CORPORATE LAW DEVELOPMENTS AND REFORM

Recent Developments, Insights and New Directions

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INTRODUCTION

The timing of this paper could not have been better arranged by the organisers. Treasurer Peter Costello released, in late April 1998, draft legislation covering four major areas of the Company Law Economic Reform Program (known as CLERP). This ambitious program, announced by him in March 1997, is aimed, inter alia, at preparing Australian companies, and the regulatory system under which they operate, for more effective competition in the Asia-Pacific region for the rest of this century and the century to come.

The areas covered in this initial tranche of draft legislation[1] are: (i) accounting standards, (ii) fundraising, (iii) takeovers and (iv) the area on which I will be concentrating – *viz* directors duties and corporate governance. Furthermore my area of coverage will constitute only a small part of this broad area – *viz* the continuing dilemma that we face in the law – ie our regulators, the Government, the courts, all of us advising, and of course directors themselves – in evaluating the duties of directors operating in the context of a group of companies. In such a situation, directors are sometimes faced with the traditionally difficult question of having to decide between two competing interests in a group or similar context.

This dilemma arises not just in times of financial difficulty when directors are forced to evaluate the issues in the context of a well established principle (yes it is only one year after the centenary of the establishment of this principle – *viz* that a company is a separate legal entity – as enunciated in *Salomon v Salomon & Co Limited*).[2] The general unwillingness of our courts to depart from the notion that every company in a group of companies is a separate "person" (whether they are wholly owned subsidiaries or not, or whether it is a true group entity in a

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1 Corporate Law Economic Reform Program – Draft Legislative Provisions, AGPS, 1998.

2 *Salomon v Salomon* [1897] AC 22.

commercial context) "arises" side by side with a series of other "developments". In these we have seen amongst other things the legislature indicating that it wishes to treat the corporate group as though it were one entity for a number of different purposes; we have seen some judges calling for a more commercially "realistic" approach to the issue. This variation in approach creates a tension in the law and a problem for directors and those involved in corporate governance. It also creates considerable work for the professionals who advise them.

In this paper I would like to examine the CLERP initiatives in this area and the background against which they may operate, assess whether they have gone far enough in the context of the dilemma, and point out some of the problems which this approach may create, and to suggest some possible further "reforms" in this area. The topic is large; the body of cases[3] and literature[4] are significant and in this paper I have dealt only with some of this rich background.

Our perspective on this particular topic will depend on what we believe our company law should be achieving in this context. Should it be trying to create one set of rules that capture the approach for all purposes, or should we be trying to create a set of workable rules which may have to be tailored from area to area depending on the circumstances that we are facing?[5] In Appendix 1 to this paper I will deal briefly with the fascinating problem thrown up by the recent dispute involving the Patrick Group of companies and the Maritime Union of Australia. The fact scenario presented by that case is one that illustrates in a rather classic way some of the tensions that can arise when the strict legal approach enunciated in *Salomon's* case is adopted in contrast to wider community expectations. It is now appropriate to turn to the more specific company law issues and the background to the main subject.

IN THE BEGINNING ...!

The decision in *Salomon's* case clearly identified the company as a separate entity from its incorporators. Only in very rare circumstances will the court look behind the company (lift the veil, pierce the veil, crack the veil – there are a myriad of other expressions to describe the way the courts sometimes avoid this critical rule) to examine the commercial scenarios. The courts will examine whether the company or its incorporators should be liable for debts, to ascertain who should gain the benefit of contracts or for a number of other reasons. The relevant statutory exceptions are set out in Appendix 2 to this paper. The most important and consistently applied exception in my view being the insolvent trading provisions of the Corporations Law – now section 588G. There have been corresponding provisions in earlier pieces of legislation, and this area of the law has produced a number of interesting cases. I will be discussing this provision in passing later in this paper to show its relevance to the CLERP initiative.

Linked to that section is the more specific provision – section 588V. This touches in part on the broad area I am discussing in this paper – that the corporate group should be treated as one entity in certain circumstances. Recently, the Australian Democrats, in the aftermath of the Patrick Maritime Union dispute have suggested a widening of the current provision in their amendment to the Company Law Review Bill. That particular proposal is also set out in Appendix 2 to this paper.

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[3] The leading cases are discussed or referred to in this paper. But there are many others which are only briefly noted.

[4] For further consideration of these issues from this and other perspectives see eg Schmitt, Koff and Woolridge *Groups of Companies* (1991); Gillooly (ed), *The Law Relating to Corporate Groups* (1993); Muscat, *The Liability of the Holding Company for the Debts of the Subsidiary*; Farrar, "Legal Issues Involving Corporate Groups" (1998) 16 *C&SLJ* 184 (forthcoming); Yeung, "Corporate Groups: Legal Aspects of the Management Dilemma", (1996) *Lloyds Maritime and Commercial Quarterly* 208. These are some of a considerable body of literature.

[5] This difference in approach is also present in other areas of the law – eg in trade practices and taxation. In both areas the relevant statute is not consistent in how groups of companies are treated.

In addition to these statutory exceptions there are also a range of judicial exceptions which I shall briefly discuss later in illustrating the possible impact of the CLERP proposals.

The principle that a company is a separate legal entity has generally been regarded as a fundamental rule of law. This is particularly so in the context of evaluating the duties of directors where they have allowed themselves to consider the interests of other companies in the corporate group.[6] Exceptions to that fundamental principle have been "recognised" by the courts from time to time. Sometimes regarded as the principal decision in this respect is the English case of *Charterbridge Corporation v Lloyds Bank Limited.*[7] In that case Pennycuick J stressed that even if the intelligent and honest directors of a company had not given separate consideration to the interests of a specific company within the corporate group, the court could still rule that they had not breached their duty to act in good faith for the benefit of the company. This would be particularly so if the directors would reasonably have expected and believed that the transaction pursued by the directors was for the benefit of the company. This kind of flexibility is one that many judges would applaud – for example Rogers CJ in the Supreme Court of New South Wales case of *Quintex Australia Finance Ltd v Schroders Ltd*[8] and later Kirby P in a minority judgment in *Equiticorp Finance Ltd v BNZ*[9] agreed that it was not an unreasonable approach. This dissenting judgement was qualified (see later).

This particular approach was also supported in evaluating whether directors could consider the interests of companies which had appointed them to the board of the relevant company to represent the views of the appointing company. Twin decisions of Jacobs J[10] in New South Wales in the 1960s (which I will discuss in more detail later in this paper) emphasised this commercial approach. They were the inspiration (in my view) for the amendments to the New Zealand legislation in 1993[11] and the CLERP proposals discussed later in this paper.

WALKER v WIMBORNE

As a result of some important cases involving questions of insolvency, however, the more "commercial" approach favoured by some judges was held to be "incorrect". The most famous decision occurred where the directors of a particular company were struggling in vain to keep afloat a "group" of companies (they were not in fact part of a formal group). This was *Walker v Wimborne*. In that case the relevant directors were prosecuted for misfeasance under the provisions of the relevant companies legislation in New South Wales because they had "shuffled" the assets of companies within a loose group of companies (there was no true holding/subsidiary company group present) to keep the group afloat. Street J in Equity (as he then was) had held[12] that the directors should not be held liable because in his view they were pursuing sensible commercial goals. The High Court of Australia, in particular Mason J (who delivered the majority judgment of the court), rejected this approach and made it clear that directors had a responsibility to each company in the group, not to the group as a whole (ignoring for the moment that this was not a true group).

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6 The high water mark of this approach is the High Court of Australia's decision in *Walker v Wimborne* (1975) 137 CLR 1 discussed shortly.

7 [1970] Ch 62.

8 (1990) 9 ACLC 109 at 111; (1990) 3 ACSR 267 at 268-9.

9 (1993) 11 ACLC 952 at 984.

