CONTROLLING THE PUPPETEERS: REFORM OF PARENT-SUBSIDIARY LAW IN NEW ZEALAND

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I. INTRODUCTION

A chain of department stores, a book publishing concern and an oil refinery may strike one as being quite unrelated lines of business, but the one thing that they may have in common is that they could well be aspects of a major corporate group’s operations. In its commonest form, the group is dominated by a parent or ultimate holding company albeit other structural forms do exist. Strung out below the parent could be any number of subsidiary companies involved in related or unrelated lines of business. This form of business enterprise has come to be utilised by many corporate entrepreneurs as the preferred vehicle for the management of their operations. The group structure is used for a variety of reasons: substantial tax advantages, ease of administration, facilitation of ventures into new fields, and also because each additional stratum of limited liability for every subsidiary created is a significant investment incentive.

Despite its prevalence, the rules of law that apply to groups of companies in Commonwealth jurisdictions is wanting in several respects. This is not entirely surprising in that substantive rules of company law clearly work better in the context of a single corporation in contrast to a group situation. As will become apparent later, the fact of divergence between law and commercial realities of group operations belies any smug reliance on the efficacy of such legal principles in the group context. Furthermore, matters are complicated by the fact that the interplay of shareholder-management-creditor-employee-public interest is more complex, as the composition of each interest group differs at each level within the structure of the group and their interests often conflict.

The foregoing suggests a more unified and group orientated legal regime is necessary. The purpose of this paper is twofold. First, it is proposed to survey the conventional legal principles and concepts applicable to corporate groups and to identify those aspects of the law which are unsatisfactory. Secondly, possible modes of reform will be canvassed with emphasis on greater recognition of the “group interest” in commonwealth jurisdictions.

II. THE DEFINITION OF A GROUP

In English and other Commonwealth jurisdictions a group is normally taken to consist of a holding and one or more subsidiaries. By Section 158(1) Companies Act 1955 (N.Z.), a company is a subsidiary of another company if that company either is a member of the subsidiary and controls the composition of the board of directors, or it holds more than half the former’s equity share capital. It may be observed that the Companies Act contemplates a vertical chain of related companies in that it recognises that a company, which is a holding company of another company, could well be a subsidiary in respect of a third company, which becomes the

\footnote{For further statutory elaboration see S.158(2) and S.158(3).}
ultimate parent company at the apex of the group structure.2 The concept of control enshrined on the Act ignores de facto control in favour of de jure control.

The definition of a subsidiary in French law is very similar to that of Commonwealth jurisdictions.3 Markedly different is the group definition in the German Joint Stock Companies Act 1965 (Aktiengesetz).4 The descriptive terminology employed is that of “dependent” and “controlling” enterprises. A controlling enterprise is one which can directly or indirectly exercise a controlling influence over another enterprise which is termed the dependent enterprise.5 By Article 17(2), an enterprise is presumed to be dependent on another if the latter has a majority interest in it. A group can exist in this basic form. It can also come about when dependent and controlling enterprises come under uniform management either by becoming parties to a control contract or through integration.6 A group may also be constituted by virtue of Article 18(2) whereby even legally independent enterprises become a group if they are effectively operating under uniform management. Thus, German law recognises the existence of horizontal groups. Groups of companies in Germany are known as ‘Konzerns’.7

The broader German definitions have formed the basis of the Seventh Directive on Group Accounts (E.E.C.).8 The primary difficulty with the

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2 S.158(1)(6). See Farrar & Russell, Company Law and Securities Regulation in New Zealand, Wellington: Butterworths, 1985, ch.29. p. 338. The discussion throughout this article is confined to vertical groups, as opposed to horizontal groups. The scope of the problems posed by the latter deserve separate and more considered treatment which is not possible here. Furthermore, although the Aktiengesetz, (see infra note 4) is confined to Public Companies, no distinction is made in this article between private and public companies.

3 Article 354 of the Law Governing Commercial Companies of July 24th, 1966 provides:

"Where one company owns more than half of the share capital of another company, the latter company shall for the purpose of this definition, be deemed to be a subsidiary of the first company".

See F. Woodridge The Definition of a Group of Companies in European Law [1982] J.B.L. 272


5 Article 17(1) Aktiengesetz (Akt G).

6 For control contracts see Articles 291-294. It is a consensual agreement which becomes part of the constitution of the dependent company and it gives the controlling company certain powers over the management of the dependent company in exchange for certain undertakings of responsibility, see infra for discussion. Integration is provided for by Articles 319-323 Aktiengesetz. It does not destroy the legal personalities of the companies concerned. The controlling company obtains full management rights over the integrated company but is subject to full liabilities as well. See infra for discussion. See also generally Wurdinger, op cit, ch. 2 and Wooldridge, op cit. p. 59-73


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definition provisions of the Seventh Directive is that the imprecise criteria therein do not endear themselves to auditors and managers, who have to decide if a company with less than the majority threshold shareholding is exercising de facto control in order to determine if it has to submit consolidated accounts.9 The Commonwealth approach is bereft of flexibility but the German approach is not without its difficulties. Defining a subsidiary in terms of what control is actually exercised irrespective of majority shareholding allows for application in varying fact situations and in most contexts other than group accounts would not be causative of the attendant difficulty mentioned. It is unlikely though to be accepted in a common law jurisdiction.10

III. SEPARATE EXISTENCE OF PARENT AND SUBSIDIARY

A company is a legal entity separate from its members. This was established by the leading case of Salomon v Salomon & Co Ltd,11 by virtue of its shareholdings, a parent is a member of its subsidiary but both are distinct entities in law. The law is oblivious to the parent - subsidiary relationship for most purposes except for the providing of consolidated group accounts and the prohibition of cross-shareholdings. The presence of certain salient features in a parent - subsidiary relationship can lead to it being classed as an agent of the parent and thereby one functional unit.12 The courts have demonstrated an occasional willingness to carve out a wider exception to the separate personality rule. In DHN Food Distributors Ltd v London Borough Council of Tower Hamlets13 a parent company’s claim for compensation in respect of the compulsory acquisition of property owned by its fully owned subsidiary, on which the parent carried on its business operations, was upheld by the English Court of Appeal. The parent, as a licensee, had no proprietary interest in the property itself capable of being compensated; however it succeeded because the court accepted that the companies were effectively one economically integrated unit.14

9 Primarily the difficulty is with the imprecise criteria for managers and auditors to decide when a company with less than 51% shareholding is in fact exercising control: Wooldridge, ibid, at 275-276.
10 Cf the definition of “control” in the American Law Institute’s Federal Securities Code S.202(29)A “... ‘control’ means the power, directly and indirectly, to exercise a controlling influence over the management or policies of a company ... whether through ownership of voting securities, through one or more intermediary persons, by contract or otherwise.” See L. Loss, Fundamentals of Securities Regulation, Little Brown, Boston, 1983, ch. 6. Courts in United States jurisdictions have not shrunk from ascribing legal consequences to legal persons who, whilst not owning a majority of shares, had effective working control. See for example, Kohn v American Metal Climax, 322 F. Supp. 1331 (1971) where the person deemed to have control owned 42% or the shares and had influence over nine directors of a 13 person directorate: see especially at 1344. If, as Loss points out, practical control does not require majority ownership, and if courts have found themselves competent to determine on a case by case basis that actual control exists, why can there not be a definition of a group of companies along German lines. Cf the discussion of control in Prudential Assurance Co. Ltd v Newman Industries (No. 2) [1982] 1 All ER 354 at 364.
12 Smith Stone & Knight Ltd. v Birmingham Corporation [1939] 4 All ER.
13 [1976] I W.L.R. 852. See also Lord Reid’s approach in Harold Holdsworth & Co (Wakefield Ltd. v Caddies [1955] 1 WLR 325 at 357. This judgment was relied on in this case.
decision has been criticised for virtually disregarding *Salomon*, and for amounting to judicial legislation.15

This germ of a new direction in corporate group matters has been neutralised in New Zealand at least, by a reaffirmation of the conventional approach by the New Zealand Court of Appeal in *Re Securitibank (No. 2)*.16 The court stressed that separate legal personality was always the starting point with any departure requiring careful consideration.17

Nonetheless, developments in other jurisdictions illustrate the fact that courts are appreciative of the artificiality of the atomistic approach have been moved to construct a new entity which, in the circumstances concerned, was more in accord with reality. Berle posited that:

> "The Courts disregard the corporation fiction specifically because it has parted company with the enterprise-fact, for whose furtherance the corporation was created; and, having got that far, they can take the further step of ascertaining what is the actual enterprise fact and attach the consequences of the acts of the component entity, to the extent that the economic outlines of the situation warrant or require."18

The analytical direction which received the judicial imprimatur in the *DHN* case can be discerned from the decision of the European Court of Justice in *Imperial Chemical Industries & Others v E.C. Commission*.19 The Court held that a parent incorporated outside the E.C.C. was subject to E.E.C. competition regulations because it had a subsidiary incorporated in, and operating within, the E.C.C., on the basis that the subsidiary’s lack of autonomy vis-à-vis its market behaviour evidenced the economic unity of the parent and subsidiary.

The United States Supreme Court has also given some impetus to the development of a group enterprise’ notion. In *Copperweld Corporation v Independence Tube Corporation*20, the Court held that for the purposes of the Sherman Act, which regulates antitrust behaviour, a parent and its fully owned subsidiary constitute a single economic enterprise, wherefore they are deemed incapable of comprising with one another. The companies share a “unity of interest” and the parent had control free of any legal or extra-legal impediment.21 The fact that the decision was heavily influenced by the statutory context in which it was decided should not deflect acceptance of the fact that the reasoning of the Court was grounded in certain underlying assumptions about the nature and workings of a parent and its subsidiary.22

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16 [1978] 2 NZLR 136. See also the decision of the House of Lords in *Woolfson v Strathclyde Regional Council* (1979) P & C R 521 where there is some indication that the Lords were prepared to countenance the *DHN* view at least in the context of wholly owned subsidiaries. See also the discussion of the recent decision in *Stewarts Supermarket v Sec. of State* (1982) 8 NILRB 1 in G. Dee, “Salomon in the Northern Ireland Courts”, (1986) & 7 Co. Lawyer 157.
17 Ibid at p. 158-159.
19 [1972] C.M.L.R. 557. Amongst the other litigants were multi-nationals like Ciba-Geigy and Sandoz. This approach was followed again in the Commercial Solvents Corporation v E.C. Commission case: [1974] 1 C.M.L.R. 309.
21 Ibid, p. 2742.
22 The Court said that a parent and its wholly owned subsidiary have “a complete unity of interest. Their objectives are common, not disparate; their general corporate actions
There are two points to be noted. First, there is some recognition, express or implied, in the cases that resolving problems in a group context using the single enterprise model is not a workable solution and leads to arbitrary decisions.

