

***Salomon's 'Accidental' Beneficiary.***

**Evaluating the Ability of Creditors of  
Wholly Owned Subsidiary Companies  
to Seek Redress from the Parent  
Company.**

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## Introduction

Now enshrined in s 15 of the Companies Act 1993, *Salomon* confirmed that an incorporated company (the ‘Company’) is legally distinct from its shareholders.<sup>1</sup> To quote Lord Halsbury, a company has “rights and liabilities of its own”, quite distinct from those of its shareholders.<sup>2</sup> Associated with this, but a discrete attribution of incorporation, is shareholder limited liability; the company’s debts are not those of its shareholders. Should a company fail, limited liability restricts shareholder liability to the value of their capital investment, in the form of fully paid shares.<sup>3</sup> Irrespective of whether limited liability is the “greatest single invention of modern times”, it has played a crucial role in the rise of the company to become the dominant business form in common law countries.<sup>4</sup>

In the years since *Salomon*, the benefit of separate legal identity and limited liability has been extended beyond companies having multiple shareholders to the ‘one-person’ company and now to the corporate group structure, in which a company (the ‘parent’) owns shares in other companies, either in conjunction with other shareholders or as the sole-shareholder. The focus of this paper is the latter situation – that of the wholly owned subsidiary (the ‘subsidiary’).

For some the parent is the “accidental beneficiary” of the subsidiary’s separate legal identity and the associated conferral of limited liability upon the parent.<sup>5</sup> In prosperous times, the parent can reap the reward of the subsidiary’s profit through the receipt of dividends. Even in times of temporary difficulty for the subsidiary, the parent may be able to utilise the subsidiary’s tax losses to offset the parent’s income.<sup>6</sup> Should the subsidiary fail however, the parent can walk away, leaving the subsidiary’s creditors to shoulder the burden of its collapse. The result, the parent “may prosper to the joy of [its] shareholders without any liability for the debts of the insolvent subsidiary”.<sup>7</sup>

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<sup>1</sup> *Salomon v A Salomon & Co Ltd* [1897] AC 22 [“Salomon”].

<sup>2</sup> At 29.

<sup>3</sup> Phillip Blumberg “Limited Liability and Corporate Groups” (1986) 11 J Corp L 573 at 574.

<sup>4</sup> Nicholas Murray Butler *Why Should we Change our Form of Government? Studies in Practical Politics* (Charles Scribner’s Sons, New York, 1912) at 82.

<sup>5</sup> Helen Anderson “Piercing the Veil on Corporate Groups in Australia: The Case for Reform” (2009) 33 MULR 333 at 356.

<sup>6</sup> A number of jurisdictions, including the United Kingdom and New Zealand, allow losses incurred by a subsidiary to be used to reduce other group member’s taxable income.

<sup>7</sup> *Re Southard & Co Ltd* [1979] 1 WLR 1198 at 1208, per Lord Templeman.

This paper considers the current protection offered to parents of failed subsidiaries. Some suggest that the privilege of limited liability should not be extended to parent companies. The conclusion in this paper is that this suggestion is too radical; Chapter two explores why this is so. This does not mean that a parent will always receive the protection of limited liability. As displayed by the use of guarantees, a parent can assume liability for some or all of the subsidiary's debts.<sup>8</sup> Additionally, both the courts and the legislature have recognised that limited liability is a privilege that can be misused, resulting in the imposition of liability upon the parent.<sup>9</sup> Chapter three explores these exceptions, addressing the ways a parent may assume liability for the subsidiary's debts or have that liability imposed upon it.

The key message of this paper is that the current 'exceptions' fail to recognise the growth of the corporate group and, with this, the legislature's recognition that, for some purposes, principally taxation, the focus is on the corporate group, and not its individual members. The result is to enable the corporate group to take advantage of a blurring of the concept of distinct legal identity. It is argued that parents who decide to take advantage of this blurring should be precluded from invoking distinct legal identity (and by implication unfettered limited liability) should the subsidiary fail. In short: the parent should not be able to pick and choose times when the subsidiary's distinct legal identity is temporarily overlooked. To deal with this situation, chapter four discusses a possible tax reform alternative, invoking a form of qualified liability in an attempt to restrict abuse of the corporate form.

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<sup>8</sup> As will be illustrated in subsequent discussion, guarantees are rare in this context.

<sup>9</sup> *Nicholson v Permakraft (New Zealand) Ltd (in liq)* [1985] 1 NZLR 242 at 250.

# Chapter One: Limited liability and its Desirability in the Parent-Subsidiary Context

## 1.1 Traditional Justifications for Limited Liability

Heralded for its contribution to the growth of enterprise, limited liability “stand[s] virtually unassailable in [its] bedrock foundations”<sup>10</sup> and pride of place among economic scholars due to the advantages that flow from a system of limited liability.<sup>11</sup> The principal justification is the associated reduction in transaction costs.<sup>12</sup> In an unlimited liability regime, not only does a shareholder face the prospect of losses in excess of their return on investment, a relatively minor shareholding may also expose a shareholder to liability beyond their initial capital investment.<sup>13</sup> In order to garner protection, prudent shareholders would need to conduct a continual monitoring process to ensure that their capital was not overly exposed to excessive risk.<sup>14</sup> Such an approach was possible in times where the most prominent form of enterprise tended to be small, closely held companies with an interconnectivity of shareholders and management. Not only did these structures provide shareholders with the ability to actively participate in the direction of the entity, their access to information allowed them to actively monitor its financial strength and their corresponding exposure. However, as the scale of enterprise continued to grow, and the separation of ownership and management became more profound, these historical expectations became unrealistic. The average shareholder was no longer closely associated with management and, in order to obviate these concerns, investors sought to minimise risk by streamlining investments into a small number of companies, allowing them to maintain a wary eye over their capital, without the incurrance of overly burdensome monitoring costs.<sup>15</sup> Unfortunately, these self-protective actions result in costly inefficiencies. Firstly, narrowing the scope of investment violates the principle of diversification, a risk management technique conditional upon the purchase of a wide variety of investments.<sup>16</sup> Limiting the number of investments deprives an investor of the counterbalancing effect that a diversified portfolio can offer and magnifies the risk of loss. Secondly, increased monitoring costs result in investors

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<sup>10</sup> Andrew Muscat *The Liability of the Holding Company for the Debts of its Insolvent Subsidiaries* (Routledge, New York, 2016) at 31.

<sup>11</sup> Phillip Blumberg *The Multinational Challenge to Corporation Law: The Search for a New Corporate Personality* (Oxford University Press, New York, 1993) at 125.

<sup>12</sup> Kurt A Strasser “Piercing the Veil in Corporate Groups” (2005) 37 Conn L Rev 637 at 637.

<sup>13</sup> Helen Anderson “Challenging The Limited Liability of Parent Companies: A Reform Agenda for Piercing the Corporate Veil” (2012) 22 AAR 129 at 131.

<sup>14</sup> Frank Easterbrook and Daniel Fischel “Limited Liability and the Corporation” (1985) 52 U Chi L Rev 89 at 94.

<sup>15</sup> Anderson, above n 13, at 131.

<sup>16</sup> At 131.

seeking higher required returns, reducing the likelihood of investment, and dampening the appetite for risk.<sup>17</sup> The overall effect of these impacts is a fetter on investment and a potential loss of economically desirable enterprise, particularly in high-risk industries.<sup>18</sup>

## **1.2 Creditors Self-Protective Mechanisms**

Further support for limited liability is provided by the classification of creditors as the “cheapest cost avoider”, recognising a creditor’s ability to implement self-protecting measures to minimise potential loss.<sup>19</sup> Contracting for credit involves a balancing of risk and reward, an assessment of whether the risk of the creditor not meeting their obligations outweighs the potential reward that accepting them as a customer could have. However, beyond this ability to consciously choose whom they contract with, creditors also have the ability to utilise selected price and non-price mechanisms to garner greater protection.

From a pricing perspective, a contracting party can incorporate a premium via increased prices, or impose interest charges based on the customer’s risk profile to ensure that an accurate and informed choice can be made. On this basis, economic theorists argue that creditors cannot complain about losses incurred as a result of insolvency as they have contracted to bear that risk and accounted for it through premiums incorporated into the cost of credit.<sup>20</sup> Therefore, those who have provided inadequate premiums or made no provision for risk should not be provided with an ‘insurance policy’ of protection due to their own failings. Parties should also adhere to the principle of diversification to ensure that they are not overly exposed to individual industries or sectors of the economy, reducing risk and potential loss.<sup>21</sup> Finally, creditors are able to introduce contractual terms to endear a greater sense of responsibility on the contracting party, ranging from personal guarantees to individual clauses entered into the contract. In these instances, the party is voluntarily accepting the imposition of unlimited liability.

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<sup>17</sup> At 131.

<sup>18</sup> Anderson, above n 5, at 356.

<sup>19</sup> Stephen M. Bainbridge “Abolishing Veil Piercing” (2001) 26 J Corp L 479 at 501.

<sup>20</sup> David Wishart, “Models and Theories of Directors Duties to Creditors” (1991) 14 NZULR 323 at 336.

<sup>21</sup> Helen Anderson “Veil Piercing and Corporate Groups – An Australian Perspective” (2010) NZ L Rev 1 at 12.

### 1.3 Pragmatic Extensions to the One Person Company and the Corporate Group

When limited liability initially displaced a regime of unlimited liability, the aim was to protect and encourage widespread commercial shareholding. But was a further extension to a one person company, dominated by a single shareholder, also warranted? *Salomon* answered this question to the affirmative.<sup>22</sup>

Mr Salomon had incorporated a company to operate his business. He responded to the then requirement of a minimum seven shareholders by having each member of his family own a single share.<sup>23</sup> Mr Salomon held the remaining 20,001 shares and was, for all intents and purposes, the dominant shareholder. The company later fell upon difficult times and was subsequently placed into liquidation. The creditors brought a claim challenging the nature of the other six shareholders, seeking to have Mr Salomon held personally liable for the company's debts. Contrary to the earlier courts acceptance that the remaining shareholders had been used to pervert the Acts legitimate use,<sup>24</sup> Lord Halsbury held that "the Act... gives a company a legal existence with... rights and liabilities of its own, whatever may have been the ideas or schemes of those who brought it into existence".<sup>25</sup> The result was the House of Lords acceptance of the legitimacy of a company having a dominant shareholder. Indeed, the 'one person company' is now a typical form of shareholding, gaining statutory recognition in the Companies Act 1993.<sup>26</sup>

Decades later, the increasingly prevalent corporate group with its wholly owned subsidiaries provided another opportunity to consider the application of limited liability to a new context, this time, the corporate group. Although Lord Denning's foray into the single economic unit may have led some to believe that the concept was inappropriate,<sup>27</sup> *Adams v Cape Industries plc* presented the decisive judgment.<sup>28</sup> Cape Industries, operated through a complex web of subsidiaries. Exposure to asbestos resulted in a number of the workers contracting asbestosis. As a result of jurisdictional issues arising from the parent's incorporation in England and the operation of subsidiaries in numerous jurisdictions, the Court of Appeal was invited to lift the veil and treat the parent and its subsidiaries as a single unit. Even though it was alleged that the

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<sup>22</sup> *Salomon*, above n 1.

<sup>23</sup> The Companies Act 1862 required an incorporated company to have seven shareholders, each owning at least one share.

<sup>24</sup> *Broderip v Salomon* [1895] 2 Ch 323 at 339. Referring to the Companies Act 1862.

<sup>25</sup> *Salomon*, above n 1, at 29.

<sup>26</sup> Companies Act 1993, s 10.

<sup>27</sup> *DHN Food Distributors Ltd v Tower Hamlets London Borough Council* [1976] 3 All ER 462.

<sup>28</sup> *Adams v Cape Industries plc* [1990] Ch 433.



subsidiaries had been incorporated for the sole purpose of avoiding liability, the Court accepted that the use of a subsidiary to insulate the parent from liability was an acceptable use of the corporate form. As Slade J observed, “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”.<sup>29</sup> This leading judgment upheld the sanctity of limited liability and confirmed that the courts were not willing to countenance an erosion of the *Salomon* principle in regards to the new corporate form.

#### **1.4 Traditional Justifications in the Group Context**

Although limited liability continues to command the utmost respect, it has come under increasing scrutiny in the group context. Considering that the doctrine was created without corporate groups in mind, and its original intention was to provide protection to “human shareholders”,<sup>30</sup> any qualification would not in fact run counter to the original intent.<sup>31</sup>

The limited liability doctrine also emerged at a time when economies began evolving from the small, closely held enterprises towards a regime of more broadly held shareholdings. As noted earlier, the associated monitoring ability was seen as an important justification for limited liability. However, when you consider the nature of the subsidiary, this proposition is more difficult to justify. A parent is “far from being an absentee owner” and often exercises control through participation in management or expressions of control.<sup>32</sup> Not only does this provide an ability to direct the affairs of the company in the desired direction, it also provides virtually unfettered access to information for the purposes of monitoring.<sup>33</sup> The imposition of limited liability therefore does not result in any mitigation of monitoring costs for the parent, they have adequate information and a vested interest in doing so.

It is true that limited liability “fosters participation by shareholders in socially desirable but risky ventures”,<sup>34</sup> but when you consider that corporate entities are in the business of taking

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<sup>29</sup> At 536.