10 *Levin v Clark* [1962] NSWLR 686 at 700 cf *Re Broadcasting Station 2GB Pty Ltd* [1964-65] NSWR 1648 at 1663; see also New Zealand cases discussed below.

11 See at 131(2), (3) and (4) of the Companies Act 1993.

12 In re *Asiatic Electric Co Ltd* [1973] NSWR 603.

As the quotation from the judgment (which is set out below) emphasises, he held that not only could the directors *not* take into account the interests of the group in this scenario, they would have to take into account the interests of creditors in such a situation. This latter statement has generated its own debate with some judges questioning the proposal that directors owe a duty to creditors.[13] Mason J noted:[14]

> "... the emphasis given by the primary judge to the circumstance that the group derived a benefit from the transaction tended to obscure the fundamental principles that each of the companies was a separate and independent legal entity, and that it was the duty of the directors of Asiatic to consult its interests and its interests *alone* in deciding whether payments should be made to other companies. In this respect it should be emphasized that the directors of a company in discharging their duty to the company *must* take account of the interest of its shareholders and its *creditors*. Any *failure* by the directors to take into account the interests of *creditors* will have adverse consequences for the company as well as for them. The creditor of a company, whether it be a member of a 'group' of companies in the accepted sense of that term or not, must look to that company for payment. His interests may be prejudiced by the movement of funds between companies in the event that the companies become insolvent." (emphasis added)

Despite some criticisms and suggestions for a new approach the courts have been reluctant to depart from the principle of each company being a separate entity when corporate insolvency is involved. Quite recently, the New South Wales Court of Appeal emphasised this approach in *Wimborne & Ors v Brien.*[15]

The facts in this case were simple and I set them out to emphasise the traditional approach.

Brien was the liquidator of Langrenus Pty Ltd (Langrenus). This was one of a number of companies in which Wimborne had an interest. Wimborne and his wife separated in April 1990. In August 1990 the wife commenced proceedings in the Family Court to obtain some of the family property. The shares in Langrenus were held equally by them (through a corporate trust relationship). Deadlock led to the winding up of the company. Brien was appointed liquidator. There were two other companies which were involved in family transactions, being Estoril Pty Ltd (in which all members of the Wimborne family were shareholders) and Topmast Pty Ltd, of which 50% was owned by Langrenus and the balance by the Wimborne family trust. Without delving into the facts in detail, it is suffice to say that the appellants in this case claimed that the liquidator should have treated the assets of the main company (Langrenus) on the basis that it and the other companies were a single commercial entity. Thus all debts could be met from this group. This was based on the assumption that all the assets were to be transferred to the husband in the settlement of the Family Court proceedings, so it did not matter which assets or liabilities were accounted for in which company.

The New South Wales Court of Appeal rejected this argument. Dunford AJA, on behalf of the Court of Appeal, put the proposition very simply and along lines that Mason J would have applauded.

> "However, to treat the companies as a single group without regard to their separate assets and liabilities would have breached a fundamental concept of company law – namely that

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13 See in particular (and only as examples) *Winkworth v Edward Baron Development Company Limited* [1987] 1 All ER 114 and *Jeffree v NCSC* [1990] WAR 183 (Jeffree's case was not followed in two Western Australian Full Court decisions – *Chew v R* [1991] 4 WAR 21 and *Lloyd v R* (1991) 4 WAR 95). Compare the comments of Hayne JA in *Bonborough Pty Ltd & Ors* (1997) 15 ACLC 638 and Gummow J in *Sycotex Pty Ltd v Baseler & Ors* (1994) 13 ACSR 766.

14 (1976) 137 CLR 1 at 5-6.

15 *Wimborne & Ors v Brien* (1997) 15 ACLC 793.

except in respect of limited statutory exceptions ... there is no such thing as a 'group' and each company must be treated as a separate entity [referring to *Walker v Wimborne*] and it was a duty of the respondent as liquidator of Langrenus to have regard only to its interests being the interests of the shareholders and the creditors as such."[16]

The court then examined the duties of the liquidator – to collect the assets, wind up the company and distribute the assets in accordance with the rights of the parties. In that context his duties were different to that of a provisional liquidator, who may have tried to run the company in a particular way, trying to keep their assets "alive" with a view perhaps to restoring the companies to financial well-being. Dunford AJA, after noting that the respondent was appointed liquidator and not provisional liquidator, held that his duties were owed to Langrenus alone and not to anyone else.

Recently the English High Court has also adopted a similar strict legal approach to companies in a group in *Re Polly Peck International plc.*[17] Robert Walker J in that case noted that the court would look at the legal "reality", not the economic substance, in assessing the rights of the creditors.[18]

BUT THIS PRINCIPLE ALSO APPLIES TO DIVIDENDS!

The notion that each company in a group is a separate legal entity was embraced in another corporate case at the same time as *Walker v Wimborne*. The decision in *Industrial Equity Limited v Blackburn*[19] concerned the fundamental question of whether a holding company could treat profits generated by a subsidiary as its own.

In that case, Industrial Equity Limited (Industrial Equity), which controlled a number of subsidiary companies, wanted to use the profits already earned by one of the subsidiary companies as though they had been passed through to the holding company by way of dividends even before dividends were declared by the relevant company. Blackburn, a minority shareholder, challenged this approach. It was argued by Industrial Equity that because the accounting provisions required the holding company to prepare a set of group accounts, this was a basis for treating the group as a single entity. In any event, the directors of Industrial Equity controlled the subsidiary company and the dividends would have been passed through to the holding company in due course.

The High Court, however, rejected this argument. It held that the effect of the consolidated or group account requirements was to reduce the significance of the separate entity doctrine in the context of corporate accounting, but certainly not to remove it. Mason J again adopted the traditional approach in this case, recognising that each company was a separate legal entity and relying on *Salomon's* case. He noted that the legislation had introduced a requirement for holding companies to prepare consolidated or group accounts. It could hardly be contended, however, that as a result of these provisions the court should ignore the fact that each company was a separate legal person for other purposes.

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16 (1997) 15 ACLC 793 at 798.

17 [1996] 2 All ER 433.

18 For a detailed discussion of some of the more interesting issues arising in such an insolvency scenario see Nolan, "The Position of Unsecured Creditors of Corporate Groups ..." (1993) 11 *C&SLJ* 461 and Farrar see note 4 above.

19 *Industrial Equity Limited v Blackburn* (1977) 137 CLR 567.

THE DUTIES OF DIRECTORS IN BALANCING CONFLICTING INTERESTS

The decision of *Walker v Wimborne* remains the high water mark in the context of assessing how directors should behave when faced with competing tensions in a corporate group context. This is so even outside the areas of liquidation or dividend accounting. It also remains the leading authority which requires directors to take into account the interests of creditors in evaluating their duty to act in good faith.

A series of recent Australian cases (with the High Court again playing a significant part in this scenario in *Byrnes v R*)[20] offer little room for any variation in this approach, especially where solvency is an issue. Useful in exploring this issue (although I recognise that the particular facts do not provide much flexibility for the relevant director) are two Western Australian cases, *Permanent Building Society (in liquidation) v Wheeler*[21] and the *Kia Ora Gold* case.[22] The *Kia Ora* case highlights in an even starker fashion the fact that directors may face a "clash" in competing duties – the duty to act honestly and to act in good faith (as to which see *Permanent Building Society (in liq) v Wheeler*, and in the instant case the duty of confidentiality and the duty of good faith (as to this see *Harkness v Commonwealth Bank of Australia*[23] which is also discussed below).