Secondly, no major jurisdiction has shed itself of the notion of separate corporate units. Even the unified West German Aktiengesetz regime does not fully embrace the single entity approach. Separate units always have been and will remain separate units in our legal system. It is the consequences of affiliation, and our outmoded rules which apply to affiliated companies which need revision. The development which is much needed in Commonwealth jurisdictions is not so much an acceptance of the single entity approach across the board, but rather a realisation that whilst the notion of nominally separate units with separate property, personnel and “interested parties” should be maintained, the group deserves different treatment in law.

IV. THE GROUP AND THE COMMERCIAL WORLD

In this section it is proposed to examine the intra-group management practices and to outline some of the advantages of group existence. How are parent and subsidiary managed? Some companies are doubtless content to leave the bulk of the management of subsidiaries to their lower level executives whilst maintaining overall control over broad matters of policy. Conversely, others may completely shackle their subsidiaries. The rest of the spectrum is filled with varying degrees of parental control. The degree of supervision undertaken by the controlling enterprises in practice, as revealed by Hadden’s study of four major United Kingdom groups, effectively reduces a subsidiary’s autonomy significantly. There were measures in place to eliminate subsidiaries from accumulating surplus funds and embarking on ventures of their own. A rule which compelled subsidiaries to surrender surplus funds produced through the subsidiary’s efforts to the parent (or to the “group banker”) for redirection to other group members is an example. Whilst such channelling of funds may make far more effective group resource allocations, it also goes some way towards neutering individual initiative in subsidiaries. The study also indicated that executive management at subsidiary level were subject to the real and ever present
threat of dismissal. Such a state of affairs does not engender any great measure of confidence in the ability of management at subsidiary level to act independently in the interests of the subsidiary. Whatever level of autonomy the subsidiary finds itself with, there are many advantages which it can derive from the group existence and equally there are advantages that the other members could derive from it.

There are financial advantages. Intra-group financing is a salient feature of group operations. The benefit stems from the availability of cheaper credit than that available from external sources. This is not so much a reason for entering a group relationship as a feature of financial practice once within it. Such intra-group financing is also evidenced by the reported cases. In Walker v Wimborne, the focus of the court action was an intra-group transfer of funds designed to enable group members to meet financial exigencies as they arose. In B.P. Exploration Limited v Hunt (No. 2) it was found that the B.P. supergroup provided interest free loans to B.P. Exploration (Libya) Co., to finance its activities. Dependency on this sort of financing also creates another means of control over subsidiaries and ultimately reduces management autonomy.

Then there are tax considerations. For instance, group members in different state (if Federal) or national jurisdictions may decide to arrange and value transfers of assets and services so as to concentrate group profit in the most favourable jurisdiction from an assessment perspective. Also, a consolidated group tax regime can lead to savings beneficial to the group as a whole. For example, in C.I.R. v Challenge Corporation Limited, the opportunity to offset the trading losses sustained by a company against group profit and thereby legitimately improving the group's tax burden formed the basis of the acquisition of two companies by the parent of a large profitable group. The motive was underlined by the fact that, as Woodhouse P observed there was no attempt by the parent to subsequently resuscitate either company commercially. In Coates (Inspector of Taxes) v Arndale Properties Limited a tax minimisation scheme involved transactions between three wholly owned subsidiaries of a parent company. One subsidiary owned a capital asset, a lease, the market value of which had depreciated since the original acquisition. In order that the difference in value be available as a trading loss to be offset against group profit, the lease was transferred through a series of transactions to a third subsidiary via the second; the effect of which was to convert a loss that was capital

27 For examples see ibid at p. 49-75, re Securitiabank (No: 2) [1978] NZIR 136 is an example.
29 [1979], W.L.R. 783 at 820. See Prentice, infra note at 103.
30 Wooldridge, supra, note 4 at 82.
31 (1985) 9 TRNZ. 81.
32 Ibid at p. 83.
in nature into a trading loss. The companies in the aforementioned examples were merely pursuing legitimate tax minimisation options open to them. What is germane to the present discussion is the fact that subsidiaries are routinely used as passive conduits in a larger system, and arguably without proper consideration for the welfare of the individual subsidiary.

The limited liability advantages to be derived through a group is a fundamental investment incentive. Effectively, several strata of limited liability would exist in a vertical group structure. Limited liability accords a company, a legal person, the same insulation from wide ranging liability for the failure of a venture that a natural person would enjoy in a speculative undertaking. Thus, a new product may be marketed by a subsidiary without the fear of unlimited liability should the product fail.

Hadden's case studies and the survey of the case law demonstrate that the raison d'être of the enterprise is the economic enhancement of the group as a whole. Admittedly it is possible to do this through each individual company maximising its profits thereby ipso facto benefiting the group. This could be especially true of a group enterprise consisting of unrelated lines of business. However it appears that by and large, the prevalence of intra-group financing and other group practices suggest that the fortunes of each company are not so detached. One could conclude by noting that there is demonstrably a tendency to resolve group problems by sacrificing the profitability of one enterprise in order that the group welfare is preserved.

V. DIRECTOR'S FIDUCIARY OBLIGATIONS IN THE GROUP CONTEXT

Directors in group enterprises have their own peculiar problems flowing from the separate entity stance of contemporary law. As the law binds them in a fiduciary relationship to the company on which they serve they are disabled from acting in a co-operative manner with directors of other group members companies in order to enhance the group interest where this would not serve their own company. This is clearly brought out in a dictum of Pennycuick J in Charterbridge Corporations v Lloyds Bank, where he said:

"Each company in the group is a separate legal entity and the directors of a particular company are not entitled to sacrifice the interests of that company."[35]

This does not mean that directors are not allowed to consider the interests of other members of the group, or the interests of the parent. It is generally recognised that directors of a particular company can act in the interests of the group where it would not prejudice that particular company's interests, or where all interests coincide. Any other approach would be too "stringent" or too "cloistered".[38]

The directors of the parent or holding company are not compelled to take the interests of the subsidiary into account. It had been argued though

36 Ibid at 132. See also a dictum of Mason J. In Walker v Wimborne, supra note 28.
37 Charterbridge Corporation v Lloyds Bank, supra note 35.
that directors of the parent should be bound to consider the interests of the subsidiary.\textsuperscript{40} This is because the subsidiary is in effect, property of the holding company by virtue of its shareholdings and therefore the directors' duties ought to extend to this property and thereby to the subsidiary. However this has been rejected by the English Court of Appeal in \textit{Lindgren v L. & P. Estates Limited}\.\textsuperscript{41} It would appear that what directors are allowed to do, and are disabled from doing, does not correspond to the commercial rationale behind the formation of a group, viz, the enhancement of overall group well-being. Undoubtedly though, such a rigid stance vis-à-vis directors' duties is necessary in order to protect minority shareholders. Even so, it would not be untrue to say that given the amount of control that dominant companies have over subsidiaries, directors of such subsidiaries in practice occasionally, and perhaps even systematically subordinate the interests of their company to that of the group or parent. In doing so they walk the tightrope of their corporate fiduciary obligations.

This would be especially so with regard to the position of nominee and common or interlocking directors. Nominee directors are basically there in practice to serve the interests of their nominators, the parent company. A classic example of nominee directors in a complicated situation is \textit{Scottish Co-operative Wholesale Society v Meyer}\.\textsuperscript{42} where the parent decided to run down the subsidiary when, for various reasons, it felt it no longer wished to operate it. Common directors, i.e. those who sit on the boards of both parent and subsidiary also cause similar difficulties. The cases have recognised the dilemma of such positions but have not been able to temper the strict application of the fiduciary obligations. In \textit{Re Broadcasting Station 2GB}\textsuperscript{,43} Jacobs J said that directors in such positions can pursue the interests of their nominators or of the parent company unless they have shown that they would so act even if they realised that their actions would not serve the best interests of the subsidiary. In \textit{Scottish Co-operative Wholesale Society v Meyer}, Lord Denning said that a nominee director was found to defend the interests of the subsidiary whenever there was a conflict of interest with the parent (i.e. with his nominator)\.\textsuperscript{44} Presumably a director who sat on both boards would also be charged with similar obligations.

\section*{VI. MINORITY SHAREHOLDER PROTECTION IN GROUPS}

A minority shareholder in a subsidiary controlled by another company has a potentially troublesome status. The interests of parent, or group, will probably differ from the interests of the minority shareholders. The former would be concerned with maximising the profits of the whole group, which is managed to that end as a single economic enterprise. The latter would be concerned with increasing the returns on their investment consisting of shares in the subsidiary. Thus, where circumstances require the subsidiary's welfare to be subordinated for the good of the parent, or group (albeit in breach of fiduciary duties of management of the subsidiary) there

\textsuperscript{40} Ibid at 582.
\textsuperscript{41} Ibid at 604.
\textsuperscript{42} [1959] A.C. 324. See infra text at note 45 for the facts.
\textsuperscript{44} Supra note 42 at 366.
is a conflict of interest. The extent of minority shareholders' problems is well illustrated by the leading case of *Scottish C.W.S. v Meyer*. A cooperative wholesale society set up a subsidiary to help in the sale and manufacture of textiles. Some time later, after differences of opinion between the parent and minority shareholders, the parent decided to transfer this activity to a division within itself, thus resulting in the inactivity of the subsidiary. The minority shareholder succeeded in an action for relief under the equivalent of Section 209 Companies Act against oppressive action by the parent company in conducting affairs of the other company and itself.

The fact that a remedy was available is unexceptional given that the allegedly oppressive conduct was patent. However there are conceivable situations where a remedy will prove a difficult option in practice. The wording of the present provision covers unfairly discriminatory and unfairly prejudicial conduct as well as oppressive conduct. The allegation by the minority shareholders might be that the parent company, with a view to the interests of the group as a whole, may have merely failed to advance that particular subsidiary's profit-making opportunities to its full potential. This is a rather more subtle state of affairs than that normally contemplated by Section 209 and it is more problematic in nature as a cause of action. Furthermore, the court may be inclined to rationalise such conduct in terms of the business judgment rule, thus making impeachment of the conduct more difficult. A shareholder may be able to overcome this by pointing to systematic subordination of the subsidiary's interests by management. This in turn brings the focus onto another difficult obstacle, viz the evidential basis for the action. As pointed out, the allegedly oppressive, unfairly discriminatory or unfairly prejudicial state of affairs is often subtle. To prove that such a state of affairs exists, a minority shareholder would naturally require details of intra-group activities of all sorts; particularly group loans and asset transfers that were not at arm's length as well as details of all corporate opportunities not pursued. Such information is difficult to obtain given that neither the parent nor subsidiary are obliged to disclose such matters.

Should a minority shareholder be fortunate enough to succeed in an action under Section 209, the question of the most appropriate remedy has to be addressed. Amongst the range of orders which a court can make is an order regulating future conduct of the company's affairs. Making this order can be difficult because management can still be deliberately but subtly passive in pursuing the profit-making enhancement of the subsidiary without overtly disobeying the court's order.

