# Enterprise liability for corporate groups - a more efficient outcome for creditors: Part 2


## Author

Dickfos, Jennifer



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# Enterprise liability for corporate groups — a more efficient outcome for creditors: Part II[1]

By Jennifer Dickfos, Lecturer, Griffith Business School, Griffith University

- Current creditor protection laws impose few restraints on owners or directors of single enterprise groups
- The adoption of enterprise liability for corporate groups may provide ex ante protection to creditors but at the expense of greater monitoring costs imposed on creditors
- Enterprise liability approach may raise cost of capital for the single enterprise group, leading to the rejection of marginal investment projects and, in turn, reduce returns on investment by group members

**The first half of this article considered how the actions of directors seeking to serve the interests of parent company shareholders may result in losses to creditors of corporate group members. In this second half, current creditor protections are compared to the adoption of enterprise liability as a means of efficiently limiting such debtor opportunism.**

## Current creditor protections to address limited recourse risk and debtor opportunism risk

The protection afforded by company law to creditors may be provided 'ex ante' or 'ex post'.

### 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, and pooling of assets and liabilities of group members on liquidation).

Deeds of cross-guarantee create an incentive for deed members to monitor each other, so as to ensure that the closed group maintains an acceptable level of limited recourse risk. Deeds of cross-guarantee reduce the risk borne by risk averse subsidiary companies and their creditors, by shifting some level of risk to the remaining solvent deed members and their creditors. 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.[2]

In *Pioneer Concrete Services Ltd v Yelnah Pty Ltd* (1986) 11 ACLR 108[3] Young J observed two instances where the separate legal personality of a company is to be disregarded in the context of a corporate group. These were where the court considers there is in fact or in law:

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

Emphasis on the entity principle prevents recognition[4] of the group's integration as evidence of the existence of a partnership between members. Thus, the certainty of Young J'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 corporate group.[5] 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, who have been misled as to the group member's corporate boundary.

Division 8 of Pt 5.6 of the *Corporations Act 2001* provides 'ex post' protection of creditors by two separate methods of pooling, voluntary and court ordered. The pooling provisions are the most efficient of the current corporate law creditor protections. Several consequences flow from the pooling provisions only being available on liquidation: the protection of creditors is paramount; returns to creditors are enhanced by the savings in transaction costs; but effectively there are no contribution orders made. Recourse to other group members is available on a restricted basis, due to the limited manner of defining the eligibility of companies to be included in the pool.

The disadvantages of such protection are that it is offered ex post, and is only available on a discretionary basis. Thus, creditors may still experience difficulty in identifying, at the time of contracting, those group member's assets, to which they may have recourse for payment of their debt.

### Debtor opportunism protections

Current Australian corporate laws offer both ex ante and ex post creditor protections to reduce the incidence of debtor opportunism.

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' under s 588G. Sections 588G and 588V provide a minimum threshold standard of conduct from the group's holding company.[6] However, s 588V imposes liability only upon the holding company. 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[7] and the contribution played by the other group members in the group's activities of debtor opportunism.

Creditors are unable to instigate recovery of their debts 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 a debt. Further complications may arise, where the liquidator is reluctant to pursue the s 588V claim. Such reluctance may be due to the expense and difficulty in gathering evidence, the real risk of incurring costs, the holding company's insolvency and the enforcement of the order.[8]

Aside from the above criticisms, ss 588G and s 588V suffer from a disadvantage common to many creditor protections, the timing of their operation. Section 588V 'does not capture any of the prior transactions taking place while the subsidiary was solvent, which may have nevertheless contributed to its later insolvency'.[9]

In real terms, current creditor protection laws[10], impose few restraints on the owners or directors of single enterprise groups, at either the organisational or operational stage, of the group's existence. Rather, current creditor protections arise only when the single enterprise members' existence is threatened, which invariably may be too late to provide adequate protection.

Because the operation of existing creditor protections is stymied, until the respective single enterprise member, with whom the creditor contracted, is insolvent or nears insolvency, existing protections are more concerned with dealing with the repercussions of such debtor opportunism, than attempting to prevent its instigation.

To prevent potentially damaging conflicts of interest within the group, ex ante protection may be warranted. The adoption of enterprise liability for corporate groups may provide such ex ante protection.

## Enterprise liability

### Addressing criticisms of CASAC's enterprise approach

The adoption of enterprise liability would address two possible reasons for the failure to implement Recommendation 2 of the Companies and Securities Advisory Committee's (CASAC's) *Corporate Groups Final Report 2000*.

#### *Drafting new legislation*

Enterprise liability may be imposed by making limited changes to the present Corporations Act. As each single enterprise member would still retain its legal entity status under the Corporations Act, substantive reform would not be required.

#### *Mandatory registration by ASIC*

Mandatory registration with the Australian Securities & Investments Commission (ASIC) as a 'single enterprise group member' avoids the difficulties of granting substantial and attractive incentives to corporate groups to opt in to enterprise liability.

Where a company objects to registration as a single enterprise group member, it may apply to a court to show that there is insufficient evidence of its participation in the group's shared business operations to warrant registration.

