Enterprise liability for corporate groups: A more efficient outcome for creditors

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In May 2000, the Companies and Securities Advisory Committee published its Corporate Groups Final Report. One of the report’s objectives was to determine whether further safeguards were needed for those dealing with corporate groups, namely, minority shareholders and outsiders, including creditors. Of the Final Report’s 24 Recommendations, to date, only two recommendations, permitting the pooling of assets and liabilities in a liquidation of group companies have led to changes in Australian corporate law. Of the remaining 22 recommendations, 11 involved no change to the current law, while the remaining 11 recommendations have not been implemented. Unsecured creditors transacting with corporate group members may make inefficient investments due to: corporate group members misrepresenting the availability and value of group assets, when such assets are insulated from creditors’ claims; the increased opportunity for debtor opportunism to arise within corporate groups. This article considers, whether the adoption of enterprise liability, within controlled and integrated corporate groups, would efficiently enable creditors to identify and to price the risk of transacting with such a corporate group member, thereby providing creditors with a more efficient outcome.

I Introduction

In May 2000, Companies and Securities Advisory Committee (CASAC) in its Corporate Groups Final Report,1 recommended as a further safeguard to creditors,2 the introduction of an enterprise approach to regulating corporate groups. However, the above recommendation, like the majority of report recommendations, was not adopted. Rather, current Australian corporate law relies upon conventional ex ante and ex post protections for creditors transacting with corporate group members.

In Australia, corporate groups3 pose specific dangers for creditors4 when transacting with their group member companies. Conflicts of interest between

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2 CASAC, above n 1, at [0.6]. In the Final Report, the Advisory Committee put forward various recommendations to assist the efficient and effective management of corporate groups while ensuring appropriate protection for minority shareholders and outsiders.
3 This article is concerned with those corporate groups which are operated and managed as single enterprises. Such groups are characterised by the following factors:
   i) control, either centralised or decentralised over day-to-day decision-making of group members;
   ii) economic integration, where group members collectively conduct complementary fragments of a common enterprise;
   iii) financial interdependence, where the members’ financing needs are met through loans from the group obtained by guaranteeing parent or sister subsidiaries within the group;
corporate group constituents arise due to the Australian corporate governance framework. Based on the entity principle, Australian corporate law generally requires directors to act in the best interests of the company to which they have been appointed. However, in practice, this duty may conflict with a director’s actions within a corporate group which is managed and controlled as a single enterprise. Directors or controlling shareholders of the corporate group member may act to maximise the wealth of the group as a whole and this may be at the expense of the corporate group members and their creditors. In the context of this article such behaviour is labelled ‘debtor opportunism’.

In the recent past, some activist shareholders have employed the powers conferred on members in relation to the amendment of a company’s constitution and the calling of company meetings to put resolutions at the meetings of various public companies with the aim of compelling the companies involved to adopt measures designed to achieve certain outcomes sought by these member groups.

Creditors look to a company’s net assets for repayment of their debt. Recourse against the company is generally limited to the value of such net assets. Dissipation of such net assets by the company, such that there are insufficient funds to repay the creditor is denoted as ‘limited recourse risk’. Use of corporate group branding and intra-group financing by the corporate group may mislead creditors, such that they cannot distinguish between each corporate group member’s ownership of assets or liabilities. Where creditors cannot accurately determine the net assets of the corporate group member they contract with, they may assume greater apparent ownership of net assets than actually exists. Such misconception may lead creditors to inaccurately price the level of limited recourse risk.

iv) administrative interdependence of constituent group companies to achieve economies of scale;
v) overlapping employment structure, where staff move around the group, training, insurance and employee benefits are offered group wide;
vi) common group persona in terms of a common group trade name, trademarks, or insignia.

Corporate groups exhibiting the first two characteristics of control and integration, as well as a majority of the remaining characteristics provide confirmation of the corporate group’s single business enterprise.

4 In the context of this article, creditors are restricted to voluntary unsecured creditors. Such creditors include: employees; consumers or customers of the corporate group member who pay in advance for goods or services, prior to delivery; and trade creditors, who are individuals or companies who supply goods or services to the single enterprise group member, but do not require immediate repayment. Such creditors are termed ‘voluntary’ as their transacting with the company involves an element of choice. Although employee wages and superannuation contributions are considered unsecured debts of the corporate group member, such payments are given priority by s 556 of the Corporations Act.

5 The constituents include directors, shareholders and creditors of each corporate group member.

6 Tomasic and Bottomley report, the vast majority of Australian directors recognise that the group context of corporate life can and does create significant legal problems for directors. See R Tomasic and S Bottomley, ‘Corporate Governance and the Impact of Legal Obligations on Decision Making in Corporate Australia’ (1991) 1 Aust Jnl of Corp Law 55 at 63.

7 Section 187 of the Corporations Act does to a limited extent allow consideration of the group interest by directors, if certain conditions are satisfied.
In Australia, there is no codified group law\textsuperscript{8} or body of common law\textsuperscript{9} that deals with the specific conflicts outlined above. This article, considers whether the adoption of enterprise liability within controlled and integrated corporate groups would provide creditors with a more efficient outcome. To be efficient, however, the costs of increased liability exposure of corporate groups must be less than the benefits of eliminating such debtor opportunism. The remainder of the article will be broken down into the following parts: Part II considers briefly CASAC’s recommendations and speculates on the reasons for their non-implementation. Part III describes how unsecured creditors, transacting with corporate group members, may make inefficient investments, due to the increased opportunity for debtor opportunism within corporate groups. Part IV highlights the weaknesses of relying upon the conventional protections to address such debtor opportunism. Part V considers whether the adoption of enterprise liability would reduce the level of debtor opportunism within corporate groups, as well as address the reasons given for the non-implementation of CASAC’s recommendations. Part VI concludes with the practical implications of adopting enterprise liability within corporate groups.

\section*{II Australia’s draft reforms}

CASAC in its Final Report on Corporate Groups in May 2000\textsuperscript{10} recommended the adoption of the single enterprise principle in regulating corporate groups.\textsuperscript{11} Under the proposal, wholly owned corporate groups could choose\textsuperscript{12} whether or not to be so regulated, by choosing to be consolidated or non-consolidated. If choosing to be consolidated then a term such as ‘consolidated corporate group company’ would be included on all public documents of the group.

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\item \textsuperscript{8} Codified group laws exist in Germany (only for German stock corporations), Portugal, Brazil and partially in Slovenia, the Czech Republic and Hungary. See B Haar, ‘Corporate Group Law’ in J Basedow, K J Hopt and R Zimmermann (Eds), Encyclopaedia of European Private Law, Oxford University Press, Oxford, 2011, p 1.
\item \textsuperscript{9} In Germany, the absence of a codified concern law for corporate groups with close corporation subsidiaries has led to a court developed approach of parent liability, known as ‘qualified concern’ doctrine. Such rules have their basis in the provisions of the Stock Corporation Act, although the German Stock Corporation Act does not cover subsidiaries in the form of close corporations. See K I Hofstetter, ‘Parent responsibility for subsidiary corporations: evaluating European trends’ (1990) 39(3) International & Comparative Law Quarterly 576 at 581; I Kalish, ‘Parent liability: an analysis of direct liability of the controlling shareholder of a German GmbH after recent decision of the Federal Supreme Court’ (1994) 5(3) International Company and Commercial Law Review 82 at 82; P Hommelhoff, ‘Protections of Minority Shareholders, Investors and Creditors in Corporate Groups: the Strengths and Weaknesses of German Corporate Group Law’ [2001] 2 European Business Organization Law Review 61 at 69.
\item \textsuperscript{10} The purpose of the CASAC Final report was to outline, having previously reviewed Australian corporate law applying to corporate groups, various recommendations to assist the efficient and effective management of corporate groups, while ensuring appropriate protection for minority shareholders and outsiders.
\item \textsuperscript{11} Recommendation 2: The Corporations Law should provide that a wholly-owned corporate group can ‘opt-in’ to be a consolidated corporate group for all or some of the group companies, by resolution of the directors of each relevant group company. All companies in a consolidated corporate group should be governed by single enterprise principles.
\item \textsuperscript{12} By resolution of the directors of each relevant group company.
\end{itemize}
companies.\textsuperscript{13} Single enterprise principles would then govern the consolidated corporate group company as ‘the Corporations Law would treat the consolidated corporate group as one legal structure’.\textsuperscript{14}

CASAC, however, recognised the difficulty of applying single enterprise regulation principles to corporate groups, regardless of their organisational structure or governance autonomy, by allowing wholly-owned corporate groups members\textsuperscript{15} to determine their inclusion in the consolidated corporate group. Once consolidated, ‘group companies could merge merely at the discretion of the directors of the holding company’\textsuperscript{16} and ‘ASIC should have the power to provide appropriate relief from accounting and any other residual separate entity requirements’.\textsuperscript{17}

Of the report’s 24 recommendations two recommendations,\textsuperscript{18} dealing with the pooling of insolvent group companies’ assets and liabilities, have only lately been adopted.\textsuperscript{19} Of the remaining recommendations, 11 were successful, in that no changes were made to existing laws as stated. A further 11 recommendations have not as yet been acted upon, including CASAC’s recommendation that wholly owned corporate groups be given the option to be regulated on the basis of one economic entity.\textsuperscript{20}

No public comment on any particular recommendation has been released, although various conjectures have been made regarding recommendation 2’s non-implementation including:

- Complications of drafting legislation to adopt a single enterprise regulatory regime within the Corporations Act 2001 (Cth) meant that path dependency of no recognition prevailed;
- Significantly, there were no real incentives granted to the corporate group to encourage directors to opt in and consolidate;
- Increased liability exposure was thought to impact on the corporate group’s ability to borrow, restricting efficient capital raising, risk taking and diversification.

CASAC’s enterprise approach to corporate group regulation was not adopted. Rather, reliance was placed on existing conventional creditor protections.

\textsuperscript{13} CASAC, above n 1, p 39.
\textsuperscript{14} Ibid, at [1.59]–[1.63].
\textsuperscript{15} By the resolution of their directors.
\textsuperscript{16} CASAC as above n 1, p 39.
\textsuperscript{17} Ibid.
\textsuperscript{18} Recommendation 22: The Corporations Law should permit liquidators to pool the unsecured assets and the liabilities of two or more group companies in liquidation with the prior approval of all unsecured creditors of those companies.
Recommendation 23: The Corporations law should permit the court to make pooling orders in the liquidation of two or more companies. This power should be based on the draft provision in the Harmer Report and:
- make clear that pooling orders do not affect the rights of external secured creditors
- permit individual external creditors to apply to have a pooling order adjusted to take their particular circumstances into account.
\textsuperscript{19} See Div 8 of Pt 5.6 of the Corporations Act which was introduced by Corporations Amendment (Insolvency) Bill 2007. For a discussion of both voluntary and court ordered pooling provisions see J Dickfos, ‘Improving outcomes for creditors: Balancing efficiency with creditor protections’ (2008) 16 Insolvency LJ 84 at 90–5.
\textsuperscript{20} CASAC, above n 1, p 39.
provided under the Corporations Act to address the specific conflicts of interest existing between directors, controlling shareholders and creditors of corporate group members.

