common directors did not themselves undertake the transaction that constituted the breach of fiduciary duty.

Sections 128 and 129 deal with the assumptions of propriety that people dealing with companies are entitled to make concerning the actions of their directors and officers. Subsection 129(4) provides that a person may assume that the officers and agents of the company properly perform their duties to the company. However, by virtue of s 128(4), a person who knew or suspected at the time of the dealings that the assumption was incorrect is not entitled to make that assumption.

See further J O'Donovan, "Corporate Benefit in relation to Guarantees and Third Party Mortgages" (1996) 24 *Australian Business Law Review* 126 at 131-132, K Yeung, "Corporate groups: legal aspects of the management dilemma" [1997] *Lloyd's Maritime and Commercial*

Agency or holding out

6.17 The arrangements within a corporate group may be such that a group company is treated as merely the agent for (or a partner of) the holding company, thereby permitting third parties who deal with that group company to enforce their rights directly against the holding company as a principal.[536] Also, a holding company will be liable if it has held out, or misrepresented, to outsiders that the group company with which they are dealing is merely the agent of the holding company, or that the holding company guarantees the debts of that group company. These principles are recognised in the case law, although a finding of agency is relatively rare.[537]

Letters of comfort

6.18 In addition to these statutory and common law remedies, a parent company who provides a "letter of comfort" for the debts of a group company could, depending on the terms of the letter, be liable for those debts in the event of the latter company's insolvency. However, much turns on the terms of any particular letter of comfort as to whether, or in what circumstances, the provider accepts secondary legal liability for

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Law Quarterly 208 at 224-228, R Schulte, "Corporate groups and the equitable subordination of claims in insolvency" (1997) 18 *The Company Lawyer* 2 at 7.

536 IM Ramsay and GP Stapledon, *Corporate Groups in Australia* (Research Report, Centre for Corporate Law and Securities Regulation, University of Melbourne, 1998) at 20 state that the most common ground argued in litigation in support of lifting the corporate veil was agency.

537 In *Smith Stone & Knight Ltd v Birmingham Corporation* [1939] 4 All ER 116, the Court identified six overlapping factors that may be taken into account in determining whether a subsidiary is acting as the agent of its parent:

- were the profits of the subsidiary those of the parent?
- were the persons conducting the business of the subsidiary appointed by the parent?
- was the parent the "head and brains" of the trading venture?
- did the parent control the venture?
- were the profits made by the subsidiary generated by the skill and direction of the parent?
- was the parent in effective and constant control of the subsidiary?

The principles in *Smith* were criticised at the time (see (1940) 3 *Modern Law Review* 226), but have subsequently been applied in *Hotel Terrigal v Latec Investments (No 2)* [1969] 1 NSWLR 676 and *Spreag v Paeson Pty Ltd* (1990) 94 ALR 679.

An agency relationship does not arise merely because the parent company might enjoy the profit earned by the subsidiary. The degree of control exercised is also fundamental. In *Adams v Cape Industry plc* [1990] 2 WLR 657, the Court ruled that a wholly-owned subsidiary was not the agent of the parent, given that the holding company did not exercise sufficient control and the subsidiary was responsible for the day-to-day management of its business. Merely acting as an agent for a parent in a particular transaction would be insufficient to prove an ongoing agency relationship.

In *Atlas Maritime Company SA v Avalon Maritime Ltd (The Coral Rose)* [1991] All ER 769 at 779, the Court said: "The creation or purchase of a subsidiary company with minimal liability, which will operate with the parent's funds and on the parent's directions but not expose the parent to liability, may not seem to some the most honest way of trading. But it is extremely common in the international shipping industry, and perhaps elsewhere. To hold that it creates an agency relationship between the subsidiary and the parent would be a revolutionary doctrine".

In *Banque Financière de la Cité v Parc (Battersea) Ltd* [1998] 1 All ER 737, the House of Lords confirmed an earlier decision that controllers of a particular corporate group did not have the agency powers to bind the group companies.

those debts.[538] The possibility therefore remains that a parent company, through its letters of comfort, could create a false impression of the creditworthiness of its group companies.[539]

Setting aside transactions

Insolvent transactions

6.19 A liquidator of a company may recover the benefit of payments which are insolvent transactions, being either unfair preferences or uncommercial transactions, entered into when the company was insolvent (or became insolvent as a result of those transactions) and within a specified relation-back period before the company's liquidation.[540] These provisions may particularly affect intra-group financial dealings, such as inter-company loans or asset transfers, as well as third party mortgages or guarantees provided to external lenders to the group. The court has a wide range of powers to nullify the effect of an insolvent transaction.[541] Various exemptions apply.[542]

6.20 *Unfair preferences.* An unfair preference is any transaction that gives a particular creditor a greater return than the creditor would have received in a winding

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538 For instance, in *Banque Brussels Lambert SA v Australian National Industries Ltd* (1989) 21 NSWLR 502, Rogers CJ in Equity, while recognising that the undertaking was promissory in that instance, did not accept that the undertaking was a guarantee if, as in this case, the agreement made clear that the giver of the undertaking did not accept secondary liability for the borrower's debts.

In *Re Augustus Barnett & Sons Ltd* [1986] BCLC 170, a parent company gave a letter of comfort, agreeing to provide its subsidiary with financial support for twelve months. This enabled the subsidiary, which was then trading at a loss, to continue trading further into debt. Nine months after the giving of the letter, the subsidiary was compelled to borrow from a sibling company or else to face liquidation. At this point the parent again assured the subsidiary's creditors that it would continue to support the company. Thirteen months after the first letter, the subsidiary went into receivership and thence into liquidation. The liquidator was unable to convince the Court that the parent should be liable for fraud (under s 332 of the Companies Act 1948) because the subsidiary's board had not carried on the subsidiary's activities with fraudulent intent and the parent could therefore not be fixed with accessorial liability. Any fraudulent intent on the part of the parent was irrelevant to s 332.

In *Kleinwort Benson Ltd v Malaysia Mining Corporation Bhd* [1989] 1 All ER 785, the Court ruled that, although the issue turns on the construction of the relevant language, letters of comfort are generally interpreted as not having contractual effect.

539 The various possible grounds on which a parent company providing a letter of comfort may be liable, including under the doctrine of estoppel and under the Trade Practices Act s 52, are discussed by K Yeung, "Letters of Comfort" (1998) 26 *Australian Business Law Review* 309.

540 ss 588FA-588FC, 588FE. For a detailed analysis of these provisions, and a comparison with comparable UK provisions, refer to A Keay, "The Avoidance of Pre-Liquidation Transactions: an Anglo-Australian Comparison" [1998] *The Journal of Business Law* 515.
On the tests for determining insolvency, refer to footnote 517. An extended relation-back period applies where a related entity is a party to the insolvent transaction: s 588FE(4).

541 Under s 588FF, the court has a range of powers including to make an order releasing or discharging, wholly or partly, the security or guarantee given by the company in connection with a transaction (s 588FF(1)(e)), or an order requiring the lender to repay to the company some or all of the money it has received under the guarantee or mortgage (s 588FF(1)(a)).

542 s 588FG.

up.[543] This provision only covers payments to a company's own creditors, not to the creditors of another group company.[544] Thus, a payment by a group company to a creditor of a related company does not fall within the statutory test of an unfair preference, unless the first company also owes that debt, for instance under a guarantee.[545]

6.21 *Uncommercial transactions.* An uncommercial transaction is one that a reasonable person in the company's circumstances would not have entered into, having regard to various factors set out in the legislation, including the benefits and detriments to that company and to any outside contracting party.[546] This provision does not require any breach of fiduciary duty by the directors of the group company in liquidation or any actual or constructive knowledge of that breach by the outside party. A guarantee or third party mortgage given by one group company to support a loan by an outside party to another group company may be an uncommercial transaction if the benefits that will accrue to the guarantor or mortgagor and the mortgagee are outweighed by the detriment it will incur by entering into the transaction.[547] The uncommercial transaction provision would also cover payments by a company to the creditor of a related company, thus overcoming the limited application of the unfair preference provisions to corporate groups.

Transactions involving knowledge of fiduciary duty breach

6.22 Particular intra-group transactions by a group company prior to its liquidation may be set aside (notwithstanding that they are not insolvent transactions) if those transactions involve the directors of the group company breaching their fiduciary duties and the other group company having actual or constructive knowledge of that fact. This could cover intra-group financial dealings such as loans, asset transfers or third party mortgages given by a company prior to its liquidation but without any

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543 s 588FA.

544 Section 588FA states that "a transaction is an unfair preference given by a company to a creditor of *the* company if…" (italics added). See J O'Donovan, 'Grouped therapies for group insolvencies' in M Gillooly (ed), *The Law Relating to Corporate Groups* (The Federation Press, 1993) at 72-73.

545 The related party provisions would make some payments of this kind unlawful, where the paying company is a public company (Corporations Law, Chapter 2E Related Party Transactions).

546 s 588FB.

547 J Hill, "Corporate Groups, Creditor Protection and Cross Guarantees: Australian Perspectives" in *The Canadian Business Law Journal* Vol 24 No 3 (February 1995) 321 at 351 raises a series of questions concerning the application of s 588FB (uncommercial transactions) to cross guarantees:

> "In determining whether a cross-guarantee constitutes an 'uncommercial transaction' under the provision, the court's approach to the issue of entrepreneurial benefits concerning the group as a whole will be crucial. Can benefit and detriment be determined against the background of the existence of a corporate group? Or is benefit and detriment to the company entering the transaction to be determined by analogy to a one-off agreement reached by independent contracting parties, without reference to the on-going relationship and collective goals in corporate groups? If subsidiary directors may only advance the interests of their company, when will benefit to a parent or sibling company be treated as indirectly conferring a sufficient benefit on the subsidiary to legitimate the guarantee? Must the benefit be quantitative or may intangible benefits satisfy the test?"

J O'Donovan, "Corporate Benefit in relation to Guarantees and Third Party Mortgages" (1996) 24 *Australian Business Law Review* 126 at 138-139 sets out a "Corporate benefit checklist" to assist lenders in determining whether a transaction might be an uncommercial transaction.

direct or derivative benefit to it.[548] In these circumstances, the recipient group company may be liable to account for any property of the first group company transferred to it under the transaction.