In the *Kia Ora* case, the director not only had an obligation to the subsidiary to which he had been appointed, but also to the holding company by virtue of being a director of both. The relevant director may find that he or she cannot properly be a director of both companies in all situations. When that occurs, of course, the tension or the dilemma becomes even more excruciating. The Duke group of companies had been the subject of investigation (and recently a very significant judgment in the South Australian Supreme Court has been handed down in that case as well).[24] That may certainly have heightened the court's unwillingness to be sympathetic to Mr Fitzsimmons, an unfortunate director of Kia Ora and of another Duke group company. The particular fact scenarios illustrate the extraordinary difficulty facing directors' advisors and the courts in assessing the problem. For the moment let us assume we are dealing with a very different set of circumstances (with the director trying to further the interests of all companies in the group).

Fitzsimmons had been prosecuted for failing to act in accordance with his statutory obligations by allowing a conflict of duty and interest to arise. He had failed in his capacity as a director to disclose to the Kia Ora Company the subject of a relevant takeover, certain information that he had received as a director of the Duke company. Disclosure of the particular fact would have impacted on the financial affairs of Kia Ora. Fitzsimmons argued that he could not disclose this information because he had a duty not to disclose the information – this arose from the duty owed to the Duke Corporation.[25] He was held liable for his failure to act with honesty under the equivalent of section 232(2) of the Corporations Law.[26] He appealed both the decision and the penalty imposed on him.

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20 (1995) 130 ALR 529 (and see also the other cases discussed in my paper "The duty of directors – Does it depend on the swing of the pendulum") in Ramsay (ed). *Corporate Governance and the Duties of Company Directors* (1997) 92 (referred to as Ramsay (ed)).

21 (1994) 14 ACSR 109.

22 *Re Kia Ora Gold Corporation NL* (1997) 23 ACSR 355.

23 (1993) 12 ACSR 165.

24 *Duke Group Ltd v Pilmer* (1998) 16 ACLR 567; 27 ACSR 1.

25 Emphasising the approach in the *Harkness* case see note 23 above.

26 Which is to be recast as a duty to act in good faith in the interests of the company in the CLERP proposals (see proposed section 3).

The Western Australian Court of Criminal Appeal rejected his appeal. Owen J, on behalf of the courts, recognised there were difficulties which faced a director in his position.[27]

> "It is a fundamental principle governing corporate governance that the relationship between a director and the company is a fiduciary one. The law imposes strict fiduciary obligations on a director so as to ensure high standards of loyalty in the performance of the duties of office. The scope and reach of a director's fiduciary duties includes the prohibition against conflict of interest. ... [(quoting from a series of important cases)].
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> It might seem from these statements that a director would have no alternative other than to resign from office where a conflict of interest existed. However, if that were the case commercial life would become very difficult, *particularly for professional directors*. ...
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> Each case will depend on its own facts. A director who is confronted with a possible conflict must assess his or her position. The minimum requirement will be disclosure of the interest. This is simply part of, or an extension of, the statutory obligation that a director who is in any way 'interested' in a contract or proposed contract with the company must declare the nature of the interest at a meeting of the directors. ... What action, above and beyond mere disclosure, the director must take will vary from case to case depending on the subject matter, the state of knowledge of the adverse information, the degree to which the director has been involved in the transaction, whether the director has been promoting the cause, the gravity of the possible outcome, the exigencies and commercial reality of the situation and so on. It may not be enough for the director simply to refrain from acting or even to absent himself or herself from the meeting during discussion of the impugned business. The circumstances may require the director to take some positive action to identify clearly the perceived conflict and to suggest a course of action to limit the possible damage."

One of the decisions he referred to was the decision of the Full Court of Western Australia in *Permanent Building Society (in liquidation) v Wheeler.*[28] This is another interesting case in which the director, behaving inscrutably in that he refused to act because of the conflict of interests scenario, finished up being "sued" for failing to act with appropriate care, diligence and honesty (although in the end the relevant victory against the director was a pyrrhic one).[29]

FINANCIAL ACCOUNTING RULES AND THE ATTITUDE OF SOME JUDGES

At the same time as these decisions were being handed down, there were of course in the Corporations Law a set of rules which indicated that the parliament of the land was concerned that we should adopt a more commercial approach in that particular context. Whilst the High Court treated these provisions as relevant in *Industrial Equity v Blackburn*,[30] some interesting statements from other judges have suggested a different approach might be adopted in the particular circumstances.

These comments (which I shall turn to shortly) did not deter our law makers from pursuing the "economic" entity approach in recent proposed changes to the Corporations Law in the Company Law Review Bill (the Bill). It includes a number of changes in the rules relating to reduction of capital where questions of solvency (which are relevant in determining when a company may

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27 (1997) 23 ACSR 355 at 357 (emphasis added).

28 See note 21 above.

29 For discussion of this case see Baxt, "The Duty of Care of Directors – Does it Depend on the Swing of the Pendulum" in Ramsay (ed) at pp 109-110.

30 (1977) 137 CLR 567.

return capital) are to be addressed, by looking at the corporate group (or rather the economic entity) rather than individual companies in the group.

Perhaps most interesting and more recent remarks are those of Rogers J in cases such as *Quintex Australia Finance Limited v Schroders*.[31] This case was concerned with the financial position of creditors who were seeking the opportunity to recover from companies within the group. This remedy was denied. Rogers CJ posed a challenge for the then Government. This challenge remains for Peter Costello and the current Government to address (as to which see later). Rogers CJ noted:

> "As I see it, there is today a tension between the realities of commercial life and the applicable law in circumstances such as those of the present case. In the every day rush and bustle of commercial life in the last decade it was seldom that participants to transactions involving conglomerates with a large number of subsidiaries should become the contracting party.
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> It may be desirable for Parliament to consider whether this distinction between the law and commercial practice should be maintained. This is especially the case today when the many collapses of conglomerates occasion many disputes. Regularly, liquidators of subsidiaries, or of the holding company, come to court to argue as to which of their charges bears a liability. As well, creditors of sale companies encounter difficulty when they have to select from among the moving targets the company with which they consider they concluded a contract."[32]

He had adopted a similar conclusion in an earlier case of *Briggs v James Hardie & Co Pty Limited*.[33]

Many writers have tackled this particular problem. Perhaps the most interesting recent evaluation (although the issue was looked at mainly in the context of insolvency and this does not address broader issues such as those thrown up by the CLERP proposals) is John Farrar's recently published article in the issue of the *Companies and Securities Law Journal* celebrating the anniversary of *Salomon's* case.[34]

For tax planning and other areas, the notion of a separate legal entity sometimes works one way and sometimes another. There is at least one peculiar inconsistency in the Trade Practices Act (in the third line forcing provision). There are clearly different pressures at work here, creating very interesting scenarios which ensure that the Companies and Securities Advisory Committee (CASAC) will need to continue the work in this area, notwithstanding the initiatives in the CLERP legislation referred to earlier.

THE CLERP INITIATIVES

This then brings me to the CLERP initiatives and where they seem to be taking us.

Section 8 of the CLERP draft legislation provides as follows:

> "(1) A director of a corporation that is a wholly-owned subsidiary of a body corporate is to be taken to act in good faith in the best interests of the subsidiary if:

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31 See note 8 above.

32 (1990) 9 ACLC at 111.

33 *Briggs v James Hardie & Co Pty Limited* (1989) 16 NSWLR 549.

34 See Farrar, note 4 above.

(a) the constitution of the subsidiary expressly authorises the director to act in the best interests of the holding company; and

(b) the director acts in good faith in the best interests of the holding company; and

(c) the subsidiary is not insolvent at the time, or immediately after, the director acts."

Section 8(2) is almost identical apart from dealing with the fact that the relevant company is not a wholly owned subsidiary. In that context, it requires in addition to paragraphs (a), (b) and (c) above (sub-paragraph (c) is renumbered (d)) that:

"(b) a resolution passed at a general meeting of the subsidiary authorises the director to act in the best interests of the holding company (no votes being cast in favour of the resolution by the holding company or an associate);"

These provisions are based to a large extent on section 131(2) and 131(3) of the New Zealand Companies Act 1993 but there is an interesting difference in the framing of clause (b) in proposed section 8(2) when compared to section 131(3) of the New Zealand statute.