Another possibility is an order for the sale of shares to the majority. There are valuation difficulties. Because the value is that which the shares would have had at pre-oppression stage, the court has to assess what the value would have been but for the interference of the parent. The group context makes valuation less straightforward especially if the complaint refers to failure to enhance the potential of the subsidiary.

45 Supra note 42.
47 Hadden, op cit, at 28.
48 Prentice, op cit, at 117.
Another option for a much aggrieved minority shareholder is to attempt to seek a winding up of the subsidiary under the provision in Section 217. The possible grounds could be the just and equitable ground (Section 217(f)) and the directors self interest ground (Section 217(da)). Proof of systematic subordination of the subsidiary's interests by the controlling shareholders could arguably satisfy the former ground; however the latter is apposite in that directors of the subsidiary could be found to have acted in their interests if their actions are designed to serve the interests of another company in which they are directors. This would cover common directors. Section 217(da) also extends to any action by the directors that is “unfair or unjust to any member of the company”. Arguably, unfair dominance and manipulation of the subsidiary by the parent which is abetted and countenanced by the directors of the subsidiary will be covered. Even so, the subtle unfairness that minority shareholders face may not justify so drastic a measure as winding up a solvent company especially if the complaint is that the company's growth potential has not been fully realised as part of group strategy, as opposed to the more blatant conduct which would justify an action under this section. In the end, these remedies have more effect simply by the threat of invocation which could goad the management into a compromise.

Thus the range of options open to the minority shareholders has been considered. One pertinent option is not provided for by New Zealand company law, to wit, the option of the minority shareholder to compel the majority shareholder (the parent) to acquire his shares independently of proving oppression etc. Such a right could alleviate the lack of transferability of the shares of certain companies. A minority shareholder

50 Such a right is discussed by Prentice, op cit, at 124 – 125. However, the difficulties attendant upon the parent as shareholder being privy to, and having control over, all price-relevant information can be an obstacle to a satisfactory sale by minority shareholders. This fact affords the parent a substantial bargaining advantage. In the absence of a general fiduciary duty on controlling shareholders to act fairly towards minority shareholders, equitable principles may be developed to compel disclosure of all price-relevant information. In Strong v Repide, 213 US 419 (1909), it was held by the United States Supreme Court that a controlling shareholder had, in special circumstances, a duty to disclose all facts material to a transaction involving minority shareholders. In particular, the special circumstances centred on the “inside” position occupied by the controlling shareholder and the attendant confidential knowledge obtained thereby. Positing acceptance of this principle in our own jurisdiction, perhaps herein lies a basis for equalising the positions of the respective parties. Farrar and Russell, op cit, at 285 proffer this suggestion in the general context of control. By advancing this argument and applying it in the parent subsidiary context, it is submitted that the fact that the parent controls management of the subsidiary and has access to relevant material supports a finding of “special circumstances”.

Viewed this way, the rules seems well suited to parent companies. Another solution could be the introduction of some form of court controlled statutory “appraisal” remedy which serves as a means of discovering information about the transaction. However, before appraisal can be pursued, there must be some triggering event. See H. Kanda and S. Levmore, “The Appraisal Remedy and the Goals of Corporate Law”, 32 U.C.L.A. Law Rev. 429 (1985) at 445 for a summary of triggering events. Basically, it is submitted that the right should be available whenever there is some significant change in either business operation, corporate policy or constitutional structure of the subsidiary instigated by the parent such as to cause minority shareholders to want to cease their participation in the subsidiary.
in a publicly listed subsidiary may not be unduly prejudiced by the absence of such a right but his counterpart in a private concern could well face problems in realising his securities. The development of such a right is surely needed.

In summary, there are special considerations which make a minority shareholder's position more complicated than in a single enterprise. In this light, consideration ought to be given to greater disclosure as to the conduct of intra-group affairs and to other forms of minority shareholder protection, perhaps along German lines, which will be discussed in the context of reform.

VII. FIDUCIARY RELATIONSHIP BETWEEN PARENT AND SUBSIDIARY

I. Duty to Act Fairly

Contemporary Commonwealth company law does not recognise any duty on the part of the majority shareholders. A shareholder is entitled to exercise the voting rights accompanying his shares in any manner he pleases provided he does not defraud or oppress or unfairly prejudice the minority shareholders. However, this aspect of the law is now in a state of flux as the courts are beginning to recognise that in some circumstances, majority shareholders are subject to equitable fetters on their voting rights. Whatever the eventual development of the law in this sphere, there are complications in the group context. The parent company is the majority shareholder in the subsidiary. Given the purposes for which groups are usually formed, the likelihood that the parent corporation will exercise its voting rights without being influenced by the group interest is remote or at least doubtful. However, the minority shareholders have different expectations. Thus in the context of controlled, as opposed to wholly owned, subsidiaries the courts ought to regulate the voting powers of the majority in some way. Viscount Simonds and Lord Keith of Avonholm said in Scottish C.W.S. v Meyer that a parent should conduct its own affairs in such a way as to deal fairly with the subsidiary and its minority shareholders. Although they referred to conduct of the parent's affairs, this could be extended to cover the exercise of the parent's voting powers by the parent's board. This would bring the law in line with the American stance.

In the United States, majority shareholders are accepted as owing fiduciary duties to minority shareholders. In the group or parent-subsidiary context, this duty has been held to entail acting fairly towards the subsidiary.

51 North West Transportation v Beatty (1887) 12 App. Cas, 589.
52 For fraud on a minority see Farrar & Russell, op cit, at 262 et seq. See also Stanford v Gillies (1880) O B & F 91. (Supreme Court).
54 [1959] A.C. 324 at 343 per Viscount Simmonds and at 362 per Lord Keith of Avonholm.
The courts have formulated a host of tests to determine fairness. One test that had been frequently applied was that of the arm's length test. Essentially the test asks whether the result would have been the same had the two parties been disinterested and acting under the same conditions. This presupposes two parties of equal bargaining power and in this sense is more appropriate to the separate entity approach. In this light, the test has been criticised as being unrealistic given the group background against which the transaction took place.\footnote{See 57 Va. L. Rev. 1223 (1971), supra note 56 at 1226, 74 Yale L.J. 338 (1964), supra note 56, at 340 and Walde, supra note 62, Bonnano, supra note 56 at 166-168.}

Another test advanced is the expectations test. This approach looks at the expectations of the parties concerned at the time when the parent-subsidiary relationship was entered into (or the last time the minority shareholder had an opportunity realistically to end his participation). It is all very well to suggest that the shareholder could have ended his participation upon adequate notice of the impending action of the parent but in reality he may be compelled to sell at a time of unfavourable market conditions. In view of this, and given the monotransactional focus of the test, it is not surprising that the test has not gained wider acceptance.\footnote{74 Yale L.J. 338 (1964) supra note 56, Walde, supra note 62.}

Two more widely used tests are the intrinsic fairness test and the business judgment test.\footnote{Sinclair Oil Corporation v Levien, supra note 56 (esp at 720).} The former is invoked when one actor effectively controls both sides of the transaction.\footnote{Ibid.} It thus applies to the parent as holding company and parent as majority shareholder of the subsidiary. The parent is charged with the burden of establishing that the transaction is fair.\footnote{Ibid.} Despite this favourable feature (from the minority shareholder's perspective) the test has significant limitations. The plaintiff is initially required to prove control and furthermore, the test does not apply if the plaintiff has not demonstrated any "self-dealing" on the part of the parent.\footnote{Ibid.} These requirements diminish the practical utility of the test. The business judgment test is not much of an improvement. The minority shareholder has to demonstrate "gross and palpable overreaching" on the part of the parent in the conduct of the subsidiary's affairs.\footnote{Ibid.} It is arguable that this test imposes too high a standard on the plaintiffs. The test apparently only applies if there is no evidence of self-dealing.\footnote{Ibid.} In Sinclair Oil Corporation v Levien\footnote{Sinclair Oil Corporation v Levien, supra note 56 at 470 et seq for a wide ranging discussion.} the court appeared to apply a composite test: first the plaintiff has to show an advantage to the parent coupled with a corresponding disadvantage to the subsidiary; where evidence of this is tendered the court will proceed to the next stage which is the application of the intrinsic fairness test. However, where there is no demonstrable advantage or disadvantage then the business judgment rule applies.\footnote{David J. Greene & Co. v Dunhill International Inc. 249 A 2d 247 (1968).}

The tests share one characteristic: they are all monotransactional in

Shareholders in a Konzern under German and United States Law", 18 Har. Int. L.J. 151 (1977), both of which contain stimulating discussions of the problems in this area. 

\footnote{Se also 57 Va. L. Rev. 1223, supra Note 56 at 1239.}
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focus. A particular transaction is challenged by irate minority shareholders, and the court’s attention is directed at the fairness of this transaction in vacuo. Group strategies and the means used to give effect to them may well seem objectionable on an individual basis but, if viewed as a whole against the background of the overall group structure, operate to benefit the group as a whole, and thereby to the indirect advantage of each subsidiary. Surely the question should not be whether any particular transaction has hurt the subsidiary; rather it should be asked whether when all transactions are viewed as a whole, the subsidiary in question has indeed been manipulated and abused. It could well be that whilst a monotransactional inquiry would reveal a detriment, the cumulative effect of group strategies coupled with the role of that subsidiary as a component of the group confers an overall benefit to the subsidiary.

2. Allocation of Corporate Opportunities

The problems thrown up by parent-subsidiary dealings are compounded by the inadequacy of the principles applying to the allocation of corporate opportunities in a group situation. It is trite law that any person who is fixed with fiduciary obligations vis-à-vis a company is prohibited from diverting commercial opportunities to himself where the company itself is capable of exploiting the opportunity concerned. As indicated earlier, there is no developed intra-group fiduciary doctrine in Commonwealth jurisdictions. Positing that such a development is capable of occurring through the growth of equitable principles in this area, then the question of intra-group corporate opportunity allocations must be dealt with. How then is a parent to allocate such opportunities? It is less meaningful to speak of “usurpation” because the parent company has its own constituents, viz. its own shareholders, who have expectations of benefiting from exploitation of the opportunity. Given the conflicting sets of interested actors, it is apparent that the duty to act fairly and the attendant tests become less capable of providing a comprehensive workable solution.

Certain other rules have been proffered. The ‘line of business’ rule eases allocation problems because by virtue of this rule, the opportunity goes to the company which already operates in that commercial field. However, matters tend to be more problematic where there is an opportunity to exploit an opportunity which is in neither parent nor subsidiary’s realm of operations; or where both parent and subsidiary are in the same field and the opportunity could be taken up by either. It has been argued that allocation of such opportunities should be determined on the basis of the promotion of efficiency and economic value. In other words, the company with the higher potential of increased return should be allowed to develop the opportunity. This desirable rule is ironically workable only in an “integrated group system” whereby it is accepted by all components that

67 See also Walde, supra note 56 at 485.
68 Aspects of the problems associated with allocation of corporate opportunities in a corporate group are discussed in V. Brudney and R. Clark, A New Look at Corporate Opportunities, 94 Har. L. Rev. 997 (1981) and Walde, op cit, at 480-484.
70 Ibid at 1051-1052.
71 Ibid at 1051-1052.
72 Ibid at 1050.
opportunities will be allocated on this basis pursuant to the overall group strategy. However, it is unworkable in a legal system in which, irrespectively of economic value and efficiency, the separate entity doctrine dictates that each company has to try its best to secure and develop the opportunity for the benefit of its own shareholders.

