

Directors' Duties under an Enterprise Approach

This paper considers the failure of current corporate law to address the conflict of common directors of corporate groups to satisfy their legal and economic obligations when controlling a corporate group.

Jenny Dickfos

Economic analysis of directors' fiduciary and statutory duties to act in good faith and for the proper purposes of their appointed company is to resolve conflicts of interest between directors and their appointed company in favour of the company. However, positive law fails to address director's conflicts of duties arising from directors owing duties to various companies comprising the corporate group. Any conflicts of interest suffered by directors of solvent wholly-owned subsidiaries may be determined by relying upon s187 Corporations Act (if satisfied) and advancing the interests of the holding company. A gap exists where the corporate group members are neither wholly owned nor solvent. This article explores whether the recognition of an enterprise entity would fill this gap, and provide an efficient means of regulating for agency conflicts within the corporate group.

I Introduction

This paper considers the failure of current corporate law to address the conflict of common directors of corporate groups to satisfy their legal and economic obligations when controlling a corporate group.

Economic analysis of corporate law supports the application of the separate legal entity principle to each corporate group member, ignoring the group's economic entity on the grounds of efficiency. However, there are agency costs associated with applying the entity principle to corporate groups, including the inevitable conflicts which arise where directors are legally obligated to act in the best interests of the corporate entity member while managing, organising and financing the corporate group members as one economic enterprise.

This paper considers whether the alignment of the corporate group's legal and economic entities and corresponding directors' statutory duty to act in the best interests of the enterprise would reduce such agency costs.

The balance of this article is broken down into a number of parts: Part II describes the economic rationale of a company's separate legal entity status. The costs of imposing the entity principle within a corporate group are then outlined. Part III briefly outlines the facts, issues and decision of the litigation arising out of the collapse of the Bell Resources group. The Bell Resources case provides a compelling illustration of the pursuit of the corporate group's economic goals at the expense of the interest of individual corporate group members. Part IV identifies the specific conflicts of interest, which arise in a corporate group, particularly when directors enter into intra-group financial transactions. The Bell Resources decision provides a case study of the current law's resolution of such conflicts. Part V identifies alternative enterprise approaches for determining the duties owed by directors within corporate groups. Part VI considers whether the recognition of an enterprise entity and a director's statutory duty to the corporate group's enterprise/s is a more efficient means of regulating for conflicts of duty within a corporate group.

II The Economic Rationale of Separate Legal Entity Status

Currently the Australian corporate law focuses on the separate legal entity principle of the corporation known as the entity approach¹. The Entity Approach is founded upon the principle established in Salomon's Case² that upon incorporation a company is a separate legal entity, distinct from its owners. Thus within a corporate group the law sees only each company as a separate distinct legal entity. No legal entity recognition is given to the idea of a corporate group where two or more companies are closely related or have common shareholdings.

The separate legal entity approach therefore fails to recognise the economic entity for a group of companies, notwithstanding the group, in economic terms, is in reality the true (and larger economic entity) conducting the business via common ownership and control of individual companies for the ultimate benefit of shareholder-investors of the parent company within the group.

Opposing the entity approach is the Enterprise Approach³, which recognizes the corporate group as a single unit. By definition the Enterprise approach is at odds with the separate legal entity approach of corporate law since the law fails to see the significance of companies operating in unison for a greater economic goal, choosing instead to concentrate on the particular issues that face each company based on the separate legal entity doctrine. There is therefore a conflict between the economic reality of group company behaviour in Australia and the legal treatment of those companies.

Within Australia, the majority of laws regulating corporate groups reflect the entity approach⁴ as an overview of the principal regulations governing corporate groups shows

¹ The two differing approaches to corporate regulation have been well documented by Blumberg in the United States with the cudgels being taken up by Ramsay who denotes the Australian experience. See Ian Ramsay "Allocating Liability in corporate Groups: An Australian Perspective" Connecticut Journal of International Law 1998-1999 pp -329-377

² Salomon v Salomon [1897] AC 22

³ In 1947 Adolf Berle, suggested disregarding the fiction of separate legal personality for corporate group members and adopting a more realistic view of the corporate enterprise where such groups operate economically as a unified whole. See Adolf A. Berle, Jr., 'The Theory of Enterprise Entity', 47 *Columbia Law Review*, 343

⁴ 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 Blumberg opcit pp ix. Some recognition of the economic entity is given, but only in specific provisions of selected legislation. See Daniel Prentice in D. Prentice "Some Comments on the Law of Groups" in McCahery, Picciotto & Scott (ed.), *Corporate Control and Accountability* p38 argues that the fragmentation of laws relating to group

overwhelmingly an emphasis on the entity approach to corporate regulation.⁵ Such failure accounts for the *Corporations Act 2001* (Cth) not defining a corporate group⁶ or recognising its boundaries. Rather, the law concentrates on the creation and maintenance of the individual company's boundary as the means of providing for efficient business investment.

–A *The Efficiency Argument*

The granting of separate entity status to a corporation allows the corporation to own assets in its own name, distinct from the personal assets of its owners⁷. In effect a boundary is drawn between those assets which are available to the corporation's creditors and to which the personal creditors of the owners have no recourse. Henry Hansmann & Reinier Kraakman describe the drawing of this boundary line, as affirmative asset partitioning and consider such partitioning to be "the core defining characteristic of a legal entity and the essential property attribute of a corporation".⁸ Haansman and Kraakman identify the essential aspect of asset partitioning as "shielding of the assets of the entity from claims of the creditors of the entity's owners or managers". Such shielding provides⁹ an economic rationale for the existence of a company's separate legal entity status. While accepting of the reduction in monitoring costs