The emphasis on *solvency* of the subsidiary is a clear recognition in the statutory sense of the duty of directors to creditors reflecting the almost blind acceptance of the second major statement of principle in *Walker v Wimborne*.[35]

As you will see from the above, these provisions only apply to cases where we are dealing with wholly owned subsidiaries and partially owned subsidiaries. It is interesting to note that in the New Zealand Act of 1993 there is a further "softening" of this statute in section 131(4) which deals with joint venture companies.

New Zealand section 131(4) provides:

> "A director of a company incorporated to carry out a joint venture between the shareholders may, when exercising powers or performing duties as director in connection with the carrying out of the joint venture, if expressly permitted to do so by the constitution of the company, act in a manner which he or she believes is in the best interests of the shareholder or shareholders, even though it may not be in the best interests of the company."

As can be seen, it is similar to the above provisions in concept. It has been based on a series of statements in cases which called for a more commercial approach and which are discussed below.

The CLERP initiatives, on the other hand, do not factor into the equation the fact that nominee directors are often not only asked to represent the interests of lenders, the minority (but significant) holders of shares in a company, and other special interests (eg a borrower or a government holding a golden share in a "statutory" company!) – they may be virtually forced to take these interests into account. The law in this regard has "developed" quite considerably (and as I shall note, dangerously) in the last few years, especially in the context of the "shadow director" provision of the Corporations Law – *viz* section 60(1)(b). I shall return to that particular provision and its relevance a little later.

Jacobs J, in the New South Wales Supreme Court, in the 1960s, had recognised the importance of commercial pressures in providing some relaxation for a director representing a particular

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35 See note 6 above and the discussion under the heading "Walker v Wimborne" above.

interest in a company. In *Levin v Clark*[36] he attempted to reconcile the position of nominee directors facing the kind of "pressure" referred to above with their duty to act in the best interests of the relevant company. In this case the nominees, Clark and Rappaport, had been appointed by a mortgagee as governing directors of the relevant company pursuant to the mortgage document. I am including his comments in full because I believe that this issue will become relevant again, if not directly in consideration of the CLERP proposals for reform, then perhaps in further arguments in the courts. In particular they should become relevant in relation to further work to be done by CASAC.

> "I consider that Clark and Rappaport did act primarily in the interests of the mortgagee once they resumed the exercise of the powers as governing directors. However, I consider that it was permissible for them so to act. It is of course correct to state as a general principle that directors must act in the interests of the company. There is no necessity to refer to the large body of authority which supports this as a general proposition. However, that leaves open the question in each case – what is the interest of the company? Is it not uncommon for a director to be appointed to a board of directors in order to represent an interest outside the company, a mortgagee or other trader of a particular shareholder. It may be in the interests of the company that there be upon its board of directors one who will represent these other interests and who will be acting solely in the interest of such a third party and who may in that way be properly regarded as acting in the interests of the company as a whole. To argue that a director particularly appointed for the purpose of representing the interests of a third party, cannot lawfully act solely in the interests of that third party, is in my view to apply the broad principle, governing the fiduciary duty of directors, to a particular situation, where the breadth of the fiduciary duty has been narrowed, by agreement amongst the body of the shareholders. The fiduciary duties of directors spring from the general principles, developed in courts of equity, governing the duties of fiduciaries – agents, trustees, directors, liquidators and others – and it must be always borne in mind that in such situations the extent and degree of the fiduciary duty depends not only on the particular relationships, but also on the particular circumstances. Amongst the most important of these circumstances are the terms of the instrument governing the exercise by the fiduciary of his powers and duties and the wishes, expressed directly or indirectly, by direction, request, assent or waiver, of all those to whom the fiduciary duty is owed ...."[37]

In a later case, Re *Broadcasting Station 2GB Pty Ltd*,[38] he again considered this matter in the context of a director appointed to a subsidiary company. As this particular issue has been addressed specifically by the CLERP legislation it is unnecessary to set out his quote from the case, but in it he adopts a similar line to that in *Levin v Clark*.

In New Zealand, in dealing with a joint venture company (as noted earlier, one of the areas not covered by our proposals but covered by the New Zealand Companies Act) Mahon J in *Berlei Hestia (NZ) Ltd v Fernyhough*[39] made some interesting comments. Observing that a director has a responsibility for the whole company, he went on to note that there had been attempts to bring the question of responsibility into harmony with commercial reality. This was so especially where the articles of association empower the directors to act with the interests of the nominator in mind. He added:

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36 [1962] NSWR 686.

37 One of the major problems I have had with the latter part of this statement is the statutory "duty" highlighted by the enactment of section 1324 of the Corporations Law. I am also concerned at similar sentiments as to the ability of shareholders to narrow the fiduciary duties of directors stated in the High Court of Australia case of *Whitehouse v Carlton Hotel Pty Ltd* (1987) 162 CLR 285. How can the statutory duty in section 232(2) of the Corporations Law be modified?

38 [1964-5] NSWR 1648.

39 [1980] 2 NZLR 150.

"Such a view proceeds on the basis that the Articles were so constructed with the intent and belief that the institution of such a special responsibility towards one class of shareholders was conducive to the interests of the company as a whole. For an illustration of this line of thinking I refer to the dicta of Jacobs J in *Levin v Clark* [1962] NSWR 686 and in *Re Broadcasting Station 2GB Pty Ltd* [1964-65] NSWR 1648. In the present case this business undertaking, stripped of its corporate shell, is a trading partnership between two organisations operating in different countries. They agreed, when the company was incorporated, that each partner nominate three directors, and they impliedly agreed, as the Articles show, that one class of directors was at liberty to bring the Board's functions to a stand-still when a disagreement arose, and that disagreement would almost certainly have its origin in a dispute between the two sets of shareholders. These consequences were all well known to the corporators when the Articles were drawn. As a matter of legal theory, as opposed to judicial precedent, it seems not unreasonable for all the corporators to be able to agree upon an adjusted form of fiduciary liability, limited to circumstances where the rights of third parties vis-à-vis the company will not be prejudiced. The stage has already been reached, according to some commentators, where nominee directors will be absolved from suggested breach of duty to the company merely because they act in furtherance of the interests of their appointors, provided that their conduct accords with a bona fide belief that the interests of the corporate entity are likewise being advanced. Cf Finn *Fiduciary Obligations* 1977, para 114".[40]

These comments of Mahon J come eighteen years or so after the first of the New South Wales cases involving Jacobs J. But the pressure for this approach to be embraced in legislation has not yet eased. Thomas J in the *Dairy Containers* case[41] also adopted a commercial approach. After reviewing the position of "nominee directors" he noted:

"Nominee directors need not necessarily approach company problems with an open mind and they may pursue their appointor's interests provided that, in the event of a conflict, they prefer the interests of the company. In such circumstances the breadth of the fiduciary duty has been narrowed by agreement amongst the body of legislators. In other words, the corporators have agreed upon an adjusted form of fiduciary obligation. The approach has been now incorporated in New Zealand companies legislation. Section 131(2) of the Companies Act 1993 provides that a director of a company which is a wholly-owned subsidiary may, when exercising powers or performing duties as a director, and if expressly permitted to do so by the constitution of the company, act in a manner which he or she believes is in the best interests of the company. Otherwise, the director of a subsidiary which is not wholly-owned may, under subsection (3), if again expressly permitted to do so by the constitution of the company, act in the same manner but only with the prior agreement of the other shareholders."[42]

These observations do not appear to be at odds with the strong view put forward by Young J in *Harkness v Commonwealth Bank of Australia Ltd*,[43] where he suggested that a director must regard his duty of confidence to the board as being more important than his duty to act in the interests of those nominating him to the board of the relevant company (recognising that in fact such an obligation might offer a sensible commercial solution in such areas of conflict). This "clash" of policy considerations also arose in the *Kia Ora Gold* case discussed earlier in this paper (but in a different context).