<sup>30</sup> Rabindra S. Nathan, “Controlling the Puppeteers: Reform of Parent-Subsidiary Law in New Zealand” (1986) 3 *Canta LR* 1 at 25.

<sup>31</sup> Anderson, above n 5, at 356.

<sup>32</sup> Blumberg, above n 11, at 126.

<sup>33</sup> At 126.

<sup>34</sup> Rabindra, above n 30, at 25.

risk in pursuit of profit, it may in fact create incentives to “engage in a socially excessive amount of risky activities”.<sup>35</sup> The comfort of limited liability may distort investment decisions and encourage a parent, through a subsidiary, to engage in a venture that has a minimal likelihood of success, knowing that in the event of its demise, the burden will simply be handed to the unsuspecting creditors.

The above concerns support Strasser’s claim that due to parents presenting different policy issues, “their limited liability should be determined by a different analysis”.<sup>36</sup> The thesis advanced is that some form of qualified liability may be appropriate to rebalance the risk equilibrium that has been distorted by the corporate group.

### **1.5 Deficiencies of Self Protection Mechanisms**

Earlier analysis identified a range of self-protective mechanisms available to creditors. As Blumberg notes, analysis of limited liability “presupposes the existence of a bargain freely reached by independent parties of equivalent position, meaning among other things, equal bargaining power [and] equal access to information”.<sup>37</sup>

This applies the ‘efficient market hypothesis’, a theory that assumes “all relevant information is available and immediately digested by the market”.<sup>38</sup> Under this assumption, a creditor is presumed to have all requisite information available to make well-informed and timely decisions. Theoretical perfection however does not always match economic reality.<sup>39</sup> Consider this summation in terms of financial reporting,<sup>40</sup> where financial statements will only reflect events and transactions up to balance date.<sup>41</sup> An initial assessment may prove to be wrong if the parent subsequently influences a regime of predatory behaviour, including the commingling of assets and excessive dividend payments. Just months after contracting, the subsidiary may no longer reflect the picture of health it once portrayed and the creditor may be left to shoulder the

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<sup>35</sup> Frank H. Easterbrook, Daniel R. Fischel *The Economic Structure of Corporate Law* (Harvard University Press, Massachusetts, 1996) at 57.

<sup>36</sup> Strasser, above n 12, at 638.

<sup>37</sup> Blumberg, above n 11, at 135.

<sup>38</sup> Anderson, above n 5, at 340.

<sup>39</sup> Wishart, above n 20, at 335-336.

<sup>40</sup> Group Reporting is addressed by s 201 of the Companies Act 1993.

<sup>41</sup> Although disclosures such as contingent liabilities will provide information about possible future obligations, these statements will not indicate future actions such as a subsidiary’s intention to make large loans to other members of the group.

burden of a contract it perceived as perfectly safe. It is true that real time reporting is an unrealistic expectation, but the parent enjoys a unique position to manipulate, well in excess of the traditional shareholder.

The variability of creditor bargaining strength is also a consideration that is particularly pertinent in the parent-subsidary context. These self-protecting mechanisms progress on the assumption that a creditor is in a position to negotiate freely or implement these practices where necessary. What this fails to consider is the immense bargaining strength wielded by a large and often multinational group. It will be virtually impossible for a small trade creditor to negotiate a guarantee from a parent. Indeed, it is likely that the only party possessing the requisite strength to do so would be a bank. The parent is simply not going to assume potential liability where they have no legal obligation to do so and have a multitude of other parties who will be willing to do business without one. The ‘ability’ to exercise these avenues is desirable, but limited bargaining strength and imperfect information, as illustrated above, can act as a significant barrier to their application.

## **1.6 A Delicate Balancing Exercise**

With these challenges considered, a number of commentators have sought a form of ‘enterprise liability’,<sup>42</sup> arguing that a systematic fragmentation of enterprise, with the sole purpose of achieving limited liability, is an abuse of the corporate form.<sup>43</sup> Proponents of enterprise liability argue that there is now a “divergence between corporate theory and the underlying economic facts”<sup>44</sup> and therefore it is time for the law to depart from its fixation with the ‘entity’ concept.<sup>45</sup> As Blumberg and Strasser note:<sup>46</sup>

Today, economic activity is predominantly conducted by giant multinational enterprises organized in complex multitiered structures, consisting of scores or hundreds of subholding companies and subsidiaries. The traditional doctrines of corporation law which focus on the particular components in a complex multitiered corporate structure, rather than on the enterprise as a whole, have become an anachronism.

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<sup>42</sup> Adolf A. Berle “The Theory of Enterprise Entity” (1947) 47 Colum L Rev 343.

<sup>43</sup> Muscat, above n 10, at 396.

<sup>44</sup> Berle, above n 42, at 344.

<sup>45</sup> Phillip I. Blumberg and Kurt A Strasser *Law of Corporate Groups: Enterprise Liability in Commercial Relationships, Including Franchising, Licensing, Health Care Enterprises, Successor* (Aspen Law & Business Publishers, New York, 1998) at 19.

<sup>46</sup> At 4.

In light of these considerations, and following both criticisms of the underlying benefits of limited liability in the group context and deficiencies in the perceived protective measures, questions arise as to whether it is time to update the law to better respond to corporate realities and start recognising substance over form.<sup>47</sup> It is true that the removal of limited liability is one means of remedying the potential for abuse, however, reflecting on enterprise liabilities struggle to garner widespread acceptance and the heavy criticism of Lord Denning’s single economic unit, implementation of such widespread change would be an even more seismic and groundbreaking change than *Salomon*.<sup>48</sup> Although “the potentially profound implication of this statutory inroad in the context of group trading has not perhaps been widely appreciated”,<sup>49</sup> the major concern would be the potential discouragement of “worthwhile entrepreneurial activity” and unnecessary punishment of those who conform to the appropriate standard of corporate responsibility.<sup>50</sup>

There are in fact a “myriad of legitimate, efficient, and normatively unproblematic reasons why a company may want to create a subsidiary” and these will often fall outside the proposition of doing so for the mere benefit of reduced risk.<sup>51</sup> A subsidiary may be created to pursue tax benefits, for compliance reasons in foreign jurisdictions or even to retain the goodwill of a business unit.<sup>52</sup> Indeed, it is “perverse to penalise a group for its superior efficiency in the absence of specific elements of abuse” and those who have created a subsidiary to pursue legitimate business pursuits should not be deprived of the fundamental doctrine of enterprise.<sup>53</sup> The next chapter revisits some of the existing qualifications, but the thesis of this paper is that an additional qualification is needed.

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<sup>47</sup> Muscat, above n 10, at 394.

<sup>48</sup> *Woolfson v Strathclyde Regional Council* [1978] AC 90.

<sup>49</sup> Muscat, above n 10, at 31.

<sup>50</sup> Anthea Nolan, “The Position of Unsecured Creditors of Corporate Groups: Towards a Group Responsibility Solution Which Gives Fairness and Equity a Role” (1993) 11 C&SLJ 461 at 487.

<sup>51</sup> Meredith Dearborn “Enterprise Liability: Reviewing and Revitalizing Liability for Corporate Groups” (2009) 97 Cal L Rev 195 at 210.

<sup>52</sup> At 210.

<sup>53</sup> At 398.

## **Chapter Two: Assumption of Liability and the Laws Protective Devices**

The above conclusion supporting the continued application of limited liability does not mean that the application of the doctrine to insulate a parent from its subsidiary's debts cannot be abused; it simply means that a better solution is the recognition of an extra qualification or exception to the availability of limited liability. As noted earlier, both the courts and the legislature have recognised that limited liability is a privilege that can be misused. We turn now to consider ways in which a parent may assume liability for the subsidiary's debts or have liability imposed upon it.

### **2.1 Assumption of Liability for the Debts of the Subsidiary**

Given the rationale for the incorporation of a subsidiary, it is rare that a parent will assume liability for its debts, but it is possible. The most extreme version is the removal of limited liability itself. Section 97(1) of the Companies Act 1993 legislatively affirms that shareholder's liability is limited, except where expressly provided for within a company's constitution.<sup>54</sup> Such provisions are exceedingly rare but if a constitution so provides, a shareholder may incur an obligation to meet calls from directors for additional funds, or in the event of the company's demise, to provide the level of funding required to meet its debts.<sup>55</sup>

A parent may also assume liability through a guarantee. By virtue of the often-undercapitalised nature of subsidiary operations, prospective creditors may seek greater surety of repayment by requiring the parent's guarantee. Alternatively, a parent that is not willing to expose themselves to the extent of a guarantee, may seek to encourage a creditor to transact with their subsidiary through a "comfort letter".<sup>56</sup>

It should also be noted that a parent subsidiary relationship does not preclude the subsidiary acting as the parent's agent. This will be rare, but if it does arise, the parent will assume liability as the subsidiary's principle.

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<sup>54</sup> Companies Act 1993, s 97(2) explains the extent of the limited liability.

<sup>55</sup> Andrew Beck and others *Morison's Company and Securities Law* (online looseleaf ed, LexisNexis) at [16.2].

<sup>56</sup> Also known as a Poor Mans Guarantee. Refer to: Struan Scott "Comfort Letters: Let the Issuer Be Aware" (1995) 5 JBFCP 197 at 197. A comfort letter too can result in some liability.

## **2.2 The Laws Protective Devices**

Parliament and the courts have recognised that the concept of limited liability can be abused. This section considers key ways in which the position of creditors is protected through qualifications or exceptions to limited liability. As will be seen, the recognition of these is an ongoing process, especially with regard to legislative reform. To date, all these devices, with the exception of pooling orders, discussed below, have applied to companies generally, irrespective of who the shareholder is. A key point of this paper is that the subsidiary attracts special concerns, especially when the group of companies is regarded as a whole, warranting the development of a protective device addressed to those concerns.

### **2.2.1 Mismanagement**

Mismanagement may ultimately lead to a company's demise, a proposition that is particularly pertinent in the wholly owned context. Contrary to the traditional human shareholder, who has only limited control in proportion to their shareholding, the parent holds a unique position of power that can be exploited. Not only does a parent have the ability to exercise power over the subsidiary's board in the exercise of day-to-day decisions, but they can also influence certain transactions, including, intercompany loans and dividend payments that can jeopardise the subsidiary's financial position.

The imposition of director's duties and the creation of pooling orders can remedy this form of abuse. In terms of director's duties, a director of a subsidiary is bound by a fiduciary duty to act in the subsidiary's best interests. When a company approaches insolvency or becomes insolvent, interests of the creditors take precedence<sup>57</sup> and the director's duties increase in scope.<sup>58</sup> Although these duties are aimed towards the directors of the subsidiary, they do not preclude the possibility of either the parent or its respective directors attracting liability as shadow directors. Alternatively, the pooling provisions present an opportunity to increase the pool of funds available to creditors in the event of liquidation by holding the parent liable for the subsidiary's loss. In assessing whether it is just and equitable to make an order, the court will assess the extent to which the parent participated in the management of the subsidiary and whether its involvement contributed to the events surrounding the subsidiary's demise.<sup>59</sup>

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<sup>57</sup> *Nicholson v Permakraft*, above n 9.

<sup>58</sup> Reflected by, among others, s 135 and s 136 of the Companies Act 1993.

<sup>59</sup> Companies Act 1993, s 272.

### 2.2.1.1 Directors Duties

#### *Section 131*

Section 131 states that a “director of a company when exercising powers or performing duties must act in good faith and in what the director believes to be the best interests of the company”.<sup>60</sup> When insolvency approaches, this duty extends to include the interests of creditors.<sup>61</sup> The High Court addressed the extent of these duties in *Sojourner v Robb*.<sup>62</sup>

The standard in s 131 is an amalgam of objective standards as to how people of business might be expected to act, coupled with a subjective criteria as to whether the directors have done what they honestly believe to be right. The standard does not allow a director to discharge the duty by acting with a belief that what he is doing [is] in the best interest of the company, if that belief rests on a wholly inappropriate appreciation as to the interests of the company.

The objective aspect of this duty means that any decision must be reasonable in the circumstances and be one that would be adopted by the ordinary and prudent director. Transactions involving the transfer of company assets in times of doubtful solvency<sup>63</sup> and the incurrence of a contingent liability in the form of a GST refund to the Inland Revenue Department<sup>64</sup> have resulted in the courts concluding a breach of s 131. In the group context however, this section can raise a predicament for a director. The mere nature of the close-knit affiliation of a parent and subsidiary means that the subsidiary’s directors are often not free to take actions that are in the subsidiary’s best interest, instead being forced to submit to the parent’s demands.<sup>65</sup> Where subsidiary directors submit to this pressure and undertake actions such as the sale of products at reduced rates or excessive dividend payments to the parent,<sup>66</sup> they are acting in a manner inconsistent with their duty of loyalty and may expose themselves to personal liability. The legislature has recognised this “commercial reality”.<sup>67</sup>

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<sup>60</sup> Companies Act 1993, s 131(1).

<sup>61</sup> *Kinsela v Russell Kinsela Pty Ltd* [1968] 4 NSWLR 722 at 730.

<sup>62</sup> *Sojourner v Robb* [2006] 3 NZLR 808 at [102].

<sup>63</sup> At [107].

<sup>64</sup> *Rowmata Holdings Ltd (in liq) v Hildred* [2013] NZHC 2435.

<sup>65</sup> Eric J. Gouvin “Resolving the Subsidiary Directors’ Dilemma” (1996) 47 *Hastings L J* 287 at 290.