issues is beneficial on the ground that once rules relating to particular issues such as consolidation of accounts for financial disclosure; taxation; and 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. Australian examples include the Consolidation Regime of the Income Tax Assessment Act located in Pt 3-90 (Div 700 to 721) *Income Tax Assessment Act 1997*⁴ which allows a wholly-owned group of resident entities to be treated as a "single entity" for income tax purposes; Division 8 of Chapter 5 of *Corporations Act 2001* (Cth) which allows for the pooling of assets in a group company liquidation. For a discussion of these provisions see Dickfos, J. *Improving Outcomes for Creditors- An analysis of the Efficiency and Strength of Creditors' Protections provided by the Provisions of part 1-4 of Schedule 1 of Corporations Amendment Insolvency Act 2007 (Cth)* Corporate Law Teachers Association Conference Sydney 3-5 February 2008, Anderson, C. Dr., and Morrison, D. Dr 'The Insolvency Implications for Corporate Groups in Australia – recent events and initiatives' *International Insolvency Review* 2007 Vol 16: 103-122; and the financial disclosure requirements for consolidated accounts required by s295(2)(b) *Corporations Act (2001)* (Cth) S295(2)(b) states if required by the accounting standards, a consolidated profit and loss statement, balance sheet and statement of cash flows are to be provided. S297 further requires that any such consolidated financial statements give a true and fair view of the financial position and performance of the consolidated entity. Under AASB 127 Each entity that is a parent in a group that is a reporting entity must present consolidated financial statements that consolidate its investments in subsidiaries, where a subsidiary is defined as an entity controlled by the parent and control is defined as the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. Knapp, J. Summary of AASB 127: Consolidated and Separate Financial Statements ICAA which are financial statements of a group (parent and subsidiaries) presented as those of a single economic entity.

⁵ See Ramsay, "Allocating Liability in Corporate Groups" *id.* pp 344- 355 where he discusses lifting the corporate veil, limits on share cross-holdings, shadow directors, directors' duties, oppression remedy, regulation of financial benefits given by public companies to related parties, cross-guarantees in corporate groups and s588V imposing liability on holding companies for the debts of their insolvent subsidiaries. Only the latter three adopt an enterprise approach to regulation.

⁶ S50 Corporations Act 2001(Cth) does recognize holding and subsidiary companies as defined in s46 Corporations Act 2001 (Cth) as being related bodies corporate.

⁷ Henry Hansmann & Reinier Kraakman, "The Essential Role of Organizational Law" (2000) 110 *Yale LawJournal* 387. 390

⁸ Henry Hansmann & Reinier Kraakman, "The Essential Role of Organizational Law" (2000) 110 *Yale LawJournal* 387.

⁹ As above note 2

offered by limited liability¹⁰ Haansman and Kraakman argue that similar monitoring economies result from the adoption of the entity principles. Economic efficiency is achieved as “affirmative asset partitioning reduces the cost of credit for legal entities by reducing monitoring costs, protects against premature liquidation of assets, and permits efficient allocation of risk”¹¹. Efficiency is measured by whether risk within the corporate group is allocated to those most capable of bearing it; that optimal levels of risk taking are undertaken such that only corporate group ventures with net positive values to society are undertaken; and that transaction and monitoring costs within the corporate group are minimised.¹² Thus current economic analysis of corporate law supports the present boundaries of the corporate group and the limitation of liability of corporate group members on the grounds of efficiency: the transaction costs of stakeholders (including creditors) are minimised and shareholder returns maximised.

B Cost of Imposing Entity Approach on Corporate Groups

However, there are costs associated with reliance upon the entity principle and ignorance of the economic entity within corporate groups. To minimize the monitoring costs of creditors and thereby maximize the extension of credit on favourable terms, sub-incorporation of the economic entity may be maximised, but at the cost of increasing the chances of insolvency and external administration of such corporate group members. Haansman and Kraakman identify the additional risk of ‘formal bankruptcy proceedings and the transaction costs associated with them are more likely to arise as asset pools of individual entities become smaller and more homogeneous’¹³. So too, the risk of debtor opportunism¹⁴ also rises,

¹⁰ Easterbrook, FH & Fischel, DR *The Economic Structure of Corporate Law* Harvard University Press 1991 pp41-44 Economic justification for the limited liability principle has been well documented¹⁰ and has been usefully summarized into providing achievement of four economic goals: *Facilitating enterprise by separating investment and management decisions. Investors are protected from any corporate loss in excess of their equity capital so that potential investors are encouraged to make investment funds available and thereby reduce the costs of raising capital; Decreasing the need for shareholder monitoring of management as shareholder risk of loss is restricted to the amount of equity invested; Market efficiency is promoted as public company share prices are not determined by the wealth of individual shareholders. Shares are traded freely with their price a function of other factors such as management efficiency; Encouraging diversity of equity holdings as the maximum potential loss of a poor investment is the relevant equity held in the various companies.*

¹¹ Henry Hansmann & Reinier Kraakman, “The Essential Role of Organizational Law” (2000) 110 *Yale Law Journal* 387, 398.

¹² This measure of efficiency was adopted by Judith Freeman in “Limited Liability: Large Company Theory and Small Firms”, (2000) 63 *The Modern Law Review*, 317, 319 when measuring limited liability in terms of economic efficiency in the context of small firms.