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40 [1980] 2 NZLR 150 at 165-166.

41 *Dairy Containers Limited v NZI Bank Limited* [1995] 2 NZLR 30.

42 [1995] 2 NZLR 30 at 60.

43 (1993) 12 ACSR 165 at 177.

The approach adopted by Jacobs J, Mahon J and Thomas J also reflects the more commercially "willing" attitude adopted by Pennycuick J in the *Charterbridge* case.[44] The more generous approach he adopted, however, was not taken to the next stage by the New South Wales Court of Appeal in *Equiticorp Financial Services Limited (in liquidation) v Bank of New Zealand*.[45] The majority of the court in this case was quite firm in limiting the flexible attitude adopted by Pennycuick J. They did not embrace the approach of Jacobs J, Mahon J and Thomas J. They rejected the recognition of this approach which had been "requested" by Rogers CJ in the *Quintex* case referred to earlier. However, Kirby P in dissenting from the majority was at least willing to reflect on this "commercial" approach in a very interesting judgment. In the light of this issue becoming more relevant in the months ahead, and with his elevation to the High Court, it is interesting to set out his comments.

Recognising the importance of *Walker v Wimborne* and the basic principle it stands for, Kirby P noted:[46]

> "This is not to say that a consequential effect of the advantage to members of a group of companies could not be taken into account by an intelligent and honest director ... of a particular company in deciding what that company should do."

It is my view that the Corporations Law should contain a range of provisions which recognise such flexibility. The concern that minority shareholders or others might be "at risk" is overstated. After all it is likely that it will be a majority shareholder rather than minority shareholders who will be at risk. Such shareholders will be adequately protected by a range of remedies in the Corporations Law and in the common law. The minority shareholders already have adequate protection under section 1324 of the Corporations Law (which as a result of decisions such as *Allen v Atalay*,[47] section 260 (the oppression remedy) and of course, until the CLERP amendments come into play, the rule in *Foss v Harbottle* (or rather the exceptions to that rule in appropriate circumstances)). When the CLERP amendments become law their remedies will probably be enhanced even more. The Australian Securities Commission, or rather its successor body, will also of course always have the right to intervene in relevant circumstances.

As I have indicated earlier, CASAC has been asked to take on some more work on this particular topic. I will follow (I suggest we all should) with interest the initiatives that they come up with in due course.

LIABILITY RAMIFICATIONS OF THE CLERP INITIATIVES

I now turn to some of the concerns that have been expressed that the initiatives contained in section 8 of the CLERP draft legislation may in fact lead to other unfortunate results. Will this lead to an easing of the strictness of the rule in *Salomon's* case in the context of making companies liable for the debts of subsidiaries? What other consequences may follow?

Bearing in mind that we are unlikely to have any further significant changes to the current CLERP provisions, what, if anything, will they do in relation to some of the traditional rules of company law? Will, for example, the holding company be liable for the debts of its subsidiaries where the directors of those subsidiary companies act in favour of the holding company – (assuming that the articles of the subsidiaries are framed appropriately and that the particular action turns out not to be advantageous for either the holding company or the group)? In other words, will the companies

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44 *Charterbridge Corporation Limited v Lloyds Bank* [1970] Ch 62.

45 (1993) 11 ACLC 642.

46 (1993) 11 ACLC 642 at 649.

47 (1994) 12 ACLC 7.

be treated as one for the purposes of the debts of the company by virtue of rules of agency and similar rules that allow the veil to be lifted in such scenarios?

This concern is expressed after examining decisions like *Smith Stone & Knight v Birmingham Corporation*,[48] and *DHN Food Distribution Limited v Tower Hamlets London Borough Council*.[49] Alternatively, will the creation of these exceptions to the law in the CLERP provisions mean that this is the *only* way to satisfy the need for directors to act in a wider context and satisfy their duty to act in the best interest of each company to which they are appointed? Will there be no room for judgments like those of Jacobs J and Mahon J referred to earlier in scenarios outside the terms of proposed section 8? It has been suggested that there should be a footnote written to the CLERP provision (the use of footnotes in the CLERP drafting picks up a fascinating development in the new style of Australian drafting) so that that kind of interpretation may still be pushed. One would hope that the law should be flexible enough in that particular context.

I have warned persons when they are making submissions about various changes to the law (especially those which pick up the notion that the group of companies is a single person) that they may be opening up the floodgates to a broad brush policy approach of treating companies in a group as one person for all purposes – in other words, eliminating the notion of the company as a separate legal entity as enunciated in *Salomon's* case. That is something which needs to be thought about very carefully because it will clearly create a new approach to our law. It is one thing to suggest that a liquidator or receiver of a company should be able to organise the company's affairs when insolvency arises in order to ensure that shareholders, but more particularly creditors, are all better off. It is quite another to suggest that we should treat all the companies as one person for the purposes of driving home liability in such cases to the holding company or enabling it to use all these assets as their owner.

This fear may be irrelevant in any event, if other developments such as those enunciated in cases such as the New Zealand *Dairy Containers* case[50] are pursued by the courts. They may achieve the same result so we might as well have the benefits of a section 8! Perhaps after considering the next section of this paper you will favour other legislative changes.

In the *Dairy Board* case, you may recall, the relevant judge (Thomas J, since promoted to the New Zealand Court of Appeal) adopted a very innovative approach to the question of vicarious liability on the part of directors. This, together with the rather enthusiastic recognition of the liability of the shadow director, and most recently the reliance by some judges on the principle of *Barnes v Addy*[51] to further extend notions of liability suggests that we may be seeing liability driven home to directors and perhaps even to holding companies in a far wider range of scenarios than was ever thought possible (see below). Perhaps the rather intriguing suggestions made regarding the restructuring of the Lang group of companies to enable certain employment contracts between one company in the group to be shifted to another company, may have created some opportunities for the law to be recast in this area. Indeed, the Australian Democrats have wasted little time in responding to this litigation by suggesting a sweeping change to the Corporations Law (see proposed section 588YA).

Perhaps the law has far more flexibility in it today than we thought. Some of the initiatives that have been mentioned briefly above show that the law is rich enough to deal with these particular matters without destroying the basic principle in *Salomon's* case, which may well be the result of

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48 [1939] 4 All ER 116.

49 [1976] 1 WLR 852.

50 [1995] 2 NZLR 30 discussed in more detail in Baxt, "One AWA Case is not enough ..." (1995) 13 *C&SLJ* 414; see also Thomas, "The Role of Nominee Directors and the Liability of Their Appointors" in Ramsay (ed) p 148.

51 (1874) 9 LR Ch App 244.

some of these policy changes. Let me examine some of these; but before doing so it is useful to remind ourselves of the willingness of the court to "lift the veil" in certain scenarios.

LIFTING THE VEIL

As noted in Appendix 2 to this paper there are a number of Corporations Law exceptions to the principle in this case. The most important of these are the provisions dealing with insolvent trading – sections 588G and 588V. If the Australian Democrats have their way the latter provision will be further "enhanced" (see proposed section 588YA). This added dimension will not directly relate to directors. The potential of directors being made personally liable as a result of the proposed extension is difficult to assess.