As with other areas of parent-subsidiary law, this area suffers from the demerit of unrealistic application of separate entity rules to multifaceted entities. The focus is again monotransactional. In a group enterprise, one opportunity denied may be compensated with a later one, with allocation being determined on the basis of overall group enhancement. Yet the conventional legal regime will not countenance any such approach. One opportunity denied is one too many. No account is taken of the planned exploitation of opportunities as a whole with each subsidiary having its role to play. The response of the present law is not surprising though given the need for protection of minority shareholders.

VIII. CREDITOR PROTECTION

Creditor protection is an important aspect of the law relating to groups of companies. The creditor has an interest in the group enterprise remaining solvent and very much a going concern, in the sense that the practical ability to discharge debts promptly is not prejudiced. However, the prevalence of the separate legal personality approach in Commonwealth company law means that creditors will, in law, be concerned with the interests of the particular group member(s) with which they have dealings. The principal of limited liability also plays a role. As a shareholder in the subsidiary, the parent company is only liable to the extent of the normal value of the shares plus any agreed premium. It therefore cannot be made liable to debts of its subsidiary simply because it is the parent even if the subsidiary is wholly owned.73 Thus creditors of the subsidiary will have to look solely to the assets of the subsidiary to satisfy their claims upon the insolvency of the subsidiary. The other consequence of this is that creditors of the parent do not have to share their asset pool with creditors of other group members.

How are creditors (especially those of subsidiaries) especially prejudiced by group enterprise as opposed to single enterprises? The policies and strategies of the subsidiary will usually be determined at parent level. These matters may directly affect the viability of a subsidiary. Also, a subsidiary may be thinly capitalised and have its operating resources financed by way of secured loans from the parent or other group members. As the initial phase of the subsidiary's existence may be economically uncertain, the parent or group member can get the subsidiary off the ground and operating through such loans (and thin capitalisation), and yet step in and claim back the loans ahead of general creditors were the subsidiary to fail and slide into insolvency.74 The parent manages to regain part of its initial investment and yet escape the responsibility for the commercial failure of the subsidiary by sheltering behind the limited liability shield.

73 In re Southard & Co. [1979] 1 WLR 1198.
Having attempted to place the issue of creditor protection in the group context, it now remains to embark on a comparative analysis of creditor protection strategies in certain jurisdictions.

1. The English Approach

The Cork Committee's review of the creditor protection provisions in English company law clearly indicates the inadequacy of such provisions. Presently, there is no means open to a court to postpone the parent's claims for repayment of secured loans to an inadequately capitalized subsidiary. Neither is English law equipped to require a parent to accept responsibility for debts of a subsidiary which it has mismanaged, manipulated or not allowed to have the opportunity to establish itself as a viable concern. The adherence to the separate corporate entity approach secures this result.

The courts have to fall back on other provisions which do not always satisfactorily provide a remedy in most contexts, let alone a group relationship. The set of doctrines relating to fraudulent conveyances could be applied. The shortcoming of these measures is that they concentrate on particular transactions in isolation, rather than focus on the wider problem, i.e. the management of the subsidiary which precipitated the insolvency. Another measure involves the provision for fraudulent trading in s.630 Companies Act 1985 (Eng.). The persons or parties responsible for the running down of the business are subjected to unlimited liability. This provision is unsatisfactory because of the difficulty in presenting sufficient evidence of the "intent to defraud". Despite its being a step in the right direction, even the Cork Committee's recommended new provision, viz wrongful trading, would not by itself completely solve the general problem of creditor protection in the group context.

2. Creditor Protection in New Zealand

There are significantly wider rules in New Zealand company law to deal with creditor protection in the group context than in the English jurisdiction. All the existing measures available under the English Companies Act are available here as well, viz. the doctrines relating to voidable preferences and that of fraudulent trading (s.320(1)(c)). There are also several other potentially applicable provisions - for example that of reckless trading under s.320(1)(b). This provision seems to encompass the carrying on of a business of a subsidiary in such a manner as to indicate blatant disregard for the

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73 Cork Committee, op cit, ch. 51 especially at 434.
75 Prentice, op cit, p. 107.
76 Cork Committee, op cit, supra note 74, ch. 44. The Committee pointed to the inadequacy of the provision of "fraudulent trading" in s.630 Companies Act (U.K.) 1985. That provision creates not only civil liability but also a criminal offence which was causative of a higher standard of proof and proof of dishonesty being required. Thus they recommended the new provision of wrongful trading wherein proof of fraud or dishonesty is not required and neither is a criminal standard of proof. Basically this was achieved by extending the new provision to visit liability on person who are party to the incurring of new debts liabilities at a time when the company was insolvent or unable to pay debts where there was not reasonable prospect of meeting them in full. Ibid, paras 1776 seq. This provision resembles the provisions of 2.320 Companies Act 1955 (N.Z.) The Cork Committee's recommendation goes further in one important respect which is discussed infra, at text accompanying note 80.
consequences and would cover directors and management of the subsidiary. S.320(1)(a) on the other hand effectively encourages management of a subsidiary to cease trading and resort to winding up of the subsidiary when it appears that debts cannot be fully repaid as they fall due. This discourages the carrying on of the subsidiary’s business by way of creditor financing. It appears from the wording of s.320(1) (a) and (b) that the directors of the parent will not come within the purview of these provisions, whilst they would under s.320(1) (c). It is submitted that these provisions should be reworded to enable liability to be visited on persons who were parties to the reckless trading so as to make directors of the parent liable as well.

The Cork Committee’s proposed wrongful trading provision goes slightly further than these provisions in one respect. The Committee suggested that in the group context, the parent ought to be presumed to be a party to the decisions of the subsidiary’s management (and therefore a party to the attendant wrongful trading) whenever the parent had been responsible for the appointment of the subsidiary’s board or a substantial part thereof; or where the boards of both parent and subsidiary have substantially similar composition. This stance was taken because the committee felt it would be difficult to prove either that instructions were given by the parent’s management, or that the subsidiary was made to trade in that manner due to covert means of influence. The effect of all this is to impose a rebuttable presumption on the parent which it can free itself of by proving that no such influence was in fact exerted over the subsidiary’s board despite the presence of common or nominee directors of the parent. This does give the provision relating to wrongful trading more bite with respect to parent-subsidiary matters. Given the reasons which prompted the committee to recommend such a provision, it is arguably more realistic to overcome the difficulties of proof of such participation by presuming it.

S.315A and s.316B of the Companies Act 1985 represent a radical disregard for separate corporate existence and marks the point of departure for creditor protection in New Zealand vis-à-vis the English and other Commonwealth jurisdictions. S.315A provides for contribution by a company to the debts of a related company. S.315B concerns the winding up of related companies. They may be wound up together (thereby forming a common asset pool) if it is just and equitable to do so. The discretion conferred upon the courts in both provisions is exercisable according to the guidelines in s.315C. These are:

(a) the extent to which the related company took part in the management of the company being wound up;
(b) the conduct of the related company towards the creditors of the company being wound up;
(c) 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; and,
(d) such other matters as the courts think fit.

79 Farrar & Russell, op cit, at 435.
80 Cork Committee, supra note 74 at para 1938.
81 Discussed by the Cork Committee, ibid, at paras 1947-1950. The Committee, mindful of the fact that its brief was restricted to a review of the law of insolvency, did not feel able to recommend the adoption of similar provisions because of the significant change to company law in general which such a person would bring about.
Regarding s.315B, there is a further factor to be taken into account, namely the extent to which the businesses of the companies have been intermingled.82 Related companies are defined in s.2(5).83 Taken as a whole, these provisions have wide application to the parent-subsidiary and group situations.84

These provisions abrogate, to an extent, the privilege of limited liability normally accorded to shareholders. It should be noted that insofar as s.315A and s.315B are applicable to controlled subsidiaries (i.e. partly owned), the practical consequence is that limited liability is effectively denied vis-à-vis the controlling shareholder (the parent) whilst still maintained for the individuals or corporations who make up the minority shareholders. It appears that no right of contribution is available and that the parent as controlling shareholder bears the burden of liability.85

It is interesting to note that the New Zealand provisions resemble that of the American doctrines of veil-piercing and consolidation of related bankrupts.86 However, it appears that the New Zealand courts have no express power to exercise postponement of a parent company's claim to repayment of a secured loan to its subsidiary (which is being wound up).87 Instead, under s.315A the court has power to demand contribution to the debts of the subsidiary. Arguably, if the circumstances were such as to have justified equitable subordination under American bankruptcy law then, despite not having an express power of postponement, the court can effectively nullify the claim by ordering equivalent or even greater contribution by the parent. Unlike s.315B, there is no legislative direction under s.315A that rights of secured creditors (i.e. the parent in this case) should not be prejudiced. This leads on to an observation about s.315B itself and that status of the parent or related company as a secured creditor. S.315B(3)(c) states that no rights of any secured creditor of any of the companies is to be affected. However, it is clear that to apply this to secured claims as between the parent and subsidiary companies themselves would amount to naught in practice because their assets will end up in a common

82 S 315 C
83 The definition of "related companies" is wide, and is not confined to the conventional notion of "holding company" and "subsidiary". See especially s. 2 (5) (d) and (e).
84 There was no criticism of the New Zealand provision; indeed the comments seemed favourable.
85 Referred to by the Cork Committee, op cit at para 1942. The New Zealand provisions are drafted in terms of liability being visited on related companies. The provisions do not use the term "persons". It could be inferred that the legislature did not intend to abrogate in any way the sanctified notion of limited liability for human (as opposed to corporate) shareholders.
86 For a comprehensive analysis of the doctrines of equitable subrogation, veil piercing and consolidation of related bankrupts see Landers, supra, note 76. In the event of the subsidiary's insolvency equitable subordination is used to postpone the claim to repayment of a purported loan to the subsidiary wherefore if not postpones, the parent as secured creditor would have secured repayment of its "loan" (but which almost always represent risk capital in substance) ahead of other creditors. Veil piercing is essentially the same concept as that used in Commonwealth jurisdictions; and it results in the assets of the parent being reached by creditors of the subsidiary. Consolidation of related bankrupts is a procedure which is similar to s 315 B in its applications and conceptual grounding.
87 Landers’s article is invaluable as a source of the circumstances in which the doctrines may be applied.
88 Unlike courts in the United States who can resort to equitable subordination: See, supra note 86.