¹³ Henry Hansmann & Reinier Kraakman, “The Essential Role of Organizational Law” (2000) 110 *Yale Law Journal* 387, 400

¹⁴ Henry Hansmann & Reinier Kraakman, “The Essential Role of Organizational Law” (2000) 110 *Yale Law Journal* 387, 401

whereby the holding company may drain assets from a subsidiary to another entity within the corporate group effectively expropriating the creditors of the subsidiary. Although various legal doctrines exist to reduce this potential opportunism¹⁵, these protections involve administrative and incentive costs of their own, the Bell Resources Case providing an illustrative example thereof. In The Bell Resources case, the directors entered into intra-group financial transactions so that group companies gave security for other group companies' loans to assist the group's economic goal to more effectively utilise its total assets in financing the group's operations. The subsequent litigation brought by the Liquidator of various corporate group members and Trustee for Bondholders challenging the way in which the securities were given and taken and seeking recovery of the realisation proceeds, culminated in one of the longest civil trials heard in Australia. The case involved in reality 20 or 21 trials¹⁶, considered transactions and events over a long time and in varying parts of the world, and, as it involved the failure of a large commercial group companies, necessarily meant the untangling of intra-group dealings.¹⁷ Haansman and Kraakman consider corporate law's separate legal entity provides 'a pattern of creditors' rights'¹⁸ for each legal entity. However, the imposition of this pattern of creditor's rights within a corporate group, managed as an economic entity, though comprised of numerous legal entities gives rise to conflicts of interest¹⁹ where common directors of corporate group members pursue the interests of the group as an economic entity, which may be at odds with the interests of the individual corporate group member. Costs arise from the failure of present laws to address such agency conflicts. Again Bell Resources Case is illustrative of such conduct and costs.

¹⁵ Including veil piercing, unauthorised share capital reductions, liquidator's power to set aside insolvent transactions.

¹⁶ 'The case (especially in terms of knowledge) had to be proved against each of the 20 banks individually and one of them as agent. See *Guide to the Reasons* [2008] WASC 239,25.

¹⁷ See *Guide to the Reasons* [2008] WASC 239,25

¹⁸ Henry Hansmann & Reinier Kraakman, "The Essential Role of Organizational Law" (2000) 110 *Yale LawJournal* 387, 390

¹⁹ Conflicts of interest arise between creditors and the controlling shareholders of the individual companies within the group as first identified by Michael C. Jensen and William H. Meckling 'Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure', (1976) 3 *Journal of Financial Economics* 305. A summation of these conflicts is made by Ian M. Ramsay, 'Allocating Liability in Corporate Groups: An Australian Perspective' [1999] 13 *Connecticut Journal of International Law* 329,362. Professor Ramsay refers to the four major sources of conflict between a company's shareholders and its creditors identified by Clifford W. Smith Jr & Jerold B. Warner, 'On Financial Contracting: An Analysis of Bond Covenants' 7 (1979) *Journal of Financial Economics* as (1) excessive dividend payments; (2) dilution of shareholders' claims by obtaining additional debt with similar or higher priorities; (3) substituting saleable for non-saleable assets; (4) excessive risk taking.

Australian corporate law's emphasis on the entity approach requires directors to consider the interests of the individual corporate members in isolation as opposed to the interests of the group enterprise of which the corporate member is an integral part. There is a wealth of academic writings on the failure of the application of the separate legal entity doctrine to address the workings of Corporate Groups.²⁰ Academic writer, Peter Muchlinski insists 'it is clear that existing legal forms of business organization were simply not designed to correspond with such extensive business structures [speaking of multinational enterprises]²¹'.

In *Qintex Australia Finance Ltd v Schroders Australia Ltd*²² Rogers CJ recognized such failure: "As I see it, there is today a tension between the realities of commercial life and the applicable law in circumstances such as those in this case. In the everyday rush and bustle of commercial life in the last decade it was seldom that participants to transactions involving conglomerates with a large number of subsidiaries paused to consider which of the subsidiaries should become the contracting party. A graphic example of such an attitude appears in the evidence of Ms Ferreira, a dealer in the treasury operations department of the defendant. In her written statement ... she said:

*'In my discussions with either Craig Pratt or Paul Lewis when I confirmed deals undertaken for Qintex, it was not my practice to ask which of the Qintex companies was responsible for the deal. I always treated the client as Qintex and did not differentiate between companies in the group. Paul Lewis and Craig Pratt always talked as being from Qintex without reference to any specific company.....'*²³

The obligation imposed on directors to act in good faith, in the best interests of the company arises by virtue of the general law's recognition of a director as a fiduciary and the statutory obligations imposed on directors under s181 of the Corporations Act. Both duties combat the inevitable agency conflicts, which arise between directors and the interests of shareholders. Consistent with the foundation principle of company law the duty is imposed on directors in

²⁰ Phillip I. Blumberg, *The Multinational Challenge to Corporation Law: The Search for a New Corporate Personality* (1993) Oxford University Press New York 1993 Schmitthoff, C.M. & Wooldridge, F. *Groups of Companies* Sweet & Maxwell London 1991 +Dine, J - see you can do it!

²¹ Peter T. Muchlinski, *Multinational Enterprises And The Law* 2007, Oxford 77.

²² (1990_) 3 ACSR 267

²³ As above note 21, 269

regard to the individual company, the separate legal entity, regardless of its membership within a corporate group.

By no means were the directors of Bell Resources Group unique in their failure to act in the best interest of the individual corporate group members. Their failure arose, and will continue to arise, because of the disconnect, between the manner in which the group of companies is organised and managed, and the positive law's refusal to recognise the corporate group or the enterprises which comprise such a group as legal entities. The irony is that the disconnect between the legal entity/ies and the operation and management of the economic or enterprise entity/ies of the corporate group creates additional agency conflicts for directors. This conflict is most apparent when directors enter into intra-group financial transactions as evidenced by the Bell Resources Case, where effectively the group companies gave security for other group companies' loans to assist the group's economic goal to more effectively utilise its total assets in financing the group's operations.

III The Bell Resources Case

A The Facts

The Bell Group of companies²⁴ headed by The Bell Group Ltd (TGBL) (In Liquidation) rose to prominence during the 1970's and early to mid 1980s. It operated throughout this time on a relatively high level of borrowings. During the mid-1980s TBGL or Bell Group Finance Pty Ltd (BGF) (In Liquidation) (Receiver & Manager Appointed) a wholly owned subsidiary of TBGL which acted as the treasury entity for the group had banking facilities with at least six banks operating in Australia. 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).