<sup>66</sup> At 290.

<sup>67</sup> *Briggs v James Hardie and Co Pty Ltd* (1989) 16 NSWLR 549 at 577.

Where approved by the subsidiary's constitution, s 131(2) provides an express ability for a subsidiary director to act in the best interests of the parent company, even if these actions run counter to the best interests of the subsidiary. As the High Court recognised in *Lewis Holdings Ltd v Steel & Tube Holdings Ltd* however, "the ability of directors to act in the best interests of the parent does not obviate the need to have regard to the separate legal status of the subsidiary".<sup>68</sup> In that case there had been a complete failure to separate the management of the respective entities, no board meetings were held and the way the subsidiary directors structured their affairs simply did not suggest that the entities reflected a separate existence. The court held that s 131(2) did not allow a flagrant disregard for the subsidiary's interests, with MacKenzie J recognizing that:<sup>69</sup>

A provision in a constitution that a director of a subsidiary may prefer the interests of the holding company to those of the subsidiary does not mean that the interests of both companies can be conflated, or that the interests of the subsidiary can be ignored. The proper application of such a provision requires the directors to recognise that there are different interests involved, and to decide which are to be preferred in the issue under consideration.

Section 131(2) is therefore a "limited exception to the s 131(1)" duty<sup>70</sup> and is not an exception to the wider duties contained within the act.<sup>71</sup> A director who has allowed the subsidiary to act recklessly or to incur an obligation that it cannot perform will not be absolved of liability by virtue of s 131(2).<sup>72</sup> Likewise in *Mountfort v Tasman Pacific Airlines of NZ Ltd*, Baragwanath considered that s 131(2) does not relieve directors of the fundamental obligation to cease trading upon insolvency".<sup>73</sup> Consequently, s 131(2) only provides for a minor inroad into the fundamental concept of separate legal identity and illustrates that the courts are not willing to accept a state of affairs where subsidiary interests can simply be ignored.

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<sup>68</sup> *Lewis Holdings v Steel & Tube Holdings Ltd* [2014] NZHC 3311, [2015] 2 NZLR 831 at [40].

<sup>69</sup> At [33].

<sup>70</sup> At [32].

<sup>71</sup> At [32].

<sup>72</sup> Companies Act 1993, s 135 and s 136.

<sup>73</sup> *Mountfort v Tasman Pacific Airlines of NZ Ltd* [2006] 1 NZLR 104 at [82].



## Section 135

In recognition of the inherent risks involved with commercial decision-making,<sup>74</sup> the preamble of the Companies Act 1993 expressly provides that directors should be entitled to take risks when carrying out their duties.<sup>75</sup> However, the extent of this autonomy must be kept within reasonable bounds and s 135 recognises that “a director<sup>76</sup> of a company must not cause or agree to the company being carried on in a manner likely to create a substantial risk of serious loss to the company’s creditors”.<sup>77</sup> This section reflects a director’s “fundamental duty to protect the interests of creditors when the company approaches insolvency”.<sup>78</sup> In applying this duty, the courts have developed a legitimate business risk test.<sup>79</sup> In *Re South Pacific Shipping Ltd (in liq)* a number of factors were deemed relevant in determining whether a director’s actions are legitimate, including whether the company continued to trade while insolvent, whether the creditors were on notice and aware of the risk to their funds, and, whether directors were conducting business in line with orthodox commercial practice.<sup>80</sup> In *Mason v Lewis*, Hammond J added that in considering whether a business risk is legitimate, it will be the responsibility of a director to make a “sober assessment... of an ongoing character, as to the company’s likely future income and prospects”.<sup>81</sup>

These considerations do not mean that on the dawn of balance sheet insolvency an automatic duty is imposed on a director to wind up the company.<sup>82</sup> The business may have the ability to trade out of the difficulty or may simply be suffering a temporary liquidity deficit.<sup>83</sup> As a result, the decision to prematurely wind up the company may inflict unnecessary and serious loss to creditors.<sup>84</sup> This decision can leave directors in a particularly precarious position. Do they “put

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<sup>74</sup> *Re South Pacific Shipping Ltd (in liq)* (2004) 9 NZCLC 263, 570 at [121].

<sup>75</sup> Companies Act 1993, Preamble.

<sup>76</sup> Obiter comments made in *Krtolica v Westpac Banking Corporation* [2008] NZCCLR 24 suggest that the words “cause or allow” may incorporate a shadow director within the sections ambit. There are however no successful cases imposing s 135 liability on a parent by virtue of shadow directorship.

<sup>77</sup> Companies Act 1993, s 135.

<sup>78</sup> *Mizeen Painters Ltd (in liq) v Tapusoa* [2016] NZAR 423 at [40]. Although s 135 is concerned with creditor protection, the fundamental duty owed by the directors is to the company itself.

<sup>79</sup> *Re South Pacific Shipping Ltd*, above n 75, at [125].

<sup>80</sup> *Re South Pacific Shipping Ltd*, above n 75, at [125].

<sup>81</sup> *Mason v Lewis* [2006] 3 NZLR 225 at [51], citing Mike Ross Corporate Reconstructions: Strategies for Directors (CCH New Zealand, Auckland, 1999) at 40.

<sup>82</sup> The value of a company’s liabilities and contingent liabilities exceed its value of assets. Refer Companies Act 1993, s 4.

<sup>83</sup> *Yan v Mainzeal Property and Construction Ltd (in rec and in liq)* [2014] NZCA 190 at [33]: “The test is one of solvency, not liquidity. A temporary lack of liquidity may not equate to insolvency if the debtor is able to realise assets or borrow funds within a relatively short time frame in order to meet its liabilities as they fall due”.

<sup>84</sup> *Re South Pacific Shipping Ltd*, above n 75, at [125].

up the shutters” because continuing to trade will damage the pool of funds available to creditors upon liquidation, or do they genuinely see “light at the end of the tunnel” which will enable them to trade out of insolvency and allow the business to continue in operation.<sup>85</sup> Where the latter option is taken, directors will only be given a short reprieve before having to reconsider the most appropriate course of action.<sup>86</sup>

Importantly, s 135 is not concerned with minor risks to creditors,<sup>87</sup> instead what is required is a “substantial risk of serious loss”.<sup>88</sup> This requirement, although reflecting a directors need to be able to take risks, generally precludes the sections application to the most common forms of group abuse. This is illustrated by *Nippon Express (NZ) Ltd v Woodward*, where, in addressing the predecessor to s 135,<sup>89</sup> Anderson J recognised that operating a thinly capitalized company at a loss for an extended period has “some risk to creditors”, but subsequently stated that the section is not concerned with mere risk, but substantial risk of serious loss.<sup>90</sup> This would tend to suggest that the section would provide no protection to creditors in terms of the undercapitalised or thinly capitalised subsidiary, a situation that commonly results in loss to creditors. Even when testing the legitimacy of the actions, an undercapitalised subsidiary may even be considered an orthodox commercial practice. Section 135 therefore provides directors with a reasonable level of comfort and will only intervene where they had made substantial errors of judgment.

### ***Section 136***

Section 136 states that “a director of a company must not agree to the company incurring an obligation unless the director believes at that time, on reasonable grounds, that the company will be able to perform the obligation when it is required to do so”.<sup>91</sup> The section focuses on “particular transaction[s] rather than the general conduct of the company’s business”<sup>92</sup> and aims

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<sup>85</sup> Insolvency Law Review Committee *Insolvency Law and Practice* (“The Cork Report”) (1982) Cmnd 8558 at [216].

<sup>86</sup> *Re South Pacific Shipping Ltd (in liq)* (2004) 9 NZCLC 263, 570 at [125] described the time being only “a few months”.

<sup>87</sup> *Cool Cars (Wholesale) Ltd (in liq) v Sharma* [2014] NZHC 256 at [35].

<sup>88</sup> Companies Act 1993, s 135.

<sup>89</sup> Companies Act 1955, s 189.

<sup>90</sup> *Nippon Express (NZ) Ltd v Woodward* (1998) 8 NZCLC 261,765 at 15.

<sup>91</sup> Companies Act 1993, s 136.

<sup>92</sup> *Peace and Glory Society Ltd (in liq) v Samsa* [2009] NZCA 396, [2010] 2 NZLR 57 at [44].

to restrict directors from entering into transactions that the company cannot perform.<sup>93</sup> O'Regan J held in *Fatupaito v Bates* that it must be proven that “the directors(s) agreed to the company incurring an obligation at a time when they did not believe (the subjective test) on reasonable grounds (an objective test) that the company would be able to perform that obligation when required to do so”.<sup>94</sup> The High Court in *Cool Cars (Wholesale) Ltd (in liq) v Sharma* held that the requirement that the company “will be able to perform the obligation” requires a “reasonably high level of certainty”.<sup>95</sup> Although this does not amount to absolute certainty, the director will however be “required to believe that there is no apparent risk that the company will not be able to perform the obligation”.<sup>96</sup> This subjective belief will then be assessed against a standard of reasonableness. Campbell, Watts and Hare in *Company Law in New Zealand* held that “it is likely that a belief will be prima facie unreasonable where the company is insolvent at the time the obligation was incurred, unless for some reason the company’s insolvency was not then apparent, or otherwise there were grounds for thinking that the company would become solvent by the time the obligation was to be performed”.<sup>97</sup>

In *Lewis Holdings v Steel & Tube Holdings Ltd*, the defendant parent had purchased a property that was subject to a perpetually renewable ground lease. The lessee of the property, ‘Stube’ was the defendant’s subsidiary. The subsidiary’s board, comprising of the CEO and CFO of the parent, failed to respond to the notice of renewal and inadvertently renewed the lease.<sup>98</sup> Although in many respects the subsidiary had failed to maintain a separate existence and the directors had not maintained their separate obligations,<sup>99</sup> when viewed as separate legal entities, MacKenzie J held that it “was clear that Stube did not have the financial capacity to continue to trade without the support of STH”, its parent.<sup>100</sup> Thus there had been a breach of s 136. Although this resulted in an entitlement to recover, it is illustrative of the limited application of the duty to parents, primarily as a result of the transaction specific approach adopted by the

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<sup>93</sup> The requirement for agreement in s 136 would appear to infer that a shadow director falls outside the sections ambit.

<sup>94</sup> *Fatupaito v Bates* [2001] 3 NZLR 386 at [80].

<sup>95</sup> *Cool Cars (Wholesale) Ltd (in liq)*, above n 88, at [50].

<sup>96</sup> At [50].

<sup>97</sup> Peter Watts, Neil R Campbell, Christopher Hare *Company Law in New Zealand* (Lexis Nexis, Wellington, 2011) at 607.

<sup>98</sup> Public Bodies Leases Act 1969, schedule 1, clause 6 states: “If the lessee fails to give to the lessor within the time specified in clause 5 the notice referred to in that clause, he shall be deemed to have agreed to accept a renewal lease at the rent specified in the notice given to him by the lessor”.

<sup>99</sup> *Lewis Holdings*, above n 69, at [37]. They held no formal board meetings and the majority of the company’s functions were carried out by the parent.

<sup>100</sup> At [39].

section.<sup>101</sup> Where a number of transactions are to be challenged, they must be assessed individually, resulting in a substantial increase in litigation costs. As long as the subsidiary keeps its head just above water and no obligations are incurred where the subsidiary is in real trouble, no liability should result. This is the case even where the compounded effect of these actions substantially weakens the subsidiary's "financial backbone".<sup>102</sup>

## Shadow Directors

A shadow director is "a person with whose directions or instructions the board of the company may be required or is accustomed to act".<sup>103</sup> Importantly for present purposes, *Gillies Bakery Ltd v Gillespie* confirmed that the term 'person' is not restricted to natural persons, thus, a parent can be a shadow director.<sup>104</sup> Both the parent and its respective directors are therefore walking the tightrope of liability if they become overly engaged in the direction of subsidiary's affairs and could see them become subject to the director's duties contained within the Companies Act 1993.

In *Re Hydrodam* Millet J advanced a four-factor test to determine if a 'person' was acting as a shadow director.<sup>105</sup> The most crucial factor was whether the directors were "accustomed to act" on the direction of, in this case, the parent company or its respective directors.<sup>106</sup> Identifying the "locus of effective decision making"<sup>107</sup> is made more difficult in the parent–subsidiary context due to the fact that expressions of power are "almost by definition, inherent in every holding company".<sup>108</sup> The courts have accepted that in considering that when considering the wholly owned status, the presence of shared directorships, or even the fact that a parent is solely responsible for the appointment (and removal) of the board of directors, does not necessarily mean that directors of subsidiaries are ordinarily obliged to follow their instructions.<sup>109</sup> This recognises that it is entirely plausible that a subsidiary which presents these features will still be able to maintain a "sufficient degree of autonomy" that would allow them to operate

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<sup>101</sup> *Bay Kiwifruit Contractors Ltd v Ladher* [2015] NZHC 63 at [46].

<sup>102</sup> Muscat, above n 10, at 253.

<sup>103</sup> Companies Act 1993, s 126(1)(b)(i) and s 126(1)(b)(ii).

<sup>104</sup> *Gillies Bakery Ltd v Gillespie* [2013] NZHC 1608 at [53], affirmed in *Gillies Bakery Ltd v Gillespie* [2015] NZCA 93.

<sup>105</sup> *Re Hydrodam (Corby) Ltd* [1994] 2 BCLC 180 at 163.