asset pool anyway. The final point to be noted is that although application of s.315A and s.315B seems unfair to creditors of the company with more assets, for the reasons already stated, given the realities of group management practices, the measures in these provisions are necessary in order to provide the most equitable solution to all concerned.\textsuperscript{88}

Although there is scant authority on the basic ambit of these provisions, there is some judicial consideration of the construction of particular phrases therein. In \textit{re Grazing and Export Meat Co.},\textsuperscript{89} the phrase “as if they were one company” was held to mean that following satisfaction of the claim of secured creditors of each group company, all the assets of the companies concerned would form a common pool from which the claims of unsecured creditors could be potentially satisfied. Thus a secured creditor whose security over the assets of three companies out of a group of seven had become worthless was entitled to participate in the common pool as an unsecured creditor.\textsuperscript{90}

Cook J was of the view that:

\begin{quote}
"the fact [that] the security which is held from one company proves worthless does not to my mind, in the absence of some limitation in the order, mean that that particular creditor's rights are limited to other assets (if any) of that particular company, or that the creditor's rights are extinguished if there are no other assets."
\end{quote}

The phrase 'just and equitable' was considered in \textit{Home Loans Fund (NZ) Limited}\textsuperscript{92} where Casey J said:

\begin{quote}
"I think Parliament intended the Court to have the broadest discretion to effect a result which accords with common notions of fairness in all the circumstances, bearing in mind the cardinal principle underlying insolvency administration, that there should be equality among creditors of the same standing."
\end{quote}

Thus the duty of the Court in regard to any order under sections 315A and 315B is to adhere to the requirement of equality amongst unsecured creditors.\textsuperscript{94}

In addition to the statutory provisions discussed above, there is a common law development which enhances creditor protection generally. This development is the somewhat tentative proposition that in New Zealand, in a situation of marginal solvency, a director may be charged with an obligation to have due regard to the interests of creditors.\textsuperscript{95} Should such

\textsuperscript{88} In other words, the supposed unfairness vis-à-vis creditors of the relatively wealthier company is mitigated somewhat by the fact that were parent and subsidiary allowed to remain separate, the creditors of the dominant company would have benefited from the wrongful treatment of the dominated company which in most cases results in financial gain of the dominant company at the expense of the subsidiary.

\textsuperscript{89} (1984) 1 BCR 668. The case actually concerned s.24 of the Companies Special Investigations Act 1958. Basically, this provision is similar to that of s.315B and therefore equally applicable to the provisions of the Companies Act discussed herein.

\textsuperscript{90} Ibid at 674.

\textsuperscript{91} Ibid.

\textsuperscript{92} Unreported, M589/78, High Court, Christchurch, 7 December 1982.

\textsuperscript{93} Ibid.

\textsuperscript{94} \textit{re Grazing and Export Meat company} supra, note 89 at 675.

\textsuperscript{95} \textit{Nicholson v Permakraft} (NZ) Ltd. (in Liq.) [1985] 1 NZLR 242. The proposition is tentative because it was only Cooke J (as he then was) who was of this view. Richardson and Somers JJ preferred to avoid expressing any final view on this point. Cooke J's view is supported by dicta of Cuming Bruce and Templeman LJJ in \textit{re Horsley & Weight Ltd}
a duty enure in circumstances of marginal solvency, then arguably
duty enure in circumstances of marginal solvency, then arguably
management of a subsidiary could well be held to have breached this duty
were they to undertake a course of action that could foreseeably undermine
the subsidiary’s ability to meet its debt obligation, whether upon the
instructions of the parent company or, a fortiori, of their own volition.
In the same vein, the conduct of the directors of the parent company on
instructing the directorate of the subsidiary to pursue such a course of
action could also be a factor pertinent to the exercise of the court’s discretion
under s.316A and s.315B. Such conduct is relevant pursuant to sections
315C (1) and (2). This should not be equated with any direct duty owed
to creditors of the subsidiary by the parent company.96

IX  REFORM

A. The Need for Reform97

It is hoped that the preceding discussion has illustrated the generally
unsatisfactory nature of the present of the law relating to groups of
companies. There is a disjointed approach to the regulation of group
enterprises; it is devoid of any coherency. There also appears to be a marked
divergence between the idealised visions of the present law, and the realities
of corporate management of group enterprises. This is evidenced by
Hadden’s case studies, and also by the brief review of the case law. Were
reform of the law considered, the aim should be to balance the interests
of all involved. Management should be allowed to manage the group as
an integrated unit if, within reasonable bounds, they think it economically
desirable, and if they think it improves their efficiency. This privilege, i.e.
of freedom to impose unified management on a subsidiary, should be granted
in exchange for reciprocal acceptance by group enterprises of group
responsibility towards creditors, and also of guaranteed protection for

[1982] 1 Ch at 454-456. The proposition that directors have to consider interests of creditors
where the company is insolvent is clearly established: Nicholson v Permakraft per Cook
J at 249-250, Richardson J at 254 and Somers J at 255, Kinsella v Russel Kinsella Pty.
It is the duty in times of marginal or questionable solvency which is controversial. The
N.S.W. Court of Appeal in Kinsella preferred to accept the narrow proposition in Nicholson
v Permakraft to wit, that the duty ensures when the company is clearly insolvent, and
left open the wider questions.

96 Positing that a duty on directors in times of marginal solvency gains wider judicial acceptance,
it would be interesting to speculate whether there could be future judicial extrapolation
of this new duty, thereby extending the boundaries to include a duty on the part of the
parent’s directorate to creditors of subsidiary. Such an extension would be out of phase
with the current single entity approach to group regulation. However, given that the duty
may be predicated on the grounds that the creditors can fairly be said to be beneficially
interested in the company or contingently so (per Cooke J. supra note 2 at 250), then
could not the obviously real and ever present exercise of control by the parent company
be tempered with a duty to give due consideration to the interest of creditors of the subsidiary?
In the group context, this approach seems to be in harmony with the general spirit of the
provisions in SS. 315A-C. It also appears to be in accord with “the now pervasive
concepts of duty to a neighbour and the linking of power with obligation”, per Cooke
J. suppra note 2 at 250. This discussion is confined to existing creditors: cf Cooke J, ibid.

97 One commentator has noted that an obstacle to reform is the lack of acknowledgement
that there actually is a problem, and therefore a need for reform. Jane Welch, Note on
minority shareholders. Reform should aim to improve the extent and nature of information provided in order that there is adequate supervision of management. Any proposal for reform should also have regard to the economic implications of group regulation and also have an eye to improving efficiency. Given all that, the question still remains: what form should it take? Having looked at the looking-glass and observed the existing state of the law in the first section of this paper, it now remains to have a look through the crystal glass at possible reform.

B. Disclosure

It has long been recognised that the provision of accurate and comprehensible information on various aspects of company structure and management is essential for various reasons. These include assessment of company performance, protection of interest groups like creditors, shareholders and employees, and for enhanced scrutiny of the workings of management. It is trite to say that this is all the more important in the context of group enterprises. The very nature of groups and the close links between the various strata of management can be difficult to comprehend unless sufficient information is available through disclosure. It is partly to this end that commonwealth company law has provided for consolidated group accounts which are required to give a true and fair view of the overall performance of the group. The provision of such group accounts, although a very necessary requirement, does not go far enough towards the provision of information for diverse interested persons; information which would help elucidate the nature of the working relationship between the various group members. For instance, it has been noted that there is a marked prevalence of intra-group activity, namely intra-group financing, asset transfers and dividend declarations etc. It has been observed that present disclosure requirements are inadequate because they fail to provide a clear indication of the extent of these important and common occurrences.

Thus it seems that disclosure is necessary although exactly how much and exactly what should be disclosed is a matter of debate. It is proposed to summarise and consider the basic proposals that have been aired elsewhere. There are suggestions that emphasis should be placed on subgroup or operating unit accounts as a means of enabling minority shareholders.

99 For example s. 154, s. 155 and s. 156 Companies Act 1955 (N.Z.).
1 Hadden, op cit at 28.
2 See L.S. Sealy, "The 'Disclosure' Philosophy and Company Law Reform", (1981) 2 Co. Lawyer 51 where arguments worthy of note are advanced against too much disclosure because of the costs involved and drawing attention to the fact that after a certain point, disclosure attention to the fact that after a certain point, disclosure can neither be understood by, nor grasp the attention of, the persons at whom it is directed. See also the same author's Company Law and Commercial Reality (London, Sweet & Maxwell, Centre for Commercial Law Studies, 1984, especially at 22-29. However, it is nonetheless still felt that disclosure of intra-group transactions which management of group members are presently not obliged to disclose, and disclosure of which is a central feature of present German and E.E.C group regulation is a necessary element in the overall structure of a group regulation regime, and that the benefits outweigh the disadvantages. At this point, advocates of a particular disclosure proposal are doubtless influenced by personal value judgment and their respective biases. It is also true that, as has been noted, certain legal goals are worth pursuing despite the fact that they are not cost effective: see Farrar & Russell, op cit, at 188.
Controlling the Puppeteers

shareholders in subsidiaries (as opposed to shareholders of the holding company who would not unexpectedly be concerned with the consolidated group accounts) to obtain a clearer understanding of operations at lower levels within complex groups.\(^3\) The Vredling Directive contains proposals on measures for the provision of information to employees.\(^4\) The information required to be given, although general in nature, must give a clear picture of the activities of parent and subsidiaries as a whole. More specifically, disclosure requires information on:

(a) The structure;
(b) The economic and financial situation;
(c) The probable development of the business and of production and sales;
(d) The employment situation and probable trends; and,
(e) Investment prospects.

This is specifically directed at employees and is tied up with the proposed shift in management decision-making to include employee representatives.\(^5\) Shareholders too should be entitled to receive more information from management, and it is submitted that there should be provision of material, prepared perhaps by externally appointed auditors,\(^6\) which gives a greater insight into intra-group transactions in addition to the already existing group accounts and proposed sub-group accounts. It is hoped that initiatives like the Vredling Directive, and the proposed disclosure covering intra-group transactions will be adopted in order to diminish the mystique surrounding management structures and intra-group dealings. It is clearer that disclosure does help in the regulation of group enterprises, and should be part of any such proposed scheme.

C. Group Regulation under German Law\(^7\)

In this section, the law relating to groups, as applicable in West Germany

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\(^3\) See Hadden, op cit, at p. 27 et seq for elaboration.


\(^5\) The trend, in Europe at least, has been of late to include some element of employee representation in the decision-making structure of an enterprise. This trend is evidenced, for example, by the Bullock Report, Report of the Committee of Inquiry on Industriam Democracy, Cmnd 6706, 1977. Employee representation has been an established part of West German Law. Consideration of this topic is beyond the scope of tis paper.

\(^6\) Presently, under s.163 (1) appointment of company auditors is by members of a company at a general meeting, at which naturally, in the case of a subsidiary, the parent qua majority shareholder controls the voting. The suggestion for externally appointed auditors is to remove the danger, however infinitesimal, that in a situation of doubt, auditors appointed by the parent, may come down in favour of the parent. See also Walde, op cit, at 503 voicing such concerns. The choice of auditor and his appointment possibly be shared equally by both parent and minority shareholders.