The cases on insolvent trading are many. They cover a wide range of fascinating scenarios and perhaps the most interesting case in this particular area is the most recent – the first to deal with the expanded section 588G specifically is *Metropolitan Fire Systems Pty Ltd v Miller*.[52] The judgment of Einfeld J discussed many of the earlier cases in which the notion of the "sleeping director" was canvassed. He also examines the nature of the remedy provided in section 588G and its predecessor sections. Whilst initially this may not appear to be of particular relevance to the broader topic being discussed in this paper, it has particular ramifications in a number of scenarios. There is the liability of the holding company for the debts of its subsidiaries contained in section 588V. However, if directors are able to take into account the interest of their holding companies when acting on behalf of the subsidiary, will this result in an implication that the directors of the holding company are also potentially liable? If this does not arise directly, can it arise as a result through the application of a range of other concepts such as the shadow director provisions in the Corporations Law referred to earlier? There is also the potential for vicarious liability discussed by Thomas J in the *Dairy Containers* case, and the reliance on *Barnes v Addy*.

The corporate veil may be lifted where there is fraud or some other breach of law. In these scenarios the courts are generally willing to lift the corporate veil and to drive home liability to the persons responsible for the particular action. Public policy almost requires such an initiative. Perhaps the best example of that is *Re Bugle Press Limited*.[53] In that case it was held that where a particular law evinces a policy requiring that it is not to be frustrated by using this separate identity of a company, the court will without exception, lift the corporate veil. However, the mere fact that the law imposes a liability will not by itself be sufficient to induce a court to lift the corporate veil. A further decision in that context is *Gilford Motor Co v Horne*.[54]

Where the court recognises that a subsidiary is an agent of the parent company (benefiting from the actions of the corporation and acting as though it were the corporation) then the veil will be lifted. The most important illustration of that is *Smith Stone & Knight Limited v Birmingham Corporation*[55] a case which has been "embraced" in a number of earlier decisions including the more recent Australian decision *Spreag v Paeson Pty Ltd*.[56] Similarly the court will lift the veil to ensure that a corporation is able to benefit from a certain transaction or bear the burden in

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52 (1997) 23 ACSR 690.

53 [1961] Ch 270.

54 [1973] Ch 93.

55 See note 48 above.

56 (1990) 94 ALR 479.

appropriate cases. *DHN Food Distribution* case[57] is a case in which Lord Denning in particular was prepared to lift the veil in order to equate the legal and the commercial position.

A recent case in which the corporate veil was not lifted is the House of Lords decision in *Williams v Natural Life Health Foods*.[58] This is an interesting unreported (as yet) case and I set out some details of it. The respondents had entered into a franchise agreement with Natural Life Health Foods Ltd, of which the appellant, Richard Mistlin, was managing director. Natural Life Health Foods gave negligent advice to the franchisees, who sued the company and then later joined Mistlin as a defendant. The court of first instance[59] and the Court of Appeal[60] both found Mistlin personally liable for the negligent advice by the company.

In allowing Mistlin's appeal, Lord Steyn, giving their Lordships' judgment, considered the theories of negligence, and the principle of assumption of responsibility. While finding that the circumstances were not such as to suggest that Mistlin had assumed personal responsibility and therefore a personal duty of care, Lord Steyn nevertheless upheld the value of the principle. He said:

> "It is important to make clear that a director of a contracting company may only be held liable where it is established by evidence that he assumed personal liability and that there was the necessary reliance. There is nothing fictional about this species of liability in tort."

Lord Steyn's reasoning in finding that Mistlin had assumed no personal responsibility was based on the principle in *Salomon's* case. In a one-person company, he said, it is inevitable that the individual's experience will play a significant part in the company's literature and work. That in itself is not enough to make the individual personally liable for the actions of the company.

THE DAIRY CONTAINERS CASE[61]

This case raises a number of important issues in the context of this subject. As a result, it is important to outline a brief background to the facts and to the issues that were discussed by Thomas J in that case.

Dairy Containers Ltd (the company) was a wholly-owned subsidiary of the New Zealand Dairy Board (the Dairy Board) which treated it as a division rather than as a subsidiary. It was incorporated under the New Zealand Companies Act 1955 (this legislation has been modified and expanded upon the Corporations Act of 1993); its primary task was to manufacture cans for dairy products for the Dairy Board. The Dairy Board provided a captive market for the product. However, the company later became a substantial investment company. Investment accounts were opened with a number of banks including the Australia & New Zealand Banking Group Ltd (New Zealand) which was the company's banker. The New Zealand Auditor-General (the Auditor-General) was engaged as the auditor of both the company and the Dairy Board.

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57 See note 49 above. See also *Woolfson v Strathclyde Regional Council* [1978] SC (HL) 90 in which the House of Lords refused to adopt the approach to the corporate veil enunciated in *DHN*. See also *Multi National Gas and Petrol Chemical Company v Multi National Gas and Petro Chemical Services Limited* [1983] Ch 258 where again an unsympathetic view was adopted by the court.

58 Unreported decision 30 April 1998.

59 [1996] 1 BCLC 288 (first instance).

60 [1997] 1 BCLC 131 (Court of Appeal).

61 *Dairy Containers Limited v NZI Bank Limited and Ors* [1995] 2 NZLR 30 and see paper by Thomas J referred in note 50 above.

All members of the company's board of directors were senior Dairy Board executives. The company was managed by Messrs Watson (the chief executive), Rose and Joyce (referred to as the managers). The Dairy Board had a very strong hands-on role vis-a-vis the company, and the general understanding was that the investments of the company would be in the short-term money market and restricted to approved trustee investments.

The history of the company's investments in the short-term money market and elsewhere was disastrous. Part of this was due to the fact that the three managers committed a diverse range of frauds on the company, including the abuse of company credit cards, diverting company funds into their own accounts and other matters. In August 1989 they were prosecuted and sent to jail.

Civil proceedings were then brought by the company against the Auditor-General for losses incurred through the misappropriations, and on the ground that the audit conducted on behalf of the company was deficient. The Auditor-General counterclaimed against the company and the directors for contributory negligence. Actions were also brought against some of the banks – these are not relevant to this discussion.

In a lengthy judgment, Thomas J followed closely the decision-making pattern enunciated by Rogers CJ (Comm D) in the first instance decision in the *AWA* case.[62] The decision of Thomas J was delivered before the appeal decision in the *AWA* case.[63]

The Auditor-General's counterclaim raised the issues of vicarious liability. He also argued that the Dairy Board was a shadow director of the company along the lines of a provision similar to section 60(1)(b) of the Corporations Law. In this case the shadow director issue was of less significance (on the facts the court was unable to find any real merit in the arguments that the Dairy Board had directed the relevant nominees to act in a particular way). On the question of vicarious liability Thomas J held that were it not for the Privy Council decision in *Kuwait Asia Bank v National Mutual Life Nominees*[64] he would have held the Dairy Board liable. In reaching this consideration he criticised the decision both directly and indirectly. His criticism (and later decision) may well give Australian courts some courage to depart from it. Some of his comments are very interesting indeed.

> "The decision [in *Kuwait*] does not appear to address important issues which require consideration before it is held that employers cannot be liable for the acts of their employee-directors. Yet these issues are fundamental to our law. One is the common law doctrine that employers are liable for the torts that their employees have committed in the course of their employment.
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> ...
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> Another issue necessarily stems from the relationship between employers and their employee-directors. The commercial reality of that relationship was recognised by all expert witnesses in the present case. One can accept the force of Lord Wilberforce's observation that the common law should take a 'practical approach according with commercial reality' (see *New Zealand Shipping Company Ltd v A M Satterthwaite & Co Ltd* [1974] 1 NZLR 505 at 510)."[65]

In his Honour's view the courts should, wherever possible, attach liability to the more appropriate party. In the case of master and servant that should usually be with the master. In these

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62 *AWA Ltd v Daniels & Ors* (1992) 10 ACLC 933.

63 *Daniels & Ors v Anderson & Ors* (1995) 16 ACSR 607; 13 ACLC 614.

64 [1991] 1 AC 187.