III Conflicts of interest unique to corporate groups

The underlying reason for conflicts of interest to arise specifically within corporate groups was made apparent in the HIH Report. The report referred to the commercial practice of corporate groups being controlled and managed as an integrated enterprise, where group executives make decisions on behalf of or affecting a particular group company, regardless that they are not employed by that company, nor previously have made any decision on its behalf:

The reality of modern public companies is that they are managed and controlled at a group level . . . with executives often employed by a subsidiary once or twice removed from the main listed entity. With some of the transactions I inquired into, a consideration of the separate legal existence of a subsidiary arose almost as an afterthought as the relevant transaction was being finally documented. Serious issues could arise (and did during the inquiry) under the current legislation as to whether the executive in question, who was neither employed by the company that became a party to the transaction and who had never previously made any particular decision concerning that individual company, nevertheless owed it the duties specified in ss 180–184. A further question is whether their actions were capable of constituting a breach of the duties they might owe to the company employing them, or perhaps to the ultimate holding company of the group.

Such underlying conflicts of interest pose a danger for creditors, as they may affect the creditor’s perception of the riskiness of transacting with the corporate group member.

A Creditors assessment of limited recourse risk and debtor opportunism risk

Creditors must correctly perceive the riskiness of contracting with the group member so as to demand the appropriate advance compensation. Such risks include the risk of ‘non-payment because of limited liability’ labelled ‘limited recourse risk’, and second, the risk that ‘after the terms of the

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23 F H Easterbrook and D I R Fischel, The Economic Structure of Corporate Law, 1st ed, Harvard University Press, Cambridge, 1991, pp 41–4. Theoretically, creditors protect themselves from the above risks by private contracting measures, such as the inclusion of higher interest rates, or charging higher prices for goods or services in advance.
24 Ibid, pp 52.
transaction are set the debtor will take increased risk, to the detriment of the lender’, labelled ‘debtor opportunism risk’.

A creditor’s perception of the risk of contracting with the group member, is determined by the nature of the group member’s investment; its ability to achieve completion; the group member’s financial position, namely, its liabilities and assets; and the likelihood of the group member undertaking activities subsequent to contracting to increase the risk of non or partial repayment.

An efficient outcome for the creditor and for the group is the creditor correctly identifying and pricing the two risks facing him or her when contracting with the group member. The group and its stakeholders will also benefit from the creditor correctly perceiving and pricing the risk, as only those investments where the compensation paid is less than the benefit of investment to the group will proceed.

However, current regulation of corporate groups prevents creditors from correctly perceiving the risks of contracting with the group member.

Legal separation and accompanying limited liability of company members, coupled with integrated control and management of group members, may accentuate agency conflicts within the group, leading to misrepresentation of the limited recourse risk of the group member, and/or greater levels of debtor opportunism.

Limited recourse risk is increased where group company shareholders or directors can misrepresent the value of corporate assets of the group member by falsely claiming that the member holds title to assets that the group company shareholders control but, that in reality, belong to other member companies within the group.

Debtor opportunism risk increases, where subsequent to contracting the debt, intra-group transactions, such as intra-group financing, enable assets to be siphoned from or additional liabilities incurred by a group member.26

25 Ibid.

26 A long laundry list of industrial and creditor disputes spanning a number of decades of corporate Australian history are illustrative of such debtor opportunism, made possible by the non-recognition of a corporate group boundary and the selective use of the separate legal entity notion within a corporate group setting. See F Clarke and G Dean, Indecent Disclosure Gilding the Corporate Lily, 1st ed, Cambridge University Press, Sydney, 2007, p 130 for examples including:

- the attempted retrenchment of Patrick Stevedores’ Maritime Union of Australia employees following the alleged intra-group shuffling of funds, other assets and capital in the late 1990s;
- the lengthy and ongoing James Hardie asbestos compensation claims by tort creditors of James Hardie subsidiaries, Amaca and Amaba, against the holding company, James Hardie;
- claims of Ansett employees in 2001, for their entitlements when Air New Zealand jettisoned its wholly owned subsidiary, Ansett Australia Pty Ltd.

The authors identify other notable instances of classes of unsecured creditors of financially stressed corporate groups, finding themselves caught up in financial hassles exacerbated by the group structure, such as Adsteam, Tricontinental, Qintex, Bond Corporation.
1 Misrepresentation of group member assets and liabilities

The group’s use of corporate group branding and intra-group financing\(^{27}\) may cause creditors transacting with the group to not distinguish between individual corporate group members, being unable to determine where the boundaries of asset partitioning lie.

**(a) Use of corporate group branding**

Group members, whether deliberately or not, blur the distinction between group members. Having member companies use the same common name helps to exploit the relationship between corporate group members. Such exploitation maximises the value of corporate branding, increases the goodwill of the corporate group and thereby generates higher returns to shareholders. The cost of having member companies use the same common names is that it exacerbates the confusion of creditors, regarding the lines of asset partitioning within the group.

The existence and exploitation of the common group persona may mean creditors are unaware of the group member’s boundary. Corporate branding, through the use of corporate logos, may further aggravate this problem. In \textit{Ackers v Austcorp International Ltd,}^{28} Rares J considered that the presence of Austcorp’s generic logo and name on a property investment brochure and building site ‘created an association with the group, and importantly, with the common company involved in the group’s projects — Austcorp itself’.\(^{29}\)

No-one seeing the Austcorp signs on the building site, or its logo on the brochure or leaflet, would stop to ask or think about if these identified a special purpose subsidiary. The message which Austcorp wished to pass to the public was that it, as the ultimate owner of the brand, was responsible for the development — Austcorp was the hands and brains of its subsidiaries’ conduct.\(^{30}\)

\textit{Austcorp} is by no means an isolated case. A further example of the confusion that can arise when a strong group brand is used to support the activities of the subsidiaries can be found in the case of \textit{Qintex Australia Finance Ltd v Schroders Australia Ltd,}^{31} where Rogers CJ recognised the divergence between commercial reality and the applicable law.

In situations where corporate groups have a common marketing brand, subsidiary companies’ names invariably include the common name. Creditors, despite entering into contractual arrangements with the group member, may do so on the basis of the financial viability of the corporate brand, which encompasses all of the group’s companies as a single business enterprise.

\(^{27}\) Current corporate group disclosure requirements may further exacerbate the problem of identifying the group member’s assets and liabilities.

\(^{28}\) \textit{Ackers v Austcorp International Ltd} [2009] FCA 432; BC200903668. A holding company, Austcorp International Ltd, was found liable under s 52 of the \textit{Trade Practices Act} 1974 (Cth) for making false and misleading representations regarding the promotion and marketing of apartments in a resort on the Central Coast of New South Wales, although the management and marketing of the development was contracted to Austcorp Development Management Pty Ltd, a subsidiary of Austcorp International.

\(^{29}\) \textit{Ackers v Austcorp International Ltd} [2009] FCA 432; BC200903668 at [81].

\(^{30}\) Ibid, at [81]–[152].

\(^{31}\) \textit{Qintex Australia Finance Ltd v Schroders Australia Ltd} (1990) 3 ACSR 267; (1990) 9 ACLC 109; BC9001715.
Where the creditor cannot distinguish between each group member’s ownership of assets, they may assume greater apparent ownership of assets than actually exists. Such misconception of the specific contracting party’s ownership of assets may lead to creditors inaccurately perceiving and pricing the level of limited recourse risk. Inefficiencies in investment may then result, contrary to the stated aim of the corporate regulatory system (as the latter assumes transparency and efficiency between stakeholders).

(b) Intra-group financing

Professor Hadden\(^{32}\) identified the technique of integrated financing as a means of concealing from creditors the true financial position of individual companies within the group, as assets and liabilities can be transferred from member to member. One example of such financing transactions\(^{33}\) is the reliance on cash pooling for the management of cash available within the group, often charging short-term interest rates on cash pools, which in reality are long-term loans to various group members. The result is that the group member who is designated as the cash pool leader reports the cash pool advantage, while the depositing group members who may be experiencing credit risk from the creation of the cash pool, only may receive a bank deposit rate of return.

Charging credit guarantee fees within the group is a means of redeploying capital from one group member to another. Intra-group loans provide an opportunity to produce a beneficial tax loss or profit, when a group member buys another member’s loan or bond, at a discount out of the market. An intra-group factoring arrangement increases the assets of the group member purchasing the accounts receivable. If this same group member also has third-party borrowings, such increased assets may be accepted as collateral, with the effect of either lowering the cost of, or increasing the amount loaned via third-party borrowings. To obtain accurate information at the time of contracting, of the corporate group member’s solvency (and hence ability to repay debt, as and when it falls due) may require analysis by a credit rating agency, whose costs may be prohibitive to the creditor.

2 Increased level of debtor opportunism

Within a single company, debtor opportunism can arise as the interests of creditors, shareholders and directors may diverge. Within the corporate group, the number, degree, and opportunity for conflicts of interest to arise and be acted upon are considerably increased. Richard Schulte identified this problem between the parent and subsidiary company:

The parent’s lack of any duty (as a shareholder) in dealing with the subsidiary means a creditor is unable to make an accurate assessment of the investment’s risk because the possible range of the parent’s conduct is very wide.\(^{34}\)

\(^{32}\) T Hadden, ‘The Regulation of Corporate Groups in Australia’ (1992) 15 UNSWLJ 61 at 65.
\(^{34}\) R Schulte, ‘Corporate groups and the equitable subordination of claims on insolvency’ (1997) 18(1) Company Lawyer 2 at 18. An exception is if the parent company is a ‘shadow director’ of the subsidiary. In such circumstances, statutory duties are then owed to the subsidiary, such as ss 180, 181, 182, 183 and s 588G of the Corporations Act.
The increased range and number of deviating stakeholder interests derive from the group’s structure, in which there are further layers of separation of ownership and control, non-existent in the single independent company.

The Bell Resources case provides an undeniable illustration of the pursuit of the corporate group’s economic utilitarian goals at the expense of the interest of constituent individual corporate group members and their creditors.

The Bell Group of companies, headed by The Bell Group Ltd (TGBL) (in liq), relied heavily on intra-group financing. The group had unsecured banking facilities with at least six Australian banks. As well as relying on bank finance, the Bell Group raised funds via five separate bond issues. The proceeds from the bond issues were lent directly or on-lent indirectly, to Bell Group member companies.

Early in 1990 the group’s Australian and UK banks entered into refinancing arrangements with the group. Under the refinancing arrangement, the banks took security over assets of group entities to support existing borrowings of some of the corporate entities within the group. If during the currency of the facility, the group sold assets, the proceeds of sale were to go to the banks, pro rata in reduction of the bank debt. All intra-group indebtedness was subordinated behind the claims of the banks. The purported purpose of these refinancing arrangements was to allow directors time to pursue the group economic goal of restructuring. Such restructure would then enable the maximisation of the commercial worth of group assets, particularly the group’s publishing assets.