\(^7\) It is not proposed to review the present E.E.C. proposal for regulation of group enterprises viz the Draft Ninth Directive, because the proposed directive is heavily influenced by German Law, and employs similar concept and procedures with certain modifications. For a discussion of the Draft Ninth Directive, see Hadden, op cit, at 34-35 and P. Derom, “The E.E.C. Approach to Groups of Companies”, 16 Va. J. Int. L. 565 (1976).
under the *Aktiengesetz*, of vertically structured group enterprises will be considered, viz. a “group and a “de facto” group. The contractual group comes into existence when a control contract is entered into between the dominant enterprises and the dependent enterprise whereby the former formalises its control over the latter.8 On the other hand, a de facto group is a combination of enterprises connected solely by a relationship involving dependence and dominance.9 The de facto group represents the more common and conventional form of group existence. The principles governing the duties, privileges and liabilities of each species are different; the choice of relationship, and therefore the appropriate legal regime, is entirely that of the dominant enterprise concerned.

A dominant enterprise wishing to formalise relations with its dependent enterprise would do so through the medium of a control contract.10 This is a consensual agreement which becomes part of the constitution of the subordinate company. Basically, it allows management of the controlled company to accept instruction from the controlling company without exposing them to liability for having abdicated their executive responsibilities.11 It follows that the legal result is the Patent and formalised uniform management of both entities. In order for the controlled company to conclude the control contract, approval must be sought and obtained from the holders of seventy-five per cent of the share capital of that company.12 The formal facilitation of wide ranging dominance naturally comes at a price; the controlling company accepts certain responsibilities in exchange. It has to ensure that any deficit in the annual trading account is extinguished and it must pay compensation for any damage or detriment suffered as a result of any act that was not in the controlled company’s interests.13 These provisions are designed to protect the interests of creditors. There is one significant limitation on the right to control, any act or direction of the controlling company must be for the good of the group as a whole, to wit, it must be economically justifiable even if it is not in the interest of the controlled company.14 Failure to adhere to this results in the controller being liable to the controlled company which is enforced by way of an action by a minority shareholder, or by a creditor where the controlled company is in a state of marginal solvency or worse.15 Usually, a control contract is coupled with a profit transfer contract wherefore the dependent company is required to transfer its profits to the controlling enterprise. The latter has a corresponding obligation to make good deficits of the dependant company.16

8 See Articles 291-292 *Aktiengesetz* (hereinafter *Akt G*).
9 Articles 17 and 18 *Akt G*.
10 Supra note 8.
11 Article 308 *Akt G*.
12 Article 293. *Akt G*. It seems somewhat incongruous that such a level of approval is required. Surely in view of the amount of voting power exercisable by the dominant enterprise, there should be separate acceptance by, say, 75% or 90% minority shareholders voting separately.

Other criticisms have been levelled at the control contract. The dominant enterprise determines when such a contract in a weak phase of the dependent company thereby imposing unfavourable settlement and compensation terms. See Weidemann, op cit, at 33.

13 Article 30 2 *Akt G*. Furthermore, a minimum statutory capital reserve must be maintained pursuant to Article 300.
14 Article 308 (1) *Akt G*.
15 Article 309 *Akt G*.
16 Articles 291, 292 and 302.
The continued participation of minority shareholders in the enterprise is facilitated by provisions which are cognizant of the changed operating circumstances, to wit, if the subsidiary's operations are no longer to be conducted in its best interests, then the prospect of it declaring attractive and satisfactory dividends is jeopardised. Therefore, taking the changed circumstances into account, minority shareholders are entitled to a dividend guarantee under Article 304. In addition, the provisions of Article 305 provide that the minority shareholder can compel the dominant enterprise to exchange their shares for cash or for shares of the latter or if a principal dominant enterprise exists, then for shares in that company.

It is evident that certain corporate groups may choose not to avail themselves of the control contract regime. Such groups may prefer to remain in a relationship of informal dominance and dependence. Therefore, the legislature devised measures to protect minority shareholders and creditors in de facto groups. Article 311 prohibits the dominant company from influencing the dependent enterprise in any matter which is detrimental to the latter's interest. However, this is qualified by the fact that the use of influence to disadvantageous ends is allowed provided adequate compensation is made to the dependant entity. If no compensation is forthcoming, then any conduct in violation of Article 311 results in the dominator being liable for any damage to the subordinate company. This is subject to yet another qualification in that a dominant enterprise can exculpate itself if it can, in accordance with Article 317(2), show that an orderly and conscientious manager of an independent association would have undertaken or omitted to under the relevant course of action.

Another feature of de facto group regulation is the Dependency Report. This buttresses the foregoing provisions. It would seem that the raison d'être for this report is the preservation of the independence of the dependant company. The report is prepared by the management of the dependant company. By virtue of Article 312, the report must necessarily include details of all transactions between the dependant enterprise and its dominator. Any action which is omitted to be taken is also within the purview of this report. The report is then referred to the dependant company's auditors who are charged with the duty of policing the relationship. The singular responsibility on the auditors cannot be overstated, as the report contains information which is not unnaturally commercially sensitive, and therefore cannot be made available to anyone else, minority shareholders included.

17 Based on the formula contained in Art 304(2) viz an amount of at least the annual payment which could foreseeably be distributed as an average dividend calculated according to the trading record and operational results of the dependent company and its expected future income.

18 The ratio is ascertained pursuant to the ratio of shares of the dominant enterprise which would have to be granted in exchange for one share of the dependent enterprise in the event of a merger. For a consideration of parent-subsidiary mergers, see V. Brudney & M. Chirelstein, "Fair Shares in Corporate Mergers and Takeovers" 88 Har. L. Rev. 297 (1974). Some of the themes there taken further in the same authors' A Restatement of Corporate Freezeouts" 87 Yale L.J. 1354 (1978).

19 Article 311(1).

20 See Walde, op cit at 502-503 for a critique.

21 However, pursuant to Article 314(2) Akt G, the supervisory board of a subsidiary, having considered the report upon referral by the auditors, is obliged to examine and report on its examination to the shareholders at a shareholders meeting. The supervisory Board's opinion must also be given.
A further consequence is that potential court proceedings under Articles 311 and 317 become all the more difficult are alleviated in the event that recourse to the report. The difficulties are alleviated in the event that the auditor has refused to approve the depending report because of the unfavourable treatment of the dependant company, or has only given his qualified approval. In these circumstances, a court appointed special audit is ordered whereby unfavourable aspects of the report are investigated; the results of this audit are made public.22

The contractual group is the German statutory model of a unified, integrated group operating in harmony with the realities of corporate group existence. The legislative intent was to encourage formation of such groups. To this end, existence as a de facto group was made as unfavourable as possible, with supposedly onerous and restrictive provisions applying in order to secure the well-being of the dependant company. Fiscal advantages flowing from a control contract were designed to tempt groups into this preferred state of existence. It is acknowledged by commentators that this goal has not quite been realised.23

D. Limited Liability and the Economics of Group Regulation

The privilege to exercise a power of unified management over subsidiaries in any reform proposal would necessarily and reciprocally involve some alteration to the limited liability enjoyed by the parent qua majority shareholder. In the West German group regulation system the major incentive to tempt a group into concluding a control contract would be the fiscal and tax advantages flowing to it, however most of the Anglo-American comparative scholarship on the West German System has not addressed the limited liability aspect of group regulation.24 The economic ramifications of any abrogation of limited liability in the group context will undoubtedly be important, considering that the privilege of limited liability is a significant investment incentive, and in this respect corporate shareholders are no different from personal shareholders.25

22 Article 315 Akt G. For discussion of this see Walde, op cit, at 503-504.

23 Weiden., supra note 4 at 30 notes that the tax incentives in favour of existence as a control contract group have been eroded. He notes that a study has concluded that fewer control contracts were being entered into: Ibid, 28-29.

Clearly, groups must be tempted into the more coherent regime by attractive tax incentives and the erosion of this is unfortunate and undesirable.

Furthermore, the de facto regime is governed by provisions which are not rigorous enough. The provisions of Article 31 vis-à-vis exercise of influence by the dominant enterprise are an example. As one commentator has noted, if the same degree of influence can be exercised independently of entering a control contract, then on a cost/benefit analysis, contractless existence is enhanced. See Walde, supra note 62 at 500-502.

24 In summary. Unlimited liability is imposed under German law for integrated groups (for a discussion which see text accompanying note 6 supra and the works cited in note 4, supra). In the case of control contract groups, there is no general liability for debts of a dependent enterprise but rather an obligation to pay compensation for losses of the dependent enterprise which effectively protects the company against insolvency. De facto Konzerns have limited liability albeit they are obliged to compensate the subsidiary for detrimental influence exercised by the dominant company.

25 The role of limited liability was an important consideration in the Cork Committee’s deliberations. See Cork Committee, op cit, Chp. 51. In the following discussion, the phrase “corporate shareholder” refers to an investor who is also the parent company in law of the subsidiary, and not to corporate investors in general.

Secondly, the phrase “qualified limited liability” means limited liability which although initially applying is subsequently abrogated or qualified ex post facto in certain circumstances.
Limited liability exists because it provides an optimum risk-sharing arrangement between corporations, their shareholders and their creditors, and it fosters investment by reducing the risks to shareholders which may otherwise be attendant upon the modern day phenomenon of separation of ownership and control. In most scholarly work on the advantages or disadvantages of a limited liability regime, discussion by and large has centred on the single enterprise model. Just as some commentators have demonstrated that an unlimited liability regime may be more appropriate for small private closely held companies, it could well be that in the parent-subsidiary context, some form of qualified limited liability may restore the shareholder-creditor risk equilibrium which is, in most cases, disturbed by the peculiarities of group management practices.

Limited liability is advantageous because it encourages investment by shareholders whose whole personal wealth would otherwise be at stake in an unlimited liability regime. Naturally, the application of unlimited liability to corporate shareholders would also expose the parent company as majority shareholder to the creditors of the subsidiary. There are however, several reasons advanced by way of justification. First, it is argued that limited liability should only be granted to companies which adhere to a model of corporateness — meaning adherence to the formalities of the separate existence, preservation of subsidiary as a separate entity, and avoidance of commingling of assets and other detrimental intra-group practices.

However, because companies who own subsidiaries typically do not, in practice, adhere to this model of corporateness, non-conformity should involve some loss of limited liability. Secondly, it is argued that the original legislative policy intent behind limited liability was primarily to benefit human shareholders. Therefore, abrogation of corporate limited liability still leaves the main layer of limited liability intact. Thirdly, and perhaps more substantially it is argued that whilst limited liability is necessary to foster participation by shareholders in socially desirable but risky ventures, parent companies as shareholders have no such aversion to investment in risky undertakings. Thus the extension of limited liability to corporate shareholders has the undesirable consequence of fostering inefficient investment in rather marginal and questionable undertakings.