Particular intra-group guarantees, charges and unfair loans

6.23 A liquidator of an insolvent group company can enforce a guarantee provided by another group company, except where the beneficiary of the guarantee was aware, at the time the guarantee was given, that the directors of the guarantor had breached their fiduciary duties in giving it.[549]

6.24 Charges granted by a company in favour of its officers, or their associates, are void if the chargees seek to enforce them within six months of their creation, except with leave of the court.[550] In some instances, group companies may be associates.[551] There are additional provisions that void certain floating charges and that can affect intra-group securities.[552]

6.25 A loan given to a company in liquidation whose terms are "extortionate" is voidable as being an unfair loan.[553] This provision could apply to some intra-group loans given on clearly unreasonable and uncommercial terms (for instance, to effectively shift assets of the borrower to the lender).

Limitations of the current law

6.26 Despite the recognition given to corporate groups in Australian insolvency law, it is possible that some creditors may still encounter considerable difficulties in liquidation proceedings. Australian law still requires that the creditors, as well as the assets and liabilities, of each relevant group company be separately identified before any distribution can be made.

6.27 This untangling process may sometimes involve a complex and costly legal inquiry to determine with which group company particular creditors dealt and to unravel the web of financial dealings between group companies.[554] In the former case,

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548 For instance, in *Rolled Steel Products (Holdings) Ltd v British Steel Corporation* [1986] Ch 246, a company issued a guarantee and debenture to secure the debts of another company within the same group. The creditor group company was unable to enforce the guarantee because it had knowledge of the facts showing that the giving of the guarantee and debenture constituted a breach of fiduciary duty by the directors. The relevant fiduciary duty issues are discussed at paras 2.6 ff. The directors of a wholly-owned group company may rely on s 187 to avoid a fiduciary breach arising.

549 Persons who knew of or suspected the breach of fiduciary duties would not be entitled to rely on the presumption that the directors had properly performed their duties to the company: s 128(4). Note, however, s 187 for wholly-owned group companies.

550 s 267.

551 ss 15, 16.

552 s 588FJ. Note also ss 565-567 which cover voidable preferences, defective floating charges and excess profits on sales arising before the commencement of Part 5.7B (June 1993).

553 ss 588FD, 588FE(6).

554 Justice Rogers, in *Qintex Australia Finance Ltd v Schroders Australia Ltd* (1990) 3 ACSR 267 at 268-269, referred to the need for reform to better match insolvency law with commercial practice.

those creditors who are held to have dealt with what turns out to be the most viable group company may be either "exceptionally astute, or simply unusually fortunate".[555] Even those creditors who have diligently ensured that they were contracting with a particular group company can still be seriously disadvantaged by the time and cost of unravelling intra-group dealings.[556]

> "There is today a tension between the realities of commercial life and the applicable law in circumstances such as those in this case. In the every day rush and bustle of commercial life in the last decade, it was seldom that participants to transactions involving conglomerates with a large number of subsidiaries paused to consider which of the subsidiaries should become a contracting party.
>
> "It may be desirable for Parliament to consider whether this distinction between the law and commercial practice should be maintained. ... Regularly, liquidators of subsidiaries, or the holding company, come to court to argue as to which of their charges bears the liability … As well, creditors of failed companies encounter difficulty when they have to select from among the moving targets the company with which they consider they concluded a contract. The result has been unproductive expenditure on legal costs, a reduction in the amount available to creditors, a windfall for some, and an unfair loss to others. Fairness or equity seems to have little role to play… If I may venture the observation, there is a great deal to be said for the suggestion … that assets and liabilities of the parent and the subsidiaries should be aggregated."

Likewise, in *Re Austcorp Tiles Pty Ltd* (1991) 10 ACLC 62, the businesses in a corporate group had been operated in such an informal manner that creditors were unaware of the identity of companies with which they had traded and it was unclear which of the companies within the group owned particular assets.

In *Wimborne v Brien* (1997) 23 ACSR 576, the New South Wales Court of Appeal rejected an application that interlocking and related companies should be treated as essentially a single entity, thereby avoiding the costs of determining the respective assets and liabilities of each company. The Court held that "… to treat the companies as a single group without regard to their separate assets and liabilities would have breached a fundamental concept of company law - namely that except in respect of limited statutory exceptions … there is no such thing as a 'group' and each company must be treated as a separate entity" (at 581).

RP Austin "Corporate Groups" in C Rickett and R Grantham, *Corporate Personality in the 20th Century* (Hart Publishing, Oxford, 1998) at 89 pointed out that "group entrepreneurship does not justify … the accumulation, layer upon layer, of intra-group transactions which can make the liquidator's task of unravelling the affairs of the insolvent subsidiaries either impossible or impossibly costly".

555 *ANZ Executors and Trustee Co Ltd v Qintex Australia Ltd* (1990) 2 ACSR 676 at 681.

556 S Fridman, "Removal of the Corporate Veil: Suggestions for Law Reform in *Qintex Australia Finance Limited v Schroders Australia Limited*" (1991) 19 *Australian Business Law Review* 211 argued that the onus should lie with creditors to determine with which group company they are dealing and to ensure that the contractual documentation reflects that understanding. In his view, the key issue is whether creditors have sufficient information about the group companies and their creditworthiness to negotiate effectively with the correct entity.

RP Austin, "Corporate Groups" in C Rickett and R Grantham, *Corporate Personality in the 20th Century* (Hart Publishing, Oxford, 1998) at 82, in reply, argued that "even if the creditor is careful to identify the subsidiary with which the contract was made, if that entity goes into liquidation there will be a delay while the liquidator sorts out the assets which are available for distribution to that entity's creditors. In all probability, several, and possibly all, group entities will be in liquidation, and a substantial part of the assets which would otherwise have been available to the group's creditors will need to be expended in ascertaining the facts and the applicable law which determine which group creditors obtain a distribution and which do not … Where the group's financial affairs have not been administered with due regard to the corporate entities involved, through carelessness or impropriety, the difficulty is magnified enormously."

6.28 Even where the creditors, assets and liabilities of a specific group company in liquidation can immediately, or eventually, be ascertained, the existing remedies are not comprehensive. For instance, the provisions in Part 5.7B Div 5 imposing liability on a holding company for the debts of its subsidiaries have various limitations, namely:

- they rely upon the legal definition of holding/subsidiary companies. Business activities that pose higher than usual risk of failure can be organised to avoid the creation of that relationship[557]
- they may require an express and expensive investigation of the company's financial situation at the time of incurring specific debts to determine whether it was then insolvent[558]
- they do not cover any debts incurred by a subsidiary whilst solvent, but which remain unpaid, and for which there are insufficient funds, after the insolvency
- they do not cover transactions, such as asset-stripping a subsidiary, that may eventually, but not immediately, lead to the insolvency of that company (though asset stripping through share buy-backs may only take place if it does not materially prejudice the company's ability to pay its creditors[559])
- they do not extend to the assets of other group companies (unless the holding company has rights over those assets).

The issue of whether Part 5.7B Div 5 should be amended to apply to a controlling company that is not a holding company has been considered earlier in this Report.[560]

Law reform options

6.29 Possible reforms of insolvency law for corporate groups centre on two principal issues:

- *liability to external creditors:* the circumstances in which any solvent company in a corporate group should be liable for the debts of failed members of that group
- *intra-group indebtedness:* how the claims of other group companies should be treated in the insolvent winding up of a group company.

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557 See paras 1.15-1.17.

558 A Rogers, "A Vision of Corporate Australia" (1991) 1 *Australian Journal of Corporate Law* 1 at 3-4. RP Austin, "Corporate Groups" in C Rickett and R Grantham, *Corporate Personality in the 20th Century* (Hart Publishing, Oxford, 1998) at 89 also points out that "the very complexity which creates problems in the liquidation of group entities will also generate problems in the proof of the ingredients of liability [under ss 588V-588X]".

559 s 257A.

560 See Recommendation 1.

Liability to external creditors

6.30 A useful approach is found in the UK Cork Committee Report, which outlined a number of policy options.[561]

- *Each group company to be jointly and severally liable for all group debts.* This approach would effectively override the separate legal entity doctrine for all corporate groups and treat their companies as if they were a single enterprise. It has not been adopted in any common law jurisdiction.

  A modification of this collective group responsibility approach is to apply it to holding companies of wholly-owned subsidiaries, on the rationale that the holding company has total control and that the allocation of assets and liabilities between these companies may be relatively arbitrary. Only German law has applied this approach for integrated groups.[562] This Report has elsewhere recommended that all companies in wholly-owned corporate groups that choose to be consolidated should be collectively liable for the contractual debts of any of the consolidated group companies.[563]

- *Group companies could accept joint group liability through a voluntary 'contracting in' agreement.* An example of this approach, in a limited context, is the ASIC Class Order relieving wholly-owned subsidiaries from the need to prepare audited accounts and directors' statements, if the holding company and the wholly-owned subsidiaries choose to enter into a deed giving appropriate cross-guarantees.[564] However, it is not mandatory for wholly-owned group companies to enter into such deeds, nor does the Class Order apply to partly-owned subsidiaries. Also, the Class Order does not apply to a company once it has been sold to an external party.[565]

- *Group companies would be deemed to accept joint group liability, unless they enter into a 'contracting out' agreement.* No common law jurisdiction has adopted this as a general approach, possibly because it would provide a simple procedure for holding companies to avoid any liability for the debts of their group companies. However, this Report elsewhere recommends that parties be permitted to enter into contracts (for instance, limited recourse or no recourse lending arrangements) that exclude some or all of the other companies in a consolidated wholly-owned corporate group from collective liability.[566]

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561 *Insolvency Law and Practice: Report of the Review Committee*, Cmnd 8558 (HMSO 1982) (the Cork Committee Report), para 1935.

562 See para 1.67.

563 Recommendation 2.

564 ASIC Class Order 98/1418. To obtain accounting relief, the holding company must covenant with its wholly-owned subsidiaries to pay the liquidator any amount by which the liabilities of those subsidiaries exceed their assets. The subsidiaries must also provide a cross-guarantee in respect of any equivalent shortfall by the holding company.