On 18 April 1991, TBGL applied for the appointment of a provisional liquidator. The banks recovered $283 million on the realisation of their securities, being the publishing assets, sale of shares and collection of debts.

The liquidators, later joined by the Trustee for Bondholders, instigated proceedings against the banks and directors, challenging the way in which the securities were given and taken and seeking recovery of the realisation proceeds, as well as of $1.5 billion from the banks.

The grounds for the challenge were, at the time the securities were given, the directors and banks knew the main companies within the group were insolvent. Thus:

entry into the refinancing transactions with the banks and the giving of securities to the banks, caused the Bell group companies to incur an obligation to the banks that had previously been limited to three Bell Group companies. As the borrowers were

35 This summary of facts is drawn from the judgment of Justice Owen in The Bell Group Ltd v Westpac Banking Corporation (No 9) (2008) 39 WAR 1; 70 ACSR 1; [2008] WASC 239; BC200809492.
36 The facilities were unsecured, but supported by negative pledge arrangements whereby, the companies within the group required the banks’ consent before dealing with certain of their assets.
37 The on-loans were not formally documented resulting in a subsequent dispute as to whether they were made on a subordinated or unsubordinated basis (did the loans rank behind the existing bank loan facilities).
38 The Group’s bankers became alarmed about their increasing risk exposure with respect to their ranking against the bondholders.
nearly insolvent, the effect of this obligation was prejudicial to the direct and indirect creditors and shareholders of the individual Bell group companies.\textsuperscript{39}

In effect, the directors of the Bell Group companies ‘focussed on one group of creditors (the banks) to the exclusion of all others’.\textsuperscript{40} Central to the decision of Owen J\textsuperscript{41} was the failure of the directors to act in good faith, in the best interests of the individual companies comprising the Bell Resources Group and to act for a proper purpose.

The directors may still have satisfied their duty to act in the best interests of the corporate group members, if the plan to restructure the group (of which the security transactions were but a part) had existed. However, none of the directors was able to define its parameters, its implementation, its length or how its operation would avoid the insolvency of the group companies.\textsuperscript{42}

Interestingly, Owen J considered there was no breach of the duty to avoid conflicts of interest, preferring to determine the failure of the directors to consider the interests of the individual corporate group members when concentrating on the interests of the group (what he termed a ‘Bond-centric’ approach to their duties) as being a breach of their equitable duties to act in good faith, in the best interests and for proper purposes of the individual companies. Justice Owen’s reasoning recognises the inevitability within corporate groups of the conflict arising from the disparity between the legal and economic entities comprising the corporate group and of the primacy of

39 The Bell Group Ltd v Westpac Banking Corporation (No 9) (2008) 39 WAR 1; 70 ACSR 1; [2008] WASC 239; BC200809492 at [6111]–[6112]. Owen J determined that the Bell Group of companies were insolvent as at 26 January 1990, although he did not find that the directors were aware of this insolvency. Rather, he found that the directors were aware that the companies were nearly insolvent. Creditors and shareholders of the following Bell Group companies were prejudiced by the transactions: TBGL, BGF, BRL, Bell Bros, WAOM, BPF, Anstead, Western Interstate and BGUK. At that time the companies’ ability to pay their debts, as and when they fell due, depended upon the cash flow contributed by the business operation of the Bell group’s publishing assets. However, there was a deficiency in such cash flows of $60 million a year. Such deficiency could not be met by the sale of Bell Group companies’ assets, as the bank’s refinancing transaction had created a prior claim for repayment of bank debts from the proceeds of any such sales.

40 Ibid, at [6065].

41 Ibid, at [6045]. Owen J considered there was a marked contrast between the Australian directors and the London-based members of the boards of BGUK, TBGIL and BIIL. The latter went to great pains to draw up lists of creditors, who might be affected and to take steps to ensure that the interests of those creditors were protected. The list was discussed in detail at meetings and was central to their thinking. Not so the Australian directors. Owen J was satisfied the Australian directors did not consider the detailed information that would have been necessary to enable them to decide whether, and to what extent, there was corporate benefit to each individual company called upon to enter into a transaction. Further, Justice Owen considered the London-based directors had breached their fiduciary duties, only by failing to obtain reliable financial statements and information to verify that the letters of comfort on which they were relying were valid and reasonable.

42 Ibid, at [6039]. Lack of a planned restructure may reflect the inability of the directors to negotiate a moratorium arrangement with the bondholders, which was central to any restructuring proposal.

43 Ibid, at [6122]. Owen J considered that some of the directors, were concerned about the interests of the Bond Group rather than the interests of the Bell group companies of which they were directors. Such directors had breached their duty to exercise their powers for a proper purpose, namely, by attempting to protect Bond Corporation by removing a threat to its continuing survival.
IV Current creditor protections to address limited recourse risk and debtor opportunism risk

Where the potential cost of debtor opportunism is considered especially high, it is considered efficient\(^{44}\) to rely on creditor protections provided by company law,\(^{45}\) rather than the operation of the debt market,\(^{46}\) to provide adequate creditor protection.\(^ {47}\) The protection afforded by company law to creditors may be provided ‘ex ante’ or ‘ex post’. Ex ante protections exist to ensure that at the time the creditor contracts with the group member, the member does not mislead the creditor as to its financial standing and stability. Alternatively, ex post protections provide a means of recourse to the creditor where the group member has misled the creditor as to its financial standing.

A Limited recourse risk protections

Currently, there are three creditor protection measures to assist the creditor when determining the limited recourse risk of transacting with a group member: one ex ante protection: entry into a deed of cross guarantee among group members; and two ex post protections: lifting the corporate veil within the group, or pooling of assets and liabilities of group members on liquidation.

1 Deeds of cross guarantee

A deed of cross guarantee makes each group company, who is party to the deed, liable to the external creditors of every other group company for any shortfall, in the event of liquidation of any group company. Parties to the deed form a *closed group*. Entry into the deed is purely voluntary, although in practice restricted to wholly owned subsidiaries.\(^ {48}\) Directors of each group

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\(^{44}\) To be efficient, the marginal costs of such regulation must be less than or equal to the marginal benefits and all voluntary methods to solve such agency problems have tried and failed. See S F Corp and C W Maughan, ‘The Law Commission and economic methodology: values, efficiency and directors’ duties’ [1999] *Company Lawyer* 116.


\(^{46}\) In theory, creditors use private contracting measures such as the inclusion of higher interest rates to protect themselves from limited recourse risk and debtor opportunism risk. However, the average trade creditor does not normally attempt to draft contracts on a transaction-specific basis as normal trading arrangements may involve sums of money that are too small and time scales that are too short to justify extensive contractual stipulations. See V Finch, *Corporate Insolvency Law*, 1st ed, Cambridge University Press, Cambridge, 2002, p 86.

\(^{47}\) Ross Grantham summarises the arguments for and against the ability of private debt contracting to take into account unforeseen changes in debtor risk, once the debt contract is made. The inclusion of debt/equity ratio covenants in loan agreements is suggested as a means of combating debtor opportunism. However, Ross Grantham cites empirical evidence that in the United States, the use of such covenants is not widespread and is considered an inappropriate response for trade creditors who are considered the least equipped to assess risk. R Grantham, ‘The judicial extension of directors’ duties to creditors’ [1991] *Jnl of Business Law* 1 at 3.

\(^{48}\) The entry into the deed administered by ASIC exempts the closed group of companies from preparing audited accounts and directors’ statements. There is no longer the requirement that
company are then obliged to reassess the continuing benefit of the deed to their company each year. Ex ante protection is provided to creditors, as deeds of cross guarantee create an incentive for deed members to monitor their fellow deed members to ensure that the closed group maintains an acceptable level of limited recourse risk. Deeds of cross guarantee reduce the risk borne by risk-adverse subsidiary companies and their creditors by shifting some level of risk to the remaining solvent deed members and their creditors. Such members and their creditors are the appropriate bearers of such risk where the corporate group is managed and operated as a single enterprise. In such circumstances, the deed endorsers monitor the riskiness of the corporate group’s portfolio of investments as an entirety. In this respect, there is then alignment of the actual limited recourse risk and the creditor’s perception of transacting with the group member.

However, the creditor protection provided by the deed is limited protection, as the decision to enter into such deeds is not mandatory, but strategically one for the group to adopt. Also it is possible for the deed where adopted to be revoked or released, which has led to criticisms in the past.49

2 Lifting the corporate veil

In Pioneer Concrete Services Ltd v Yelnah Pty Ltd50 Young J observed, two instances where the separate legal personality of a company is to be disregarded in the context of a corporate group. If the court considers there is in fact or in law:

(i) a partnership or agency between companies in a group or
(ii) the creation or use of the company was designed to enable a legal/fiduciary obligation to be evaded or a fraud to be perpetuated.

Emphasis on the entity principle, as outlined in Salomon,51 by Australian courts, prevents recognition of the group’s integration as evidence of the existence of a partnership between members. Thus, the certainty of Justice Young’s outlined exception to the separate legal entity rule is at odds with the occasions when the veil has been successfully lifted within the context of a

subsidiaries are to be wholly owned subsidiaries registered in Australia. Rather, relief is extended to ‘controlled entities, including foreign registered entities’, by virtue of ASIC Class Order (98/14). ASC, Class Order for Wholly-owned Subsidiaries 91/996, 19 December 1991, ASC Update 41, Public Hearings, Report on the Public Hearing on Accounts and Audit Relief for Wholly-Owned Subsidiaries, 1991, at [19]. The rationale behind the ASIC class order is that consolidated accounts give a more accurate picture of the environment within which the wholly-owned subsidiary operates.

49 D Murphy, ‘Holding Company Liability for Debts of its Subsidiaries — Corporate Governance Implications’ (1998) 10 BondLR 241. Murphy discusses whether it is for the corporate benefit of each company to enter the deed of cross guarantee, and whether the entry into such a guarantee obliges directors of group companies to monitor other group companies.

50 (1986) 5 NSWLR 254; (1986) 11 ACLR 108; (1987) 5 ALC 467 (Yelnah), where the issue was, in an action for breach of contract, whether a contractual promise by a subsidiary company could be treated as a promise by the parent company.

51 Salomon v Salomon & Co Ltd [1897] AC 22; [1895-9] All ER Rep 33; (1896) 75 LT 426; (1897) 13 TLR 46.

52 In Salomon, the court held the element of control was insufficient grounds to lift the corporate veil. Australian courts require lifting of the corporate veil to prove an implied agency exists.
corporate group. 53 Similarly, there are no Australian authorities to support Young J’s second instance of when the corporate veil will be lifted. The lack of certainty surrounding the availability and use of lifting the corporate veil prevents such a remedy being an efficient ex post protection measure for creditors transacting with group members, where such creditors have been misled as to the group member’s corporate boundary.

