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THE CORRELATION OF CONTROL AND LIABILITY IN THE REGULATION OF CORPORATE GROUPS: HOLDING AND SUBSIDIARY COMPANY MANAGEMENT UNDER THE COMPANIES ACT 1993

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The Companies Act 1993 (the "Act") changes the law as it relates to the management of holding and subsidiary companies. This paper presents an analysis of these changes. Particular consideration is given to sections 126, 131 and 133 of the Act. In respect of section 126 this paper discusses when a holding company will be deemed a director of its subsidiary and the consequences this gives rise to. Section 131, by allowing a subsidiary's directors to act in the interests of the holding company, represents a departure from the strict requirement that directors act in the best interests of the company. It is argued that this potentially conflicts with the duty of directors under section 133 to exercise their powers for a proper purpose. The example which is used to highlight this conflict is the provision of a guarantee by a subsidiary for the debts of its parent. Ultimately it is concluded that the combined operation of these two sections is inconsistent with what is presumed to be the intention in moderating the duty of subsidiary directors under section 131. Furthermore it is maintained that section 131 presently places a disproportionate risk of company failure upon the subsidiary's creditors. In concluding that further reform is necessary several suggestions are made as to how this can be achieved. Essentially it is proposed that what is required is the correlation of control and liability.

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I INTRODUCTION

In the developed world the corporate form is the predominant means by which business operates. The role of company law in facilitating the use of the corporation to maximise economic development is pivotal to this. It is therefore essential that any regulation imposed be both efficient and effective. To achieve this company law should provide a clear framework for governing the interrelationship within the company between those controlling its management on the one hand, and investors, whether they be shareholders or creditors, on the other.

The concept that the company is an entity separate from its shareholders is essential to company law. In turn, management and control of corporate direction lies almost exclusively with the company's board of directors. In order to guard against misuse of the corporate form, a company's directors are charged with various duties to the company. To the extent that directors uphold these duties creditors must, as a general rule, bear the risk of corporate insolvency and accept the losses that they sustain as one of the perils of doing business.

In this manner, liability for misuse of the corporate form is correlated with control. Where the distinction between investors and management becomes somewhat blurred, however, company law has been less effective in achieving its regulatory aims. This has proved to be of particular difficulty in the context of corporate groups operating as holding and subsidiary companies.

One problem lies in providing a regulatory mechanism which caters both for those holding companies which seek to take an active part in their subsidiaries' affairs as well as those that are prepared to permit their subsidiaries to operate as largely autonomous entities. To achieve this it is necessary to define the nature and extent of the relevant company interests in a substantive, rather than a formulaic, manner. Fundamentally such an approach entails that the classification of a holding company either as a director or a shareholder should be determined by the control it exercises over its subsidiary rather than by its label as an investor. It is, however, only in relatively recent years that this has begun to receive legal recognition.

The second key difficulty which the operation of holding and subsidiary companies presents is the extent to which the law is prepared to permit the unitary administration of the

group's constituent companies. Traditionally little latitude has been permitted in this regard, in light of the law's insistence that each company is to be treated as a separate legal entity. Increasingly, though, such a rigid stance has lost touch with commercial reality. As those responsible for the establishment of the group enterprise seek to take advantage of the obvious benefits which can be derived from a more integrated approach to inter-company dealings.

It is against this background that the Companies Act 1993 (the "Act") has introduced several changes to the law relating to the management of corporate groups. The purpose of this paper is to assess these reforms and to propose any amendments considered necessary in light of this assessment. Part II provides a brief outline of the law as it was prior to the 1993 Act and the key changes which the 1993 Act has introduced. Parts III and IV then attempt a detailed explication of these reforms. Finally, Part V involves a discussion of the amendments that are considered necessary to achieve a more optimal regulatory scheme for the management of corporate groups.

II COMPANIES ACT 1955, THE COMMON LAW AND THE CHANGES INTRODUCED BY THE COMPANIES ACT 1993

A *Acting in the Best Interests of the Company*

Prior to the introduction of the 1993 Act, regulation of corporate control within the holding and subsidiary company context did not differ from that for companies generally. The courts' adherence to the separate entity status of each company within a corporate group entailed that directors were required to act, bona fide, in what they believed to be the best interests of the company upon whose board they sat. This did not mean that the directors of a subsidiary could not look to the interests of the group as a whole. As was stated by Cooke J such an approach would be "out of touch with reasonable commercial practice."[1] What it did mean, though, was that where the interests of a holding and subsidiary company conflicted, the subsidiary company's directors were required to give preference to the interests of the subsidiary.[2]

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[1] *Nicholson v Permakraft (NZ) Ltd* [1985] 1 NZLR 242, 251.
[2] *Scottish Co-operative Wholesale Society Ltd v Meyer* [1959] AC 324, 366-367.