565 Recommendation 4 proposes no change in this regard.

566 Recommendation 2.

- *One or more companies in the group to be liable for breach of a pre-determined code of conduct.* An example of this approach is Part 5.7B Div 5 of the Corporations Law which imposes liability on holding companies in some instances for the insolvent trading of their subsidiaries. That liability arises where a holding company fails either to properly monitor the financial position of a subsidiary that has engaged in insolvent trading or to appoint an appropriate delegate to undertake that task. The limitations of this approach are outlined elsewhere in this Report.[567]

- *One or more companies in the group to be made liable for the debts of other group companies, pursuant to certain stipulated guidelines.* These guidelines do not involve any breach of a code of conduct, but rather reflect the degree to which a corporate group has operated as a single enterprise. New Zealand has adopted this approach through the use of contribution and pooling orders. Contribution orders permit a court to require that a group company not in liquidation contribute specific funds to cover all or some debts of another group company in liquidation. A pooling order permits the assets and liabilities of two or more group companies in liquidation to be merged. US courts have also developed a form of pooling order. The UK Cork Committee proposed that UK courts be given a power to order that the assets and liabilities of two or more group companies in liquidation be pooled.[568] The Cork Committee pooling proposals were not adopted in the UK but have been enacted in Ireland. However, UK liquidators have a power, in limited circumstances, to enter into pooling agreements.[569]

The Australian Law Reform Commission *Insolvency Report* (the Harmer Report) (1988) recommended that Australian courts should have specific powers to make contribution or pooling orders where the affairs of a corporate group have been intermingled. Neither recommendation was adopted.

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567 para 6.28.

568 The Cork Committee Report, paras 1949-1951. The Committee recommended that, in deciding whether to make that order, the court should have regard to whether the businesses of the companies were conducted together and their assets and liabilities intermingled. However, the Committee was concerned that imposing a general liability on parent companies for the debts of insolvent group companies may necessitate a reformulation of the duties of directors of parent companies, given that they may consequently be required to consider the interests of creditors of all group companies.

569 In *Re Bank of Credit and Commerce International SA (No. 2)* [1992] BCC 715, the UK Court of Appeal approved a pooling agreement under a liquidation. The Court held that since the affairs of the group companies were so commingled that it was not possible to say what the assets of each were, and since it was impracticable to hold separate creditors' meetings, it was open to the liquidators to pool the assets and liabilities of all the companies. This could be done under the UK equivalent of s 477 of the Corporations Law. The Court could approve the proposal, notwithstanding the opposition of particular creditors. See, subsequently, *Re Bank of Credit and Commerce International SA (No. 4)* [1995] BCC 453, and also *Taylor v Morris* [1992] BCC 440.

Intra-group indebtedness

6.31 The issue here is whether the rights of related companies under intra-group debt arrangements[570] should be deferred to those of any external creditors of the group company in liquidation. In the Australian context, this would be in addition to existing powers to set aside some intra-group transactions.[571]

6.32 US courts may review intra-group financial arrangements to determine whether particular funds given to a group company now in liquidation should be treated as an equity contribution rather than an intra-group loan (and therefore be postponed behind creditors' claims), and whether debts owed by a borrowing group company in liquidation under any intra-group lending arrangement should be involuntarily subordinated to the rights of external creditors of that borrowing company.[572]

6.33 A power to permit UK courts to determine whether particular funds were equity rather than loan funds was recommended by the UK Cork Committee but was not adopted. Likewise, there are no subordination provisions comparable to those in the US under Australian or New Zealand corporate law.

Contribution orders

Overseas precedents

6.34 Under a contribution order, a court can require a group company not being wound up to contribute specific funds to cover all or some debts of another group company in liquidation.

New Zealand

6.35 New Zealand introduced contribution orders in 1980, on the recommendation of a Law Reform Committee.[573] The New Zealand Companies Act 1993 provides that a

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570 The Cork Committee Report pointed out that "such debts may represent trading balances arising from intercompany trading within the group; or they may arise from loans and subventions made by other companies in the group to support continued trading by the borrowing company. The parent company may have adopted a policy of channelling subsidiaries' profits upwards by way of dividend to the parent, leaving the operating subsidiaries' working capital to be financed by loans and subventions from other companies in the group, repayable on demand, and provable in a liquidation in competition with debts owed to external creditors" (para 1955).
The Cork Committee further pointed out that "intercompany debts may also arise from the practice of using all available money and assets in the group, not solely for the benefit of the company to which they belong, but wherever they may be put to the best commercial use in the interests of the group as a whole, balancing the books at the insistence of the auditors by loans and 'intercompany balances'" (para 1956).

571 See paras 6.19-6.25.

572 This contrasts with voluntary subordination, where one creditor agrees not to be paid until one or more other creditors at an equal or lower recovery ranking are paid in full.

573 The New Zealand Special Committee to Review the Companies Act, Final Report (Wellington, 1973) (McArthur Committee) §405 recommended that provision should be made for holding companies that seek to abandon a wholly- or partly-owned subsidiary, with resultant loss to creditors:

> "We think that the court should be empowered, on the application of the liquidator of the subsidiary, to make an order that the holding company pay the whole or part of the subsidiary company's liabilities to its creditors."

court may order that a company not in liquidation that is, or has been, related to the company in liquidation pay the liquidator all or part of any claims made in the liquidation. An application may be made by a liquidator, creditor or shareholder of a company in liquidation, though any contribution payment must go to the liquidator to meet the company's overall debts, rather than to any applicant creditor or shareholder.[574] The related company need not necessarily be the ultimate holding company of the company in liquidation.[575]

6.36 Before making a contribution order against a related company not in liquidation, the court must be satisfied that it is "just and equitable" to do so, taking into account:

- *intermingled management:* the extent to which the related company took part in the management of the company in liquidation
- *conduct towards creditors:* the conduct of the related company towards the creditors of the company in liquidation
- *action of one company leading to the liquidation of another:* the extent to which the circumstances that gave rise to the liquidation of the company are attributable to the actions of the related company, and
- *other matters:* such other matters as the court thinks fit.[576]

6.37 However, the mere fact that creditors of a company in liquidation relied on the fact that another company was, or is, related to the company in liquidation is not a sufficient ground for a contribution order.[577] This provision was included to allay concerns that creditors might seek a contribution order merely because they had dealt with a particular company on the basis that another company was its principal shareholder.

6.38 New Zealand courts have not often exercised their contribution order power. The most common problem encountered in determining whether to make the order is reconciling the interests of two sets of unsecured creditors who have dealt with two separate companies:

The Report set out a number of instances where creditors of one company in a group (which was the failing company) lost money through its remaining assets being transferred, for inadequate consideration, to another company in that group. The Report also considered it inequitable that a holding company could take the benefit of tax advantages accruing from the failing subsidiary and then leave the creditors of that subsidiary to a reduced payout in a subsequent winding up.

The original contribution provisions were found in the New Zealand Companies Act 1955 ss 315A (contribution orders) and 315C (guidelines for making contribution orders), now ss 245 and 246 of that Act.

574 Companies Act 1993 s 271(1)(a).

575 The Companies Act 1993 s 2(3) defines a related company as a holding company or a subsidiary company or any company that holds more than half of the fully participating issued shares of the company. In addition, companies are related if their businesses have been carried on in such a manner that the separate business of each company, or a substantial part of it, is not readily identifiable. Also, companies are related if there is another company to which both companies are related.

576 s 272(1).

577 s 272(3).

> "If the contribution sought from a related company threatens that company's solvency, then the court must consider the equities involved affecting the creditors of that company. These creditors will rely on arguments that they have relied on the separate assets of the company when trading with it and should not be denied a full payout because of that company's relationship with another company."[578]

In considering these competing equities, New Zealand courts have taken the view that a full contribution order may be inappropriate if its effect is to threaten the solvency of the related company not in liquidation. Instead, a contribution order might be levied only against the balance of assets in the solvent company's hands after it has satisfied its bona fide debts.[579]

6.39 The New Zealand courts have also held that, in determining whether to make a contribution order, it is appropriate to take into account any actions of the solvent company after the commencement of the liquidation of its related company which either directly or indirectly affect the creditors of the related company.[580]

Other countries

6.40 US, UK and Australian corporate laws have no equivalent of New Zealand contribution orders.

Australian proposals for contribution orders

6.41 The Australian Law Reform Commission *Insolvency Report* (the Harmer Report) (1988) recommended that a court should have a specific power, similar to that in New Zealand, to make a contribution order where a group's affairs have been intermingled.[581]

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[578] J Farrar, "Legal Issues Involving Corporate Groups" (1998) 16 *Company and Securities Law Journal* 184 at 197.

[579] In *Lewis v Poultry Processors* (1988) 4 NZCLC 64,508 at 64,513, the Court doubted whether contribution orders were intended to prejudice the position of bona fide unsecured creditors of a related company not in liquidation:

> "I doubt very much whether [the section] is intended to prejudice the position of bona fide unsecured creditors of the related company. If the related company is fully solvent then there is no problem. … [the section] will only run against the balance of assets in the related company's hands after it has satisfied its bona fide indebtedness."

This approach is consistent with the decision in *Re Liardet Holdings Limited* (1983) BCR 604, where the Court doubted whether a contribution order should be made against a related company in the face of evidence that nothing would be available to satisfy that order after the related company had paid its own creditors.

[580] In *Rea v Barker* (1988) 4 NZCLC 64,312, it was alleged that the solvent group company had failed to honour a contract with the insolvent related company to purchase stock of the latter company after the commencement of its liquidation. The Court ruled that this conduct, if proved, could be taken into account in determining whether to make the contribution order against the solvent group company.

[581] The National Companies Bill 1975 (Cth) Clause 433 would have empowered a court in the winding up of an insolvent subsidiary company to order the holding company to pay the subsidiary's debts where the court considered that the debts arose in such circumstances as to make it just and equitable to so order.

6.42 However, the Harmer Report indicated that the Law Council of Australia had opposed the contribution order proposal on various grounds.[582]

- *Separate entity principle.* It is a fundamental principle of company law that separate companies have separate legal entities. However, the Law Reform Commission saw no reasonable objection to imposing liability where a parent company permits an insolvent subsidiary to incur debts.

- *Project financing.* Financing for large resource and other projects is often done on a limited recourse basis, but the Law Reform Commission's proposal would make it difficult for a parent company to avoid liability for the overall debts of the project. The Law Reform Commission argued that the fact that creditors have entered into contracts on a limited recourse basis would be one of the "other relevant matters" to which the court would be required to have regard.