### Prevention of limited recourse risk misrepresentation and lessening of debtor opportunism

The creditor's misperception of the limited recourse risk of contracting with the single enterprise member stems from a lack of information regarding the member's boundary. The adoption of enterprise liability for single enterprise members would address the creditor's information deficiency in two ways.

First, enterprise liability means each single enterprise member is jointly and severally liable for the debts of its remaining 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 single enterprise members, have been led to believe they are doing business with the group as a whole and can rely on the overall group's creditworthiness.

Second, all single enterprise members would be required to disclose on all public documents and on the ASIC database that they are members of that single enterprise group. The mandatory public disclosure of the members of the group and foregoing the preparation of consolidated financial statements,[11] in lieu of alternative means of reporting the group's solvency, may be an efficient means of eliminating this information deficiency.

The disadvantage of relying on existing pooling provisions is overcome as the protection is offered ex ante. Creditors, at the time of contracting, are aware of the members' joint and several liability. Creditors can specifically identify those single enterprise members' assets to which they may have recourse, regardless of whether such a 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.

The adoption of enterprise liability may also be a more effective deterrent for directors or shareholders of a single enterprise group to establish undercapitalised subsidiaries, as well as create an incentive for earlier identification of detrimental transactions.

Further, identifying 'single enterprise groups' and legally obligating directors to act in the best interests of such enterprises would relieve directors of the potential risk of conflicts of interest, as the disconnect between the corporate structure and the management of the economic enterprise is reduced.

## Advantages and disadvantages of enterprise liability

### Effect on monitoring costs

*Creditor monitoring costs*

Monitoring costs of creditors would increase. On contracting, and throughout the duration of the debt, creditors would need to monitor, not only the net assets of the contracting member, but the net assets of all the single enterprise members. Ultimately creditors would, where possible, pass these costs onto the group, in the form of increased borrowing costs charged to members.

Offsetting such increased monitoring costs, is the lessened likelihood of debtor opportunism. The imposition of enterprise liability creates a 'system of mutual surveillance,' in which single enterprise members monitor the level of debt within the group, thus bonding with creditor interests and diminishing the need for monitoring by creditors. 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.

*Shareholder monitoring costs*

As unlimited liability does not extend to individual shareholders, or to corporate shareholders of single enterprise members (unless they too form part of the controlled and integrated enterprise) shareholders' monitoring costs are 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 where company liability is unlimited would not apply to imposing enterprise liability on such single enterprise groups. As group membership is a matter of public record, complicated liability tracing mechanisms would not be needed.

### Effect on enterprise and investment

The cost of capital for single enterprise members may rise due to:

- pressure to adopt risk averse investment strategies, as costs previously incurred by creditors are now borne by single enterprise members or
- increasing transaction costs, as group members contract around joint liability.

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

## Conclusion

This article does not advocate a blanket abolition of corporate limited liability. Only those members of controlled and integrated corporate groups would share joint and several liability for the debts of each group member. Certainly, the operation of the 'endowment effect' makes changing basic liability rules, unlikely.[12] However, the adoption of enterprise liability, within controlled and fully integrated groups, may yet be an efficient response to the problems of misrepresenting the limited recourse risk of such group members, as well as debtor opportunism arising within such groups.

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Jennifer Dickfos can be contacted on (07) 5552 8812 or by email at j.dickfos@griffith.edu.au.

## Notes

1 Part I of this article appeared in the July 2011 issue of this journal. See Dickfos J, 2011, 'Enterprise liability for corporate groups — a more efficient outcome for creditors: Part I', *Keeping good companies*, Vol 63 No 6, pp 350–353

2 Murphy D, 1998, 'Holding Company Liability for Debts of its Subsidiaries: Corporate Governance Implications' *Bond Law Review*, Vol 10 No 2, pp 241–272

3 In an action for breach of contract, the issue was whether a contractual promise by a subsidiary company could be treated as a promise by the parent company

4 *In Salomon v Salomon & Co Ltd* [1897] AC 22 the House of Lords 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

5 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. The particular facts of the *Yelnah* case did not warrant such recognition

6 Ramsay I, 1994, 'Holding Company Liability for the Debts of an Insolvent Subsidiary: A Law and Economics Perspective', *University of New South Wales Law Journal*, Vol 17 No 2, pp 520–545, at p 541

7 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

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

9 Anderson H, 2009, 'Piercing the Veil on Corporate Groups in Australia: The Case for Reform', *Melbourne University Law Review*, Vol 33 No 2, pp 333–367, at p 347

10 Current creditor protections include share capital maintenance provisions, the liquidator's power to set aside antecedent transactions: ss 588G, s 588V and s 187 Corporations Act

11 Clarke F and Dean G, 2007, *Indecent Disclosure Gilding the Corporate Lily* (1st edition), Cambridge University Press, pp 195,197. Clarke and Dean question the notion of determining group solvency from a perusal of consolidated financial statements. Alternatively, they suggest the disaggregation of consolidated financial statements and market pricing for corporate groups

12 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 D, Knetsch JL and Thaler R, 1990, 'Experimental Tests of the Endowment Effect and the Coase Theorem', *Journal of Political Economy*, Vol 98, pp 1325–1348 and Korobkin R, 1998, 'The Status Quo Bias and Contract Default rules', *Cornell Law Review*, Vol 83, 608–687, at p 631 ■