To an unlimited liability regime, each shareholder’s wealth is at stake; thus, there arises a corresponding need to monitor the wealth of other shareholders. Limited liability removes the need for such monitoring. The separation of ownership and control in the modern day corporation necessitates further efforts at monitoring; in this case the actions of

27 The discussions cited in note 26 supra touch upon the parent-subsidiary aspect but they do not develop it in great detail: See Easterbrook and Fishel, op cit at 110-111, Halpern, Trebilcock and Turnbull, op cit at 180.
29 Landers, op cit at 621 et seq.
30 Ibid at 618-619.
32 Fisherbrook and Fisher, supra note 26 at 95.
management will need to be scrutinised because investment decisions made by management will threaten a shareholder's investment and personal wealth, the point being that because management themselves have only a small stake in the company there is less incentive for them to tie their gains solely to the well being of the corporation.33 Limited liability reduces the need for scrutiny of management as personal wealth is no longer at stake. Removal of the privilege of limited liability from the parent as shareholder will not result in a need for increased monitoring because in a parent-subsidiary relationship there is no substantive separation of ownership and control at least in so far as the parent is concerned. The parent is in a unique position in that it is basically an investor-manager; it is therefore somewhat odd to speak of a parent monitoring the management of a subsidiary which it controls. Therefore, qualified limited liability can, in this sense, be economically justified.

Diversification of an investor's portfolio is enhanced by a system favouring limited liability.34 Basically, there are two forms of risk: unique risk and market risk. Unique risk represents that aspect of risk which flows from the peculiar characteristics of the particular company itself which might effect investment returns.35 Conversely the market risk is that component of the risk which is common to all industries and corporations and which flows from the general state of the economy.36 Diversification facilitates cumulative reduction of the unique risk component. In an unlimited liability regime, diversification could decrease the risk-lowering benefit normally attendant upon diversification, in that the actual realisation of even one of the diverse market risks associated with a particular shareholder's portfolio exposes the entire wealth of this shareholder. Limited liability avoids this result; consequently, diversification is encouraged. It has been demonstrated that whilst diversification is desirable for individual shareholders, it is not necessarily so for a corporate shareholder. A diversified corporation does not have any greater appeal as a potential investment vehicle than a relatively undiversified corporation.37 One can conclude that qualified abrogation of limited liability for corporate shareholders would reduce excessive diversification of corporate activities which in itself is beneficial to individual shareholders who do not gain by a company parent attempting to diversify its interests too widely.

Abrogation of limited liability for corporate shareholders would have the effect of introducing an undesirable factor into the transferability of shares. It has been convincingly argued that limited liability facilitates an organised securities market.38 Because a shareholder's contribution is restricted to the quantum of his investment, without the possibility of his wealth being exposed, the transferability of his shares in a particular corporation will be facilitated; conversely, were unlimited liability the norm, then the value of shares would be unduly influenced by considerations like the transferor's personal wealth and that of other shareholders of the

33 Ibid at 94.
34 Ibid at 96-97. See also Manne, supra note 26 at 262-263.
36 Ibid.
37 99 Harvard L R 986 (1986) at 990, Brearley and Myers, supra note 35 at 132-133.
38 Halpern et al, supra note 26 at 129 et seq.
Transferees would value the shares in the light of this information after having estimated the chances of putting their own wealth at stake through the purchase of the shares. Limited liability avoids this consequence. It follows therefore that abrogation of limited liability for corporations as majority shareholders would reintroduce these considerations. A potential take over could be influenced by the need to consider the changes of the potential target holding company, for example, being made liable for debts of its subsidiaries. Furthermore by exposing only the parent to unlimited liability and maintaining limited liability for minority shareholders in a subsidiary, a price differential between the values of shares will be created. Indeed, the effect of this could lead to an increase in the value of the minority shareholder's shares in comparison with that of the parent. The latter bears the risks, whilst the former enjoys the best of both worlds.

It is arguable that this would diminish the transferability of ownership of major holding companies. On the other hand, a potential purchaser of control, appraised of the history and performance of the target company, would tend to have the fact of potential intro-group liability reflected in the ultimate consideration payable for the transfer of ownership, wherefore movement in and out of major corporate groups would not necessarily be discouraged or unduly hindered.

Stripping the parent as corporate shareholder of limited liability will undoubtedly, and ironically affect certain creditors. Whilst creditors of certain group companies may benefit from piercing of the veil, creditors of the parent company may not be so enthused. Indeed, creditors of the parent will be forced to monitor activities of the parent in relation to its management of the subsidiary. Similarly creditors of the subsidiary, who would normally have looked only to assets of that company, would now have to undertake some measure of monitoring of the parent company's assets which they might have to reach for in the event of the subsidiary's insolvency. The problem is compounded in a situation whereby there are numerous holding corporations in the conventional sense, to wit, intermediaries in the vertical structure. Creditors who restrict their debt investment to the ultimate holding company are likely to be in most danger of being disadvantaged by the abrogation of limited liability in the parent subsidiary context. The result is an increase in the need for the creditor supervision and this need will extend to assessing the credit worthiness of all firms in the group. This will involve an increase in transaction costs for creditors which in turn will be translated into increased cost of credit for corporate groups.

Several factors may alleviate the problem faced by creditors. First, limited liability increases the magnitude of the moral hazard factor. Moral hazard

39 Ibid at 129-130, 136-137.
40 Expanding and applying to the group context the analysis by Halper et al. in the single enterprise context. They note that shares held by the minority could command a premium in a securities market. Ibid at 137.
42 Posner, supra note 41, at 516-519.
in these circumstances represents the increased likelihood that, after having secured finance, management of a corporation, emboldened by the reduced fear of liability, would be tempted to embark on marginal, questionable ventures, given that they are already safe behind the shield of limited liability.\textsuperscript{43} Clearly moral hazard in this sense increases the risk to the lender. Were the privilege of limited liability removed, the parent would have less inclination towards such behaviour. Correspondingly, creditors would benefit by a reduction in the moral hazard component which would otherwise be inherent in any credit facility. Therefore, partial abrogation of limited liability in the group context acts as a counter incentive.

Secondly, financial creditors may already possess specialized expertise in relation to investment in corporations active in particular fields. Banks and other institutional investors possess enough substantive information through their expertise in these areas to be able to assess the liability of investment decisions in groups.\textsuperscript{44} To the extent that this knowledge is part and parcel of the creditors expertise, monitoring will be reduced. It is conceded that this need not be universally true nor can it be automatically extended to groups engaged in wide-ranging unrelated lines of business. In addition, whilst banks and institutional lenders are generally substantial providers of credit, significant contributions numerically are made by trade creditors, who rely mostly on past trading history and who may lack the capacity to undertake costly supervision.\textsuperscript{43}

Thirdly and more significantly, it may be envisaged that a potential material pertinent to supervision could be generated by the companies themselves. Were a variant of the West German Dependency report to be adopted, then supervision of intra group practices is mandatory and undertaken at the expense of the companies involved. Creditors, whilst still having to bear the initial costs involved in assessing the risk of default at the point of entering into a credit transaction, could rely to a significant extent on the monitoring engendered by such a report as a means of ensuring subsequent supervision of intra group relations.

Secured debt may also assist in alleviating the supervision problems faced by creditors. Security over tangible assets would require monitoring of the state of only that security.\textsuperscript{46} In its present form, the provisions of sections 315A, 315B and 315C do not override in any way the rights of secured creditors. Therefore, in the group context, secured debt seems desirable. A secured creditor can also provide an additional monitoring service for minority shareholders, to wit, by providing signals to the latter; these signals

\textsuperscript{43} Also termed debtor misbehaviour. See Halpern et al, supra note 26 at 140.

\textsuperscript{44} Easterbrook and Fishel, supra note 26 at 100.

\textsuperscript{45} Protection of trade creditors would however be enhanced by a rule favouring qualified limited liability. This is because, as is generally acknowledged, they rely on the debtor's history of repayment, its tangible assets and group ties in their estimation of the risk. See Landers Another Word on Parents, Subsidiaries and Affiliates in Bankruptcy 43 U Chi L R 527 91976) at 530-513. To the extent that they do not engage in supervision, their interests will be served by such a rule. The other substantive avenue available to trade creditors in the absence of such a rule would be the reservation of proprty mechanism, to wit, \textit{Romalpa} clauses. The vagaries of this security device, especially the vexed question of whether the security amounts to a share and, therefore, requires registration, does not advance matters.

\textsuperscript{46} Easterbrook and Fishel, supra note 26 at 99. Furthermore, to this extent, it would seem that secured debt reduces the incidence of freeriding amongst creditors. See further, the discussion in Levmore, supra note 41 at 68-72.
Consist of overt actions taken by secured creditors in order to assert and buttress their rights whenever their security is threatened by harmful intra-group transactions.47

Some further observations may be made. First, if veil piercing is not allowed, it is generally true that creditors of the manipulated company will, to an extent, be indirectly taken advantage of by creditors of the manipulator. Abrogation of limited liability allows a more equitable spreading of the risk amongst all creditors. Secondly, the New Zealand legislature has already sanctioned the use of qualified veil piercing in New Zealand corporate law through the provisions of section 315A, 315B and 315C. In view of this, it must be the case that creditors in this country have already made the relevant adjustments needed to cope with credit provision in a group context.48 Thirdly, it is arguable that creditors always have, when so minded, negotiated some form of contracting out of limited liability in the group context; for example, by way of individual group members guaranteeing debt obligations of related companies.49 In conclusion it is arguable that some qualified abrogation of limited liability is economically feasible in the group context; and when aspects of the economics of limited liability are considered, the benefits which stem from the introduction of qualified limited liability seem to outweigh the disadvantages.

E. Proposed Mode of Reform

In this section, proposed modes of reform will be analysed. There are basically two approaches: first an intermediate regime could be created wherein existing fiduciary doctrines are modified whilst more stringent safeguards are introduced for the protection of minority shareholders and creditors. Development of this intermediate regime could be accommodated within the existing framework of the law. The second approach involves adopting in toto the German scheme of group regulation thereby importing new and unfamiliar concepts.