Further, a wholly owned UK subsidiary of the Group, Bell Group UK Holdings Ltd (BGUK) (In Liquidation) (In Administrative Receivership) in 1986 established a loan facility with a syndicate of European, Canadian and Middle Eastern banks known as Lloyds Syndicate. Similarly this loan facility was unsecured but supported by a negative pledge.

²⁴ The following summary of facts is drawn from the judgement of Owen J in *The Bell Group Ltd v Westpac Banking Corporation (No 9)* [2008] WASC 239

As well as relying on bank finance between December 1985 and July 1987 the Bell Group raised \$585 m via five separate bond issues. by Bell Group NV, another wholly owned subsidiary of TBGL, and one each by TGBL and BGF. The proceeds from the bond issues went directly or on-lent indirectly to TGBL or BGF. The onloans were not formally documented resulting in a subsequent dispute as to whether they were made on a subordinated or unsubordinated basis.

The stock market crash of October 1987 caused the Bell Group to re-evaluate its level of borrowings and t to reduce its debts by a programme of asset sales. The Bell Group had two main assets. First, the publishing assets held in a sub-group headed by Bell Publishing Group Pty Ltd (BPG), an intermediate holding company within the Bell Group. Second, a major major asset was the approximate 39% shareholding in Bell Resources Ltd (BRL) whose assets consisted of liquid funds of approximately \$1.2 billion.

After a forced takeover bid by Bond Corporation Holdings Ltd (BCHL) of TBGL, the conclusion of 1988 saw BCHL controlling the Bell Group and the boards of both TBGL and BRL manned entirely by persons associated with BCHL. A portion of BRL’s liquid assets, were exchanged by way of deposit of \$996m on the Bond Brewing Holdings Ltd (BBHL) brewery assets.

By the end of 1989 TGBL or BGF owed the six Australian banks about \$131.5M in respect of “on demand” facilities. Lloyds syndicate banks were owed the equivalent of \$131m which was to be repaid on 19/5/1991. The extent of the group’s liabilities at the end of 1989 consisted of:

Owing to six Australian banks by TBGL/BGF due on demand	\$131.5m
Owing to Lloyd’s Syndicate banks due 19/5/1991	\$131.0m
Westpac Overdraft	\$ 5.0m
Outstanding Bonds (maturity date 1995- 1997)	\$546.0m

Early in December, 1989, the Group’s bankers became alarmed about their increasing risk exposure as TBGL contended that the bondholders might rank equally with the banks on liquidation. BCHL lost control of the BRL Board, and a banking syndicate successfully applied for appointment of a receiver to BBHL, thus affecting control of the Bond brewery assets.

Early in 1990 the Australian and UK banks entered into refinancing arrangements with the group whereby:

All of the bank facilities were extended, to be repaid on 30th May 1991;

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 publishing assets.

On 18/4/1991 TBGL applied for the appointment of a provisional liquidator. The banks recovered \$283 m on the realisation of their securities, being the publishing assets, sale of BRL 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 \$1.5b from the banks on the grounds that at the time the securities were given the directors and banks knew the main companies within the group were insolvent. With such knowledge the directors and banks knew that the effect of giving securities was prejudicial to the shareholders and external creditors of companies within the group, notably the bondholders and Deputy Commissioner of Tax. The banks remained the only defendants after action against individual directors was discontinued.

B The Decision

Justice Owen objectively 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.²⁵ At that time the companies' ability to pay their debts as and when they fell due depended upon

²⁵ *The Bell Group Ltd v Westpac Banking Corporation (No 9)* [2008] WASC 239, para 6035

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.

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 BGF (to the Australian banks) and BGUK (to the Lloyds syndicate banks) and TBGL (as guarantor)"²⁶. As the borrowers were nearly insolvent, the effect of this obligation was prejudicial to the direct and indirect creditors and shareholders of the individual Bell group companies.²⁷ In effect the directors of the Bell Group companies 'focussed on one group of creditors (the banks) to the exclusion of all others'²⁸. 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.²⁹ 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.

Central to the decision of Justice Owen 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 the duty to exercise powers only for proper purposes. Owen, J. stated 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

²⁶ *The Bell Group Ltd v Westpac Banking Corporation (No 9 [2008] WASC 239*

²⁷ Creditors and Shareholders of the following Bell Group companies were prejudiced by the Transactions : TBGL, BGF, BRL, Bell Bros, WAOM,BPF, Wanstead, Western Interstate and BGUK. See *The Bell Group Ltd v Westpac Banking Corporation (No 9 [2008] WASC 239* para 6111-6112.

²⁸ *The Bell Group Ltd v Westpac Banking Corporation (No 9 [2008] WASC 239* para 6065

²⁹ *The Bell Group Ltd v Westpac Banking Corporation (No 9 [2008] WASC 239*, para 6039

*so the Australian directors. I am 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.*³⁰

Further, 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’³¹. Such directors, (not Aspinall, the BIL directors and the London-based directors of BGUK, but Mitchell and Oates) 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.

Interestingly, Justice Owen 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’³² 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 may be considered recognition of 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 the entity approach within Australian corporate regulation.

IV Current Corporate Law’s Resolution of Conflicts of Interest arising in Corporate Groups

In *Walker v Wimborne*³³ the court recognised the potential conflict arising between the interests of a subsidiary and the group with the resolution that directors must act in the subsidiary’s best interests and not in the interests of the group as a whole. Partial recognition of the operation of the group entity was made however, by acknowledging that a holding or

³⁰ *The Bell Group Ltd v Westpac Banking Corporation (No 9)* [2008] WASC 239, para 6045 Owen J. 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.