3 Pooling in external administration

Division 8 of Pt 5.6 of the Corporations Act 54 provides ‘ex post’ protection of creditors by two separate methods of pooling: voluntary pooling and court ordered pooling. 55 As the pooling provisions are only available on liquidation, the protection of creditors is paramount, 56 while returns to creditors are enhanced by the savings in transaction costs generated by pooling. Where the credit has been misled as to the financial standing of the group member, recourse to other group members is available 57 on a somewhat restricted basis. These restrictions arise by virtue of the limited manner of defining the

53 To date, there would appear to be no Australian case law where a common law partnership within a corporate group has been held to exist. Although in Yelnah Young J recognised that the court would lift the corporate veil where there was, in fact or in law, a partnership between the companies in a group, the particular facts of Yelnah did not warrant such recognition.

54 Hereafter all legislative references are to the Corporations Act unless otherwise indicated.

55 The general effect of a pooling determination, once made by the liquidator under s 571(1) and enforceable on approval by the eligible unsecured creditors of each company in the group under s 578(1) is:

(i) Each company in the group is taken to be jointly and severally liable for each provable debt payable by and each provable claim against, each other company in the group.
(ii) Inter-group company debts and claims are extinguished
(iii) The pooling determination does not alter the order of priority under s 556, 560 and 561 for each company in the group.
(iv) The pooling determination does not affect a secured creditor’s interest as long as the secured debt is not an inter-group debt.

Pooling determinations are aimed to be flexible and reflect the specific circumstances of the companies in the particular pooling group. See Explanatory Memorandum to Pt 4, ‘Facilitating Pooling in External Administration’, Corporations Amendment (Insolvency) Bill 2001, at [4.251]. The consequences of a court pooling order are the same as those of a liquidator’s pooling determination.

56 See Street CJ in Kinsela v Russell Kinsela Pty Ltd (1986) 4 NSWLR 722 at 730; (1986) 10 ACLR 395; (1986) 4 ACLC 215 where he held in a solvent company, the proprietary interests of the shareholders entitle them, as a general body to be regarded as the company, when questions of the duty of directors arise. But where a company is insolvent, the interests of the creditors intrude. They become prospectively entitled, through the mechanism of liquidation, to displace the power of the shareholders and directors to deal with the company’s assets.

57 The availability of a pooling order or pooling determination under Australian corporate law would appear to be more widely drawn than the United Nations Commission on International Trade Law (UNCITRAL)’s Legislative Guide on Insolvency Law, which restricts the availability of substantive consolidation to circumstances of: (i) where the court is satisfied that the assets or liabilities of the enterprise group members are intermingled to such an extent that the ownership of assets and responsibility for the liabilities cannot be identified without disproportionate expense or delay; or (ii) where the court is satisfied that enterprise group members are engaged in a fraudulent scheme or activity with no legitimate business purpose and that substantive consolidation is essential to rectify that scheme or activity. See UNCITRAL, ‘Legislative Guide on Insolvency Law Part three: Treatment of enterprise groups in insolvency’, July 2010, Recommendation 220.
companies to be included in the pool (only companies in liquidation, qualify for pooling) which result in the denial of access to solvent corporate group members.

(a) Boundaries of corporate group pooling

Although no definition of corporate groups is provided, the legislation places limits on when companies may be placed in the pool.\(^{58}\) To be eligible for pooling, companies must be in liquidation\(^{59}\) and be related bodies corporate;\(^{60}\) or share joint liability for one or more debts; or jointly or singularly own property used in a jointly carried on business, scheme or undertaking. Court ordered pooling provides a more accurate if somewhat limited ex post protection for creditors than voluntary pooling. This arises as the circumstances when a court may order pooling of corporate group assets follows more closely the circumstances existing within groups controlled and operated as single enterprises.\(^{61}\) Whether it is ‘just and equitable’\(^ {62} \) to make a

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\(^{58}\) Section 571(1) (pooling determinations) and s 579E (pooling orders). “The expression “group” is not defined. It should, therefore, be given its ordinary meaning, “of a collection or plurality”. A “group” will exist for these purposes, simply if two or more companies are identified. The “group” terminology does not require anything more. The need for the identified companies to have certain attributes or connectedness comes from aspects of s 579 other than the word “group”. See Barrett J in Allen v Feather Products Pty Ltd (2008) 72 NSWLR 597; (2008) 26 ACLC 224; [2008] NSWSC 259; BC200801998 at [9].

\(^{59}\) The restriction of pooling determinations or pooling orders to companies in liquidation may be recognition that the existing voluntary administration and deed of company arrangement procedures enable creditors to efficiently determine whether or not to pool. The Insolvency Practitioners Association of Australia (IPAA) has stated that, currently administrators can seek to pool a group of companies in a voluntary administration by taking a vote of creditors at the second meeting in respect of proposed ‘Pooling Deeds’. These resolutions are passed by a simple majority. Some administrators seek the approval of the court for the pooling arrangement under s 447A, some choose not to: Insolvency Practitioners Association of Australia, Submission on Exposure Draft to Corporations Amendment (Insolvency) Bill 2007, p 11.

\(^{60}\) In Australia, related bodies corporate require holding/subsidiary company status to exist. In New Zealand the court may make an order that provides for the pooling of insolvent related companies and in addition may make contribution orders where a related company is in liquidation. The order is dependent on companies being ‘related companies’. In s 2(3) of the Companies Act 1993 (NZ), the term ‘related companies’ is defined to include: (i) the holding subsidiary relationship, but also includes (ii) where there is a majority of shares held by the other company or other related companies (iii) as well as the position where the business of the companies has been carried on in a way that the separate business of that company (or a substantial part of it) is not readily identifiable. In contrast, the Australian provisions identify the companies subject to possible pooling, in terms of the operation of, or ownership (or co-ownership) of assets in a joint business.

\(^{61}\) The court has the power to make pooling orders, on the application of the liquidator/s where it is satisfied that it is just and equitable to do so. See ss 579E(1) and 579E(12). The matters, which the court must take into consideration in making the order, are open-ended and echo those factors that The Law Reform Commission Report No 45, General Insolvency Inquiry, known as the Harmer Report, originally identified as justification for court-ordered pooling.

\(^{62}\) Although Vaisey J in Re Serene Shoes Ltd [1958] 3 All ER 316 at 317; [1958] 1 WLR 1087, could not differentiate between the terms ‘just and equitable’ and ‘just and beneficial’, it is considered that the former phrase is distinct from the latter term. The expression ‘just and beneficial’, used in s 511 (which allows the court to determine a particular question, or exercise all or any of the court’s winding up orders, if satisfied to do so, would be just and beneficial) appears to take into consideration elements of cost and efficiency of function. Justice Young in Dean Willcocks v Soluble Solution Hydroponics Pty Ltd (1997) 42 NSWLR
pooling order takes into account the relative positions of the creditors within the group of companies vis-à-vis themselves, and the respective shareholders of those companies given the management practices of those companies; the degree of intermingling of business and management between companies and the creditors knowledge thereof. To some extent the factors address the characteristics previously identified as indicative of a controlled and integrated corporate group. Section 579E(12)(b) is particularly relevant where the actions of a group member have led the creditor to incorrectly identify the assets and liabilities and thereby the limited recourse risk of transacting with such member. To this extent, court ordered pooling provides a much more effective ex post creditor protection for creditors than lifting the corporate veil.

The Australian pooling provisions are similar to the NZ provision, that empowers NZ courts to make pooling orders in respect of related companies, once one of those companies is placed into liquidation. The term ‘just and equitable’ is used in the corresponding NZ provisions and Farrar has suggested that the term provides the court with the ‘widest discretion to affect a result which accords with common notions of fairness in all the circumstances’. 67

One of the three objectives of pooling orders recognised by CASAC was enhancing returns to unsecured creditors. 68 Pooling can mean substantial savings on transaction costs. However, the ability to generate greater resources to insolvent group members is limited because of the manner of defining the companies to be included in the pool. In the NZ legislation the circumstances of being a pooled company include where the activity is carried on in a way that the separate business of each company is not readily identifiable. In contrast, the Australian provision sets out more specific requirements relating to owning or operating property that is used in a joint undertaking.

(b) Denial of access to solvent group company members.

The fact that only companies in liquidation are able to be part of the process suggests that creditors could potentially be disadvantaged where (to the extent that it is commercially possible) assets are available in a solvent company that is part of the group. Division 8 of Pt 5.6 excludes solvent companies. In this respect, CAMAC’s recommendation 41 that ‘solvent group companies should

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63 Section 579E(12)(e).
64 Specifically s 579E(12)(a), (c) and (d).
65 The NZ provision does not include s 579E(12)(e).
66 See s 271(1)(b) of the Companies Act 1993 (NZ). However the application for pooling in New Zealand can be lodged by not only the liquidator, but a creditor or shareholder.
68 CASAC, above n 1, pp 39, 166, 176, 180, 184.
be permitted to enter into an administration with other group companies, where at least one of those companies satisfies the voluntary administration prerequisite. CAMAC considered that in certain circumstances where the affairs of the solvent group company are so intertwined with those of other group companies, then pooling within the voluntary administration may be beneficial. Such circumstances may include where the solvent group company relies on information technology or other logistical or financial support from an insolvent group company. The draft Bill’s Explanatory Memorandum argues that this potential benefit is outweighed by the need to protect the interests of the solvent company’s shareholders. The NZ experience shows that at least some form of provision might be written to enable a contribution order to be made from companies that are part of the group, but not in liquidation and that it need not require fundamental changes to the position of shareholders.

4 Summary

The degree of connectedness required to exist between group companies to be eligible for the award of a court ordered pooling order or liquidator’s pooling determination, mirror the circumstances existing within a controlled and integrated group. In light thereof, the pooling provisions provide the most efficient of the current corporate law creditor protections available to creditors. The disadvantages of such protection are that it is offered ex post. Pooling is available on a discretionary basis only. Thus creditors may still experience difficulty in identifying those group member’s assets, to which they may have recourse for payment of their debt, as the terms of the pooling order or determination are made at the discretion of the court, or liquidator of the group members.

Lastly, pooling is only available against those single enterprise members in liquidation and so may not provide adequate protection where the single enterprise group has misled the creditor into thinking there was a sufficient pool of group assets to meet its liabilities. Thus lifting the corporate veil, entry into deeds of cross guarantee, or the granting of pooling determinations or court ordered pooling, offer somewhat limited protection to creditors in perceiving and correctly pricing the limited recourse risk of transacting with a group member.