- *Uncertainty.* The wide discretion proposed for the court would create uncertainty in commercial dealings. Lenders to a company in a corporate group would be unable to ascertain the extent of that company's liabilities, as the court may subsequently order the company to pay the outstanding debts of any of its related companies in liquidation. However, the Law Reform Commission pointed out that creditors of a group company usually have regard to the consolidated balance sheet of the group and generally take cross-guarantees or similar intra-group security.

- *Accounts.* Auditors and company directors would have enormous difficulty in producing accounts which produce a true and fair view of the parent company. The Law Reform Commission argued that the widespread use of consolidated accounting is evidence that acknowledging corporate groups can serve to simplify group financial accounting and reporting.

6.43 One commentator has suggested that the *Uncertainty* problem, and consequently the *Project financing* difficulty, might be overcome by creating a specific exception to a court's contribution order power which would allow a creditor's claims to be limited to a designated one or more group companies. That exception should apply where those group companies were financially managed in a manner that fully segregated their assets and liabilities from those of the rest of the corporate group, and that segregation was documented in such a manner as to permit a liquidator to trace the affected assets. Equally, the *Accounts* problem could be dealt with by clarifying the extent to which potential liability for the debts of a group company should be disclosed in a notation to the parent company's financial statements. In effect, the preservation of the *Separate entity principle* in the liquidation of corporate group companies would have to be "purchased" by adopting a regime of intra-group financial segregation and accounting.[583]

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582 ALRC 45, vol 1, para 336.

583 RP Austin, "Corporate Groups" in C Rickett and R Grantham, *Corporate Personality in the 20th Century* (Hart Publishing, Oxford, 1998) at 86-87 argues that the challenge will be to develop an effective regime of financial segregation which is neither too restrictive nor too easily abused. For instance, the legislation might state that a parent and other group companies should not be required to meet any creditors' claims in the liquidation of a particular group company if, during

6.44 The Harmer Report proposal for contribution powers was not adopted. Concern was expressed that the discretion proposed to be given to the court might create uncertainty in commercial dealings.[584] Instead, the Corporations Law was amended by introducing Part 5.7B Div 5, to make holding companies potentially liable for the insolvent trading of their subsidiaries.[585] These provisions emphasised the potential liability which holding companies may have in operating through subsidiaries. However, they did not cover pre-insolvency debts or apply to group companies which did not satisfy the holding/subsidiary company test. The Harmer Report proposal for contribution orders was not so limited.

Issue 21. *Should the Corporations Law be amended to introduce court contribution orders? If so:*

- *should the New Zealand, or some other, approach be adopted*
- *should there be a specific prohibition on contribution orders that would render the contributing company insolvent*
- *should there be a specific provision that contribution orders not affect the rights of external secured creditors of the contributing company?*

Submissions on Issue 21

Support

6.45 Some submissions supported court contribution orders based on the New Zealand legislation.[586]

6.46 One respondent considered that there should be:

- a specific prohibition on contribution orders that would render the contributing company insolvent
- a specific provision that contribution orders not affect the rights of external secured creditors of the contributing company.[587]

6.47 A further respondent considered that a requirement that the court be satisfied that any contribution order is just and equitable would deal with these two issues.[588]

(say) the three years prior to the commencement of the winding up, the group company in liquidation had paid no dividends to its parent, had not entered into or repaid, or received payment of, any intra-group loan, and had not engaged in any share buy-back or reduction of share capital.

584 The first draft of the Explanatory Memorandum to the Corporate Law Reform Act 1992 (para 1271) expressed this concern.

585 ss 588V-588X, as discussed at paras 6.11-6.14.

586 Australian Credit Forum, Carter Holt Harvey Limited, Christopher F Symes. Coles Myer Ltd supported contribution orders only for wholly-owned group companies.

587 Australian Credit Forum.

588 Carter Holt Harvey Limited.

6.48 Another submission proposed a court contribution order power that is limited to the payment of employee entitlements.[589]

6.49 Another respondent,[590] in supporting contribution orders, also argued that the Corporations Law should:

- allow injunctions to be granted against companies which seek to move assets within the corporate group, to the detriment of employees
- allow employees to approach the court to seek the appointment of a receiver or provisional liquidator where it is practicable and the interests of justice require it
- make it clear that employees are creditors and that they should be thought of in some circumstances as equivalent to other creditors and in other circumstances as preferred creditors.[591]

Opposed

6.50 Some submissions opposed court contribution orders,[592] for the following reasons.

- Each company in a group should have limited liability. Companies may choose to contract out of limited liability, for instance by a parent company guaranteeing the debts of a group company or vice versa.[593]
- The court power "would institutionalise a regime in the event of a divide between what is perceived to be the legal reality for ongoing firms (the separate legal entity) and that for firms in distress (group entity)".[594]

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589 D Noakes.

590 Christopher F Symes.

591 The Report by the Legal Committee of the Advisory Committee *Corporate Voluntary Administration* (June 1998) recommended that employees should be permitted to vote as creditors on a deed of company arrangement, even if they have priority under that deed (Recommendation 19).

592 Australian Institute of Company Directors, F Clarke, G Dean & E Houghton.

593 Australian Institute of Company Directors.

594 F Clarke, G Dean & E Houghton.

Advisory Committee response to submissions on Issue 21: Draft Recommendation 21

6.51 The court should not have a general power to make contribution orders, given the impact this power would have on the separate legal entity principle, the uncertainty in its application and its possible effect on project financing, particularly for limited or non-recourse financing.

6.52 The Harmer Report in 1988 recommended the introduction of general contribution orders. However, the Government in 1992 introduced s 588V (possible liability of a holding company for the debts of its insolvent subsidiary), rather than general contribution orders. New Zealand appears to be unique in permitting these general orders.

6.53 While general contribution orders should not be introduced, a question remains whether specific contribution orders should be introduced on public policy grounds in certain circumstances, for instance as one possible means to protect the entitlements of employees in the insolvency of a group company which is their employer.[595]

Accordingly:

The Corporations Law should not be amended to introduce a general court contribution order power. Any such power, if introduced, should be limited to specific situations, such as outstanding employee entitlements.

Submissions on Draft Recommendation 21

6.54 No submission supported a general court contribution order power.

6.55 Two submissions opposed any contribution power for outstanding employee entitlements, arguing that this should be left to specific legislation dealing with this area.[596]

6.56 Two other submissions[597] supported a statutory contribution order power as one means of protecting the interests of employees in the event of their employer going into insolvent liquidation. Contribution orders for the benefit of employees may also reduce the costs of other possible protection schemes, such as insurance or trust fund arrangements, or avoid the need to resort to other options such as financing controls over group companies.

Advisory Committee response to submissions on Draft Recommendation 21

6.57 The Advisory Committee does not support either a general court contribution order power or a contribution power specifically tailored to employee entitlements.

6.58 In the context of employee entitlements, the Advisory Committee notes the proposals in the Corporations Law Amendment (Employee Entitlements) Bill 2000 to

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595 For a summary of the position of employees in a corporate insolvency, see T Taylor, "Employee Entitlements in Corporate Insolvency Administrations" (2000) 8 *Insolvency Law Journal* 32.

596 Australian Society of Certified Practising Accountants, Law Council of Australia.

597 New South Wales Attorney-General, D Noakes.

extend s 588G (the insolvent trading provision) to uncommercial transactions and to introduce a new s 596AB dealing with entering into agreements or transactions with the intention of avoiding the payment of employee entitlements.

6.59 The Advisory Committee considers that, given its general disposition against court contribution orders, it is not appropriate to recommend these orders for the benefit of employees in addition to any legislation which is specifically tailored to the circumstances of employee entitlements.

Recommendation 21

The Corporations Law should not be amended to introduce any court contribution order power.

Pooling orders

6.60 A pooling order permits the assets and liabilities of two or more group companies in liquidation to be merged.

Overseas precedents

New Zealand

6.61 Pooling orders were first introduced in New Zealand on a limited basis in the 1950s.[598] The New Zealand Companies Act 1993 provides that where two or more related companies are in liquidation, the court may order that the liquidation of all the companies proceed together "as if they were one company to the extent that the Court so orders and subject to such terms and conditions as the Court may impose".[599] An application for a pooling order may be made by a liquidator, a creditor or a shareholder of any of those related companies in liquidation. New Zealand courts have taken the view that the provision can be interpreted to include only assets, or may extend to include liabilities as well.[600]

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598 The New Zealand Companies Special Investigations Act 1958 ss 24-25 provided as follows:

> "s 24(1) Where, in the opinion of the Court, the affairs of two or more companies… to which this Act applies have been so carried out that it is just and equitable that they should be wound up together by the Court, the Court, on the application of the receiver or liquidator of any of the companies, may order that, subject to such conditions as the Court may impose, the companies shall be wound up together and, to the extent that the Court considers it just and equitable, that they shall be so wound up as if they were one company…
>
> s 25…for the purposes of winding up any company or companies … to which this Act applies, the Court may settle, as it considers just and equitable, a scheme prescribing the order in which all claims (whether secured or unsecured creditor, shareholder, or otherwise) in respect of the company or companies shall rank for payment, and providing for the postponement of any claim or any part of any claim…"

Pooling orders were included in the New Zealand Companies Act 1955 ss 315B and 315C, now ss 245 and 246 of that Act.

599 s 271(1)(b).

600 J Farrar, "Legal Issues Involving Corporate Groups" (1998) 16 *Company and Securities Law Journal* 184 at 198 argues that a more consistent interpretation would be that assets and liabilities should be combined except to the extent that a court places contrary conditions on a pooling order under its discretionary power in s 272(2).