³¹ *The Bell Group Ltd v Westpac Banking Corporation (No 9)* [2008] WASC 239, para 6039

³² *The Bell Group Ltd v Westpac Banking Corporation (No 9)* [2008] WASC 239, para 6122

³³ (1976) 137 CLR 1

parent company may acquire a direct or derivative commercial benefit from the making of a loan to a subsidiary.³⁴ So too where a subsidiary company provides security to support a parent's borrowing, recognition has been given to the mutual benefits of continuing stability of the corporate group comprised of corporate members³⁵. No such recognition has been extended to those circumstances where the group of companies operates as one economic entity. Thus a director would per se satisfy his duty to act in the best interests of each corporate group member by acting in the best interests of the corporate group, in those circumstances where the member entity's going concern status is inextricably tied to the continued existence of its fellow corporate group members. Certainly, the manner in which the Bell group companies were managed reflected such circumstances.

*The Bell Group was characterised by the large number of interlocking debt and equity relationships amongst TGL and its subsidiaries. The concept of 'cascading demands' (used within the case) refers to the domino effect that would result from demands made by Bell group companies to their intra-group debtors. In order to realise its assets, a Bell group company that was a creditor of another company in the group would need to make demands for and collect its debts. The debtor company may, in turn, need to make demand on other own intra-group debtors. In the plaintiff's case (Liquidator), unless debtors could meet demands made on them (as well as their other debts), it would follow that they were insolvent and should be wound up.*³⁶

However, it has long been recognised³⁷ that directors breach their fiduciary duty to act in good faith for the benefit of the legal entity, the company, if in providing intra-group security no real commercial benefit devolves to the provider and the directors know at the time of providing the security it would be enforced, stripping the company of its assets. In the Bell Resources Case, there was no possibility of the necessity for the security being given by corporate group members to allow the continued existence of the group and therefore its members to be recognised. Justice Owen determined that there was no possibility of

³⁴ ... the payment of money by Company A to Company B to enable Company B to carry on its business may have derivative benefits for Company A as a shareholder in Company B if that company is enabled to trade profitably or realise its assets to advantage. Even so, the transaction is one which must be viewed from the standpoint of company A and judged according to the criterion of the interests of that company. *Walker v Wimborne* (1976) 137 CLR 1 at 6

³⁵ *Charterbridge Corporation Ltd v Lloyds Bank Ltd* [1970] 1 Ch 62 at 74

³⁶ *The Bell Group Ltd v Westpac Banking Corporation (No 9)*³⁶ [2008] WASC 239 para 1877

³⁷ *Rolled Steel Products (Holdings) Ltd v British Steel Corporation* [1986] 1 Ch 246

individual members of the group remaining solvent as the directors lacked a definitive plan for restructuring the group.

Partial recognition of the group or enterprise entity and thereby partial protection of directors is granted by s187 of the Corporations Act 2001 (Cth), which allows directors, in limited circumstances to act in good faith in the best interests of the corporate group, and thereby be deemed to act in good faith in the best interests of the subsidiary. The limited circumstances when s187 applies, ensure that the management of the wholly owned group in this manner has been agreed to by directors, shareholders and the subsidiary company as evidenced by the constitution. Nevertheless, acting in good faith, in the interests of the holding company, while for the benefit of the group as a whole, cannot result in the insolvency of the subsidiary. Nor can s187 be relied upon if the subsidiary is already insolvent. Within the wholly owned group, once the corporate group member is insolvent or approaching insolvency, the director's duty to the corporate group company member is no longer satisfied, by considering the interests of the holding company and its general shareholders. Instead, the directors' duty to the corporate group member is satisfied, by considering the interests of the corporate group member's creditors.

The rationale for limiting s187 protection to those circumstances where the corporate group members remain solvent is an economic one. While solvent, there is a sufficient cushion to absorb potential losses arising from the pursuit of the parent company's objectives for the group, which may be at the expense of the individual corporate group member or members. However, once, corporate group member/s become insolvent, then to reduce the risk of the continuing pursuit of what may be progressively riskier parent/group company pursuits at the expense of individual corporate group members and their creditors, the protection to directors of s187 is withdrawn. The problem arises in identifying when the shift from the pursuit of corporate group pursuits to maintenance of going-concern status of individual corporate members is made. Would the recognition of an enterprise entity with directors owing fiduciary duties to the enterprise entity, address the conflict unresolved by s187, thereby provide an efficient means of regulating for agency conflicts within the corporate group.

V Alternative Enterprise Approaches To Regulate Corporate Groups

A number of jurisdictions have adopted an enterprise approach to corporate group regulation.³⁸ Most notably, Germany's Konzernrecht

*sought to rectify what the legislature viewed as an inherent conflict of interest in their model, since the parent corporation would presumably seek to maximize its own shareholders' welfare at the potential expense of the subsidiary's minority or passive shareholders and creditors. Thus, the Konzernrecht imposes a system of shared liability that rebalances the conflict of interest in order to protect the minority shareholders and the subsidiary's creditors.*³⁹

Germany has adopted an enterprise liability based upon the control, either actual or presumed between legally separate corporate entities. The major feature of enterprise liability is that the dominant company (whether formally a parent or not) must always compensate the subsidiary for its losses if the dominant company caused the subsidiary to enter into a detrimental transaction. Thus 'the German system directly protects the subsidiary and its shareholders from mismanagement and detrimental transactions, but only indirectly protects the subsidiary's creditors'⁴⁰ Corporate rights and duties extend across the various corporate entities of the group such as the management of each affiliated company must report to the supervisory boards of every other affiliated company in the group, and shareholders of one corporation have information rights about their entity's relationship with affiliated companies.⁴¹

³⁸ For a summary of such countries as Germany's legal regulation of corporate groups (the Konzernrecht); Brazil's Lei das Sociedades Anonimas (LSA), Portugal's,Codigo das Sociedades Comerciais, and the European Union's draft proposal for the regulation of a multinational corporation "the European Company" or Societas Europea (SE) see Meredith Dearborn 'Enterprise Liability: Reviewing and Revitalizing Liability for Corporate Groups' 2009 97 *California Law Review* 195, 216-223.