1. The First Proposal

To recapitulate on the discussion earlier in the course of this article, it was observed that contemporary Commonwealth law has an obsession with fiduciary doctrines which have a monotransactional bent. It was argued that this monotransactional focus was unrealistic given the realities of group existence, and thereby unsuited to the policing of group operations. Some modification of fiduciary doctrines could well be apposite. Rather than label each single unfavourable transaction a breach of a fiduciary duty to act for the good of the subsidiary, the focus could be shifted onto the net position of the subsidiary after any given accounting period at which point the cumulative effect of all intra-group transactions and all benefits (whether tangible or intangible) flowing from membership of a group are weighed.50 If the subsidiary has obtained some overall benefit, then despite

47 Levmore, supra note 41 at 69 et seq.
48 The new provisions were introduced in 1980.
49 Or even personal convenants with particular directors in a small group with common directorates.
50 For example, a subsidiary may be required to sell components of a motor engine to its parent, a motor vehicle production concern, at a profit albeit the profit level is much
the occasional unfavourable transaction, neither the management of the subsidiary or parent ought to be in breach of any fiduciary obligations. This will facilitate flexible decision-making for a parent company thereby allowing it to allocate resources, opportunities and expertise on a group-wide basis in what it considers to be the most efficient way whilst ensuring that despite occasions when the subsidiary has to be passed over, the position *ex post facto* is that the subsidiary has received some net advantage from its group existence. This should not be construed as a licence for the parent to impose its will on a subsidiary to its overall detriment in favour of some overall grand group design. Minority shareholders in subsidiaries will be accommodated by the concomitant introduction of specific statutory provisions modelled on the German *Aktiengesetz*, which reflect the fact that subsidiaries are no longer in theory, managed with the same single minded emphasis on profitability.\(^{51}\)

Any losses to the subsidiary caused by purely commercial reasons, for example, the market failure of a certain product or a sudden increase in the market cost of raw materials, both of which cannot be attributed to bad management on the part of the group, will be borne by creditors of the subsidiary concerned.\(^{52}\) However, if the insolvency of the subsidiary is due to unfair domination and manipulation of the parent, then creditor protection provisions based on the current New Zealand provisions can be involved to ascribe responsibility to the dominator.\(^{53}\) This imposition or qualified limited liability is the price exacted, by way of trade-off, when fiduciary obligations and rules of similar ilk are related in the group context. It may be argued that creditors will be prejudiced by this intermediate regime in the sense that granting a little more freedom from fiduciary duties lower than that potentially attainable by an independent company in similar circumstances. Viewed singly, it could be treated as a breach of fiduciary obligation. However, other transactions may counter this detriment. The subsidiary may receive raw materials at favourable prices from another subsidiary of the parent. Thus, ultimately, it is arguable more realistic to look at the overall state of affairs.

\(^{51}\) Refer to the discussion, supra, at text accompanying notes 17 and 18.
\(^{52}\) This is consistent with the current philosophic approach to limited liability in New Zealand and Commonwealth company law.

Factors which, if present, would tend to establish this would include (i) manifestly inadequate capitalisation thereby neutering any notion of viability on the part of the subsidiary, (ii) evidence of intra-group transactions which consistently involve detriment to the subsidiary (iii) the presence of a regular stream of management directives to the subsidiary which are, by nature, manifestly unrealistic and risky in the operational sense. Bear in mind that a monotonarchical focus is to be avoided. It is submitted that these factors could constitute relevant considerations vis-à-vis the application of selections 315A, B and C to a parent thereby abrogating its privilege of limited liability. To the extent that such factors are not present, then failure of a subsidiary will be borne by creditors.

Cf. Landers loc cit at 621-626 proffers a viability procedural observance test to help differentiate between instances where a parent has used its privilege of limited liability in a justifiable manner, and cases where the subsidiary has never been commercially viable entity to the parent's detrimental influence. The factors pertinent to this test are:

(i) adequate capitalisation of the subsidiary.

(ii) the subsidiary must be managed in such a way that it has a reasonable prospect of profitability, or potential for such.

(iii) the subsidiary must not be excessively dependent on the parent.

(iv) corporate formalities must be observed.

Ibid at 621-626.
without imposing reciprocal unlimited liability seems counterproductive. It is not envisaged that this will be so because the intermediate regime offers a compromise between absolute unlimited liability wherein corporate investors assume the role of primary risk bearers and absolute limited liability for groups wherein creditors are the primary risk bearers.54

Difficulties could arise in the event of the insolvency of the subsidiary if the insolvency was precipitated by a combination of disadvantageous group practices and commercial factors. A search for the actual operative factor may prove elusive in some cases, wherein the issue becomes a complicated question of causation. One possible means of avoiding complicated inquiries would be automatically to abrogate limited liability for the parent or related companies where a combination of commercial factors and disadvantageous group practices causes the subsidiary's insolvency. Due to the difficulty involved in dissecting the causes of the insolvency, the appeal of this intermediate approach could be diminished. On the other hand, this is countered by the fact that New Zealand courts are already saddled to some extent with the task of determining these matters in exercising their jurisdictions under Sections 315A and B. However, by and large, modification of existing obligations with concomitant strengthening of minority shareholder provisions does provide a route to reform within the existing legal framework.

2. The Second Proposal

The other alternative is a contractual group and de facto group regime derived from the Aktiengesetz. In form and substance, the proposed reform provisions will resemble the provisions of the German code; modifications may be appropriate in certain instances to take account of criticisms of aspects of the Aktiengesetz already discussed earlier.55 Should an Aktiengesetz type of proposal be adopted, there should ideally be as many fiscal and other commercial incentives as possible to tempt groups into control contract type group existence, to wit, existence as de facto groups should be made as unfavourable as possible with rigid and onerous obligations being imposed on dominating enterprises.56

For wholly owned subsidiaries an integration option should be made available.57 Basically this will allow the parent to integrate the subsidiary's

54 As Easterbroom and Fishel point out, when two parties are risk averse, optimal risk sharing is the most desirable goal; supra, note 32 at 101.

Furthermore, the authors conclude that the courts disregard the corporate form when the corporate arrangement has increased risks over what they would be if firms generally were organised as separate ventures. Ibid at 111. It is submitted that the approach outlined in this paper is consistent with this conclusion. The intermediate liability rule is imposed when the group management practice, as evidenced by the factors outlined in note 57 supra, indicates an unjustifiable situation which increases risks to creditors liability regime. Therefore qualified limited liability is interposed, not to groups in general but where group practice endangers risk sharing.

Furthermore, creditor protection will generally be enhanced by the adoption of the Cork committee's recommendation discussed supra at the text accompanying note 80 and by the development of a duty on directors to consider the interests of creditors in times of marginal solvency: supra notes 95-96.

55 See supra, text accompanying note 12.

56 See supra, note 23.

57 Basically see Articles 319-327 Akt G. The dependent company is still a separate legal person; however its interest merged with that of the parent upon integration. It is not proposed to outline the integration option in any great detail here — reference should be made to the works cited in note 4 supra.
operations with its own, with a reciprocal obligation to meet the debts of the subsidiary. This option avails the parent of full management powers free of any legal impediment. However it also necessarily imposes full unlimited liability. Parent companies with ninety per cent or ninety-five per cent controlled subsidiaries should be given the option of integrating the subsidiary through a shareholder approval mechanism. As discussed earlier, the shareholder approval threshold should be seventy-five per cent or ninety per cent of all minority shareholders voting separately.

For parents with majority-control subsidiaries and those parents who do not wish to integrate the subsidiary, the control contract option can be introduced. The same provisions applicable to control contracts under present German law and the proposed E.E.C. statute should be incorporated into the scheme. However, certain aspects of control contract regulation should be tightened so as to protect minority shareholders. For instance, a control contract should not be terminable at the whim of the parent after the mandatory operational period; instead, approval of the minority shareholders should again be sought.58 Secondly, there ought to be provision for the parent to restore the subsidiary as far as possible to the operational state in which it existed prior to the control contract. In other words any assets diminished during the course of the control contract should be replenished, and operational losses made good.59 Minority shareholders have the same protection as in German Law and therefore they will have the option of selling out or participating in the subsidiary in return for a fixed dividend or exchanging their shares for shares in the parent and thereby participating in the whole enterprise via the parent. Creditors will be protected by the provisions currently applying under the Aktiengesetz.60

For all other groups, viz those who do not avail themselves of either the integration or control contract modes, there will be an unbending obligation to treat every subsidiary at arm’s length.61 Full disclosure must be made in accordance with German law and a variant of the Dependency Report ought to be introduced. Minority shareholders will have a right to compel the majority to acquire their shares aided by a statutory appraisal mechanism if necessary. Directors of both parental subsidiary will have to certify that all transactions entered into between parent or related company and subsidiary or by the subsidiary at the instigation of the parent are proper and that they are in the interests of the subsidiary.62 Any unfavourable transactions as disclosed by the Dependency Report should be indicated by the auditors whereupon minority shareholders are entitled to call for a special audit.63 The provisions of Article 311 should be modified

58 Weidemann, op cit at 33 discusses the lack of any shareholder approval for termination of a contract.
59 Cp. the response of the Institute of Chartered Accountants (U.K.) to Article 30 of the proposed E.E.C. statute noted at (1986) 7 Co. Lawyer 29 at 30 by Jane Welch.
60 See supra, text accompanying notes 13-14.
61 Hadden, Forbes and Simmonds, op cit at 646-647.
62 Ibid. The authors are also of the view that such strict measures are necessary in order to maintain the independence of subsidiaries who do not opt for integrated or contractual group existence.
63 The main objection to the introduction of a Dependency report into common law jurisdictions has been that it would saddle auditors with additional obligations, and that the magnitude of the responsibility thrust upon them also increases their exposure to misfeasance proceedings. See the views of the Institute of Chartered Accountants (U.K.) discussed by Welch, supranote 59. Furthermore, the ICA argues that auditors may not necessarily be
in the sense that in no sense is a parent allowed to cause its subsidiary to act otherwise than in the subsidiary's best interest. As it presently stands, Article 311 allows detrimental directives to be given provided compensation is made.

Creditors will undoubtedly be protected by the strict insistence on maintenance of separate entities and operations. In addition, a section 315A, B and C type provision ought to be available to a Court such that in the event of the insolvency of the subsidiary, and upon application by a creditor or the liquidator, the Court ought to have the means to visit full liability on the parent or a related company if it is satisfied that the independent status of the subsidiary was merely a façade. Furthermore, a presumption of detrimental influence on the part of the parent along the lines suggested by the Cork Committee ought to be introduced in these provisions as well as in the reckless trading provision. In order to encourage groups to enter into control contracts, consideration could be given to the removal of tax advantages for de facto groups, or at least some weakening of the benefits currently available to groups. Full consolidated tax benefits should enure only to control contract and integrated groups.

The proposed reform along German lines will make it a matter of choice for the management of groups as to which regime it wishes to exist under. It is hoped also that the impact of the proposed de facto group provisions will be such that there will be an incentive to exist under the more unified and desirable regimes viz integrated and control contract groups.

X. CONCLUSION

The mode of reform proposed is not free of potentially controversial provisions but then this is a reflection of the differing perceptions of the most appropriate way to regulate the activity of group enterprises. However for the reasons stated herein, legal regulation is both necessary and desirable, and if the experience of West Germany is any indication, eventually the commercial world will adapt. One thing is certain and that is that there is nothing to be gained by preserving the status quo, for such a disjointed approach to groups is more hindrance than help.
Books

Articles

Notes
“Creditors Rights Upon the Insolvency of a Parent Company or its Instrumentality” 46 Harvard Law Review 823 (1933).