6.62 Before granting a pooling order, the court must be satisfied that the order would be "just and equitable", having regard to the following factors:

- *intermingled management:* the extent to which any of the companies in liquidation took part in the management of any of the other companies in liquidation

- *conduct towards creditors:* the conduct of any of the companies towards the creditors of any of the other companies

- *action of one company leading to the liquidation of another:* the extent to which the circumstances that gave rise to the liquidation of any of the companies are attributable to the actions of any of the other companies

- *intermingled business:* the extent to which the businesses of the companies have been combined, and

- *other matters:* such other matters as the court thinks fit.[601]

6.63 As with contribution orders, the fact that creditors of a company in liquidation relied on the fact that another company also in liquidation is, or was, related to it is not a ground for making a pooling order.[602]

6.64 New Zealand courts have made only relatively few pooling orders. In so doing, they have applied the just and equitable factors. A useful way to understand how these factors have been applied in practice is through analysing the leading New Zealand case of *Re Dalhoff and King Holdings Ltd*.[603] In making a pooling order to merge the assets and liabilities of three group companies in liquidation, the Court took into account the intermingled corporate group management practices, including combined board meetings of the various group companies, the use of a single bank account for all the group companies and the policy of using whichever group company was convenient for the business operation in hand. In turn, this intermingling policy, together with the management practice of encouraging creditors to treat the corporate group as a single entity, created confusion amongst many creditors as to which of the entities they were dealing with and otherwise blurred the legal boundaries of the group companies. The Court also considered that, given the intertwining of transactions within the group, and the extent of intra-group debts, the liquidity of each group company affected that of the others. The actions of one group company could therefore lead to the liquidation of another. The Court also took into account, as an "other matter", that the only way to determine the status of various intra-group debts if a pooling order were not made would be through separate legal proceedings, which could considerably increase the cost and length of the liquidation, and thereby deplete funds otherwise available for creditors.[604] Taking all those factors cumulatively into account:

601 s 272(2).
602 s 272(3).
603 (1991) 5 NZCLC 66,959.
604 Compare *Re Pacific Syndicates (NZ) Limited* (1989) 4 NZCLC 64,757 at 64,768, where the Court considered that a relevant consideration in whether to grant a pooling order would be whether the cost and length of the liquidations would be reduced.

> "It would be unjust and inequitable both to shareholders and creditors to allow [the three companies to be separately liquidated], thus preferring some fortuitously as against others and, further, separating out activities which have always in the past operated together. … Also, it would be "next to impossible [to] separate the activities [of each company] so as to allow liquidation of the companies individually".[605]

6.65 The Court in *Re Dalhoff* also considered the competing interests of shareholders and creditors. The Court held that, in an insolvency, the rights of creditors should outweigh those of shareholders.[606] A pooling order, in this case, would advantage creditors over shareholders. Without that order, shareholders of some corporate group companies would receive a return at the expense of creditors of other group companies.[607]

6.66 The competing interests between secured and unsecured creditors and between shareholders of the different group companies in liquidation must also be considered in the exercise of pooling powers. The original New Zealand legislation contained two provisions which directly dealt with these matters:

- nothing in the pooling powers affected the rights of any secured creditor of any of the pooled companies[608]
- in deciding the terms and conditions of a pooling order, the court was required to have particular regard to the interests of those persons who were shareholders of some, but not all, of the pooled companies.[609]

6.67 Both provisions were omitted from the current legislation. However, it is arguable that they are preserved by other means.[610]

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605 (1991) 5 NZCLC 66,959 at 66,971-66,972.

606 Id at 66,970. Compare *Kinsela v Russell Kinsela Pty Ltd* (1986) 10 ACLR 395 at 401 where the Court pointed out that in an insolvency, the creditors "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' 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".

607 In *Re Dalhoff and King Holdings Ltd*, the effect of pooling was that the unsecured creditors in all three related companies in liquidation recovered 90% of their debts, while the shareholders of those companies received nothing. The pooling order therefore benefited the corporate group creditors at the expense of shareholders of the parent company in liquidation, who would otherwise have received a dividend of 28c per share in the liquidation of that company.

608 New Zealand Companies Act 1955 s 315B(3)(c).

609 New Zealand Companies Act 1955 s 315B(2).

610 Under the New Zealand Companies Act 1993, the rights of secured creditors under the general liquidation provisions in Part XVI remain. The pooling powers (ss 271, 272) do not seek to create an exception to those provisions. Rather, by virtue of the definition of "creditor" in s 240(1), references to a creditor in the pooling provisions means a reference to unsecured creditors.
One New Zealand commentator has observed that "a court in the exercise of its just and equitable discretion under s 271 [of the New Zealand Companies Act 1993] could not ignore the different interests of shareholders who are not common to all companies in liquidation and could hardly upset the securities of secured creditors": A Borrowdale in C Rickett and R Grantham, *Corporate Personality in the 20th Century* (Hart Publishing, Oxford, 1998) at 93-94.

6.68 Individual creditors may also be affected by the court treating any charges, guarantees or other intra-group securities between the companies in liquidation as invalid. In *Re Dalhoff*, the Court ruled that an external creditor could not enforce an intra-group guarantee which depended on retaining the separate identity of the group companies in liquidation. That creditor would be treated as an unsecured creditor except if a court considered that it was just and equitable for that creditor to retain some priority right over other creditors.[611]

United States

6.69 US insolvency law provides for pooling orders (known as "substantive consolidation" orders) whereby a court may order that the assets and liabilities of related group companies in liquidation be consolidated, that all claims, guarantees and other legal obligations between these group companies be voided, and that the claims of unsecured creditors be met from the net pooled assets.[612] Pooling does not, however, affect the rights of secured creditors, other than holders of intra-group securities.[613] That remedy is available where, on balance, "creditors [will] suffer greater prejudice in the absence of consolidation than the debtor [companies] (and any objecting creditors) will suffer from its imposition".[614] In the context of corporate groups, US courts have ordered pooling in either of the following situations:

- *intermingling:* where the financial affairs and business functions of the group companies in liquidation are so commingled that a pooling order would either benefit all unsecured creditors (taking into account either the practical impossibility or the time and cost of attempting to disentangle these affairs) or assist in any reorganisation of the corporate group,[615] or

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611 In *Re Dalhoff and King Holdings Ltd* (1991) 5 NZCLC 66,959, the assets and liabilities of various group companies in liquidation were merged, notwithstanding that one creditor thereby lost a guarantee provided to it by one of those companies for debts owed to it by another of those companies, and thereby became an unsecured creditor for the combined assets of the companies in liquidation. However, the Court reasoned that, given the application of the just and equitable factors in this case, an assets and liabilities pooling order should be made, with no particular provision for that creditor. However, in exceptional cases, provision could be made to retain the specific rights of such creditors:

> " … it is inappropriate to allow [the creditor] to retain a position which involves the retention of the separate identity of two of the companies within the group and which would be to that extent inconsistent with the whole basis of the [pooling] order being made. … it is conceivable that in a quite exceptional case reference to the just and equitable aspect of the section might allow sufficient latitude to accommodate the retention of two rights to claim" (at 66,973).

This residual discretion may be some response to the criticism that the creditor in this case who had attempted to secure its trading position by requiring intra-group guarantees gained no priority over unsecured creditors.

612 United States Bankruptcy Code §105.

613 *Re Gulfco Investment Corp* 593 F 2d 921 at 926-927 (1979).

614 *Eastgroup Properties v Southern Motel Association Ltd* 935 F.2d 245 (11th Cir. 1991).

615 One US commentator has stated that: "In many of the reported cases in which consolidation has been ordered, the assets of the corporate group cannot be segregated and identified with any particular entity within that group. Substantial consolidation in these cases may be attributed to the need for resolution in a situation in which the protection of contractual expectations is impracticable. When the cost of allocating the assets of a corporate group into the constituent corporations is so high that it will consume the estate, pragmatism requires that the assets and

- *reliance:* where the unsecured creditors generally reasonably held, and relied on, the expectation that they were dealing with the group companies as a single economic entity, and did not rely on the separate identity of any one company in extending credit to it.[616]

Pooling is more commonly ordered where intermingling has taken place.[617]

6.70 A court may make a full pooling order. That order would:

- cover all the assets of, and claims against, the various companies in liquidation
- void any claims, charges, debts, guarantees or other securities between these companies
- require claims to be satisfied *pari passu* from the pooled common fund, and
- combine the creditors of the companies in liquidation for the purpose of voting on any reorganisation plans for those companies.

6.71 A full pooling order may create a conflict between unsecured creditors if the total assets of the combined companies are insufficient to meet all their claims. In this circumstance:

> "Creditors wanting consolidation will state that they have relied on the assets of the entire group and that it would be inequitable that the notional separate legal status of the companies should prevent their recovery against the total assets

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liabilities of the group be pooled": CW Frost, "Organisational Form, Misappropriation Risk and the Substantive Consolidation of Corporate Groups" (1993) 44 *Hastings Law Journal* 449 at 456. See also PI Blumberg, *The Law of Corporate Groups: Bankruptcy Law* (Little, Brown & Co, 1985) at §§10.09—10.10.

616 *Soviero v Franklin National Bank* 328 F.2d 446 (2d Cir. 1964), *Chemical Bank NY Trust Co. v Kheel* 369 F.2d 845 (2d Cir. 1966). In *Re Augie/Restivo Baking Company* 860 F.2d 515 (1988), the Court noted the importance of determining whether creditors had relied on the collective assets of the group or on individual company assets. In the latter instance:

> "Creditors who make loans on the basis of the financial status of a separate entity expect to be able to look to the assets of the particular borrower for satisfaction of that loan. Such lenders structure their loans according to their expectations regarding that borrower and do not anticipate either having the assets of a more sound company available in the case of insolvency or having the creditors of a less sound debtor compete for the borrowers' assets. Such expectations create significant equities. Moreover, the lenders' expectations are central to the calculation of interest rates and other terms of loans and fulfilling those expectations is therefore important to the efficacy of credit markets. Such efficacy will be undermined by imposing substantive consolidation in circumstances in which creditors believed that they were dealing with separate entities."

617 One US commentator (CW Frost, "Organisational Form, Misappropriation Risk and the Substantive Consolidation of Corporate Groups" (1993) 44 *Hastings Law Journal* 449) has argued that the difficulties experienced in determining from the US case law when substantive consolidation will be ordered might be reduced by courts adopting a policy of typically consolidating corporate groups that are vertically integrated while horizontal corporate groups or conglomerates should be consolidated only rarely. However, that commentator acknowledges that the division between vertically and horizontally organised corporate groups is imprecise and many corporate groups may have elements of both forms of structure.

they have bargained for. Creditors against consolidation will argue in opposition that they have contracted with the relevant company relying on its separate assets and that it would be inequitable to reduce their prospects of recovery by including the liabilities of another company."[618]

6.72 The approach of US courts is to take into account fairness to unsecured creditors as a whole. In doing so, they consider whether the savings to the collective class of creditors would outweigh incidental detriment to individual creditors.[619] However, the court may make a limited pooling order by exempting the claims of specific unsecured creditors and satisfying them from the particular assets of one of the companies in liquidation. The onus is on any applicant requesting that a pooling order be limited to establish that:

- it specifically relied on the relevant company as a separate entity and not as a component of a corporate group
- partial pooling is required to avoid injustice.[620]

6.73 Partial pooling is relatively uncommon, given the assumption in favour of full pooling where the intermingling or reliance criteria are satisfied.