<sup>106</sup> At 163.

<sup>107</sup> *Australian Securities Commission v A S Nominees Ltd* (1995) 133 ALR 1 at [52].

<sup>108</sup> Muscat, above n 10, at 61.

<sup>109</sup> *Delegat v Norman* [2012] NZHC 2358 at [28].

independently, and thus, not ‘accustomed to act’ on the direction of the parent.<sup>110</sup> On the basis of these considerations, although the group context presents an opportunity to exercise control, the fundamental consideration will be whether “the power to control was put into practice”.<sup>111</sup>

Both the courts and commentators have recognised the difficulty in establishing the requisite degree of control.<sup>112</sup> Deciding whether the subsidiary directors were ‘accustomed to act’ on the parent’s direction or whether they maintained their own discretion does not elicit a simple answer. No New Zealand<sup>113</sup> or United Kingdom case has successfully argued for the substantiation of a parent as a shadow director<sup>114</sup> and even in jurisdictions where such liability has been introduced,<sup>115</sup> they have not seen vigorous enforcement.<sup>116</sup> This evidential difficulty was recognised by the Cork Report which suggested, unsuccessfully, that there should be a presumption introduced where the parent would be a party to the decisions of the subsidiary directors wherever the parent had been responsible for the appointment of the subsidiary’s board or a substantial part thereof, or where the boards of the two companies consist of substantially the same persons.<sup>117</sup> Although increasingly detailed reporting in the form of director’s minutes and financial statements may assist to some extent, the level of control exercised is generally likely to be far in excess of what is evident on paper and able to be proven in court.<sup>118</sup> A creditor will have the greatest likelihood of success in the position of the pure “subservient subsidiary”, generally evidenced by a lack of autonomous decision-making and unbridled acceptance of the parent’s direction.<sup>119</sup> Beyond these more such readily identifiable instances however, proving the evidential burden will be difficult.

Shadow directorship also fails to be of assistance against the undercapitalised or artificially fragmented subsidiary.<sup>120</sup> Even where a parent incorporates a heavily undercapitalised

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<sup>110</sup> Muscat, above n 10, at 214.

<sup>111</sup> *Buzzle Operations Pty Ltd (in liq) v Apple Computers Australia Pty Ltd* (2011) 81 NSWLR 47 at [76].

<sup>112</sup> Anderson, above n 5, at 363.

<sup>113</sup> *Dairy Containers Ltd v NZI Bank Ltd* [1995] 2 NZLR 30 addressed the issue but the High Court held that the parent did not give the subsidiary “identifiable directions or instructions” and therefore the parent could not be deemed a shadow director.

<sup>114</sup> Fiona Tolmie *Corporate and Personal Insolvency Law* (2<sup>nd</sup> Edition, Routledge, London, 2003) at 373.

<sup>115</sup> Jurisdictions which have introduced such liability include, France, Germany and Switzerland. Refer K Hofstetter “Parent Responsibility for Subsidiary Corporations: Evaluating European Trends” (1990) 39 ICLQ 576 at 583.

<sup>116</sup> Ian M Ramsay “Holding Company Liability for the Debts of an Insolvent Subsidiary: A Law and Economics Perspective” (1994) 17 UNSWLJ 520 at 529.

<sup>117</sup> The Cork Report, above n 86, at [1938].

<sup>118</sup> Muscat, above n 10, at 215.

<sup>119</sup> At 200.

<sup>120</sup> At 64.

subsidiary, as long as they subsequently maintain a separate existence, liability will not be forthcoming as the subsidiary directors have not been ‘accustomed to act’ on the parents direction.<sup>121</sup> The initial act of undercapitalisation will not be deemed an action relevant to the establishment of the requisite degree of control. Likewise, the decision by the parent to segment the enterprise into a number of risky factions, even where ultimately responsible for the entities demise, will not alone be sufficient to incur liability. The fundamental consideration will remain whether the control exercised by the parent company was inherently accepted by the subsidiary directors, something that requires more than a single act.

### 2.2.1.2 Pooling

The many collapses of conglomerates occasion many disputes. Regularly, liquidators of subsidiaries, or of the holding company, come to court to argue as to which of their charges bears the liability.<sup>122</sup>

The MacArthur Report considered that the available remedies in regards to corporate group collapses were insufficient.<sup>123</sup> To remedy this, it was suggested that the courts be empowered (on application of the liquidator) to make an order that would hold the parent company liable for the debts of the subsidiary.<sup>124</sup> This recommendation led to the Companies Amendment Act 1980 and the creation of the, then revolutionary, pooling provisions.<sup>125</sup> Effectively these sections create an exception to the fundamental principle of separate legal identity laid down in *Salomon* and seek to ensure that the law treats a group of companies in a similar manner “as was displayed during their active commercial life”.<sup>126</sup> A successful application for a pooling order provides creditors with a claim to a greater pool of assets, albeit at the cost of increasing the number of claimants.

The pooling provisions apply to “related companies”, a term exhaustively defined in s 2(3) of the Companies Act 1993. Entities will be considered “related companies” where, more than half of the shares on issue are held, where the entities are carried on in such a way that a

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<sup>121</sup> At 340.

<sup>122</sup> *Qintex Australia Finance Ltd v Schroders Australia Ltd* (1990) 3 ACSR 267 at 268.

<sup>123</sup> New Zealand Special Committee to Review the Companies Act *Final Report of the Special Committee to Review the Companies Act* (Government Printer, Wellington, 1973) (“The MacArthur Report”).

<sup>124</sup> At 159.

<sup>125</sup> Companies Amendment Act 1980, s 315A - s 315C.

<sup>126</sup> *Qintex Australia Finance Ltd*, above n 122, at 269.

substantial part of it is not readily identifiable, or as is relevant for present purposes, where it is a subsidiary.<sup>127</sup> Section 271(1)(a) allows the court to hold a related company liable for the debts of the insolvent company while, s 271(1)(b) allows the court to wind up two related companies that are both in liquidation as a single entity. When addressing a claim, s 272 provides a number of considerations for whether it will be just and equitable to make an order, including the extent to which the related company took part in the related company's management.<sup>128</sup> Finally, s 271(3) maintains the important contention that the mere fact that creditors of a company in liquidation relied on the fact that another company is, or was, related to it, is not a ground for making an order under s 271.<sup>129</sup>

The unique sections<sup>130</sup> have unfortunately attracted little judicial consideration.<sup>131</sup> Early cases tended to focus on the predecessor to s 271(1)(b)<sup>132</sup> and s 271(1)(a) has only recently come under judicial consideration. Two key cases for present purposes are *Mountfort v Tasman Pacific Airlines of NZ Ltd* and *Steel & Tube Holdings Limited v Lewis Holdings Ltd*, with both cases premised on the exercise of control by a parent company. In *Mountfort*, the subsidiary ('Regional') was heavily dependent on the parent ('Airlines'), relying on it for 99% of its business income. The subsidiary also shared the same directors, held no formal directors meeting and was only responsible for the employment of staff, with all other functions being conducted by the parent. This control allowed Airlines to direct Regional to make a transfer of \$650,000 to it. Following a reduction in financial support by the new owners and the unexpected failure to obtain the Qantas franchise, the two companies were placed into receivership. Although the High Court held that the "mere participation of the holding company in the management of the subsidiary would not of itself, justify a pooling order", Regional's reliance had effectively made it a 'slave', dependent on Airlines for its own survival.<sup>133</sup> The two companies were therefore so closely linked that there was no denying that the demise of Airlines caused the subsequent capitulation of Regional. The court also accepted that at the

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<sup>127</sup> Companies Act 1993, s 2(3).

<sup>128</sup> Other factors include, the conduct of the related company towards the creditors, the extent to which the circumstances gave rise to the liquidation and any other matters that the court sees fit.

<sup>129</sup> It is aimed at dealing with the cases such as *Norhawk Investments Inc v Subway Sandwich Shops Inc* 61 Wn App 395 (Div 1 1991) where a creditor who was aware that that subsidiary was simply a vehicle to secure the lease, still decided to contract. The association with the parent company cannot be used to gain a more superior contract.

<sup>130</sup> Ireland Companies Act 1990 (Ireland), s 140-141 contains similar provisions.

<sup>131</sup> *Lewis Holdings*, above n 68, at [16] stated that pooling provisions have "not been frequently invoked".

<sup>132</sup> Companies Act 1955, s315B. Also concerned the liquidation of two related companies. Refer for example, *Re Dalhoff and King Holdings Ltd* [1991] 2 NZLR 296.

<sup>133</sup> *Mountfort*, above n 73, at [86]-[87].

time Regional made the transfer, Airlines was insolvent.<sup>134</sup> As a result, the “risk to Regional’s creditors was therefore systemic, not adventitious...[and] to permit Regional to continue to extend credit to Airlines meant that it would be the Regional creditors who carried the risk”.<sup>135</sup> Based on these considerations, the court held that it was just and equitable to treat the companies as one.

*Lewis Holdings v Steel & Tube Holdings Ltd* presented an opportunity for the court to assess the rarely invoked s 271(1)(a). It will be recalled that Stubes directors had inadvertently renewed a 21-year lease, a decision that would eventually result in the decision to liquidate the subsidiary. The liquidator sought recovery of the unpaid portion of the lease through a pooling order. In assessing whether it was just and equitable to grant a pooling order, the respective guidelines contained within s 272 were assessed. Section 272(1)(a) involves an assessment of the extent to which the parent took part in the management of the subsidiary. Various features indicated that Stube had not been operated as a separate company but merely a division of the parent. These features included Stube having no employees of its own, its directors were senior managers of the parent, it relied on staff from the parent, used group stationery without expressing who the employee was acting for and they held no formal board meetings. The subsidiary was managed almost exclusively by the parent.<sup>136</sup> Other elements of financial intermingling, evidenced by a lack of a separate bank account, offered further support for this conclusion.<sup>137</sup> In considering s 272(1)(b), the court found that even though the landlord was aware that Stube was the lessee, the fact that the parent paid the rent and rates as remediation costs indicated that it “stood behind” its subsidiary.<sup>138</sup> In considering the other guidelines, the parents removal of their historical financial support, which ultimately led to the subsidiaries demise, was seen as a relevant consideration under s 271(1)(c), while the parent company’s public status was also noted as an additional consideration within s 271(1)(d). Baragwanath J subsequently concluded on the basis of the above considerations that it was just and equitable to hold the parent liable for the unpaid portion of the lease. The Court of Appeal subsequently upheld the High Court’s decision, adding that even if causation and detrimental reliance were not present, an order under s 271(a) would still be possible.<sup>139</sup> This means that, even where

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<sup>134</sup> At [97].

<sup>135</sup> At [97].

<sup>136</sup> *Lewis Holdings*, above n 68, at [34].

<sup>137</sup> At [51].

<sup>138</sup> At [71].

<sup>139</sup> *Steel & Tube Holdings Ltd v Lewis Holdings Ltd* [2016] NZCA 366 at [52].



there is no causative link between the parent's conduct and the subsidiary's loss, an order may still be forthcoming. This case illustrates a previously unutilised inroad into the rigidity of company laws foundational doctrines and led to numerous law firms publishing corporate updates to alert clients to the importance of maintaining distinct boundaries between a parent and its subsidiaries.<sup>140</sup>

Other applications of the pooling provisions have specifically sought to address the 'group persona' type abuse, where the individual components of the group are held out as a single entity.<sup>141</sup> Relevant considerations have included, intermingled management and a lack of differentiation from a legal and accounting perspective,<sup>142</sup> a complete inability to differentiate the individual entities<sup>143</sup> and the substantial use of intercompany borrowing and shared bank accounts.<sup>144</sup>

Although the pooling sections recognise the most notable encroachment on limited liability in recent times, their lack of enforcement in a commercial landscape where subsidiary's collapse on a relatively regular basis is of minimal comfort.<sup>145</sup> The substantial cost associated with a claim is likely to result in a significant barrier, with a creditor only being likely to pursue this avenue if they perceive a reasonable likelihood of success.<sup>146</sup> This could result in viable claims possibly not being litigated. It will also restrict the availability of the remedy to instances where the subsidiary contracts with one or simply a few notable creditors, presenting the possibility of a sizeable claim. In comparison, a small trade creditor with a minor outstanding claim will not be in a position to pursue the parent without incurring disproportionately large legal fees. Whatever the reason, the sections rare application has greatly reduced their utility, but they do recognise the legislature's increasing willingness to protect creditors where the corporate structure has been the subject of abuse.

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<sup>140</sup> Pip Greenwood and others "Corporate Advisory Legal Update – Steel & Tube Holdings Limited v Lewis Holdings Limited" (24 September 2016) Russell McVeagh <[www.russellmcveagh.com](http://www.russellmcveagh.com)>.

<sup>141</sup> Muscat, above n 10, at 416.

<sup>142</sup> *Goodson v Wingate Two Ltd* (2010) 3 NZTR 20-002 at [27].

<sup>143</sup> *Re McCullagh* HC Auckland CIV-2008-404-3417, 14 July 2008.

<sup>144</sup> *Shepard v Carm Holdings Ltd (in liq)* HC Wellington CIV-2009-485-1332, 16 September 2009.

<sup>145</sup> Although this does not rule out the possibility of an out of court settlement being achieved when this section is raised.

<sup>146</sup> Muscat, above n 10, at 213.