B Debtor opportunism protections

Current Australian corporate laws offer both ex ante and ex post creditor protections to reduce the incidence of debtor opportunism. Ex ante protections include: share capital maintenance provisions; s 187 of the Corporations Act;

69 Corporations and Markets Advisory Committee (CAMAC Report), Rehabilitating large and complex enterprises in financial difficulties, 2004, at [6.4.2].
70 Explanatory Memorandum to Pt 4 Facilitating Pooling in External Administration, Corporations Amendment (Insolvency) Bill 2007, p 53.
71 Section 271(a) of the NZ Companies Act 1993, provides a wide discretion to the court to hold a related company liable for the debts of a company being wound up, where there has been involvement with or misconduct of the related company towards the creditors of the company in liquidation.
liability of directors/parent company for insolvent trading. Ex post protections include: liability of directors/parent company for insolvent trading and liquidator’s power to set aside antecedent transactions.

1 Sections 588G, 588V of the Corporations Act

Where excessive risk taking or opportunistic behaviour by the holding company within the group leads to the insolvency of the group member, liability is imposed on the holding company directly under s 588V or as a ‘shadow director’72 under s 588G.73 To some extent s 588V reflects the group’s commercial reality. Economic integration, encompassing administrative, financial or managerial control and supervision by the holding company within the group is a key parameter in determining whether the holding company is held accountable for debts of an insolvent subsidiary.74 Thus s 588G and s 588V provide a minimum threshold standard of conduct from the group’s holding company.75

However, s 588G and s 588V may create an incentive for the holding company to place an insolvent subsidiary into the insolvency regime, either voluntary administration or liquidation, as both sections provide as a defence against liability ‘if the corporation took all reasonable steps to prevent the company from incurring the debt’.76 Such action would be efficient where the particular subsidiary’s assets could be used more effectively in an alternative

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72 Section 9(b) defines a director to include a shadow director, being ‘a person who is not validly appointed as a director if (ii) the directors of the company or body are accustomed to act in accordance with the person’s instructions or wishes’. In Standard Chartered Bank v Antico (1995) 18 ACSR 1, the NSW Supreme Court held that a parent company (42% shareholder) controlled the affairs of its subsidiary to such an extent that it was considered a shadow director.

73 The operation of s 588G and s 588V are dependent upon the degree of control exercised by the holding company over the company’s affairs. Liability arises under s 588G or s 588V when having regard to the holding company’s control it is reasonable to expect that the holding company would be aware of the subsidiary companies insolvency.

74 When determining whether the holding company has subjectively reasonable grounds for suspecting insolvency, or objectively, should have been aware of grounds to suspect insolvency, the court will consider the general control of the subsidiaries’ affairs by the holding company. Such control will be indicated by the corporation’s culture including:
   i) the nature of the relationship between the holding company and subsidiary;
   ii) reporting arrangements between companies;
   iii) the nature of the enterprise carried on by the subsidiary or the parent;
   iv) the extent to which the day-to-day activities are controlled by the subsidiary;
   v) the relevant skill of the company’s directors to perform their expected functions and
   vi) the behaviour of the board in establishing mechanisms for the monitoring and control of both the holding company and of the subsidiary.


75 I Ramsay, ‘Holding Company Liability for the Debts of an Insolvent Subsidiary: A Law and Economics Perspective’ (1994) 17(2) UNSWLJ 520 at 541. Ramsay argues that s 588V is efficient in terms of: providing incentives to individuals and firms to behave efficiently, as the holding company is encouraged to monitor its subsidiaries to ensure that they do not contract with creditors while insolvent; correctly allocating risk among relevant holding company shareholders, or creditors, or the insolvent subsidiary directors or creditors.

76 Sections 588X(5) and 588H(5).
manner. Mokal, however, labels this incentive as the 'haste effect' and identifies the cost from such haste as being the loss of going concern value, where the firm’s assets are more valuable together as an entirety, than if they were split up and sold piecemeal under an insolvency regime.

In Australia, this incentive may prove overly attractive as no cases of s 588V being successfully litigated in Australia since its introduction to date could be found. Although another reason for the lack of successful s 588V claims may be that the subsidiary’s insolvency is indicative of the financial position of the corporate group, such that the holding company likewise is insolvent. In such circumstances, pursuit of a s 588V/s 588G claim against the holding company would be costly and fruitless.

Section 588V imposes liability only upon the holding company as defined by s 46 thus presenting obvious strategies for evasion, such as the establishment of joint ventures to undertake particularly hazardous activities that may result in insolvency . . . which would be outside the scope of s 588V. By failing to impose liability upon each group member, s 588V fails to recognise the corporate group’s operations as a single economic entity and enterprise. Such recognition was made by the Harmer Report which sought a fuller bodied law reform by seeking to impose liability for insolvent trading of a subsidiary on not only the holding company, but on ‘related companies’.

Extension of liability to other group members addresses the

78 A search of corporate law cases on the CCH database over the period of s 588V’s introduction to date was undertaken. It is acknowledged that the link between the level of reported cases and any particular law’s impact is complex and by no means uni-linear. There are concerns whether financing is available for pursuing s 588V or s 588G claims.
79 Such reasoning may account for the liquidators’ contention in Ho v Akai Pty Ltd (in liq) (2006) 24 ACLC 1526; [2006] FCAFC 159; BC200609217. The corporate group had initially sought a corporate rescue. The liquidator argued that a financially sound company, Grande Group Ltd (GGL) a participant in the corporate rescue process was the holding company of the insolvent subsidiary, Akai Pty Ltd (relying on s 46(a) or (b)) and thereby liable under s 588V in relation to a number of vulnerable transactions entered into as part of the corporate rescue. The Full Court, affirming the judge at first instance, found that the GGL was not a holding company of Akai Pty Ltd. The corporate rescue agreement did not extend beyond its declared purpose of managing the actual businesses of the companies concerned. The agreement was not intended to, nor did it give GGL the power to control the composition of the board of Akai Pty Ltd or to control its general meeting.
80 I M Ramsay, ‘Allocating Liability in Corporate Groups: An Australian Perspective’ 13 (1998-1999) Connecticut Jnl of International Law 329 at 375. Ramsay suggested that s 588V’s response to the capital boundary problem would have been stronger, if reliance had been made on the broad definition of control contained in the Accounting Standards, rather than the narrow legal definition of subsidiary contained in the Corporations Act.
81 Proponents may argue that imposing liability on the parent, equates to imposing liability on the group due to the parent’s ultimate ownership of the value of the group. However, such arguments only apply to pyramid-structured corporate groups, rather than decentralised, but controlled and integrated corporate groups.
82 The basis of such liability included: the extent to which the related company took part in the management of the company; the conduct of the related company towards the creditors of the company and the extent to which the circumstances that gave rise to the winding up of the company are attributable to the actions of the related company. The pooling provisions have imposed such liability using very much the same styled tests. See s 579E(e)(2), where a court ordered pooling order is made on just and equitable grounds.
contribution played by such members in the group’s activities of debtor opportunism.

Creditors are unable to instigate recovery of their debt against the holding company where there is a breach of s 588V as s 588W gives power only to the company’s liquidator to recover the debt. 83 However, there may be a further problem where the liquidator is reluctant to pursue the s 588V claim. A liquidator owes fiduciary duties and duties of care to the company and thus is by nature risk adverse. He or she may not pursue a claim under s 588V because of the expense and difficulty in gathering evidence, the real risk of costs, the holding company’s insolvency and the enforcement of the order. 85

Aside from the above criticisms s 588G and s 588V suffer from a disadvantage common to all creditor protections: the timing of their operation which is discussed below.

2 Timing of creditor protections

In real terms current creditor protection laws, impose few restraints on the owners or directors of corporate groups, at either the organisational or operational stage of the group’s existence. Rather current creditor protections arise only when the group members’ existence is threatened, which invariably may be too late to provide adequate protection.

(a) Share capital maintenance

Share capital maintenance provisions 86 do not prevent the initial undercapitalisation of the group’s subsidiaries, nor the subsequent depletion of subsidiary capital, unless through the payment of excessive dividends.

(b) Section 187 of the Corporations Act

Within a wholly-owned group, pursuit of the holding company’s interests (and thereby the group’s economic entity’s interests) at the possible expense of group members’ creditors, will (relying upon s 187) become problematic, only

83 It is argued, that the restriction requiring s 588V claims to be commenced by a liquidator, representing all creditors and not by individual creditors, is to overcome enforcement problems where individual creditors may have insufficient incentive to commence litigation. See Ramsay above n 75, at 532.

84 A liquidator’s duties also include: to take possession of and protect the assets; to make lists of contributories; to have disputed cases adjudicated upon; to realise the assets and to apply the proceeds in due course of administration amongst the creditors and contributories. See in Re Partridge [1961] NSWR 15; [1961] SR (NSW) 622; (1960) 78 WN (NSW) 351.

85 The increase in availability of litigation funders may to some extent reduce the barriers to litigating s 588V.

86 Recognition of the increasing irrelevance of the capital maintenance doctrine, as a creditor protection device, was made apparent by the Australian Government’s recent changes to s 254T by the Corporations Amendment (Corporate Reporting Reform) Act 2010 (Cth). The amendments allow a company to pay dividends other than out of profits if it satisfies three tests:

(i) The company’s assets exceed its liabilities immediately before the dividend is declared and the excess is sufficient for the payment of the dividend;

(ii) The payment of the dividend is fair and reasonable to the company’s shareholders as a whole; and

(iii) The payment of the dividend does not materially prejudice the company’s ability to pay its creditors.
when such actions result in the insolvency of the member, despite the many more opportunities for creditor/shareholder/director conflict to arise within the group.

Two issues arise from the imposition of such limits on the operation of s 187. First, there is the issue of identifying when the shift from the pursuit of corporate group pursuits to maintenance of going-concern status of individual corporate members is made. It would appear the timing of such shift should occur before the corporate group member/s becomes insolvent.

Second, as a means of imposing a minimum threshold standard of conduct on single enterprise group directors, it may be that such protection is provided too late. Conduct by directors which does not result in the insolvency of the group member, but in reality causes harm to the group member, specifically its creditors, goes unchecked as long as such conduct is acting in the interests of the holding company or its shareholders.87

Thus s 187 provides protection to group directors, pursuing group objectives, which may place group member resources at risk and provide little protection to creditors until insolvency is reached.

(c) Antecedent transactions

Certainly, the liquidator’s power to set aside antecedent transactions are more remedy-like than standard setting behaviour and deal with the specific repercussions of insolvent transactions made by the group member/s.

3 Summary: Protection comes too late

Existing protections are deficient, because until insolvency is reached, there is little if any protection to creditors against the dissipation of the member’s resources, although such resources may be at risk, given the corporate group’s pursuit of group maximisation of profit. This deficiency is not met by relying upon statutory or fiduciary duties owing by directors to group members. While the member is solvent, the directors’ duty to the group member is satisfied by considering the interests of its shareholders. Section 187 is consistent with this view. While the wholly owned member is solvent, its directors, if authorised by the company’s constitution, by acting in the best interests of the holding company, satisfy their obligation to the group member. Only when the group member is insolvent is the director to consider the interests of creditors.88 As this duty is owed to the group member, it may only be enforced by the company and not directly by the creditors.89

Paul Davies considers the creditor protections are offered too late. Davies comments, ‘directors’ creditor-regarding duties which bite only when the

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87 Harm to creditors can arise even though the group member is not insolvent. For example, intra-group transactions which re-direct cash from a subsidiary may cause the subsidiary to experience a temporary lack of liquidity. In turn such lack of liquidity may lead to slower payment of creditors, which may have consequential effects to the creditors’ liquidity and ultimate solvency.