Current law

6.74 Australian corporate law has no equivalent of the New Zealand statutory pooling powers or the equivalent US substantive consolidation orders. The general principle remains that creditors of a particular group company in liquidation should be paid only from the property of that company (subject to limited further rights of recourse identified earlier in this Chapter[621]). However, voluntary pooling of the assets and liabilities of group companies is possible in limited circumstances under:

- group cross-guarantee arrangements
- schemes of arrangement
- arrangements between creditors and companies being wound up or about to be wound up (winding up arrangements)
- voluntary administrations
- liquidations.

618 J Farrar and A Darroch, 'Insolvency and Corporate Groups - the Problem of Consolidation' in J Lessing and J Corkery (eds), *Corporate Insolvency Law* (Bond University, 1995) at 256.

619 "The fact that … [particular] creditors may be adversely affected by … substantive consolidation is not controlling and the Bankruptcy Court must weigh the conflicting interests which should be balanced in such a way as to reach a rough approximation to some rather than to deny justice to all": *In re Commercial Envelope Manufacturing Company* 14 Collier Bankr. Cas. (MB) 191 (S.D.N.Y. 1977).

620 PI Blumberg, *The Law of Corporate Groups: Bankruptcy Law* (Little, Brown & Co, 1985) at §10.07, *Re Llewellyn* 26 Bankr 246 (Iowa 1992).

621 paras 6.10-6.25.

6.75 Corporate groups may apply to ASIC for a class order to grant relief from separate accounting and audit requirements for specified wholly-owned group companies.[622] One of the preconditions to granting this relief is that the holding company and those wholly-owned group companies execute a prescribed deed of cross-guarantee under which they each guarantee the debts of all the group companies covered by the class order (the closed group). In effect, this provides a form of voluntary contribution or pooling in the event that one or more of the companies in the closed group goes into liquidation while the cross-guarantee is still operative.[623]

6.76 Schemes of arrangement, if approved by the requisite majority of the creditors of each affected company and the court, bind all creditors, including dissenters.[624] However, they can be expensive and cumbersome, involving two court applications and one or more creditors' meetings for each company.[625]

6.77 Voluntary pooling can be achieved under winding up arrangements.[626] However, this procedure has significant limitations. For instance, it is questionable whether pooling under these arrangements could override the *pari passu* rule of distribution to unsecured creditors unless they all consent to a variation.[627] Likewise, winding up pooling arrangements will not be possible where it is unclear who are the creditors of each particular group company in liquidation.[628]

6.78 Voluntary pooling is available under the voluntary administration provisions.[629] Deeds of company arrangement under Part 5.3A may permit pooling in a more

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622 ASIC Class Order 98/1418, pursuant to s 341.

623 Pro Forma 24: Deed of cross-guarantee. Clause 4 deals with the revocation of cross-guarantees. Some of the accounting and other problems that may be encountered in determining creditor equality in the winding up of a closed group of companies are discussed in G Dean, P Luckett and E Houghton, "Notional calculations in liquidations revisited: the case of ASC [ASIC] Class Order Cross-Guarantees" (1993) 11 *Company and Securities Law Journal* 204, F Clarke, G Dean and E Houghton, "Cross-guarantees and negative pledges: a preliminary analysis" (1995) *Australian Accounting Review* vol 5, no 1, 48.

624 s 411. In *Dean-Willcocks v Soluble Solution Hydroponics Pty Ltd* (1997) 24 ACSR 79 at 85, the Court ruled that a consolidation of assets and creditors of a group of companies should normally be obtained by a form of scheme of arrangement approved by the creditors and the courts. In *Mentha v GE Capital Ltd* (1997) 27 ACSR 696, the Court stated that pooling was permissible under a scheme of arrangement, given that s 411 enables a court to approve any arrangement agreed to between companies and their creditors, including consolidating assets and creditors of various related companies under a scheme of arrangement.

625 *Dean-Willcocks* at 84.

626 s 510.

627 *Dean-Willcocks* at 84.

628 *Dean-Willcocks* at 84.

629 s 447A. In *Dean-Willcocks v Soluble Solution Hydroponics Pty Ltd* (1997) 24 ACSR 79 at 85, Young J relied on s 447A as an avenue for pooling where creditors approved combining recoveries, costs and distributions to creditors in the relevant companies under voluntary administration. In this case, all the creditors (except one absent creditor) had agreed that the assets and liabilities of each company should be consolidated. The Court approved this pooling, subject to the absent creditor having an opportunity to agree with, or to move the Court to discharge, the pooling order.

In *Mentha v GE Capital Ltd* (1997) 27 ACSR 696, the voluntary administrators devised a pooling arrangement using separate deeds of company arrangement for each group company in voluntary administration. They took their proposal to separate meetings of each company's creditors, which overwhelmingly supported the proposal (97% by value of creditors present and voting approved

flexible and less expensive manner than under a scheme of arrangement, given that court approval is not required. Also, liquidators of group companies may themselves appoint an administrator, thereby providing a means to enter into a pooling arrangement under Part 5.3A.[630] However, in most instances under Part 5.3A the creditors of each company concerned should have the opportunity to separately consider and vote on any pooling proposal.

6.79 Voluntary pooling has been undertaken during the course of liquidation of various group companies at the initiative of liquidators[631] and ASIC.[632] However,

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the proposal). The proposal required the voluntary administrators to transfer all the assets of the various companies under voluntary administration into one company (the pooled company) and to enter into a deed poll of novation whereby the pooled company assumed the obligations of all the other companies. Secured creditors were given new securities over the assets of the pooled company. The unsecured creditors had residual rights of recovery against the assets of the pooled company. The secured creditors were concerned to ensure that all of the pooling steps could be taken whilst the company was under administration so as to gain the protection of s 451C. The Federal Court approved orders enabling the voluntary administrators to dispose of encumbered property under s 442C, and directions permitting them to enter into and give effect to the transactions setting up the pooled company. The effect of this arrangement was that the unsecured creditors who would otherwise receive between 0 and 45c in the dollar, depending on which company was their debtor, would receive at least 21c, and more likely 31c in the dollar, under the pooling arrangement. In approving this arrangement, Finkelstein J noted that it prima facie contravened the insolvency rule that the unsecured creditors of a company are usually only entitled to a rateable share of the assets of their own insolvent debtor. However, in his opinion, "the power to enter into a deed of company arrangement under Part 5.3A is sufficiently broad to permit an arrangement binding on two or more insolvent companies pursuant to which their respective assets and creditors will be consolidated. There is no justification for a construction of this Part of the Corporations Law that would lead to the conclusion that arrangements made pursuant to Part 5.3A must be more narrowly confined than arrangements made under s 411" (at 702).

630 The liquidator may appoint an administrator under s 436B.

631 s 477. In *Dean-Willcocks v Soluble Solution Hydroponics Pty Ltd* (1997) 24 ACSR 79 at 85, the Court held that in exceptional cases (for instance where there would be considerable costs in calling further meetings of creditors and obtaining court approval under s 411) a consolidation of the assets and liabilities of the various companies in liquidation can be approved under s 477. Paragraph 477(1)(c) gives the liquidator power to make any compromise with creditors.

In *Re Charter Travel Co Ltd* (1997) 25 ACSR 337, the liquidators of two group companies sought a pooling order. The respective businesses of the two companies were intertwined and it was virtually impossible to define which creditor belonged to which company. It was impractical to keep the assets and liabilities of each company separate. Also:

> "even if it were possible, there would be a tremendous waste of time and effort in rejecting proofs which the liquidator thought were lodged against a wrong company only to have them admitted against the other company".

A pooling order would overcome the problem of potentially expensive and useless litigation.

Young J made orders for a combined meeting of known creditors of the two companies so that they could consider a proposal for joint administration of the two companies in liquidation:

- the liquidators would open a joint account into which would be paid recoveries from both companies
- claims entitled to priority in the winding up of either company would be treated *pari passu*
- other creditors would be treated equally regardless of the company of which they were creditors.

The order made by the Court convening the meeting provided that if the creditors unanimously approved the pooling proposal, the liquidators of the two companies could implement it. If there was dissent, the matter should be returned to the Court.

while "it would be possible for the court to advise a liquidator in a court winding up to consolidate debts [of various related companies in liquidation], 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".[633]

6.80 The various avenues of voluntary pooling lack a clear and consistent legislative basis. Also, there is no specific provision for court-ordered pooling. As one judge has commented:

> "While the courts can continue to deal with these sorts of problems on a case to case basis, the time may shortly be coming when it would be a great saving for the Corporations Law itself to make provision for liquidators to consolidate in appropriate cases".[634]

De minimis pooling by liquidators

6.81 One possible incremental reform to the voluntary pooling powers would be to introduce a de minimis provision permitting liquidators, of their own motion, to pool the assets of two or more group companies in liquidation that have a low debt level (for instance, each company has total debts of no more than $100,000). This would avoid the relatively high costs in these instances of having to determine the separate assets and liabilities of each company in liquidation. This power might be purely discretionary or, conversely, subject to an appealable prerequisite, for instance, where it is fair and reasonable for the liquidator to act, taking into account relevant behaviour of the corporate group.

Issue 22. *Should the Corporations Law be amended to introduce a de minimis provision permitting liquidators, of their own motion, to pool the assets of two*

However, in *Mentha v GE Capital Ltd* (1997) 27 ACSR 696 at 702, Finkelstein J left open whether he would follow the view of Young J in *Re Charter Travel Co Ltd*. Instead:

> "One day it will be necessary to determine to what extent, if at all, the court can make a similar [pooling] order in the case of insolvent companies".

By contrast, in *Re Austcorp Tiles Pty Ltd* (1992) 10 ACLC 62, the Court doubted whether the liquidators of group companies could enter into a pooling arrangement with creditors under s 477, notwithstanding that the investment, financing and managerial activities of the three companies were interdependent. The Court held that this pooling arrangement by liquidators would be contrary to the requirement in s 555 of *pari passu* distribution between creditors of each company. Pooling arrangements of this nature could proceed only by way of a scheme of arrangement under s 411.