## 2.2.2 Piercing the Corporate Veil

Despite the recognition of separate legal identity, the courts have historically retained a jurisdiction to ‘pierce the veil’ and disregard the corporate form.<sup>147</sup> Judicial opinion tended to suggest that the courts lacked the ability to pierce the veil in the interests of justice,<sup>148</sup> however, among the quandary of “incautious dicta and inadequate reasoning”,<sup>149</sup> a broader principle emerged that the corporate veil may be pierced to prevent abuse of corporate legal personality.<sup>150</sup> This was generally accepted to include, fraudulent conduct<sup>151</sup>, where the subsidiary exists as a mere façade or sham<sup>152</sup> and where the subsidiary has been used in order to avoid a legal obligation.<sup>153</sup> In these instances, the Courts were prepared to look behind the corporate structure and “identify the real nature of the transaction and the reality of the relationship created”.<sup>154</sup>

In terms of the ‘undercapitalised subsidiary’, some commentators have argued that setting up a ‘flimsy’ organisation with insufficient assets to meet available debts is an abuse of the corporate form, presenting valid grounds for denying the separate entity privilege.<sup>155</sup> The courts however, have tended not to accept this. Prior to the 1950s undercapitalisation had been virtually unconsidered<sup>156</sup> and it was not until the case of *Re F.G (Films Ltd)* that it received any attention.<sup>157</sup> A company had been incorporated with trivial capital of £100 for the purpose of creating a film. Vaisey J considered the minimal capital issued and the use of financing to be significant factors. For Gower, this was “the first signs of recognition that the undercapitalisation of the subsidiary may be a significant element” in piercing considerations.<sup>158</sup>

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<sup>147</sup> The Court of Appeal in *Attorney-General v Equiticorp Industries Group Ltd (In Statutory Management)* [1996] 1 NZLR 528 at 541 held: “to lift the corporate veil...is not a principle. It describes the process, but provides no guidance as to when it can be used”.

<sup>148</sup> *Bentley Poultry Farm v Canterbury Poultry Farmers Cooperative Ltd (No 2)* (1989) 4 NZCLC 64,780 at 64,791, accepted that doing so “would lead to enormous commercial uncertainty. Also refer to *Adams v Cape Industries plc* [1990] Ch 433 at 536.

<sup>149</sup> *Prest v Petrodel Resources Ltd* [2013] UKSC 34, [2013] 2 AC 415 at [19].

<sup>150</sup> At [34].

<sup>151</sup> *Jones v Lipman* [1962] 1 WLR 832.

<sup>152</sup> In *NZ Seamens Union IUIW v Shipping Corp of NZ Ltd* (1989) 2 NZELC 96,728, the court was willing to pierce the veil after holding that the group structure was simply a sham. Façade was also described as the “one well recognised exception” in *Adams v Cape Industries plc* [1990] Ch 433 at 539.

<sup>153</sup> *Gilford Motor Co Ltd v Horne* [1933] Ch 935.

<sup>154</sup> *Attorney General v Equiticorp Industries Group Ltd (In Statutory Management)* [1996] 1 NZLR 528 at 541.

<sup>155</sup> Henry Ballantine *Ballantine on Corporations* (Callaghan, Chicago, 1946) at 302-03.

<sup>156</sup> Muscat, above n 10, at 346.

<sup>157</sup> *Re F.G (Films Ltd)* [1953] 1 All ER 615.

<sup>158</sup> Laurence Gower *Principles of Modern Company Law* (3<sup>rd</sup> ed, Stevens, London, 1969) at 203.

Unfortunately, Gower's enthusiasm appears to have been unfounded,<sup>159</sup> with the undercapitalisation factor subsequently never being given any profound status, aligning with the courts continual narrowing of the doctrine.<sup>160</sup> The judicial reluctance towards adopting undercapitalisation as a factor appears well founded when you consider the following passage from Latty, "[o]ne thousand dollars may be adequate capital for a barber shop, but grotesque for a steel mill".<sup>161</sup> It is simply not possible to derive an arbitrary figure that adequately covers all possible situations of enterprise. Even where minimum capital requirements have been introduced, they are often too trivial to have any impact,<sup>162</sup> being described as "empty ritual[s]"<sup>163</sup> that can be easily evaded.<sup>164</sup> Although operating an undercapitalised subsidiary may not be the "most honest way of trading",<sup>165</sup> it will not be sufficient to 'pierce the veil'.

The mere existence of control, interference or even the ability to dominate is also typically seen as insufficient to pierce the veil.<sup>166</sup> Consequently, the a minor degree of subservience, where the parent merely exercises a degree of control, will unlikely lead to the veil being pierced.<sup>167</sup> Some have however argued that where the subsidiary's existence is particularly nefarious, the "one well recognised exception<sup>168</sup>" may present a glimmer of hope. In *Adams v Cape Industries plc*, the Court of Appeal, when presented with an "invoicing [subsidiary] with no employees of its own", saw no difficulty in concluding that it was merely a façade.<sup>169</sup> Unfortunately, the court decided not to provide any form of "comprehensive definition", depriving subsequent courts of any substantive precedent on the issue.<sup>170</sup> The Supreme Court then dealt a blow to the argument in *Prest v Petrodel* when they held that "references to a 'façade' or 'sham' beg too many questions to provide a satisfactory answer". In the leading judgement, Lord Sumption held that two key principles, the concealment and evasion principles and the inability to distinguish them

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<sup>159</sup> Laurence Gower *Principles of Modern Company Law* (5<sup>th</sup> ed, Stevens, London, 1992) at 134: "Undercapitalisation is just a factor to consider".

<sup>160</sup> *Adams v Cape Industries plc*, above n 28 and subsequently in *Prest*, above n 147.

<sup>161</sup> Elvin Remus Latty *Subsidiaries and Affiliated Corporations* (Foundation Press, New York, 1936) at 137.

<sup>162</sup> Minimum capital requirements can be as low as \$500. Although a larger requirement may appear more beneficial, they fail to consider the benefits of debt capital, including lower cost and the associated tax savings. They also cannot guarantee that capital levels would not be altered or heavily reduced by further deductions.

<sup>163</sup> Ernest L. Folk "Some Reflections of a Corporation Law Draftsman" (1968) 42 Conn Bar J 409 at 421.

<sup>164</sup> Eike Thomas Bicker "Creditor Protection in the Corporate Group" (27 July 2006) Social Science Research Network <www.ssrn.com> at 21.

<sup>165</sup> *Atlas Maritime Co SA v Avalon Maritime Ltd, The Coral Rose (No 1)* [1991] 4 All ER 769 at 779.

<sup>166</sup> *Briggs v James Hardie and Co Pty Ltd* (1989) 16 NSWLR 549 at 577.

<sup>167</sup> Muscat, above n 10, at 254.

<sup>168</sup> *Adams v Cape Industries plc*, above 28, at 539.

<sup>169</sup> At 536. The Court of Appeal held that the subsidiary was no more than a "corporate name".

<sup>170</sup> At 543.

was behind much of the confusion.<sup>171</sup> It was held that the only remaining avenue for veil piercing would appear to be where it is necessary to apply the evasion principle<sup>172</sup>. This principle allows piercing “for the purpose and only for the purpose, of depriving the company or its controller of the advantage that they would otherwise have obtained by the company’s separate legal personality”,<sup>173</sup> and is only to be applied where it is the only means of restricting abuse.<sup>174</sup>

The judgment of the Supreme Court in *Prest* therefore thoroughly narrowed the veil-piercing jurisdiction, effectively rendering it to the status of something “almost entirely mythical”.<sup>175</sup> Lord Neuberger even went so far as to say that; “there is not a single instance in this jurisdiction where the doctrine has been invoked properly and successfully”.<sup>176</sup> The foundational nature of the principle in *Salomon* and the availability of other remedies, means that even where piercing the veil may be relevant, the circumstances are likely to be “novel and rare”.<sup>177</sup> Although the veil could still apply, it is unlikely to be applied in the parent-subsidary situation.

### 2.2.3 Agency

A company is not, per se, the agent of its shareholders, even if control is concentrated in only one shareholder. The mere fact that a person owns all the shares in a company does not make the business carried on by that company his business. Once the company is legally incorporated, it must be treated like any other independent person with rights and liabilities of its own.<sup>178</sup>

As indicated in this quote, a subsidiary is not automatically an agent of the parent. Similarly, a small paid up capital and/or shared directorships is not in and of itself sufficient for the assumption of agency in the group context.<sup>179</sup> But a subsidiary may become the parent’s

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<sup>171</sup> *Prest*, above n 149, at [28].

<sup>172</sup> At [35].

<sup>173</sup> At [100], per Lord Sumption.

<sup>174</sup> At [35].

<sup>175</sup> Mayson, French and Ryan *Mayson French and Ryan on Company Law* (33<sup>rd</sup> ed, Oxford University Press, Oxford, 2016) at 125.

<sup>176</sup> *Prest*, above n 149, at [64].

<sup>177</sup> *Prest*, above n 149, at [100], per Lord Mance.

<sup>178</sup> *Salomon*, above n 1 at 31 per Lord Halsbury. *Smith Stone & Knight Ltd v Birmingham Corporation* [1939] 4 All ER 116 at confirmed that this proposition is just as true if the shareholder is itself a limited company.

<sup>179</sup> *Re Polly Peck International Plc (In Administration) (No.4)* [1996] 2 All ER 433 at 445.

agent.<sup>180</sup> Where the express or implied consent<sup>181</sup> of both the principal and the agent<sup>182</sup> establishes the relationship, then the general principles of agency will impose liability on the parent, “[q]ui facit per alium facit per se” – he who does an act through another does it himself.<sup>183</sup>

*Smith Stone & Knight Ltd v Birmingham Corporation* presented the courts with the opportunity to assess the potential for an agency relationship in the parent–subsidiary context.<sup>184</sup> Smith Stone & Knight Ltd were manufacturers operating from a substantial land holding, later acquiring a subsidiary that operated a waste business from their premises. The parent held 497 of the 502 shares in the subsidiary, with the remaining 5 shares held by the company directors. Birmingham Corporation sought to compulsorily acquire the subsidiary’s land and associated buildings, however the parties failed to reach a mutual agreement. The substantive issue turned on whether Smith Stone & Knight Ltd were entitled to compensation for the disturbance to the subsidiary’s business by virtue of an agency relationship.<sup>185</sup> Although cases prior to *Smith* had accepted that an agency relationship in this context may be “difficult”, they had rendered it “conceivable”.<sup>186</sup> Atkinson J held that each respective case required a factual analysis to test whether an agency relationship could be established, necessitating an assessment of whether the subsidiary was carrying on business as an individual entity or for the parent company.<sup>187</sup> After identifying a number of factors including who was at the helm of the business and the respective parties responsible for those people’s appointment, Atkinson J held that “the waste company was in this case a legal entity, because that is all it was” and therefore as the subsidiary had merely acted as a “simulacrum” of the parent company, an agency relationship was established.<sup>188</sup>

Although this case confirmed the potential ability to substantiate an agency type relationship in the context of a parent and subsidiary, subsequent cases have largely sought to confine it to its

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<sup>180</sup> *Smith Stone & Knight Ltd v Birmingham Corporation* [1939] 4 All ER 116 at 10.

<sup>181</sup> *Garnac Grain Co Inc v H M F Faure & Fairclough Ltd* [1967] 2 All ER 353 at 358, per Lord Pearson.

<sup>182</sup> At 1137, per Lord Pearson. This will be an objective assessment as per *Atlas Maritime Co SA v Avalon Maritime Ltd, The Coral Rose (No 1)* [1991] 4 All ER 769.

<sup>183</sup> *Peterson v Moloney* (1951) 84 CLR 91 at 94.

<sup>184</sup> *Smith Stone & Knight*, above n 180.

<sup>185</sup> If the company was deemed to be a separate entity then the acquirer would not have to pay compensation in accordance with s 121 of the Land Clauses Consolidation Act 1845.

<sup>186</sup> *Inland Revenue Commissioners v Sansom* [1921] 2 KB 492 at 503, Per Lord Sterndale.

<sup>187</sup> *Smith Stone & Knight*, above n 180 at 121.

<sup>188</sup> At 121.

rather unique facts.<sup>189</sup> Atkinson J's admirable effort at providing a number of guiding features have been subject to criticism, with the focal point being his reference to the requirement of control. Accepting an element that is ingrained in the parent–subsidiary relationship would lead to an anomaly where every wholly owned situation would result in a deemed agency. Although the Court of Appeal in *Adams v Cape Industries plc* accepted that in certain circumstances, the respective wording of a statute or contract has occasionally justified the treatment of the parent–subsidiary relationship as a “single unit”, a presumptive agency relationship was firmly rejected.<sup>190</sup> *Yukong Line Ltd of Korea v Rendsburg Investment Corporation of Liberia (No 2)* also rejected Atkinson J's test, considering that in order for an agency relationship to be established, there would need to be intention to create the relationship”.<sup>191</sup> Considering that voluntary assumption of agency effectively runs counter to commercial sensibility, this is unlikely to arise. Finally, in *Atlas Maritime Co SA v Avalon Maritime Ltd, The Coral Rose (No 1)* Staughton LJ observed that there may be some inequity in the way some subsidiaries are operated but he held the way the shipping industry operated meant that to confer an agency relationship would be “revolutionary”.<sup>192</sup> On the basis of the above analysis, the substantiation of an agency relationship, unless consensual, is unlikely.