89 Sycotex Pty Ltd v Baseler (1994) 51 FCR 425 at 445; 122 ALR 531; 13 ACSR 766; BC9406506, where Gummow J stated there is a duty of imperfect obligation owed to creditors, one which the creditors cannot enforce save to the extent that the company acts on its own motion or through a liquidator.
company is in a state of insolvency are triggered too late in the process of corporate decline.\textsuperscript{90} The timing of this protection is reflective however of the present law’s recognition that directors do not owe a duty directly to creditors. Rather, their duty is owed to the company, which generally is represented by the interests of shareholders unless upon the onset of insolvency when the interests of the creditors have primacy over the interests of shareholders.

Difficulty arises in pinpointing when a group member is insolvent as opposed to the so-called ‘intermediate’ or ‘twilight zone’,\textsuperscript{91} being the period of time when otherwise legitimate transactions take place, immediately preceding the insolvency. Although there are indications that an earlier point in time than a company being insolvent, such as near, or in the vicinity of insolvency,\textsuperscript{92} or doubtful solvency\textsuperscript{93} will give rise to a duty on directors to take into account creditors’ interests. Debell J in \textit{Pascoe v Lucas} stated:

The proposition by Mason J in \textit{Walker v Wimborne} (1976) 137 CLR 1 at 7; 3 ACSR 529 that directors of a company must, in the discharge of their duties, take account of its shareholders and creditors is widely expressed and requires a degree of qualification. Creditors are entitled to consideration if the company is insolvent or near insolvent or of doubtful insolvency or if a contemplated payment or other course of action would jeopardise the solvency of the company.\textsuperscript{94}

Academic argument\textsuperscript{95} supports the view that the duty to consider creditors’ interests should arise ‘where a company’s situation is such that a director can reasonably expect that the action, upon which he or she is going to embark, could lead to the insolvency of the company’.\textsuperscript{96} This viewpoint appears consistent with the wording found in the statutory duties to prevent insolvent trading, under s 588G and s 588V. Regardless, of which trigger point is accepted, determining whether a company is, or is nearing insolvency is not necessarily adjudged easily.\textsuperscript{97}

Temporary illiquidity is not the same as insolvency, even though because of a company’s temporary illiquidity, it is not, in one sense, able to pay all its debts as

\textsuperscript{90} P Davies, ‘Directors’ Creditor-Regarding Duties in Respect of Trading Decisions Taken in the Vicinity of Insolvency’ [2006] 7 European Business Organization L Rev 301 at 313.

\textsuperscript{91} This term was used by T Ciro, ‘The twilight zone revisited: assessing the enforceability of pre liquidation transactions in a corporate group insolvency’ (2005) 20(1) Int'l of International Banking Law and Regulation 590 at 590.


\textsuperscript{94} (1998) 27 ACSR 737 at 769; (1998) 16 ACLC 1247; BC9801454.

\textsuperscript{95} A Keay, ‘The Director’s Duty to Take into Account the Interests of Company Creditors: When is it Triggered?’ (2001) 25 MULR 315 at 334–8.


\textsuperscript{97} In \textit{ASIC v Plymin (No 1)} (2003) 46 ACSR 126; 21 ACLC 700; [2003] VSC 123, Mandie J listed 14 indica of insolvency, although in any particular case, only certain factors may have particular significance and the absence of one or more of those factors does not of itself establish solvency.
they become due and payable. The question is whether it would be able to pay all its debts as they became due and payable by appropriately deploying its assets or taking other steps open to it.98

Although a definition of insolvency is provided in s 95A, its application presents difficulties. A truly accurate determination of when a company ceases to be solvent can necessarily only be made in hindsight.99 It is possible that membership of the corporate group may make the determination of insolvency even more complex, as each member may look to other group members for financial support.100

It has been considered that this uncertainty allows the holding company and its directors the benefit of the doubt regarding their responsibilities to creditors and gives the holding company and its directors some latitude in choosing whether to try to trade out of a perceived temporary liquidity problem, or to place the group member into voluntary administration.101 While this latitude may be laudable, as it is in creditors’ interests for a business to be saved if possible through corporate reorganisation, anecdotal evidence102 suggests that the severity of s 588G liability on directors and hence s 588V liability on a holding company, makes them reluctant to take on restructuring responsibilities.

This may result in wrongful allocation of risk borne by creditors, as directors are motivated to act inefficiently as:

financially viable companies [are] put into insolvency, with the adverse consequences [which] ultimately disadvantage creditors, who may have been paid a higher return (or possibly full repayment) if the company were given a chance to effectively restructure itself and return to profitability.103

Current creditor protections to reduce the incidence of debtor opportunism within groups are inefficient in that their operation is stymied until the respective group member with whom the creditor contracted is insolvent or nears insolvency. Thus, the existing protections are more concerned with dealing with the repercussions of such debtor opportunism, than attempting to prevent its instigation.

To prevent the initiation of conflicts of interest within the group, ex ante

100 Such complexity arose in the case of Lewis (as liq of Doran Constructions Pty Ltd) v Doran (2005) 219 ALR 555; 54 ACSR 410; [2005] NSWCA 243; BC200506071. The Court of Appeal in dismissing the appeal recognised, as did the judge at first instance Palmer J, that the determination of insolvency under s 95A had to be ascertained from a consideration of the company’s financial position taken as a whole. In doing so the court must have regard to commercial realities (referring to Southern Cross Interiors Pty Ltd (in liq) v Deputy Commissioner of Taxation (2001) 53 NSWLR 213 at 224; 188 ALR 114; [2001] NSWSC 621; BC200105105. The commercial reality was that Constructions was solvent . . . as the company had available as a resource to pay its debts the voluntary extension of credit by another company. Holdings had acted and continued to act as banker to the Doran Group.
102 Ibid.
103 Ibid.
protection may be warranted. The adoption of enterprise liability for corporate
groups may provide such ex ante protection.

V Enterprise liability

Currently, Australian corporate law is predicated on the entity approach.\textsuperscript{104} The antithesis of the above entity approach is the enterprise approach. Within Australia, the majority of laws regulating corporate groups are reflective of, or
premised upon the entity approach.\textsuperscript{105} This deficiency is evident in the failure
of the Corporations Act to define a corporate group in s 9 (the ‘definitions’
section),\textsuperscript{106} leaving it to case law to establish corporate group existence.\textsuperscript{107} Nor
does the Corporations Act demarcate a corporate group’s regulatory
framework from other corporate structures.\textsuperscript{108} Concentration by the
Corporations Act on the entity approach in regulating the operations of closely
controlled and integrated corporate groups may create additional conflicts of
interest unique to such groups.

\textsuperscript{104} The two differing approaches to corporate regulation have been well documented by Phillip
Blumberg in the United States. See P I Blumberg, \textit{The Multinational Challenge to
Corporation Law: The Search for a New Corporate Personality}, Oxford University Press,
Liability in Corporate Groups: An Australian Perspective’ Spring (1999) 13(2)
Connecticut Jnl of International Law 329.

\textsuperscript{105} However, the enterprise approach is adopted where it appears to accomplish more effectively
the underlying policies and objectives of the law than does continued reliance on traditional
entity law doctrines. See P I Blumberg, \textit{The Multinational Challenge to Corporation Law:
The Search for a New Corporate Personality}, Oxford University Press, New York, 1993,
p ix. Some recognition of the economic entity is given, but only in specific provisions of
selected legislation. See D Prentice, ‘Some Comments on the Law of Groups’ in J McCahery, S Piccotto and C Scott (Eds), \textit{Corporate Control and Accountability}, 1st ed,
Clarendon Press, Gloucestershire, 1992, p 371, where Prentice argues that the fragmentation
of laws relating to group issues is beneficial on the grounds that once rules relating to
particular issues such as consolidation of accounts for financial disclosure, taxation,
directors dealings within the context of groups, minority shareholder oppression, and
insolvency are formulated, there will be little left to be mopped up by a law, which
specifically addresses the problems of groups.

\textsuperscript{106} Section 50 of the Corporations Act does recognise holding and subsidiary companies as
defined in s 46 of the Corporations Act as being related bodies corporate. A public
company’s related parties are defined in s 228 of the Corporations Act based on their
‘control’ of the public company. Section 50AA of the Corporations Act determines when a
first entity controls a second entity, based on the capacity of the first entity to determine the
outcome of the second entity’s decisions regarding financial and operating policies.

\textsuperscript{107} Walker v Wimborne (1976) 137 CLR 1; 50 ALJR 446; (1976) 3 ACLR 529 at 532;
(1975–76) CLC 40-251, where Mason J held the word group is generally applied to a
number of companies which are associated by common or interlocking shareholdings, allied
to unified control or capacity to control.

\textsuperscript{108} There is some recognition of the economic entity but only in specific provisions of selected
legislation such as the Consolidation Regime of the Income Tax Assessment Act 1936 (Cth),
which allows a wholly-owned group of resident entities to be treated as a ‘single entity’ for
income tax purposes; Div 8 of Ch 5 of the Corporations Act which allows for the pooling of
assets in a group company liquidation; and the financial disclosure requirements for
consolidated accounts required by s 295(2)(b) of the Corporations Act, which are financial
statements of a group (parent and subsidiaries) presented as those of a single economic
entity. For a discussion of the pooling provisions see J Dickfos, ‘Improving outcomes for
creditors: balancing efficiency with creditor protections’ [2008] Insolvency LJ 84;
C Anderson and D Morrison, ‘The Insolvency Implications for Corporate Groups in
Australia — recent events and initiatives’ (2007) 16 International Insolvency Review 103.
Coupled with single entity status is the limited liability of each single enterprise member. Although limited liability is credited with facilitating enterprise, the market-related reasons for limited liability are largely absent within closely controlled and integrated corporate groups. Such reasons are couched in terms of large public companies, with many and varied passive investors holding diversified portfolios that do not participate in management. These circumstances do not exist within closely controlled and integrated groups, where the parent company and its subsidiaries actively engage in the business enterprise. Further, limited liability may result in the corporate group making ‘morally hazardous’ investments, as limited liability shifts the risk of failure from shareholders to creditors.

Blumberg considers limited liability for corporate groups to be an ‘historical accident’, resulting from limited liability and legal entity status pre-dating the emergence of corporate groups. Blumberg is not alone in questioning the ‘validity and legitimacy of the original regulatory framework’, in particular the traditional liability regime to corporate groups.

A Addressing criticisms of CASAC’s enterprise approach

The adoption of enterprise liability would address two concerns, previously listed as possible reasons for the failure to implement CASAC’s Corporate Groups Final Report, Recommendation 2.