³⁹ Meredith Dearborn 'Enterprise Liability: Reviewing and Revitalizing Liability for Corporate Groups' 2009 97 *California Law Review* 195, 216.

⁴⁰ Meredith Dearborn 'Enterprise Liability: Reviewing and Revitalizing Liability for Corporate Groups' 2009 97 *California Law Review* 195, 224. Unless the subsidiary is bankrupt the creditors do not have standing to sue the parent.

⁴¹ Meredith Dearborn 'Enterprise Liability: Reviewing and Revitalizing Liability for Corporate Groups' 2009 97 *California Law Review* 195, 217.

Within Australia, an enterprise approach was adopted within the recommendations of the Companies and Securities Advisory Committee (CASAC)⁴² final report into corporate groups in 2000. Prior to the Report's release, only piecemeal changes had been made to corporate legislation to deal with issues arising specifically in the corporate group context.⁴³ The objectives of the Discussion Paper and Final Report were to examine various means of resolving possible legal difficulties for corporate groups and their directors in carrying out their functions effectively. As well, the Discussion Paper considered whether further safeguards were needed for those dealing with corporate groups, namely minority shareholders and outsiders including creditors. A Draft Proposals Paper was published in September 1999, including a summary of the issues raised, with accompanying recommendations. Public comment was invited regarding the draft recommendations which resulted in the publication of the Corporate Groups Final Report in May 2000.⁴⁴ The Final Report contained 24 Recommendations which can be summarized into four areas:

Methods of regulating corporate groups

Directors of group companies

Corporate group reconstructions

Liquidation of group companies.

Of particular importance to the issue of directors' duties within the corporate group were Recommendations 2, and 3,⁴⁵ which are outlined below. Namely:

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.

⁴² the precursor to the Companies and Markets Advisory Committee (CAMAC). The members of both CASAC and CAMAC were and are appointed respectively by the Federal Government based on their knowledge of the law, economics and accounting and their experience in business, company administration and financial markets.

⁴³ For example, certain transactions entered into between Mr Christopher Skase and the Quintex group of companies had led to the introduction of related party provisions found in Chapter 2E *Corporations Act 2001* (Cth)

⁴⁴ [www.camac.gov.au/camac/camac.nsf/byHeadline/PDFFinal+Reports+20000/\\$file/Corporate Groups](http://www.camac.gov.au/camac/camac.nsf/byHeadline/PDFFinal+Reports+20000/$file/Corporate%20Groups)

⁴⁵ A number of recommendations were to the effect that there be no change to the current laws regulating a single company as opposed to a partly-owned corporate group. These recommendations concerned nominee directors, the fiduciary obligations of such nominee directors, even where a conflict may arise because of common directorships existing within the partly-owned group.

All companies in a consolidated corporate group should be governed by single enterprise principles.

Recommendation 3: The Corporations Law should permit directors of a solvent partly-owned group company to act in good faith and in the interests of the parent company where the minority shareholders of the former company pass an ordinary resolution, in accordance with its constitution, that approves the directors so acting.

Apply the principle, found in the capital reduction provision (s256B(1)(b)), that the action of directors in exercising the power should not materially prejudice the company's ability to pay its creditors.

Neither of the above recommendations, have as yet been acted upon. No public comment on any other particular recommendation has been released, although various conjectures have been made regarding recommendation 2's non-implementation.⁴⁶

CASAC's support of the enterprise approach relies on two reasons. Firstly, the enterprise approach reflects the manner in which highly centralized corporate groups operate economically and organizationally. Secondly, the enterprise approach reflects creditors' expectations, who have been led to believe they are doing business with the group as a whole and can rely on the overall group's creditworthiness.⁴⁷

CASAC, however, recognized 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 to determine their inclusion in the consolidated corporate group⁴⁸. Once consolidated, directors could act solely in the interests of the consolidated group without reference to their particular group company's interest; merger of group companies was at the discretion of the holding company directors and relief from accounting and other residual separate entity requirements were offered, thereby providing incentives to consolidate.⁴⁹ CASAC considered that such law reform

⁴⁶ Including: 1. Complications of drafting legislation to adopt a single enterprise regulatory regime within the Corporations Act meant that path dependency of no recognition prevailed; 2. Failure to offer adequate incentives to encourage corporate groups to consolidate meant that Recommendation 2 only offered what was already available to corporate groups under the ASIC class orders for cross-guarantees, or was more limiting in some respects. See Vicky Priskich, "CASAC's proposals for reform of the law relating to corporate groups", *Company & Securities Law Journal*, 2001, 362; 3. Increased liability exposure would impact on the corporate group's ability to borrow, restricting efficient capital raising, risk taking and diversification; 4. Recommendation 2 did not provide a satisfactory response to the long tail liability issues raised in the James Hardie Case and the Jackson Report as it specifically excluded a consolidated corporate group from being collectively liable for the torts of any group company merely by virtue of the consolidation.

⁴⁷ As above note 8 paras 1.59-1.63

would provide ‘greater flexibility for directors to take into account the overall group interest, while ensuring that creditors and any minority shareholders do not suffer undue detriment from intra-group financial dealings’⁵⁰.