65 [1995] 1 NZLC at 62; see also paper by Thomas J in Ramsay (ed) note 50 above.

circumstances, in Thomas J's view, while recognising that the Privy Council decision was binding on him, it was desirable to review the law. He added:

> "Recognising the economic reality of employee-directors and their employers requires that those who employ employees as directors to represent their interests accept responsibility for their resulting conduct. Liability can be determined in accordance with the established law of employer and employee and principal and agent. There is no reason in principle why employers should be exempt from liability for the negligent acts of their employees whom they have required to act as directors to protect and promote their interests. The measure of real control exercised by the employer should be recognised in law. It carries with it the responsibility and that responsibility should, in the event of the default on the part of the company they control through their employees, be exposed to the potential of vicarious liability."[66]

Since the decision by Thomas J in *Dairy Containers*, the Privy Council has itself qualified its decision in *Kuwait Asia*. In *New Zealand Guardian Trust Co Ltd v Brooks and Ors*[67] it indicated that in a situation where directors of a company are negligent the company itself may be vicariously liable, although in this case the facts did not deal with the position of nominee directors. One suspects there may be further qualifications of the *Kuwait* decision in the not too distant future.

SHADOW DIRECTORS

Much has been written about shadow directors in Australia and overseas in the last few years.[68] The decision in the *Dairy Containers* case raises the prospect of the shadow director provisions being utilised in appropriate scenarios. More importantly the *Antico* case (*Standard Chartered Bank of Australia v Antico Limited*)[69] has highlighted that section 60(1)(b) of the Corporations Law may well be more potent than previously anticipated. In that decision Hodgson J suggested that the mere fact that Pioneer International Limited (Pioneer) owned 42 percent of the shares in Giant Resources Limited (Giant) and nominated three directors to the board of Giant was by itself insufficient to make Pioneer either a director or a person participating in the management of Giant. When he looked at the facts more closely, in particular the way in which decisions had been reached in relation to the activities of Giant, Hodgson J was satisfied that from a particular point of time – from 4 March 1989 in that case when the operations of Giant started to be developed in a more aggressive fashion – Pioneer "showed a willingness and ability to exercise control and actuality of control over the management and financial affairs of Giant."[70]

When he examined the evidence of the directors involved, Hodgson J was much more willing to drive home a liability on the part of Pioneer:

> "[The three nominees] all say that they recognise the duty, as directors of Giant, to act in the interests of all Giant's shareholders; and they all say they had no instructions from Pioneer as to how they should act in that capacity. Antico and Gardner said that, if any

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66 Ibid at 63.

67 [1995] 1 WLR 96.

68 See eg Koh, "Shadow Director, Shadow Directors who are art thou" (1996) 14 *C&SLJ* 340; Yeung, "Corporate Groups: Legal Aspects of Management Dilemma" (1996) *Lloyds Maritime Commerce Law Quarterly* 208; and Carrol, "Shadow Director and other Third Party Liability for Corporate Activity" in Ramsay (ed) 162 and the various articles and cases discussed in these articles and paper.

69 (1995) 18 ACSR 1; see also the decision of Finn J in *Australian Securities Commission v AS Nominees Ltd* (1996) 133 ALR 1.

70 (1995) 18 ACSR 1 at 70.

question arose when they were acting as shareholders of Giant which involved a conflict of Pioneer's interest, they would abstain from voting on that matter. Quirk asserted that he did not see any conflict, because he considered what was in the best interests of Giant would also be in the best interest of Pioneer, by reason of its 42 percent shareholding.

This evidence does not lead me to the view that, having carefully considered, in their capacity as directors of Pioneer, these strategic decisions concerning the affairs of Giant, they gave any separate consideration to them in their capacity as directors of Giant. In my view, the directors of Giant, including [the three nominees] simply accepted the decision which had been effectively made by Pioneer."[71]

Obviously if pursuant to the CLERP amendments, directors are allowed to act in the interests of the holding company in pursuing the interests of the subsidiary, this may add further weight to the suggestion that a holding company is itself a director in the appropriate circumstances (or that it is vicariously liable). The dimension of potential liability (in the area of insolvent trading) is just one further concern in the range of concerns experienced in ascertaining whether holding companies are to be separately liable for each subsidiary company in relation to contracts and other transactions.

BARNES v ADDY[72]

Pursuant to this case a parent company may be exposed to liability if it participates in a breach of fiduciary duty by its nominees or representatives in the subsidiary company. The utilisation of the shadow director provisions may provide a further way in which the principles on this case may be utilised to further enhance potential liability in the group company scenario being discussed. Recently we have seen this particular case being utilised as the basis for claims against a parent company in certain scenarios (I refer specifically to the decision of Hansen J in the Victorian Supreme Court in *Farrow Finance v Farrow Properties*).[73]

Karen Yeung, now a lecturer in commercial law at St Anne's College in Oxford (formerly a colleague of mine at Arthur Robinson & Hedderwicks) has described the consequences of the liability under *Barnes v Addy* in these words:[74]

"A stranger who 'knowingly receives trust property in breach of trust' or 'knowingly assists' in a breach of trust by a trustee may be personally liable to account in equity to the wrong beneficiary for the trustee's breach of fiduciary duty ... Although formulated in terms of a breach of trust, both limbs of *Barnes v Addy* may be applied to defaulting fiduciaries who are not trustees in the formal sense including company directors. This doctrine applies to fiduciaries generally and serves to discourage outsiders from acting in derogation of the fiduciary standard, thereby reinforcing its strictness."

She outlines two scenarios in which she distinguishes between dishonest self dealing by directors (for which we should have little sympathy) and the rather more troublesome area where liability may still be driven home – namely where an honest but nevertheless illegitimate exercise of fiduciary power occurs.

Where the parent company actively participates in the management of a subsidiary company and this results in the commission of an honest breach of duty by the nominee director appointed by

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[71] (1995) 18 ACSR 1 at 70.

[72] (1874) 9 LR Ch App 244.

[73] (1997) 26 ACSR 544.

[74] See note 68 above at 224-228.

the parent, the parent "can be held personally liable if it 'knowingly' receives the property of the subsidiary as a consequence of that breach or if the *parent's* intervention in the affairs of the subsidiaries is characterised as 'dishonest' so as to render the parent liable as accessory for dishonestly assisting in a breach of trust."[75]

The second scenario in which the doctrine might "bite" is where the parent adopts what Yeung describes as a "hands off" approach to the management of the companies in the group. If this occurs normally directors may engage in dishonest activities with rather drastic consequences. Yeung notes that in such a situation "the parent may nonetheless be liable for either 'knowing receipt and dealing' (if it has received property of the subsidiaries as a result) or if the parent can be regarded as 'dishonestly assisting' in the directors breach."[76]

Either way, the potential for this case to impact in this area has grown. Yeung discusses one or two cases in her article which are of interest. Finn J had foreshadowed the use of it in *Australian Securities Commission v AS Nominees*.[77] The more interesting decision is that of Hansen J in the *Farrow* litigation referred to earlier. In that case Hansen J discussed the arguments raised in *Barnes v Addy* and added some useful commentary reflecting on the Privy Council decision in *Royal Brunei Airlines Sdn Bhd v Tan*.[78] In summary he concluded that where common directors of two companies resolved that one of those companies was to enter into a transaction, and it turned out (in hindsight as is the usual case) that the decision should be judged as one for an improper purpose, if the directors had left the actual pursuit of the particular transaction to someone else (their nominee) who in turn selected which assets were to be used, a claim against the common directors might arise. A claim under *Barnes v Addy* was not precluded because the directors themselves did not participate in the actual selection of the relevant assets, or in the pursuit of the action in the appropriate circumstances. In his view, however, inaction on the part of the directors might not be strong enough to create liability in such a scenario. However, he did not have to apply the decision on the facts of the particular case.