632 Two companies in the Remy Moffatt group were wound up in the Federal Court on 6 October 1998 on the just and equitable ground (s 461(k)) (Federal Court VG No 3315 of 1998). One of these companies held most of the group's assets while the other company had significant liabilities in the form of wages. ASIC successfully sought the appointment of the same liquidator to both group companies and received an undertaking from the liquidator to pool the assets and liabilities of those companies, thereby ensuring that creditors of both group companies would have recourse to the combined assets of those companies: ASIC Media Release 98/306.

633 *Dean-Willcocks v Soluble Solution Hydroponics Pty Ltd* (1997) 24 ACSR 79 at 85. Also, in *Re Austcorp Tiles Pty Ltd* (1992) 10 ACLC 62 at 64, the Court ruled that in relation to a liquidation pooling, it "would need evidence of the consent of the creditors, not just evidence of their failure to object".

634 *Re Charter Travel Co Ltd* (1997) 25 ACSR 337 at 339.

or more group companies in liquidation where each of these companies has a low debt level (for instance, not exceeding $100,000)?

If so, should this power be purely discretionary or, conversely, subject to an appealable prerequisite, for instance, where it is fair and reasonable for the liquidator to act, taking into account relevant behaviour of the corporate group?

Submissions on Issue 22

6.82 All submissions that commented on this Issue opposed any automatic right for the liquidator to pool the assets of group companies having a low debt level,[635] for the following reasons.

- Any pooling should only be possible with the approval of the court or creditors.[636]
- The pooling of the assets or liabilities of companies should only occur in very limited circumstances. An automatic power for liquidators to pool where there is a low debt level could cause real hardship to some creditors.[637]
- The suggested figure of $100,000 is quite high. The number of companies with debt levels below $100,000 which go into liquidation could be relatively large.[638]
- A prerequisite that pooling be fair and reasonable would not assist, particularly in relation to smaller companies which will not have sufficient money at stake to justify litigation.[639]
- The proposed right could lead to uncertainty and a different treatment of the contractual positions of parties for ongoing firms and those in distress.[640]

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635 Australian Credit Forum; Carter Holt Harvey Limited; F Clarke, G Dean & E Houghton; Coles Myer Ltd.
636 Australian Credit Forum.
637 Carter Holt Harvey Limited.
638 Carter Holt Harvey Limited.
639 Carter Holt Harvey Limited.
640 F Clarke, G Dean & E Houghton.

Advisory Committee response to submissions on Issue 22: Draft Recommendation 22

6.83 Permitting liquidators to pool assets and liabilities could reduce the complexities of some group insolvencies and enhance returns to unsecured creditors. However, the right of all creditors to prevent their interests from being compromised without a court order should be protected. Accordingly:

The Corporations Law should permit liquidators to pool the unsecured assets, and the liabilities, of two or more group companies in liquidation with the prior approval of all unsecured creditors of those companies.

Submissions on Draft Recommendation 22

6.84 One submission supported the Draft Recommendation.[641] Another respondent preferred that the liquidator be given the power to pool with the consent of 90% of the creditors by value, with provision for a fall-back application to the court.[642]

Advisory Committee response to submissions on Draft Recommendation 22

6.85 The Advisory Committee maintains the approach in the Draft Recommendation. The requirement for unanimous approval by all unsecured creditors should remain, given that Recommendation 23 (court pooling orders), post, would apply where one or more unsecured creditors do not approve the voluntary pooling.

Recommendation 22

The Corporations Law should permit liquidators to pool the unsecured assets, and the liabilities, of two or more group companies in liquidation with the prior approval of all unsecured creditors of those companies.

Court-ordered pooling

6.86 The Australian Law Reform Commission *Insolvency Report* (the Harmer Report) (1988) recommended that a court should have a specific power to make a pooling order where a group's affairs have been intermingled. The court could make that order for any related companies in liquidation, taking into account the level of intermingling of the affairs of those companies, including:

- the extent to which the related company took part in the management of the company in liquidation
- the conduct of the related company towards the creditors of the company in liquidation (for instance, the extent to which the corporate group dealt with creditors as a single economic unit)
- the extent to which the circumstances giving rise to the liquidation are attributable to the actions of the related company, and

641 Australian Society of Certified Practising Accountants.

642 Law Council of Australia.

- the extent to which creditors of any of the companies in liquidation might be advantaged or disadvantaged by the making of a pooling order.[643] This administrative convenience factor is not specifically included in the New Zealand provision, which instead refers to "such other matters as the Court thinks fit".

The Harmer Report also proposed that pooling orders not affect the rights of secured creditors.[644]

6.87 No respondents to the Law Reform Commission Inquiry opposed the pooling proposal.[645] The following discussion of pooling deals with external secured creditors. Intra-group creditors are dealt with under **Subordination of intra-group claims**, paras 6.99 ff.

Issue 23. *Should the Corporations Law be amended to permit court-ordered pooling? If so:*

- *should the New Zealand, or some other, approach be adopted*
- *should there be a specific provision that pooling orders not affect the rights of external secured creditors*
- *what, if any, specific provision should be made for external creditors who hold securities that depend on maintaining the separate identity of the group companies in liquidation*
- *should the court have a discretionary power to provide for different creditors of companies in liquidation to receive different levels of return in appropriate circumstances?*

Submissions on Issue 23

Support

6.88 Some submissions supported court-ordered pooling based on the New Zealand legislation.[646]

6.89 One respondent considered that there should be a specific provision that pooling orders not affect the rights of external secured creditors. This respondent favoured the court having a discretionary power to provide for different creditors of companies in liquidation to receive different levels of return in appropriate circumstances.[647]

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643 ALRC 45, vol 1, paras 854-857, vol 2, s PR9.

644 ALRC 45, vol 1, para 856: "In particular [the pooling order proposal] would ensure that the rights of the holder of a floating charge are only postponed to priority creditors of the company which gave the charge".

645 ALRC 45, vol 1, para 857.

646 Australian Credit Forum, Christopher F Symes. Coles Myer Ltd supported pooling orders only for wholly-owned group companies.

647 Australian Credit Forum.

Opposed

6.90 Some submissions opposed court-ordered pooling.[648] One of those respondents argued that these orders would lead to uncertainty and possible unfairness.[649] The other respondent argued that these orders "would institutionalise a regime in the event of a divide between what is perceived to be the legal reality for ongoing firms (the separate legal entity) and that for firms in distress (group entity)".[650]

Advisory Committee response to submissions on Issue 23: Draft Recommendation 23

6.91 The Advisory Committee considers that any move to introduce court-ordered pooling in Australia would represent a desirable further extension of the existing pragmatic exceptions to the separate legal entity principles applicable to corporate group insolvencies. This power might have particular application to corporate groups which operate their finances through interlocking loan accounts, with the result that the insolvency of one group company has a consequential effect on the solvency of other group companies.

6.92 Any reform initiative in Australia must balance the respective interests of the various creditors and shareholders of corporate group companies. With pooling orders, creditors of one group company in liquidation could be disadvantaged if that company had to contribute to the debts of another group company in liquidation. However, this uncertainty problem for creditors already arises under the Corporations Law where a holding company can be held liable in some circumstances for the debts of an insolvent group company.[651]

6.93 A clearer balance of interests, and reduction of uncertainty, in pooling might be achieved by expressly providing that:

- pooling orders should not affect the rights of external secured creditors to enforce their securities, except those that depend on retaining the separate identity of the group companies in liquidation. The court should retain a discretion to protect those latter creditors, where appropriate.[652] Also, a secured creditor with an insufficient security should be able to claim as an unsecured creditor for the remaining debt from the remaining pooled assets of the group[653]

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648 Carter Holt Harvey Limited, F Clarke, G Dean & E Houghton.

649 Carter Holt Harvey Limited.

650 F Clarke, G Dean & E Houghton.

651 See paras 6.11 ff.

652 See para 6.68.

653 This approach was adopted in the New Zealand legislation. In *Re Grazing & Export Meat Company Ltd* (1984) 2 NZCLC 99,226, two banks had security over the assets of three companies within a group comprising seven companies, now in liquidation. The banks had insufficient security to cover these debts. The issue to be determined was whether they should be entitled to claim as unsecured creditors of only those three companies or of the group as a whole. Cooke J held that, in a pooling:

> "the assets of all the companies form a common pool and are available to meet … the claims of all unsecured creditors. No doubt, if particular assets should be subject to a charge in favour of a creditor, they would remain so charged, but the fact the security which is held

- the court should have a discretionary power to provide for different creditors of companies in liquidation to receive different levels of return in appropriate circumstances. This power might be used, for instance, to exclude from the pooling arrangements, and uphold according to their terms, various supply or limited recourse project financing arrangements entered into with clearly identified particular group companies on arm's length commercial terms.

6.94 Pooling orders cannot resolve all the difficulties involved with corporate group insolvencies. They are only effective to the extent that there are corporate group assets available to meet the claims of creditors. These orders cannot benefit creditors of assetless corporate groups.

6.95 Court-ordered pooling could reduce the complexities of some group insolvencies and enhance returns to unsecured creditors. Such orders could also assist in international insolvencies involving jurisdictions that allow pooling orders. Accordingly:

The Corporations Law should permit the court to make pooling orders in the liquidation of two or more companies. This power should be based on the current New Zealand provision. The legislation should also:

- *make clear that pooling orders do not affect the rights of external secured creditors*
- *permit individual external creditors to apply to have a pooling order adjusted to take their particular circumstances into account.*

Submissions on Draft Recommendation 23

6.96 The two submissions that commented on the Draft Recommendation supported the introduction of pooling powers.[654] One of those respondents favoured the legislation adopting the provisions proposed in the Harmer Report, subject to any amendments that are considered appropriate having regard to the way the New Zealand legislation has worked in practice.[655]

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from one company proves worthless does not mean that that particular creditor's rights are limited to other assets … of that particular company, or that the creditor's rights are extinguished if there are no other assets. The liquidator is entitled to regard the banks as unsecured creditors ranking with other unsecured creditors and entitled to share with them *pari passu* in the assets of the group."

654 Australian Society of Certified Practising Accountants, Law Council.

655 Law Council of Australia.

Advisory Committee response to submissions on Draft Recommendation 23

6.97 The Advisory Committee continues to support the Draft Recommendation, with the provision adopting the principles employed in the Harmer Report.