VI A More Efficient Means of Regulating Conflicts of Duty within Corporate Groups

The question earlier posed was whether the recognition of an enterprise entity and associated statutory duty upon directors to act in good faith, in the best interests of the enterprise would result in fewer conflicts of duty arising, thus reducing agency costs and thereby increasing efficiency. Efficiency⁵¹ is gained if costs are reduced without a commensurate reduction in benefits to the enterprise’s stakeholders, principally shareholders and creditors. The following considerations then arise:

1. Would recognising an enterprise entity/entities reduce the incentive of directors to take excessively risky decisions or would it lead to suboptimal levels of risk being taken?
2. Would the recognition of an enterprise entity/entities potentially increase the returns to shareholders or amounts recoverable by creditors if the enterprise were to become insolvent.
3. Would the recognition of enterprise entity/entities provide a means of filling the gaps in creditor’s contracts⁵² providing protection for creditors contracting with corporate

⁴⁸ By the resolution of their directors.

⁴⁹ As above note 8, 39, Recommendation 2.

⁵⁰ CASAC *Corporate Groups Final Report* May 2000, 49
[www.camac.gov.au/camac/camac.nsf/byHeadline/PDFFinal+Reports+2000/\\$file/Corporate_Groups,_May_2000.pdf](http://www.camac.gov.au/camac/camac.nsf/byHeadline/PDFFinal+Reports+2000/$file/Corporate_Groups,_May_2000.pdf),

⁵¹ Kaldor Hicks measurement of efficiency has been adopted. Kaldor-Hicks efficiency developed by two British 20th century economists, which holds a change is efficient if in aggregate the benefits associated with the change exceed the costs of the change. Those who gain can compensate those who lose, although there is no need for compensation to occur under their model. Brian Cheffins, *Company Law: Theory, Structure and Operation* (1997), 15.

⁵² Contractarian theory suggests that unsecured creditors address their lack of protection by: the imposition of higher interest rates or harsher penalties when contracting with the respective corporate group entities; by restricting company activities such as dividend payouts, or the incurrence of further debt, see Ian M. Ramsay, ‘Allocating Liability in Corporate Groups: An Australian Perspective’ (1999) 13 *Connecticut Journal of International Law* 329,363;

by obtaining contractual guarantees from other corporate group members to secure repayment of the debt;

or by restricting their dealings to those corporate group members who have entered into a regulatory administered ASIC Deed of Cross-Guarantee or one of its earlier variants.

groups. The reality is that unsecured creditors do not obtain additional contractual protection at the time of contracting with the corporate group member.⁵³ This may be the result of: (i) the transactions costs of doing so; (ii) lack of negotiating power of such creditors due to the level of competition and their inferior bargaining position; (iii) their perception of the debtor with whom they are negotiating; (iv) the refusal of the debtor to provide such protection; or (v) deficiencies in information regarding the corporate group members' finances.

A Excessive or Sub-optimal Risk Taking

Haansmann and Kraakman⁵⁴ argue that 'subpartitioning assets within a single firm into corporate subsidiaries' reduces the monitoring costs of creditors such that the cost of credit to the firm is minimised. However, this cost saving may lead directors to adopt excessive risk taking where they consider corporate group diversification to be a bankruptcy-prevention device.⁵⁵ To avoid the consequences of such excessive risk taking, the holding company may drain assets from the nearly insolvent subsidiary to the parent corporation or another subsidiary, hence effectively expropriating the creditors of the nearly insolvent subsidiary.⁵⁶ Recognising an enterprise entity would reduce the likelihood of excessive risk taking occurring. An enterprise may consist of a selected number of corporate group members based upon the particular interconnected web of corporations that function as an economic entity to achieve a unified goal. Where the enterprise is restricted to a selected number of corporate

In 1985 Henry Bosch, then Chairman of the National Companies Securities Commission (NCSC) initiated a Deed of Indemnity. By entering into a deed of cross-guarantee group companies form a "closed group" guaranteeing to meet the debts of one another. However, despite being promoted as a method of offering creditor protection as well as reducing financing costs by allowing creditors to deal with only one company in a closed group, empirical evidence appears to support the contrary: that the use of cross guarantees does not provide much protection. Frank Clarke and Graeme Dean *Indecent Disclosure Gilding the Corporate Lily*, (1st ed. 2007)161-163. Having conducted a survey of the ASIC Ascot Database for the period 1991-2002 Clarke et al identified that deed covenants have only crystallised in a few cases; potential benefits from deeds were heavily weighted in favour of participating group companies; and that to date courts had not had to adjudicate on an ASIC deed dispute. Reasons given for the non-operation of the deed are the popularity of voluntary administration procedures over liquidation in common law jurisdictions (the deed only crystallising in liquidation) and the difficulties of implementing the deed where cross-claim guarantees exist within the closed group.

⁵³ For criticism generally of the argument that 'voluntary creditors can build the risk of insolvency into the interest they charge and can demand protection in the form of collateral, minimum capitalisation or some other protection' see Judith Freeman, 'Limited Liability: Large Company Theory and Small Firms', (2000) 16 *The Modern Law Review* 317, 330.

⁵⁴ As above note 2,400

⁵⁵ As above note 2,400

⁵⁶ As above note 2,400

group members such as for example, the publishing sub-group within the Bell Resources Group the additional monitoring costs of creditors would not be greatly enlarged.

B Increasing returns to shareholders or the amount recoverable by creditors

Economists⁵⁷ have long recognised the benefits of synergies or economies of scale existing within the corporate group. Under current corporate regulation such synergies are only separately identifiable as an asset of the corporate group where consolidated accounts are prepared.⁵⁸ The recognition of an enterprise entity may mean the clearer identification of synergy benefits as an asset of the enterprise which may be distributed to shareholders in the form of increased dividends or capital appreciation of their shares.

The administrative efficiency of pooling assets and liabilities in a corporate group liquidation was recognised by the recent introduction of voluntary or court ordered pooling of insolvent companies in liquidation.