It may well be, however, that the proposition put forward by Yeung creates a further opportunity for potential liability to be driven home against directors of the holding company. Given the potential liability pursuant to the shadow director provisions of the Corporations Law, the possibility that vicarious liability may also arise, and some of the other general principles which may be applied, the willingness of holding companies to allow their representative on the boards of subsidiaries to give some form of primacy to the interests of the holding company, may in rare cases turn out to be tempered. The consequences of such action may be dangerous (but in rare cases) for the representative, the persons responsible for the appointment and their companies.

CONCLUSIONS

I believe the concerns I have raised are manageable. The ability of courts to forgive honest behaviour by directors under section 1318 (and section 1317JA) of the Corporations Law will be preserved and should provide adequate protection for the honest and intelligent director. Creditors and minority shareholders are adequately protected. The cases in which holding companies (or the directors of holding companies) will be held liable as a result of section 8 of the CLERP proposals operating will, in my view, be rare. Commercial pragmatism must continue to be adequately recognised and we should be willing to rely on specialist courts to adequately assess the ramifications of finely balanced decisions.

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75 Yeung at 225.

76 Ibid.

77 (1996) 133 ALR 1.

78 [1995] 2 AC 378.

APPENDIX 1 – TO PAPER PRESENTED BY PROFESSOR ROBERT BAXT

A CASE IN POINT OR AN ABERRATION ON THE LAW OF GROUPS – THE MUA DISPUTE

The general perception in the community is that the recent waterfront dispute between Patrick Stevedores and the Maritime Union of Australia may have exposed a very severe inadequacy in the law relating to companies in a corporate group. Some have equated the transactions as not unlike the infamous bottom of the harbour schemes of the 1970s. We all know corporate groups are used extensively and very widely in all kinds of scenarios. Tax planning in particular is a favourite area; but it seems they may also be used to find loopholes in the corporate law. This in fact led to the related party legislation being introduced. The fact that our laws are themselves schizophrenic in dealing with all aspects of the group concept means that there are times when it is necessary to use different companies in a group scenario in the corporate law area as well as in others such as taxation and it seems industrial law.

It is difficult to speak with absolute confidence about the arrangements in this matter as I have not been involved in any direct way, but on the facts that emerged from the report of the decisions in the High Court and Federal Court, as well as from the newspaper articles which have dealt at length on this particular subject, it would appear that the following fact scenario was relevant. The group in question consisted of 16 companies. The ultimate holding company was Lang Corporation Limited (Lang). It operated a stevedoring business at 17 facilities around Australia through the Patrick group of companies. Consistent with what can only be regarded as legitimate uses of the group as a vehicle for corporate planning, the Patrick group of companies (Patrick Holdings Ltd (Patrick) was the operating company) was divided into functional components. In particular four of the Patrick companies (they were the employers) were given the task of employing labour to operate the stevedoring businesses.

In September 1997, these employer companies were in fact wholly owned subsidiaries of Patrick and ultimately of course of Lang. There was one exception, Stevedores Tasmania Limited in which Patrick Stevedores No. 1 Pty Ltd held 83% of the shares. The minority shareholding in that company was later acquired by another company in the Patrick group. Each of the employer companies had one director and that person was the same director for all of the companies.

Despite the profits of each of the employer companies being substantial for the year ended 30 September 1997, reflecting potential future tax benefits, officers of the group decided to reorganise the group around September 1997.

As part of this restructuring the employer companies sold their stevedoring businesses and assets to Patrick Stevedore Operations No. 2 Limited (PSO No. 2) at arm's length terms. They retained only their contractual interests relating to the employees. PSO No. 2 in return entered into non-exclusive agreements under which relevant employer companies supplied PSO No. 2 with labour. That companies' interest in the business assets and labour supply agreements was later transferred within the group to Patrick Stevedoring Operations Limited (PSO). When the labour supply was subsequently interrupted due to industrial action, PSO terminated the labour supply agreements as it was entitled to under the particular agreements. This left the employer companies insolvent with nothing but a host of contractual liabilities. Administrators were then appointed.

As a result of this restructuring the bulk of the capital of the employer companies was returned to the shareholders (which were wholly owned companies in the Patrick group) and was of course not available either to the employers or to the creditors (or to potential creditors).

Despite the fact that each member company was an independent legal entity they were managed as if part of a single enterprise (not unlike the position in many other similar scenarios). The four employer companies of course had the same director. Counsel for Lang in describing the events indicated that the restructuring had been undertaken for the commercial advantage of the group "to streamline the business and place it in a more modern footing" (reflecting the language of

some of the judges who have commented on this particular topic). Nevertheless, the decision of the employer companies to take part in the restructuring process was supposedly an independent one in each case.

As discussed in the main paper, under the Corporations Law and the common law there is a separate duty imposed on directors to act bona fide in the best interests of the company as a whole. Each company is a separate legal entity and the directors must have the interests of the company (which means the shareholders) in mind when pursuing their activities. At times the interests of creditors, however, also have to be taken into account. Other interests are clearly not relevant.

One could be forgiven for asking the question how in this fact scenario it was in the interests of the Patrick companies as a whole for each of the profitable employer companies to sell their businesses returning capital to the shareholders while leaving the companies with no cash and a host of liabilities. Further, how could this be in the best interests of those individual companies? The shareholders in this instance were unlikely to complain as they were the owners of each of the companies. They received an influx of capital while at the same time being insulated from any liability to the employees or to the creditors due to the separate existence of each of the companies notwithstanding the rearrangement.

This set of facts clearly identifies the kind of issues that will arise in this area of the law and which pose problems for directors of the different companies within the group. This scenario, which will no doubt return to the court in due course, will be a fascinating one against which to measure some of these proposals for reform and the way in which the law has developed.

APPENDIX 2 – TO PAPER PRESENTED BY PROFESSOR ROBERT BAXT

THE LIFTING OF THE CORPORATE VEIL – THE CORPORATE LAW PROPOSALS AND THE AUSTRALIAN DEMOCRATS AMENDMENTS

There are a number of statutory provisions contained in the Corporations Law under which the corporate veil may be "lifted" and liability driven home to either directors or perhaps other companies in the context of the corporate group. The most important of these are as follows:

- promoters may incur personal liability when purporting to act on behalf of the company: Corporations Law (the Law), section 183;
- personal liability will attach to directors when negotiable instruments have been signed without the company name appearing on them: section 219;
- directors will be liable should the company trade with less than the minimum number of members: section186;
- directors will be liable if a dividend is paid out of areas other than profits: section 201;
- the relevant interest provisions. Part 1.2 of the Law, and the preferential charges provision, section 267, also allow the corporate veil to be lifted; and
- perhaps the most important provisions of the Law involve insolvent trading sections 588G and 588V. These provisions allow personal liability to be imposed on the directors or holding company when the company has traded in circumstances where it is unable to meet its debts or in similar situations governed by them.

The proposed amendment to the Company Law Review Bill tabled by the Australian Democrats (Senator Murray) provides as follows:

"588YA **Liability of a company for the debts or liabilities of a related body corporate**

(1) On the application of the liquidator of a company that is being wound up in insolvency, the Court may, if it is satisfied that it is just, order that a company that is or has been a related body corporate must pay to the liquidator the whole or part of the amount of a debt or liability of the first-mentioned company that is an admissible claim in the winding up.

(2) In deciding whether it is just to make an order under subsection (1), the matters to which the Court must have regard include:

(a) the extent to which the related body corporate took part in the management of the company;

(b) the conduct of the related body corporate towards the creditors of the company generally and to the creditor to which the debtor liability relates;

(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 body corporate; and

(d) any other relevant matters.

(3) An order under this section may be subject to conditions.

(4) An order must not be made under this section if the only ground for making the order is that creditors of the company have relied on the fact that another company is or has been a related body corporate of the company."