1 Drafting new legislation

First, adopting enterprise liability for controlled and integrated corporate groups, rather than treating the consolidated corporate group as one legal structure would mean substantially less drafting of new legislation.

Enterprise liability may be imposed by making limited changes to the present Corporations Act. As each group member company would still retain its legal entity status under the Corporations Act, substantive reform would not be required. For example, registration of group company members would need to comply with the existing company registration requirements found in Ch 2A of the Corporations Act. However, s 112(1) would be amended to include an additional registration requirement for those companies who are

109 Easterbrook and Fischel above n 23, pp 44–7, by reducing the firm’s cost of capital.
110 F H Easterbrook and D R Fischel, ‘Limited Liability and the Corporation’ (1985) 2 University of Chicago L Rev 89 at 111. Morally hazardous investments are those investments whose risk level is so high that they are undertaken by the member of the corporate group only because the cost of such risk is transferred to the creditors of the corporate group member.
113 The third possible reason for non-implementation of CASAC’s Recommendation 2 is not addressed by this article, as the article’s analysis is restricted to protection of voluntary unsecured creditors not tort creditors.
114 CASAC, above n 1, Recommendation 2.
115 See earlier Pt III of this article.
members of a controlled and integrated group. Membership would require registration under the Act as a ‘single enterprise group member’ whose liability would be ‘joint and several for the debts of its single enterprise group members’. Amendments to s 9 would include definitions of a ‘single enterprise group’ and ‘single enterprise group member’.

On registration as a single enterprise group member, as well as the imposition of enterprise liability, various regulations would automatically apply, including disclosure mandates, and the protection of any minority shareholders of the single enterprise group members. Where minority interest shareholders of group members exist, they may exercise buy-out rights. If such minority interests are retained in the group member, their liability remains limited.

Where membership of the single enterprise group ceases, or an existing company joins a single enterprise group, then the company’s status would be altered, by complying with the provisions under Pt 2B.7. Amendments to ss 163 and 164, would ensure that a company leaving the group, would retain residual joint and several liability for the debts of the group incurred while a member, unless otherwise agreed. Similarly, a company would only be jointly and severally liable for debts incurred after obtaining membership of the group, unless otherwise agreed.

116 A ‘single enterprise group’ would be defined as one or more companies which are controlled by one or more companies for the purposes of operating parts of the same business. Factors providing evidence of the same business operations are:

1. Shared or intermingled resources such as premises, equipment, facilities, management, accounting services, employees or corporate brand name so as to present a unified enterprise to the public;
2. Financial relationships or dependencies such as common banking relationships, the existence of intra-company loans, cross-guarantees, cross-securities, and mortgages;
3. Substantive trade between companies, the existence of common suppliers, or trade/agency agreements; purchases of one company constitute a large proportion of the sales of another company;
4. Common Customers; customers of one company automatically become customers of other companies; companies provide complementary services; companies add value to the goods/services provided by other companies.

117 A ‘single enterprise group member company’ would be defined in s 9 of the Corporations Act as: ‘a company registered under s 117 Corporations Act, who is a member of a single enterprise group’. ‘Member’ is defined as: ‘a company under control of, or a company which controls, another company for the purposes of conducting a single enterprise’. ‘Control’ is to be defined as per s 50AA(1) and (2) of the Corporations Act.

118 ‘The best protection for minority shareholders in a subsidiary within an integrated corporate group, however, would be a general right to require the holding company to buy them out at a fair price. This principle has been adopted in the context of take-over bids in most jurisdictions. There is no reason in principle why it should not be extended on a more general basis’. Hadden, above n 32, at 77.

119 Such minority interest investors, fall outside the criteria of a single enterprise group member, and do not directly participate in the synergistic benefits derived from the single enterprise group’s operations. Imposing unlimited liability onto such shareholders: will not deter debtor opportunism within the single enterprise group, nor would it address the misrepresenting of limited recourse risk by the single enterprise group (an analogy could be drawn between the limited liability of these minority interests and the limited liability for passive investors in partnerships). The single enterprise group member performs a different economic or functional role to the minority interest investor shareholder, and the justifications for limited liability for the latter, do not apply to the former.
2 Mandatory registration by ASIC

ASIC would have the power to require a company to seek registration as a single enterprise group member, where it is satisfied on the balance of probabilities that there is sufficient evidence of a single enterprise group in existence, of which the company is a member. Alternatively, a company may seek such registration on its own volition. Where a company objects to registration as a single enterprise group member, then it may apply to the court to show that there is insufficient evidence of its participation in the group’s shared business operations to warrant registration. Mandatory registration as a ‘single enterprise group member’ avoids the difficulties of granting substantial and attractive incentives to corporate groups to opt in to enterprise liability.

B Prevention of limited resource risk misrepresentation

The creditor’s misperception of the limited recourse risk of contracting with the group member germinates from a lack of information regarding the company member’s boundary. The adoption of enterprise liability for corporate group members would address the creditor’s information deficiency in two ways.

First, enterprise liability means each group member is jointly and severally liable for the debts of its remaining group members, subject to any contrary agreement. Enterprise liability reflects those creditors’ expectations, who, through reliance on corporate group branding and accompanying use of the common name for corporate subsidiaries, have been led to believe they are doing business with the group as a whole and can rely on the overall group’s credit-worthiness.¹²¹

Second, all group members should be required to disclose on all public documents and on the ASIC database, that they are members of that corporate group. Such disclosure is a matter of public record. The mandatory public disclosure of the members of the group and foregoing the preparation of consolidated financial statements¹²² in lieu of alternative means of reporting the group’s solvency may be an efficient means of eliminating this information deficiency.

The adoption of enterprise liability would mean, rather than the solvency of the particular group member, the solvency of the group would be of paramount importance in the creditor’s assessment of limited recourse risk.

¹²⁰ See earlier discussion in Pt II, as to the possible reasons for failure to implement CASAC’s Recommendation 2.
¹²¹ Those creditors without such misperception when contracting may be said to obtain a windfall gain from the imposition of joint and several liability among the group’s members.
¹²² F Clarke and G Dean, Indecent Disclosure Gilding the Corporate Lily, 1st ed, Cambridge University Press, Sydney, 2007, pp 195, 197. Current criticism levelled at such consolidated statements is based on the group’s economic entity not being the legal entity, and the consolidated totals of assets and liabilities of the group being a mishmash of differently derived values. Clarke and Dean question the notion of determining group solvency from a perusal of such financial statements.

Instead, Clarke and Dean proscribe wholly owned subsidiaries with recourse to branch operations and branch accounting; disaggregation of consolidated financial statements and market pricing for corporate groups as alternatives to the preparation of consolidated financial statements.
Such solvency would be dependent upon those assets and liabilities externally generated by the group members, such that all unsecured intra-group transactions, would be subordinated, effectively preventing the group member overstating or understating its debt servicing capabilities.

The disadvantages of relying upon the existing pooling provisions, discussed in Pt IV are overcome, as the protection provided to creditors by enterprise liability is offered ex ante. Creditors, at the time of contracting with the group members, are aware of the members’ joint and several liability. Assessment by creditors of the limited recourse risk is made, specifically identifying those group member’s assets to which they may have recourse, regardless of whether such member is solvent, insolvent or approaching insolvency. Thus possibly identifying at an earlier stage where the single enterprise group has an insufficient pool of assets to meet the liabilities of its members.

Possible savings in regulatory costs may also follow from the adoption of enterprise liability. The subordination of intra-group liability would ensure that the analysis of cascading demands evident in _Bell Resources_ would be unnecessary, as insolvency of the enterprise would be determined only by consideration of debtors and creditors extraneous to the enterprise.

C Elimination of debtor opportunism within the group

Part IV of the article identified that current creditor protections impose few restraints on the owners or directors of groups, at either the organisational or operational stage of the group’s existence. The existing protections are more concerned with dealing with the repercussions of such debtor opportunism, than attempting to prevent its instigation. Certainly, the current protections against fraudulent phoenix activity within groups are illustrative of ex post protections which ‘provide little incentive not to phoenix and remedial action is conducted on a case by case basis, well after the damage has been done’._123_

The adoption of enterprise liability within single enterprise groups would be an ex ante protection against such phoenix activity, as entities within the group would be jointly and severally liable for the payroll obligations, and direct and indirect tax obligations for another member of the group. Further, depending upon group membership, liability may extend to ‘the risen company’._124_

The use of a similar grouping provision in Commonwealth legislation was suggested by the Cole Royal Commission as a means of addressing fraudulent phoenix activity._125_

The adoption of enterprise liability, where creditors have a direct claim against the remaining members of the group, may be a more effective deterrent for directors or shareholders of a group to establish undercapitalised subsidiaries, as well as create an incentive for earlier identification of detrimental transactions. Where the group is operated and managed as one

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_124_ Ibid, p 3. The risen company is the entity which becomes active once the first entity has transferred all workers into it, and/or the first entity has gone into liquidation.

_125_ Ibid, p 16. In 2003, the Cole Royal Commission considered the prevalence and problems of fraudulent phoenix activity in the building and construction industry, often associated with tax avoidance and the avoidance or underpayment of workers’ compensation premiums.
economic entity, enterprise liability: reallocates risk, forcing the group’s members to internalise such risks of operating as one enterprise; reducing the likelihood of excessive risk taking occurring, by limiting the opportunities to exploit the sub-incorporation of the economic entity. Enterprise liability removes the moral hazard associated with limited liability, by making all group members accountable, at the time of their joint and unified action. The imposition of joint and several liability on the members of the group, reduces the opportunities for ex post creditor expropriation, thereby allowing enterprise members to bond to creditors’ interests. The imposition of enterprise liability has a deterring effect. By making group members jointly and severally liable, intra-group transfers or financing arrangements to shift assets away from the reach of creditors are pointless.

The recognition of enterprise liability, with an accompanying obligation upon member company directors (whether such member companies are solvent or insolvent, wholly or partly owned) to act in the best interests of the enterprise, may well mean earlier intervention by directors or creditors in identifying when enterprise members approach insolvency or are insolvent. The proviso being that the action of directors in exercising the power should not materially prejudice the ability of enterprise members to pay creditors.

Relying upon procedures, which exist under the current Corporations Act, creditors would have the right to seek an injunction to prevent the pursuit of enterprise goals, where such pursuit materially prejudices the interests of enterprise members’ creditors.

Identifying controlled and integrated groups as ‘single enterprise groups’ and legally obligating directors to act in the best interests of such enterprises, would reduce the number of potential conflicts of interest, as the disconnect between the corporate structure and the management of the economic enterprise is reduced.

VII Practical implications of enterprise liability adoption

The lack of empirical evidence, supporting either limited liability or unlimited liability, in terms of voluntary creditors has been previously recognised:

Because liability systems within societies tend to be unitary, empirical work has generally been difficult to undertake. There are a few examples of parallel systems

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127 Based on Recommendation 3 of CASAC Final Report on Corporate Groups and existing s 256B of the Corporations Act.