The obtaining of a voluntary pooling determination or granting of court ordered pooling does not mean the recognition of a separate corporate group entity with associated group liability. Rather, the joint and several liability arising among the companies within the pooled group and the administration of such liability on a joint basis is a means of reducing complexities within group insolvencies, and thereby enhancing returns to creditors.⁵⁹

Delaying such statutory intervention until liquidation, may also reflect the ascendancy for consideration of creditors' interests over shareholders interest by company fiduciaries⁶⁰ arises only as the company approaches insolvency or is insolvent.⁶¹ Recognition of an enterprise entity would ensure that the analysis of cascading demands evident in the Bell

⁵⁷ Oliver Hart, 'An Economist's Perspective on the Theory of the Firm' 1989 7 *Columbia Law Review*, 1757 and Neil Kay *Pattern in Corporate Evolution* 1997, 20-21

⁵⁸ Goodwill on consolidation is identified as the difference between the carrying amount of the parent's investment in each subsidiary and the parent's portion of equity of each subsidiary. See Para 22 of Accounting Standard AASB 127 *Consolidated and Separate Financial Statements*.

⁵⁹ Jennifer Dickfos, 'Improving outcomes for creditors: Balancing efficiency with creditor protections' (2008) 16 *Insolvency Law Journal* 84, 93.

⁶⁰ Company fiduciaries include company directors, voluntary administrators and liquidators.

⁶¹ Company directors owe fiduciary and statutory duties to the company, not to creditors, see *Spies v The Queen* (2000) 201 CLR 603. While the company is solvent, it is the shareholders' interests which have priority as representative of the company's interest, but creditors' interests will override those of shareholders once the company approaches or becomes insolvent, see *Kinsela v Russell Kinsela Pty Ltd* (1986) 4 NSWLR 722.

resources case would be unnecessary as insolvency of the enterprise would be determined only by consideration of debtors and creditors extraneous to the enterprise.

The recognition of an enterprise entity with accompanying obligation upon directors to act in best interests of the enterprise may well mean earlier intervention by directors or creditors in identifying when the enterprise approaches insolvency or is insolvent. CASAC's recommendation 3 ensures that interests of creditors and shareholders are taken into account to ensure that pursuit of the economic entity's goals is not at the expense of creditor's interests. Relying upon procedures, which exist under the current Corporations Act 2001 (Cth), creditors would have the right to seek an injunction to prevent the pursuit of enterprise goals where such pursuits materially prejudice the interests of creditors.⁶²

C Filling the Gaps in Creditors' Contracts

Identifying sub-groups within a wholly-owned corporate group as enterprise entities and legally obligating directors to act in the best interests of such enterprises would relieve directors of potential risk of conflicts of interest, as the disconnect between the corporate structure and the management of the economic enterprise is reduced.

For example, in regard to the Bell Resources Case selection of the sub-group BPG as an enterprise entity would have enhanced the importance of such an enterprise to Bell Resources Group, highlighted to directors, shareholders and creditors (other than the banks), the enterprise's self-funding ability to meet its debts and thus the director's obligation to preserve the assets of such an enterprise, and not to imperil such ability by the securing of additional debt. This may well have been bargained for by creditors if it were not for the transaction costs of doing so as it reflects creditors' expectations, who have been led to believe they are doing business with the enterprise as a whole and can rely on the enterprise's creditworthiness.

In reality, however, after October 1988 until January 1990 decisions regarding the financing of the activities of the Bell Resources Group 'fell under the umbrella of the Bond Group's Finance & Administration Division'⁶³(FAD). The FAD 'swept the bank accounts of all

⁶² S1324 (1) & (1A) Corporations Act 2001 (Cth) 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 2001 (Cth), where the creditor or member are persons whose interests are affected by a company's contravening conduct.

⁶³ *The Bell Group Ltd v Westpac Banking Corporation (No 9)*⁶³ [2008] WASC 239,328.

Bonds' subsidiaries, including TBGL and its subsidiaries, and collected all the funds into a central pool over which it then had control'⁶⁴. Funds were then allocated back to the operating businesses on a "needs" basis according to the FAD's assessment of cash flow requirements of the various businesses. Western Australian Newspapers, WAN, a subsidiary within the Bell Group's publishing sub-group was representative of other operating entities within the Bell Group. By relying on its overdraft facility, it had sufficient funds to meet its normal operating expense, however large expenses such as newsprint required funds from FAD. This practice resulted in the Bell group companies having no or no reasonable prospect of meeting their liabilities from their own moneys as those liabilities fell due.

VII Conclusion

In the aftermath of the global financial crisis the current generation of corporate group collapses will no doubt lead to a reconsideration of some of the issues faced by the directors in the Bell Resources Case. Directors of corporate groups are inevitably faced with such conflicts of interest, where directors are legally obligated to act in the best interests of the corporate entity member while managing, organising and financing the corporate group members as one economic enterprise.

The irony is that the conflict between the legal entity/ies and the operation and management of the economic or enterprise entity/ies of the corporate group creates additional agency conflicts for directors and associated costs for the corporate group. This conflict is most apparent when directors enter into intra-group financial transactions. Conflicts arise where effectively, the group companies give security for other group companies' loans to assist the group's economic goal to more effectively utilise its total assets in financing the group's operations. The current law's failure to adequately resolve this conflict has prompted the consideration whether the alignment of the corporate group's legal and economic entities and corresponding recognition of directors' fiduciary and statutory duties to act in the best interests of the enterprise would reduce such agency costs. Arguments have been advanced that recognition of an enterprise entity/ies would not lead to excessive or sub-optimal risk taking by directors, would be administratively efficient by increasing the amounts recoverable by creditors potentially increase shareholder returns and provide protection to creditors by filling gaps in creditors' contracts.

⁶⁴ *The Bell Group Ltd v Westpac Banking Corporation (No 9)*⁶⁴ [2008] WASC 239,329

Issues of implementation have not been canvassed, being beyond the scope of this article, but will be the subject of future research.