#### 2.2.4 Misrepresentation

To the lay the person, the distinction between a parent and a subsidiary can be “a slender one”<sup>193</sup> and in some instances, as Posner illustrates below, there may be a tendency to abuse this fine distinction:<sup>194</sup>

A bank holding company establishes a subsidiary to invest in real estate. The holding company gives the subsidiary a name confusingly similar to that of the holding company's banking subsidiary, and the real estate corporation leases office space in the bank so that its offices appear to be bank offices. Unsophisticated creditors extend generous terms to the real estate subsidiary on the reasonable belief that they are dealing with the bank itself.

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<sup>189</sup> Thomas K. Cheng “The Corporate Veil Doctrine Revisited: A Comparative Study of the English and the U.S. Corporate Veil Doctrines” (2011) 34 B.C. Int'l & Comp. L. Rev. 329 at 337.

<sup>190</sup> *Adams v Cape Industries plc*, above n 28, at 536. Citing *DHN Food Distributors Ltd v Tower Hamlets London BC* [1976] 3 All ER 462, [1976] 1 WLR 852.

<sup>191</sup> *Yukong Line Ltd of Korea v Rendsburg Investment Corporation of Liberia (No 2)* [1998] 2 BCLC 485 at 496.

<sup>192</sup> *Atlas Maritime Co SA*, above n 165, at 779.

<sup>193</sup> *Adams v Cape Industries plc*, above n 28, at 536.

<sup>194</sup> Richard A. Posner “The Rights of Creditors of Affiliated Corporations” (1975) 43 U Chi L Rev 499 at 521.

The aforementioned example illustrates the ability to blur the true identity of the contracting party, or mislead creditors about the subsidiary's financial affairs. The use of common group names, logos and the reported affiliation to a larger group enterprise can all lead to a perception that the individual subsidiary is simply a unit of a larger entity or more financially sound than its reality reflects.<sup>195</sup> Although actions such as a subsidiary stating on their website that they are a part of a wider group cannot always be deemed to be prejudicial to creditors, liability may be forthcoming where this misconception has arisen on the basis of a misrepresentation.<sup>196</sup> The inherent difficulty lies with substantiating when such actions are deemed to require legal sanction.<sup>197</sup>

Although possible representations may be addressed in a pooling claim, the most likely avenue for misrepresentation will arise in terms of pre-contractual negotiations, requiring the satisfaction of five key elements. Firstly, the court must determine whether a representation has been made before conducting a factual assessment of whether it amounts to a misrepresentation by examining its meaning and reasonableness of reliance.<sup>198</sup> Although mere silence will not be sufficient in the circumstances,<sup>199</sup> liability could be imposed where there has been a representation about the financial surety provided by the parent company or where representations have been made which mislead creditors as to the subsidiary's true financial position.<sup>200</sup> Secondly, the misrepresentation must be made "by or on behalf of" another party to the contract, which will in most instances be made by directors, or occasionally, senior staff members within their authority as agents. Thirdly, the misrepresentation must be made to the plaintiff,<sup>201</sup> a factor that could be satisfied explicitly through the contractual negotiation process or by a more indirect holding out, including factors that portray a "group persona".<sup>202</sup> Fourthly, the misrepresentation must induce the creditor to enter into the contract.<sup>203</sup> This does not have to be to the sole reason for contracting and therefore in most instances, the surety and financial backing of the parent will 'impress' a firm and give them greater comfort in contracting.<sup>204</sup>

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<sup>195</sup> Muscat, above n 10, at 416.

<sup>196</sup> At 422. Entities are to be entitled to gain some goodwill out of their mutual association.

<sup>197</sup> At 421.

<sup>198</sup> *West v Quayside Trustee Limited* [2012] NZCA 232 at [30].

<sup>199</sup> There is no common law duty to speak in these circumstances.

<sup>200</sup> In accordance with s 6 of the Contractual Remedies Act 1979, liability will be forthcoming regardless of whether the misrepresentation was innocent or fraudulent.

<sup>201</sup> Stephen Todd and others *The Law of Torts in New Zealand* (7<sup>th</sup> ed, Thomson Reuters, Wellington, 2016) at 240.

<sup>202</sup> Muscat, above n 10, at 65.

<sup>203</sup> Stephen Todd and others *The Law of Torts in New Zealand* at 240.

<sup>204</sup> At 240.

Finally, “the representor must intend that the representee should act in reliance on the misrepresentation”.<sup>205</sup> Once again, subsidiary directors will generally hope to portray a powerful group image or financially sound subsidiary so that parties will contract with them, a position that is often “mercilessly exploited by the subsidiary for its own commercial purposes”.<sup>206</sup>

Unfortunately, even where the highly factual task of proving a misrepresentation is surmounted, the likelihood of a remedy against the parent is unlikely. Liability will fall on the party who has made the representation and although occasionally, a parent may be involved in contractual negotiations, the directors of a subsidiary will generally carry out this responsibility. Consequently, even where a claim is successful, recovery will have to be sought from the now defunct subsidiary or the subsidiary directors in their personal capacity.<sup>207</sup> Even though parental pressure was likely to have been the ultimate cause of the misrepresentation, they will be exonerated of liability, most likely depriving creditors of an ability to recover sufficient funds. A further limiting consideration is that the claim focuses on individual representations.<sup>208</sup> With the exclusion of a widespread standard form contract, a subsidiary is likely to have contracted with a vast array of different creditors and engaged in unique contractual discussions. Each of these will therefore give rise to different factual considerations and separate claims. Creditors as a body as a whole are therefore unlikely to recover without the incurrence of exorbitant litigation costs.

## **2.2.5 Preserving Assets and Creditor Equality**

### **2.2.5.1 Distributions**

In accordance with the general order of preference, creditors are entitled to payment before shareholders, however, where insolvency approaches, shareholders may be inclined to use their influence to gain a greater share of assets by way of a distribution. Consider the example of a precariously placed subsidiary. If the subsidiary were to collapse, the parent’s position in the

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<sup>205</sup> At 241. Although there is no explicit requirement for the reliance to be reasonable in s 6 of the Contractual Remedies Act 1979, the Court of Appeal in *Vining Realty Group Ltd v Moorhouse* [2010] NZCA 104 at [46] read in the requirement and this has seen subsequent support.

<sup>206</sup> (26 February 1980) 979 GBP D HC 1253.

<sup>207</sup> Muscat, above n 10, at 424.

<sup>208</sup> At 424.



order of recovery means that they will most likely only be entitled to a minimal recovery, or may not even recover any value at all. If, however, the parent influences the subsidiary directors to pay a dividend before the subsidiary's inevitable demise, the parent could 'leapfrog' their way towards a much greater recovery, unfairly bypassing creditors in the chain of preference.

Directed at mischief such as this, s 56 of the Companies Act 1993 provides that if, after a distribution has been made, the company does not satisfy the solvency test, a recovery may be made from shareholders and/or directors.<sup>209</sup> Although recovery will first be sought from the shareholders, if directors are at fault in making the distribution, they may be liable in their personal capacity.<sup>210</sup> Distributions are given a wide definition in s 2(1) of the Companies Act 1993, including the direct or indirect transfer of money or property or the incurring of a debt for the benefit of the shareholder in relation to shares held, encapsulating a variety of transactions.<sup>211</sup>

Section 56(1) does provide a defence for the shareholder, however when considering the first of three elements, a difficulty is encountered.<sup>212</sup> Section 56(1)(a), requires an assessment of whether the "shareholder received the distribution in good faith and without knowledge of the company's failure to satisfy the solvency test".<sup>213</sup> In considering the nature of the parent subsidiary relationship and the associated level of knowledge that comes with it, a parent is unlikely going to be able to satisfy the onus of proving that they were not aware that the subsidiary was not in a position to meet the solvency test.

It is conceivable that a parent may exert pressure on subsidiary director's to make a distribution, however, doing so is a perilous risk to run.<sup>214</sup> With directors having the ultimate power to sign off distributions and the potential to incur liability if they incorrectly do so, directors will be particularly vigilant when issuing dividends in times of questionable solvency. Thus, liability for a distribution will tend to occur in all but the rarest of circumstances, where directors have acted in complete disregard of their duties to the subsidiary.

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<sup>209</sup> Companies Act 1993, s 56.

<sup>210</sup> Companies Act 1993, s 56(2) and s 56(3).

<sup>211</sup> Exclusive of the company's own shares.

<sup>212</sup> Companies Act 1993, s 56(1)(a), (b) and (c).

<sup>213</sup> Companies Act 1993, s 56(1)(a).

<sup>214</sup> They may in fact be a director of both the parent company and the subsidiary.

### 2.2.5.2 Voidable Transactions

The law is generally not concerned with how a company or an individual chooses to pay its creditors or in what order. If however the payment occurs in a certain specified time prior to the company being placed into liquidation, or the individual being adjudicated bankrupt, and at a time when the company was insolvent, the law may deem that the payment made in priority be set aside.<sup>215</sup>

Rather than seeking a distribution, a parent may seek preferential recovery over the subsidiary's other creditors through early payment of its debts and/or the transfer of property at an undervalue. Such a transaction may constitute a voidable transaction, allowing the liquidator to either seek to have the transaction avoided or recover money or property from the other party to the transaction.<sup>216</sup> Generally, a successful claim will see the recovered assets added to the pool of funds available for distribution to creditors.

Three fundamental purposes have been identified as underpinning the voidable transactions regime. Firstly, they seek to achieve "equality as between creditors according to priorities set out in the Act", secondly, "promoting a collective, orderly and cost-effective approach to the management of failed companies" and finally, "sharing the burden of loss associated with corporate financial collapse".<sup>217</sup> The fundamental consideration for present purposes involves maintaining equality between creditors, aimed at restricting certain knowledgeable parties from attaining "an anomalous advantage".<sup>218</sup> This is particularly pertinent in terms of corporate groups as the parent has intricate knowledge of the subsidiary's affairs, which will generally put them on notice of potential solvency issues in a much timelier manner than the traditional shareholder. Armed with this knowledge, a parent has the opportunity to undertake transactions that result in them receiving more than they would otherwise have received in an equal distribution of the available assets on liquidation.<sup>219</sup> Where they do however undertake such transactions, this level of knowledge is likely to restrict a parent from being able to avail

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<sup>215</sup> Paul Heath and Mike Whale *Heath and Whale: Insolvency Law in New Zealand* (LexisNexis, Wellington, 2013) at 612.

<sup>216</sup> Lynne Taylor and Grant Slevin *The Law of Insolvency in New Zealand* (Thomson Reuters, Wellington, 2016) at 645.

<sup>217</sup> *Timberworld Ltd v Levin* [2015] NZCA 111, [2015] 3 NZLR 365 at [65], citing Insolvency Law Reform Bill 2005 (14-1) (explanatory note) at 1-2.

<sup>218</sup> *Re Modern Terrazzo Ltd* [1998] 1 NZLR 160 at 174.

<sup>219</sup> Lynne Taylor and Grant Slevin *The Law of Insolvency in New Zealand*, above n 217, at 645.

themselves of liability under s296(3), as “its purpose is to achieve relief for creditors who did not actually suspect insolvency and where no reasonable creditor in their shoes and circumstances would suspect insolvency”.<sup>220</sup> A parent is unlikely to not be furnished with an intricate knowledge of a subsidiary’s financial status.

The voidable transactions regime certainly reduces the likelihood of a parent conducting certain practices including transfer pricing, draining of assets and the provision of financial support to other members of the group.<sup>221</sup> However, a number of considerations mean their efficacy can be challenged. Firstly, the ‘specified period’ means that it will fail to consider that the ultimate demise of a subsidiary will often be a systematic extraction by a parent over a number of years, with only those captured within the ‘specified period’ being considered. Secondly, certain actions such as the diversion of corporate opportunities essential to the continued operation of the subsidiary will fall outside of the sections ambit as they will not meet the definition of a ‘transaction’. As an example, a parent could encourage a subsidiary not to renew a contract with a major client, causing them to collapse, but subsequently allowing them to attain the contract for themselves. Thirdly, the sections are premised on the requirement of insolvency, as Muscat described, “nothing will stop the dissipation of the subsidiary’s resources until it is in dire financial straits”, effectively allowing an extraction until the point of insolvency.<sup>222</sup> Finally, the voidable transaction regime adopts a “monotransactional approach” which focuses on individual transactions.<sup>223</sup> As a result of the nature of the parent subsidiary relationship, there is likely to be a broad array of transactions even within the specified period, which will ultimately mean that only a number of the more significant transactions will much likely be assessed, often resulting in excessive legal costs.

Although a number of deficiencies have been identified, these deficiencies can be remedied and provide the impetus for the suggested tax loss solution.

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<sup>220</sup> David Brown *Voidable Transactions - A Report for the Ministry of Commerce* (October 1999) At 75.

<sup>221</sup> Muscat, above n 10, at 234.

<sup>222</sup> At 235.

<sup>223</sup> At 235.

## **Chapter Three: Introducing the Tax Loss Solution**

Parliament and the courts have recognised that the concept of limited liability can be abused. The previous section considered key ways in which the position of creditors is protected through qualifications or exceptions to limited liability. The recognition of new qualifications or exceptions is an ongoing process, especially with regard to legislative reforms. To date, with the exception of pooling orders, these devices have applied to companies, generally irrespective of who the shareholder is. A key point of this paper is that the subsidiary attracts special concerns, especially when the group of companies is regarded as a whole, warranting the development of a protective device addressed to those concerns. The challenge, however, is to “formulate a standard which is flexible enough to impose group responsibility in only those situations where it is appropriate”.<sup>224</sup> This chapter responds to this challenge.