Recommendation 23

The Corporations Law should permit the court to make pooling orders in the liquidation of two or more companies. This power should be based on the draft provision in the Harmer Report and:

- make clear that pooling orders do not affect the rights of external secured creditors
- permit individual external creditors to apply to have a pooling order adjusted to take their particular circumstances into account.

Tax implications of pooling

6.98 The current Australian taxation provisions would not readily accommodate pooling, as employed under New Zealand or US law. Under pooling, any distribution to shareholders would be made from the remaining pooled funds of the group companies in liquidation after distributions to creditors. Currently, the taxation of any return to shareholders of companies in liquidation depends upon whether that return is characterised as the company's "income" (and therefore taxable as dividend income) or a return of capital (and therefore taxable as a capital gain). This means that, despite pooling, the source of any net return would have to be traced back to each pooled company. The effectiveness of any court-based pooling legislation would partly depend on consequential amendments to the taxation law.

Subordination of intra-group claims

Overseas precedents

United States

6.99 US corporate law, like that in other common law jurisdictions, generally does not control or regulate the funding mix of a company. A group company may be funded by a mixture of shareholder equity, intra-group loans and external debt finance. Corporate group lenders may seek to protect intra-group loans through appropriate securities, giving them priority over outside unsecured creditors of the borrowing group company.

6.100 In many corporate groups, whether particular funds of a group company are characterised as equity or intra-group debt depends primarily on the accounting procedure adopted or is determined by legislation.[656] US courts can scrutinise intra-group loan arrangements in the event of the liquidation of the borrowing group

[656] For instance, some Australian legislation treats contributions in specific exploration industries as equity rather than debt.

company, to determine whether those loans should be treated as equity rather than debt (and therefore be postponed behind creditors' claims). This turns on whether they bear the indicia of equity or loans, judged by substance rather than form. The relevant factors include:

- the original debt—equity ratio. The higher that ratio before the funds were contributed, the more likely those funds would be characterised as equity, to reduce that ratio

- the adequacy of the paid-up share capital.[657] If that capital is clearly inadequate, the contributed funds will be more likely to be treated as equity

- the terms on which the advance was made, the length of time for which it has been outstanding, and whether there is any reasonable expectation of payment. If those terms and expectations are not characteristic of an arm's length loan, the contributed funds will be more likely characterised as equity

- whether outsiders would make such advances. If that is unlikely, taking into account all relevant factors, the contributed funds are more likely to be characterised as equity

- the motives of the parties.[658]

6.101 In US law, even when an advance by a group company is treated as a bona fide loan, it may nevertheless be subordinated to the rights of external creditors of the borrowing group company (regardless of whether it is secured or unsecured). US bankruptcy courts can alter the priority of claims in a corporate liquidation where it is just and equitable to do so (under what are known as "equitable subordination" orders). In the context of corporate groups, a parent company which is the secured creditor of a controlled company in liquidation may nevertheless have its claims subordinated to those of unrelated unsecured creditors or even minority shareholders of the controlled company, taking into account such factors as:

- the level of capitalisation of the controlled company

- the parent company's participation in the management of the controlled company

- whether the parent company has sought to manipulate intra-group transactions to its own advantage at the expense of external creditors

- whether the parent company has otherwise behaved unfairly, to the detriment of the creditors and shareholders of the controlled company (for

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657 "(1) Capitalisation is inadequate if, in the opinion of a skilled financial analyst, it would definitely be insufficient to support a business of the size and nature of the bankrupt in light of the circumstances existing at the time the bankrupt was capitalised; (2) Capitalisation is adequate if, at the time when the advances were made, the bankrupt could have borrowed a similar amount of money from an informed outside source": *Benjamin v Diamond (in re Mobile Steel Co)* 563 F 2d 692 (1977).

658 The relevant case law is discussed by J Cox, T Hazen, F O'Neal, *Corporations* (Little, Brown & Co 1995) at §7.19 (pp 7.50-7.56).

instance, under any dividend policy designed to strip the controlled company of its funds or by the controller imposing excessive management or consulting fees).[659]

6.102 Subordination does not nullify a claim, but gives it a lower priority than other competing claims. However, the practical result of a subordination order may be to reduce, or even effectively extinguish, any repayment to the parent company, given the size of claims of secured and unsecured external creditors. This could be detrimental to the interests of creditors of the parent company if it were itself insolvent, or was rendered insolvent by the subordination order. In exceptional cases, the court may order that the external creditors of the parent company and those of the controlled company share *pari passu* (or according to some other proportionality criterion) in the assets of the controlled company.[660]

United Kingdom

6.103 The Cork Committee did not support deferring any of the secured or unsecured claims of related companies that arose from ordinary arm's length trading activities carried on between group companies.[661] However, it supported deferring intra-group claims which, in substance, represented long-term working capital, even though the finance was provided by way of loan rather than share capital.[662] The Committee considered that:

> "… a person who provides part of the capital of a business cannot call for payment until the creditors of that business have been paid. … It appears to us to be a natural application of the same principle to require external creditors of a subsidiary company to be paid before long-term finance provided by other companies in the group is repaid."[663]

6.104 The Cork Committee recommended that, on the winding up of a group company, those of its secured or unsecured liabilities which are owed to other group companies, and which appear to the court to represent all or part of the long-term capital structure of the company in liquidation, should be deferred until the claims of all other creditors have been met in full.

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659 This is known as the 'Deep Rock' doctrine, from *Taylor v Standard Gas & Electric Co* 306 US 307 (1939). In that case, a parent corporation sought to enforce its creditor claims against a subsidiary company in its reorganisation. These claims, if allowed, would have exhausted the funds otherwise available to public investor minority shareholders of that subsidiary company in the reorganisation. The Court ordered that, in light of the subsidiary's inadequate capitalisation and financial dependence on the parent, the parent's excessive participation in management, and the parent's utilisation of control to manipulate intra-group transactions to its own benefit, the parent's claim should be subordinated to the claims of the minority public investors in the subsidiary. In consequence, the minority shareholders received a return, whereas the parent company received nothing for its claim.
See further PI Blumberg, *The Law of Corporate Groups: Bankruptcy Law* (Little, Brown & Co, 1985), Chapter 4.

660 *Re WT Grant Company* 366 F 2d 599 (1983).

661 The Cork Committee Report, para 1959.

662 Id, para 1960.

663 Id, para 1962.

"Where such liabilities are secured, whether by a fixed or floating charge, we recommend that the security shall be invalid as against the liquidator or administrator or any creditor of the company until all claims to which it is deferred have been met in full."[664]

6.105 The Cork Committee referred to relevant US case law, which set out criteria to distinguish disguised capital contributions from genuine loans and similar advances.[665] In determining capital, no distinction should be drawn between contributions of money and contributions of property.[666]

6.106 The Cork Committee recommendation regarding intra-group indebtedness was not adopted in the UK. However, UK courts may in limited cases postpone the prior rights of intra-group creditors to those of unsecured external creditors, under the principles of unjust enrichment.[667]

Current law

6.107 Australian courts have no power to subordinate intra-group claims[668] (as opposed to setting aside some intra-group transactions[669]). However, a creditor group company may voluntarily agree to subordinate its claims to those of external creditors.[670]

Issue 24. *Should the Corporations Law be amended to permit courts to subordinate intra-group claims in the insolvency of a group company? If so, what guidelines should be applied to this power?*

Submissions on Issue 24

6.108 One submission supported a court power to order subordination.[671] That respondent said that liquidators and creditors should have the power to apply for an order.

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664 Id, para 1963.

665 Id, para 1964.

666 Id, para 1965.

667 In *Banque Financière de la Cité v Parc (Battersea) Ltd* [1998] 1 All ER 737, a bank lent funds to a group company relying, as security, on a "postponement letter" provided by the controllers of that corporate group to the effect that the various group companies would not enforce their prior creditor rights against the borrowing group company until the bank had been repaid in full. The House of Lords confirmed that the corporate group controllers had no agency authority to bind the creditor group companies in that manner. Nevertheless, applying the principles of unjust enrichment, the bank was entitled to priority over the rights of intra-group creditors.

668 The principles of equitable subordination have not generally been applied in Australia, with the possible exception of *Waters v Widdows* [1984] VR 503 at 512. Compare the principle of contractual subordination recognised in *Horne v Chester & Fein Property Developments Pty Ltd* [1987] 11 ACLR 485. However, any attempt to enforce a charge granted by a company in favour of its officers or their associates within six months of its creation without the court's leave is void: s 267.

669 Refer to paras 6.19-6.25.

670 s 563C. Compare *Horne v Chester & Fein Property Developments Pty Ltd* (1987) 11 ACLR 485.

671 Australian Credit Forum.

6.109 Other respondents opposed the power[672] for the following reasons.

- Subordination of intra-group claims is contrary to corporate veil principles and could disadvantage creditors of the company whose claims are subordinated.[673]

- To maintain certainty and consistency between the commercial activities of ongoing firms and those of firms in financial trouble, as well as to ensure equal treatment of creditors, intra-group claims should be treated like similarly ranked external claims.[674]

Advisory Committee response to submissions on Issue 24: Draft Recommendation 24

6.110 Subordination orders, like contribution orders, could detrimentally affect the interests of creditors and/or shareholders of the parent company. A court-based subordination power may discourage parent companies from putting loan capital into their controlled entities, given the possibility that the parent company would rank behind other creditors for recovery of that loan. Accordingly:

The Corporations Law should not be amended to permit courts to subordinate intra-group claims in the insolvency of a group company.

Submissions on Draft Recommendation 24

6.111 Submissions supported the Draft Recommendation opposing any power to subordinate intra-group claims, arguing that this could unfairly affect creditors of a company whose claims are subordinated.[675]

Advisory Committee response to submissions on Draft Recommendation 24

6.112 The Advisory Committee maintains the approach in the Draft Recommendation.

Recommendation 24

The Corporations Law should not be amended to permit courts to subordinate intra-group claims in the insolvency of a group company.

672 Carter Holt Harvey Limited; F Clarke, G Dean & E Houghton; Lend Lease.
673 Carter Holt Harvey Limited.
674 F Clarke, G Dean & E Houghton.
675 Australian Society of Certified Practising Accountants, Law Council of Australia, R Schulte.