128 Section 1324 (1) and (1A) of the Corporations Act grants a creditor, or a member of a company, the right to apply to the court for an injunction to prevent the company contravening the Corporations Act, where the creditor or member, are persons whose interests are affected by a company’s contravening conduct.

of limited and unlimited liability, but the evidence on the effects of limited liability (and therefore unlimited liability) remains extremely limited.  

Ultimately, the article can only canvass the theoretical economic arguments of the efficiency of enterprise liability over limited liability for corporate groups.

**A Effect on monitoring costs**

According to orthodox economic theory, it does not matter, in the absence of transaction costs, if the default rule is one of limited or unlimited liability as the parties will bargain to the efficient result.

**1 Creditor monitoring costs**

However, the choice of liability regime impacts on the magnitude of creditors’ information costs, otherwise known as ‘monitoring, enforcement and surveillance costs’. Under enterprise liability, the risk to the creditor depends upon the member’s earning power and the ability of the remaining members to pay any unsatisfied claims and bankruptcy costs. The remaining members' net assets provide part of the collateral for the credit extended. Creditors, wanting to ensure that this collateral is maintained, will face increased costs of surveillance with regard to the activities of the group members. The monitoring costs of creditors would increase. On contracting, and throughout the duration of the debt, the creditors would need to monitor, not only the net assets of the contracting single enterprise member, but the net assets of all the single enterprise members. Ultimately creditors would, where possible, pass these costs on to the group in the form of increased borrowing costs charged to members. David Goddard identifies such increased monitoring costs as a potential competitive disadvantage suffered by corporate groups over single companies. However, he fails to identify a compensating decrease in risk enjoyed by creditors of the group.

Off-setting such increased monitoring costs, is the reduction in the likelihood of debtor opportunistic activity. The imposition of enterprise liability creates a ‘system of mutual surveillance’ in which group members monitor the level of debt within the group, thus bonding with creditor interests and diminishing the need for monitoring by creditors. The adoption of enterprise liability creates an inverse relationship of potentially higher creditor

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131 According to orthodox economic theory, in the absence of transaction costs the initial choice between alternative default rules has no effect on the terms of the agreement reached by the parties. They will bargain to the efficient result in either case and that result will be the same regardless of the initial default rule. See R Coase, ‘The Problem of Social Cost’ [1960] 3 Jnl of Law & Economics 1 and R Meiners et al, ‘Piercing the Veil of Limited Liability’ [1979] 4 Delaware Jnl of Corporate Law 351, for applying this argument to limited liability.
monitoring costs and decreased likelihood of debtor opportunism. A reduction in the likelihood of debtor opportunism would be reflected in reduced corporate borrowing costs. Whether the costs counterbalance, such that the cost of raising debt under limited and enterprise liability is unaltered, is an empirical question. Indeed, in 1931, when California adopted limited liability in lieu of pro-rata unlimited liability, the change was vigorously opposed by trade creditors who applying conventional economic theory, might have otherwise benefitted from the saving in monitoring costs.

2 Shareholder monitoring costs

This article is not advocating a blanket abolition of corporate limited liability. Only the members of controlled and integrated corporate groups would share joint and several liability for the debts of each group member. Unlimited liability extends neither to the individual shareholders, nor to corporate shareholders of such members, unless they too, form part of the controlled and integrated enterprise. To that end, passive shareholder’s monitoring costs are considered not likely to increase. Monitoring group members is considered less costly than monitoring individual shareholder wealth, given modern financial reporting techniques. Likewise, the significant costs associated with administering a regime in which company liability is unlimited would not apply to imposing enterprise liability on such corporate groups. As group membership is a matter of public record there would be no need for complicated liability tracing mechanisms.

135 M I Weinsein, ‘Limited Liability in California: 1928–1931’ [2001] University of Southern California Law School, Online Research Paper No 00-17, p 41, at <http://papers.ssrn.com/paper.taf?abstract id=244333>. Citing as evidence, minutes from a meeting of the State Bar Committee on Revision of the Corporation Laws (whose function was to draft the revised corporate code): The San Francisco Association of Credit Men is at present in favour of the unlimited stockholders’ liability in connection with extending credit to corporations. While some in favour of the change argued that the existing regime of unlimited liability reduced the supply of equity capital.

136 S Blankenburg, D Plesch and F Wilkinson, ‘Limited liability and the modern corporation in theory and in practice’ [2010] 34 Cambridge Jnl of Economics 821 at 829. Contributors to the special issue on limited liability and the modern corporation made clear that calls for a blanket abolition of corporate limited liability and a return to the full liability norm of early nineteenth century partnerships were as a-historically blind and counter-productive, both politically, as well as economically, as the insistence of mainstream corporate theory on the ‘bedrock’ nature of corporate limited liability.

137 Carney, above n 130. It has long been argued that joint and several unlimited liability would discourage wealth investors from investing in risky enterprises, particularly when they intended to play a passive role, where they could not monitor and supervise the firm’s risky activities.

138 L T Evans and N C Quigley, ‘Shareholder Liability Regimes, Principal-Agent Relationship and Banking Industry Performance’ (1995) 38 Jnl of Law and Economics 497. Corporate level information systems such as BPI (Business Process Integration); ERP (Enterprise Resource Planning); SCM (Supply Chain Management); CRM (Customer Relationship Management) are designed to ensure an efficient, effective and integrated information flow within large business organisations. See also A Huang, D C Yin, D C Chou and Y Xu, ‘Corporate Applications Integration: Challenges, Opportunities and Implementation Strategies’ [Spring 2003] Jnl of Business Management 137.

139 Goddard, above n 133, at 24. The author suggests the need for a mechanism for identifying which shareholders bore liability for particular events and the practical difficulty in tracing shareholders, at the time of a wrongful act or series of acts, would be significant.
B Effect on enterprise and investment

Although the majority of economic justifications for limited liability do not apply within the single enterprise group, the greatest hurdle to overcome is the effect on investment in the group from the adoption of enterprise liability.

1 Increase in cost of equity financing

In Australia, the cost of capital for group members may rise due to: pressure to adopt risk-adverse investment strategies, as costs previously incurred by creditors, are now borne by group members and the increase in transaction costs, as group members contract around joint liability.

2 Decline in the value of the single enterprise group

In either case, the cost of capital for the group may rise, leading to the rejection of marginal investment projects, whose rate of return is less than the group’s cost of capital. Rejection of such marginal investment projects, in turn, may lead to smaller returns on investment by group members, which may result in a decline in the market value of the group members’ shares. This factor previously influenced the rejection of an enterprise approach in Australia.

The effect enterprise liability would have on the investment economy is ultimately an empirical question. Some support can be gained from a study undertaken of the change from pro-rata unlimited to limited liability in California in 1931. The study indicated there was no evidence that adopting limited liability led to any significant change in corporate activity, and no detectable increase in shareholder wealth. Germany provides the only substantial empirical evidence of a version of enterprise liability operating today. However, the circumstances of its adoption are unique to Germany and its continued use has, it is postulated, continued the preference in Germany to

140 R Thompson, ‘Piercing the Corporate Veil: An Empirical Study’ (1991) 76 Cornell L Rev 136 at 171. See also J Antunes, Liability of Corporate Groups: Autonomy and Control in Parent-subsidiary Relationships in US, German and EU Law, 1st ed, Kluwer, USA, 1994, where the author argues that the justifications for limited liability for investor shareholders, simply don’t fit the economic reality of parent companies as shareholders.

141 See Pt II for the failure of the CASAC Corporate Group Final Report recommendations. In Germany, which boasts an enterprise approach to corporate group regulation, such influence is not as great. Rather, there exists a preference for bank financing, rather than a reliance on equity funding. ‘Deutsche Telekom stock’, The German Way & More, at <http://www.german-way.com/>.

142 M Dearborn, ‘Enterprise Liability: Reviewing and Revitalizing Liability for Corporate Groups (2009) 97 California L Rev 256. Economists argue that limited liability is indispensable to the functioning of an efficient capital market. They maintain that limited liability facilitates business organisation, promotes investment in capital, reduces the investor’s need to monitor investments, makes it feasible to invest in multiple business ventures and generally contains administrative costs associated with investments.

143 Weinstein, above n 135.

144 Ibid. The study’s limitations are noted by the author: it examines only one US state at one particular point in time; limitations on the pro-rata limited liability in California may have already served to insulate shareholders from the worst possible outcomes; shareholders were only liable for debts for a period of three years after they were incurred, and there was no instance of creditors ever being able to collect from the shareholders of a publicly traded corporation.
rely upon bank financing, rather than equity financing.

VII Conclusion

Certainly, the operation of the ‘endowment effect’ makes changing basic liability rules and the adoption of enterprise liability unlikely.\(^{145}\) However, the adoption of enterprise liability within controlled and fully integrated groups may be a more efficient response to the problems of misrepresenting the limited recourse risk of such group members, as well as debtor opportunism arising within such groups. Commentators defining good corporate law argue that a key ingredient is the continuous evolution of law. Such commentators believe that:

successful legal systems encourage and facilitate this adaption process of corporations and then respond to changed circumstances.\(^{146}\)

Commentators\(^{147}\) on the debate between limited and unlimited liability, while considering a limited liability regime, as a general rule, to be the most efficient regime for large, widely held companies, consider that an unlimited liability regime would be a more efficient regime for small, closely held companies. The distinction is based on economic factors. The benefits of limited liability such as, reduction of monitoring costs and facilitating efficient risk bearing and monitoring by the capital market, are absent for closely held corporations.\(^{148}\) Co-existent with the lack of benefits is the greater likelihood of moral hazard, created by limited liability within closely held companies.\(^{149}\)

Part III of this article has illustrated that there is a greater likelihood of moral hazard created by limited liability within closely controlled and integrated groups. Given the market-related benefits of limited liability do not apply to closely controlled and integrated groups, then, like small, closely held companies, enterprise liability may be a more efficient response to the problems of misrepresenting the limited recourse risk of contracting with such groups or debtor opportunism arising within such groups.


The endowment effect has been documented by numerous experiments, which demonstrate that people tend to demand more money, if they are selling a piece of property or other entitlement, than they would be willing to pay for the same item outright, if they did not already own it. Although experiments have focused primarily on a subjects' valuation of property rights or other legal entitlements, experimental evidence indicates that the endowment effect is at work in the valuation of contractual default rules as well as property rights. See D Kahneman, J L Knechtsch and R Thaler, ‘Experimental Tests of the Endowment Effect and the Coase Theorem’ (1990) 98 Jnl of Political Economy 1325 and R Korobikin, ‘The Status Quo Bias and Contract Default rules’ (1997–1998) 83 Cornell L Rev 608 at 631.


\(^{147}\) Halpern et al, above n 132, at 130.

\(^{148}\) Easterbrook and Fischel, above n 23, at 110.

\(^{149}\) Ibid.