As discussed, although vulnerable to misuse, corporate groups enjoy limited liability.<sup>225</sup> A common theme with the current exceptions or qualifications is the use of corporate control. The pooling order also shows the recognition of the “group persona”.<sup>226</sup> This paper builds upon these themes to advance a new protective mechanism for the creditors of a subsidiary. The suggestion is that parents that seek to use group tax losses may attract liability for the subsidiaries debts at least to the value of the tax loss. Through drawing an analogy to the voidable transactions regime, the monetary value of tax losses that have been utilised within the specified period, prior to the subsidiaries demise, would be recoverable from the parent.

Before progressing with a more detailed analysis of this proposal, factors underlying the legislative introduction of group tax loss offsets will provide both important background and support for the tax loss solution.

### **3. 1 Group Loss Offsets**

#### **3.1.1 History of Provisions**

The Land and Income Assessment Act 1891 imposed income tax in New Zealand. After various amendments and recognition of the increasing importance of income tax, Parliament separated

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<sup>224</sup> Anthea Nolan, above n 50, at 490.

<sup>225</sup> Muscat, above n 10, at 398.

<sup>226</sup> At 65.

the Income Tax Act 1954 into two Acts, the Income Tax Act 1976 and the Land Tax Act 1976 (later abolished).<sup>227</sup> The Income Tax Act 1993 was then enacted as part of a substantial rewriting process, which, after various amendments and rewritings gave rise to the present Income Tax Act 2007.

The group tax provisions emerged from what were initially anti-avoidance provisions. New Zealand operates a progressive tax system, where the rate of tax increases as income increases.<sup>228</sup> This encouraged businesses to segment their enterprises into various different companies to avoid paying tax in the higher tax brackets.<sup>229</sup> Under s 141 of the Land and Income Tax Act 1954 the Commissioner applied a test of whether two or more companies “consisted substantially of the same shareholders or under the control of the same persons”.<sup>230</sup> If this was deemed to be so, and it was done for the purpose of reducing their tax liability, the Commissioner was to treat the companies as jointly and severally liable for their tax obligations. The concept of the corporate group was still yet to be formulated, but these sections provided the impetus for the future provisions.

In an important development, s 27 of the Land and Income Tax Amendment Act (No.2) 1968 repealed s 141, instituting changes where the Commissioner no longer needed to invoke avoidance to deal with the increasingly prominent group enterprise. This provided the Commissioner with a less restricted ability to aggregate the income of two or more companies. The section applied where two thirds of the prescribed proportions of the paid-up capital or the nominal value of the allotted shares were held, or alternatively, where two thirds of the voting powers were held in each of those companies.<sup>231</sup> As the sections continued to develop, this increasing flexibility was maintained.

### **3.1.2 Current Sections**

After various iterations, s IC2 of the Income Tax Act 2007 became the fundamental provision, allowing the grouping of tax losses on satisfaction of various statutory requirements. Firstly, the loss company and the profit company must be in the same “group of companies” for the

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<sup>227</sup> Land Abolition Act 1990.

<sup>228</sup> Aureliana Man and Vanina Adoriana Boglea “Progressive Tax or Flat Tax” (2013) 2 JBER 179 at 179.

<sup>229</sup> Inland Revenue *Loss Grouping and Imputation Credits: An Officials’ Issues Paper* (September 2015) at 4.

<sup>230</sup> Land and Income Tax Act 1954, s 141.

<sup>231</sup> Land and Income Tax Amendment Act (No.2) 1968, s 27(1)(a).

duration of the commonality period.<sup>232</sup> Section IC3(1) states that a group of companies means 2 or more companies,<sup>233</sup> in relation to which a group of persons holds common voting interests that add up to at least 66%.<sup>234</sup> The commonality period is defined as being from the start of the income year where the tax loss has been incurred by company A and the end of the income year in which company B makes the tax offset.<sup>235</sup> Secondly, for the duration of the “commonality period”, the loss company must be incorporated or carrying on business in New Zealand through a fixed establishment.<sup>236</sup> Thirdly, in order to carry forward a loss balance, the group must maintain continuity of at least 49% voting interests for the duration of the continuity period.<sup>237</sup> Finally, the amount of the tax loss being made available must not exceed the net income of the company that is to utilise the loss.<sup>238</sup> Under the assumption that the shareholding remains the same throughout the continuity period and the subsidiary operates in New Zealand, members of the group who satisfy the respective requirements are able to utilise the tax losses incurred by the subsidiary to offset their taxable income.<sup>239</sup>

A parent has two mechanisms to facilitate a group tax loss offset. Firstly, the subsidiary loss company is able to elect that the tax loss is to be made available to the parent profit company in its tax return, or alternatively, the parent profit company may make a subvention payment to the subsidiary loss company which is then offset against the parent profit company’s net income.<sup>240</sup> These options have important differences, but for the present purposes, tax loss offsets will be considered in aggregate so as to avoid unnecessary complexity.<sup>241</sup>

### **3.1.3 The Financial Benefits of Group Tax Loss Offsets**

Although the loss offset provisions emerged in response to tax avoidance, they have become an ingrained and integral part of modern commerce. The ability to utilise these tax offsets supports the court’s continued acceptance of a taxpayer’s right to conduct their affairs in a manner that

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<sup>232</sup> Income Tax Act 2007, s IC2.

<sup>233</sup> Excluding a multi-rate PIE or a listed PIE.

<sup>234</sup> Income Tax Act 2007, IC3(1).

<sup>235</sup> Income Tax Act 2007, s IC6(1).

<sup>236</sup> Income Tax Act 2007, s IC7(1)(a) and (b).

<sup>237</sup> Income Tax Act 2007, s IA5(2).

<sup>238</sup> Income Tax Act 2007, s IC8(1).

<sup>239</sup> This also assumes that the loss will not exceed the net income of the parent.

<sup>240</sup> Stephen Barkoczy *Foundations of New Zealand Taxation Law* (CCH New Zealand Ltd, Auckland, 2017) at 501. There is also no restriction on a company utilising a mixture of both methods.

<sup>241</sup> A subvention payment may provide a better solution as they put value into the loss making company that the creditor can subsequently collect. Allowing a liquidator to require a voidable loss offset be converted to a subvention payment could be a way to facilitate this.

minimises their tax obligations.<sup>242</sup> As the Supreme Court affirmed in *Ben Nevis Forestry v CIR*, taxpayers “may utilise available tax incentives in whatever way the applicable legislative text, read in light of its context and purpose, permits”.<sup>243</sup> Given the profound impact that these offsets can have on the income tax obligations of the profit company, they have emerged as a prominently used measure. Although the figure in New Zealand is difficult to attain, tax losses claimed in Canada in 2008 amounted to \$103.8billion, against total income of \$208.9billion, while losses to carry forward amounted to \$236.3billion.<sup>244</sup> These values are not reflective of an economy the size of New Zealand, however, companies such as Xero illustrate just how substantial the associated benefit can be. In recent times, Xero has recorded multi-million dollar operating revenues, but to date, has not yet reached a state of profitability. When they do however, and assuming that they maintain continuity of ownership, the company will have carried forward losses to the value of \$325.6million available for use.<sup>245</sup> Depending on future income, they may not pay tax for a number of years, even when recording profits in the vicinity of hundreds of millions of dollars. These offsets therefore provide a reprieve in the early years of operation and give loss making firms a chance to recover from sustained deficits.

The benefits, however, are not only provided to companies in their infancy or development phases, they also offer substantial benefit during difficult economic times. The reduction in tax payable can provide a lifeline to firms in financial distress by providing crucial cash flows. Analysis conducted by Altshuler estimated that during the 2001 recession there were nearly as many tax-paying companies as there were non-tax paying companies, primarily the result of incurred losses.<sup>246</sup> Beyond these periods of recession, those who survive the financial pressures will have the ability to carry forward these losses, providing a tax reprieve for future years.<sup>247</sup> These provisions can also generate an increased propensity for corporate restructurings and mergers, as there is some benefit that can be extracted from a struggling subsidiary that may eventually be able to be returned to profitability.<sup>248</sup>

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<sup>242</sup> *Commissioner of Inland Revenue v Duke of Westminster* [1936] AC 1, affirmed in New Zealand in *Commissioner of Inland Revenue v Europa Oil (NZ) Ltd* [1971] NZLR 641.

<sup>243</sup> *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* [2009] 2 NZLR 289 at [111].

<sup>244</sup> Matt Krzepkowski “Debt and Tax Losses: The Effect of Tax Asymmetries on the Cost of Capital and Capital Structure” (November 2013) Oxford University Centre for Business Taxation <www.sbs.ox.ac.uk> at 3.

<sup>245</sup> Xero “Annual Report” (2017) <www.xero.com> at 37.

<sup>246</sup> Rosanne Altshuler and others “Understanding US Corporate Tax Losses” (2009) 23 Tax Policy and the Economy 73 at 74.

<sup>247</sup> It is estimated that after the global financial crisis of 2007/2008, many firms will only just be beginning to use up the incurred tax losses.

<sup>248</sup> John Brondolo “Collecting Taxes During an Economic Crisis: Challenges and Policy Options” (14 July 2009) International Monetary Fund <www.imf.org> at 18.

### 3.2 Inequity in the Current Sections

The financial benefits of tax losses are undeniable. But as the Accountants Society submitted to the authors of the MacArthur Report, there is an inequity in allowing a parent to utilise tax losses of a subsidiary, while lumping creditors with the burden if the subsidiary collapses.<sup>249</sup> The Cork Report echoed similar concerns:<sup>250</sup>

It is unsatisfactory and offensive to the ordinary canons of commercial reality that a parent company should allow its wholly owned subsidiary to fail, or that a company should be permitted by other companies in the same group, and particularly by its ultimate parent, to take commercial advantage from its membership of the group, without there being incurred by those other companies any countervailing obligations.

In considering these comments, the current state of affairs appears questionable. In prosperous times, a parent can reap the rewards of the subsidiary's profit through dividend payments. In times of difficulty, a parent may utilise the subsidiary's tax losses to offset their income. But, in the unfortunate circumstances of a subsidiary's demise, a parent can simply walk away, leaving the subsidiary's creditors to shoulder the burden of its collapse. It is this lack of countervailing duties that provides the rationale for change. This paper accepts that the concept of limited liability must be maintained in the corporate group context. However, as Nolan identified:<sup>251</sup>

This does not justify the continuation of a legal system, which ignores the reality, and the too often unjust consequences of group organisation. A 'compromise position' is desperately needed to cater for those situations where the separate entity doctrine simply does not make sense.

The veil piercing jurisprudence noted earlier, accepts that the mere ability to control is insufficient to disregard the corporate form, accepting that some level of control is an inherent characteristic of the relationship<sup>252</sup>. Other exceptions and qualifications to limited liability do however recognise the importance of holding a parent responsible for unbridled exercises of control. It has been accepted that (assuming the right circumstances) a parent can become a

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<sup>249</sup> The MacArthur Report, above n 123, at 159.

<sup>250</sup> The Cork Report, above n 85, at [1924].

<sup>251</sup> Anthea Nolan, above n 50, at 487.

<sup>252</sup> Muscat, above n 10, at 61.



shadow director. Although a claim was unsuccessful in *Dairy Containers Ltd v NZI Bank Ltd*, with the High Court, holding that the parent did not give the subsidiary “identifiable directions or instructions”, the appropriate facts may give rise to a valid claim.<sup>253</sup>

Pooling provisions provide a more recent legislative recognition. In considering whether it is just and equitable to make an order, the degree of the parent’s managerial control and the extent to which the actions of the parent contributed to the circumstances giving rise to the liquidation are express considerations.<sup>254</sup> Successful orders in both *Steel and Tube* and *Mountfort* recognised that the subsidiaries were devoid of individual managerial autonomy, instead, being the subject of parental control. In *Mountfort* the subsidiary board were directed to make a transfer of \$650,000, even though the parent was at all material times, insolvent.<sup>255</sup> This decision meant that the debt required radical discounting and the subsidiary creditors held the risk if the parent did not secure the Qantas franchise which would be pivotal to its survival.<sup>256</sup> In *Steel and Tube*, the subsidiary was held to be a “puppet” of the parent, “devoid of any capacity to conduct its own affairs”.<sup>257</sup> These exercises of control resulted in liability upon the parent company. The importance of control is also recognised by both the voidable transactions and distributions regime. Although the subsidiary’s directors make the ultimate decision as to whether a dividend is paid or undertake certain, potentially voidable transactions, subsidiary directors may in fact be forced to submit to the parent’s demands. Where a parent has influenced a transaction during a time of questionable solvency, redress may be forthcoming.

The aforementioned qualifications illustrate an increasing recognition of the need to address the exercise of ‘control’ by the ever-powerful parent. In recognition of the propensity for abuse, the courts may impose a countervailing burden.

The “group persona” is another theme increasingly recognised.<sup>258</sup> Although some goodwill is warranted in regards to the association with a larger group, the law has endeavoured to keep the level of holding out within reasonable bounds. Merely stating that the subsidiary is part of a wider group will not, in and of itself, incur liability, however, other representations may breach

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<sup>253</sup> *Dairy Containers Ltd v NZI Bank Ltd* [1995] 2 NZLR 30 at 91.

<sup>254</sup> Companies Act 1993, s 272(a) and (c).

<sup>255</sup> *Mountfort*, above n 73, at [96].

<sup>256</sup> *Mountfort*, above n 73, at [97].

<sup>257</sup> *Lewis Holdings*, above n 68, at [65].

<sup>258</sup> *Muscat*, above n 10, at 65.

the legal boundary. The conduct of the subsidiary and/or its parent can blur the separateness of the individual entities and has seen the courts impose liability for misrepresentation. The most common misrepresentation arises where the subsidiary espouses that it has the financial backing of the parent. The pooling provisions also recognise the inequity in allowing a parent to hold out the individual components of the group as a single entity.<sup>259</sup> Relevant considerations have included, intermingled management, a lack of differentiation from a legal and accounting perspective,<sup>260</sup> a complete inability to differentiate the individual entities<sup>261</sup> and the substantial use of intercompany borrowing and shared bank accounts.<sup>262</sup> In *Steel and Tube*, the court held that various features indicated that the subsidiary was merely a division of the parent company. These factors included the fact that the subsidiary had no employees of its own, its board was made up of senior managers of the parent company and group stationery was commonly used without expressing which party the employees were acting on behalf of. These cases indicate that although the principle of *Salomon* has firmly entrenched itself in modern company law, the courts are increasingly willing to impose liability beyond the legal form, particularly where the concept of separate legal identity has been abused.

### 3.3 The Tax Loss Solution

The new qualification to limited liability advanced here is the ‘tax loss solution’. Although a parent would still be entitled to utilise the tax losses of their subsidiaries (assuming they meet the legislative requirements), a parent will be potentially liable to repay to the subsidiary the value of those tax losses, should the subsidiary become insolvent within a specified period thereafter.<sup>263</sup> This approach recognises that if a parent is to utilise the value of the tax loss while the subsidiary continues in operation, they should be exposed to a countervailing obligation in the event of the subsidiary’s demise.

An immediate benefit of this approach is that it encourages a parent that utilises tax losses to vigilantly monitor its subsidiary’s financial health. It is self-evident that a parent endeavours to operate a profitable subsidiary, but where profitability issues are encountered, there is currently

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<sup>259</sup> Muscat, above n 10, at 416.

<sup>260</sup> *Goodson*, above n 142.

<sup>261</sup> *Re McCullagh*, above n 143.

<sup>262</sup> *Shepard*, above n 144.

<sup>263</sup> Two years would maintain consistency with the current voidable transactions regime.

little incentive to restore the subsidiary's financial health. Attempting to restore profitability may come at a substantial cost or a significant capital outlay, but there is a risk that these costly endeavours may be unsuccessful. With no countervailing obligations in place and liability being reserved to only the most abusive or imprudent actions, most parents will simply be content with extracting the maximum available benefit, predominantly utilising the large tax losses and making substantial dividend payments, before liquidating the subsidiary upon its inevitable demise. Although the parent is likely to have suffered some loss from the venture, the creditors will shoulder much of the burden. When Mainzeal collapsed, (New Zealand's third largest construction company and a subsidiary of Richina Pacific Ltd), the liquidators received in excess of 1,400 claims from creditors, totalling \$153million.<sup>264</sup>

Under the suggested regime, with the potential for liability, a parent would be incentivised to attempt to turn the misfortune of the company around, as a failure to do so would result in the imposition of potentially substantial liability. In the pursuit of profit, businesses tend to respond where potential liability ensues, and with this deterrent in place it is questionable whether the most abusive subsidiary would even be incorporated in the first place. With the current regime premised on liquidation, there is a need for an approach which seeks to encourage a more responsible business environment, rather than simply assessing whether the parents actions require legal sanction after the subsidiary's demise.

Some may see this proposal as a radical implementation. But when considering the development that the law has undergone and critiquing the current changes being implemented elsewhere, it simply seeks to continue the current direction. In New Zealand, on the basis of recommendations made by the Base Erosion and Profit Shifting (BEPS), analysis conducted by the OECD,<sup>265</sup> Parliament is considering thin capitalisation rules that will limit excessive interest deductions on taxable income by multinational corporations.<sup>266</sup> This recommendation arose after it was recognised that many locally incorporated companies that are members of multinational conglomerates, are heavily laden with debt. Not only does this result in high risk, but the associated interest payments also result in minimal taxable income. Such measures are

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<sup>264</sup> Brian Mayo-Smith and others "Mainzeal Group Liquidation: Liquidators Six Monthly Report to Creditors and Shareholders" (2016) <[www.bdo.co.nz](http://www.bdo.co.nz)> at 2. \$16.7m worth of claims were subsequently rejected.

<sup>265</sup> Hon Steven Joyce and Hon Judith Collins *BEPS: Strengthening our interest limitation rules* (Inland Revenue, March 2017) at 25.

<sup>266</sup> Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009, s 47(1).

specifically focused on the increasingly prevalent “undercapitalised subsidiary”.<sup>267</sup> In a recent review of corporate insolvency law, the Ministry of Business, Innovation and Employment (‘MBIE’) suggested an extension of the vulnerability period in the voidable transactions regime to four years for “related parties”.<sup>268</sup> Although it was accepted that this would lead to an increase in administrative and compliance costs, this was justified on the basis of the parent’s level of knowledge and the “mischief often associated with related party transactions”.<sup>269</sup> In the United Kingdom, the draft of the Finance Bill 2017,<sup>270</sup> included provisions to restrict the amount of profit that can be offset by carried forward losses at £5,000,000, with any losses above this level being limited to only 50% of profits in any single year.<sup>271</sup> As BDO reported, the burden will fall on large groups.<sup>272</sup> From the government’s perspective, these loss restrictions should help to “counter public criticism of large corporations paying no tax despite high levels of reported profit”.<sup>273</sup> The Bill also suggested a limitation that would require a group to pay tax on at least half of their profits regardless of the level of carried forward losses.<sup>274</sup> A number of anti-avoidance provisions seeking to restrict the practice of loss buying and the artificial segmentation of an enterprise to gain access to a separate £5million allowance were also addressed.<sup>275</sup> Other countries have limitations on the number of years that tax losses can be carried forward,<sup>276</sup> while in the aftermath of the global financial crisis, San Marino even introduced a tax of 1.5% on the total amount of accumulated losses to be carried forward that were incurred during 2009-2012.<sup>277</sup> These developments in New Zealand and across the globe align with greater public scrutiny of the tax practices of many of the world’s companies. Many

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<sup>267</sup> Muscat, above n 10, at 65.

<sup>268</sup> Ministry of Business, Innovation and Employment *Review of Corporate Insolvency Law: Report No. 2 of the Insolvency Working Group, on voidable transactions, Ponzi schemes and other corporate insolvency matters* (May 2017) at 24. MBIE suggested a reduction to 6 months where the parties were not “related”.

<sup>269</sup> At 24.

<sup>270</sup> Although these provisions were intended to apply from 1 April 2017, it was subsequently removed from the pre-election Finance Bill, but expected to be incorporated in a subsequent bill. Refer <https://www.out-law.com/en/articles/2017/april/new-uk-corporate-tax-loss-relief-rules-increase-flexibility-for-carried-forward-losses/>.

<sup>271</sup> Iain Kerr “Reform of CT Loss Relief” (22 March 2017) KPMG <<https://home.kpmg.com>> However if not all of these losses have been utilised and the company goes into liquidation, losses incurred 3 years prior to the liquidation are able to be used to offset profits.

<sup>272</sup> BDO “Use of brought forward tax losses” (05 May 2016) <[www.bdo.co.uk](http://www.bdo.co.uk)>.

<sup>273</sup> These concerns have spawned headlines such as ‘how do a third of the top Australian companies pay no tax?’, and ‘Google, Amazon, Starbucks: The rise of ‘tax shaming’.

<sup>274</sup> BDO “Use of brought forward tax losses” (05 May 2016) <[www.bdo.co.uk](http://www.bdo.co.uk)>.

<sup>275</sup> Eloise Walker and Penny Simmons “New UK corporate tax loss rules increase flexibility for carried forward losses” (26 April 2017) Out-Law <[www.out-law.com](http://www.out-law.com)>.

<sup>276</sup> Marian Murphy *The OECD Small and Medium Enterprise Outlook 2002* (OECD, Paris, 2002) at 47. Canada has a period of 7 years, while the United States is limited to 20 years.

<sup>277</sup> International Monetary Fund “Annual Report on Exchange Arrangements and Exchange Restrictions (2013) <[www.imf.org](http://www.imf.org)> at 49. Restricted to Financial Institutions.

of the tax loopholes once available have been closed and the legislatures have begun to increasingly regulate corporate groups tax practices. These considerations, and the above developments, present an increasing propensity to punish abuse of the corporate form through taxation mechanisms and support the implementation of the posited amendment.

Some supporters of the status quo may suggest that the utilisation of a tax loss is a transaction between the Inland Revenue Department, the subsidiary and the parent and not a transaction involving the subsidiary's creditors.<sup>278</sup> Only members of the group can utilise tax losses, with creditors having no ability to utilise the losses incurred by the subsidiary. The posited approach however, analogises a tax loss to the acquisition of a subsidiary's asset by the parent (or the payment of debt to the parent), thus allowing it to be treated akin to a voidable transaction. Although not an 'asset' in the traditional sense, when considering that the future economic benefit of an asset is defined in the NZ framework as "the potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the entity", the analogy is appropriate.<sup>279</sup> By utilising a tax offset, the company is able to reduce their tax liability, preserving important cash flow. Indeed, the Institute of Chartered Accountants in England and Wales suggested that "a transfer of tax losses between group companies for no consideration is potentially a transfer at an undervalue and may therefore be unlawful in the absence of distributable reserves".<sup>280</sup> The utilisation of a tax loss raises many of the same concerns as the voidable transactions regime, and the tax loss solution recognises the inequity in allowing a parent to reap the benefit of a tax loss before the liquidation of the subsidiary, while leaving creditors devoid of a similar ability to extract any value. Some supporters of the status quo may also suggest that the adoption of the tax-loss solution could result in a loss of enterprise in New Zealand, as entities decide to move to more tax friendly destinations where they can utilise tax loss offsets without the countervailing burden.<sup>281</sup> However, when you consider that tax losses result from an unprofitable business, a number of the companies that go elsewhere would be ones that conduct excessively risky businesses. Although this change may result in the loss of some socially desirable business, the overall impact would encourage a more economically responsible

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<sup>278</sup> Although the subsidiary must accept the tax loss offset, this will unlikely present any issues in the context of a wholly owned subsidiary.

<sup>279</sup> External Reporting Board "New Zealand Equivalent to the IASB Conceptual Framework for Financial Reporting (NZ Framework)" (February 2010) <www.xrb.govt> at 19.

<sup>280</sup> Institute of Chartered Accountants in England and Wales "UK Regulation Fact Sheet" (29 April 2010) <www.icaew.com> at 4.

<sup>281</sup> Business Tax Working Group *Final Report on the Tax Treatment of Losses* (Department of Treasury Australia, 2012) at 15.

business landscape. An overly harsh punishment for a few would be the unfortunate sacrifice for a commercial environment that provides greater certainty and better protection of subsidiary creditors' rights.

## **Conclusion**

Limited liability is a key feature of company law. This paper has considered its application in the parent-subsidary context and how the protection that limited liability confers upon shareholders can be misused and/or operate to unduly prejudice creditors. Responding to misuse and the need to protect creditors, the courts and Parliament have created a range of exceptions and qualifications, designed to encourage good corporate management, and to protect the company's creditors. A key theme of this paper is that the application of limited liability to insulate the parent from the subsidiary's debts brings concerns that are not present in companies whose shareholders are human beings, even the 'one-person' company. These concerns have received recognition with Parliament responding with the creation of statutory pooling orders.

This paper suggests an additional qualification to limited liability is desirable in the parent-subsidary situation – this is the tax loss solution. This 'solution' recognises that the parent that utilises a subsidiary's tax loss is receiving something of perceived value from the subsidiary (a reduction in its tax liability), but without the imposition of any countervailing burden to pay for it. Currently the parent can simply reap the benefits of a subsidiary's poor performance and, in all but the rarest of circumstances, be absolved of liability for its debts. This creates a propensity for misusing the subsidiary structure to extract maximum value before winding the subsidiary up when it encounters financial difficulty. This perverse incentive means that creditors tend to shoulder the financial burden in the event of a subsidiary's demise.

The tax-loss solution not only has the benefit of lessening the impact of that financial burden upon creditors, but also encourages the parent's greater vigilance in the subsidiary's operation. It recognises that current measures qualifying the protection of limited liability tend to be premised on liquidation; as such they address the issue once the inevitable occurs. In contrast the tax-loss solution seeks to ensure that a parent is incentivised to act prudently during the continued operation of the subsidiary; at least when it seeks to take personal advantage of tax-losses. Although the introduction of this 'solution' 'may have an initial impact of a slight

unsettling of the commercial landscape, the implications are limited to a period of two years tax losses and will provide important protections to subsidiary creditors.

Although the law has continued to develop alongside the rise of the corporate group, it would now appear to be lagging behind. With the weight of this burden being shouldered by subsidiary creditors, further legislative development is needed.

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