A common basis for an allegation that a director had failed to act in what they believed to be the interests of the subsidiary, was that no separate consideration had in fact been given to the subsidiary's interests. In the opinion of Pennycuick J, though, such a finding was not enough to establish a breach of duty. Rather, the test to be applied, "in the absence of actual separate consideration," was "whether an intelligent and honest man in the position of a director of the company concerned, could in the whole of the existing circumstances, have reasonably believed that the transaction was for the benefit of the company."[3]

However, as the Supreme Court of New South Wales Court of Appeal notes, whether a director has acted in what they consider to be the interests of the company is a question of fact. It is not a question of whether the actions of the director are in the company's interests but rather whether the director has acted in the belief that his or her actions were in the company's interests. The objective test proposed by Pennycuick J above overlooks, therefore, the nature of the duty.[4] In light of this the Court proposed that it was more appropriate to resolve this issue by holding that where a director fails to consider the interests of their company they have committed a breach of duty. However, if the transaction, viewed objectively, was in the interests of the company "then no consequences would flow from that breach."[5] Whatever the formulation of this test the law remained that a holding company could not simply subordinate the operation of its subsidiary to its own interests.

B *Definition of Director and Deemed Directorship under the Companies Act 1955*

Furthermore, to the extent that a holding company wished to enforce an integrated policy of group management, consideration had to be given to the possibility that it would consequently be held to be a director of its subsidiaries. This was not a trivial matter given the potential for liability which company directors faced under, for example, sections 319 and 320 of the Companies Act 1955 (the "1955 Act"). The definition of a director in the 1955 Act was not, however, overly inclusive. In order for a holding company to be deemed a director it had to be demonstrated that the board of the subsidiary were accustomed to act in accordance with its instructions.[6]

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[3] *Charterbridge Corporation v Lloyds Bank* [1969] 2 All ER 1185, 1194.
[4] *Equiticorp finance Ltd (in liq) v Bank of New Zealand* (1993) 11 ACSR 642, 727 ["*Equiticorp*"].
[5] *Equiticorp* above n 4.
[6] Companies Act 1955, s 2 "Director" ["*1955 Act*"].

In *Re Hydrodam (Corby) Ltd*,[7] Millet J, interpreted a similar definition of a director in the English legislation. He determined that "a pattern of behaviour in which the board did not exercise any judgment of its own, but acted in accordance with the direction of others" was necessary for the expanded definition of a director outlined above to be satisfied.[8] While this case was decided since the introduction of the 1993 Act, it is nevertheless a concise statement of what the law was previously and, given that this definition of a director has been carried over, what the law continues to be.

The object of having a definition of director encompassing a group broader than those who simply purport to act as such, is to capture those who wish to control the direction of a company, yet are not prepared to accept the responsibility and, in turn, the exposure to liability which this entails. At the same time, however, directors of a company are expected to act independently and, to the extent that they receive advice from third parties, ultimately decide the direction of the company themselves. The presumption, therefore, was that unless some pattern could be established whereby the board could be said to have acted at the behest of another, then decisions relating to the management of the company were regarded to have been made by its directors acting alone.[9]

Considerable scope, however, still remained for a holding company to direct its subsidiary to follow a particular course of action, without having to exercise the care that it would were it a director. A holding company simply had to ensure that it did not interfere in the management of its subsidiaries too often. In addition, the need to establish a pattern of action in accordance with another's directions, between the "persons", who were directors, and an outsider, negated the suggestion that control of less than the board would elevate someone to the position of director.[10] This further restriction on the application of the expanded definition of a director essentially endorsed the appointment of directors to represent the interests of others provided the board as a whole acted independently.

C *Changes Made by the 1993 Act*

The introduction of the 1993 Act has brought about several significant changes to the law regarding the operation of corporate groups. While the separate entity status of holding and

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[7] [1994] 2 BCLC 180 ["*Hydrodam*"].
[8] *Hydrodam* above n 9, 183.
[9] See, for example, *Standard Chartered Bank v Antico* (1995) 18 ACSR 1, 66 ("*Antico*"].
[10] See, for example, text at fn 13.

subsidiary companies has not changed,[11] the requirement for directors to act solely in the best interests of their company has. Section 131 of the 1993 Act provides that, where a holding company has a wholly owned subsidiary, its subsidiary may act contrary to its own interests provided that it acts in the best interests of the holding company. This is provided that the subsidiary company is expressly permitted to do so by the subsidiary's constitution. Where the subsidiary is not wholly owned there is an additional requirement that there must be unanimous shareholder consent before the subsidiary is able to neglect its interests in favour of the holding company's.

Section 126 further broadens the expanded definition of a director. Under the 1993 Act a person is now deemed to be a director where a "[a] person occupying the position of director of the company by whatever name called ... *may be required* or is accustomed act" in accordance with their instructions. [Emphasis added]. As a result of this section *control* over only one company director will now suffice to be deemed a director. The definition of control, while not explicitly referred to as such, now includes anyone who has the ability to require someone occupying the position of director to act in accordance with their instructions.

In interpreting this provision the critical question is when can it be said that a director "may be required to act" at the behest of another. This is significant. Unlike the requirement that it be established that a director is accustomed to act in accordance with the instructions of another, pursuant to the 1955 Act, it would now appear that, under the 1993 Act, for a person to be deemed a director, they no longer need to actually exercise control over a board member. All that is required is the potential to be able to exercise control not the actual exercise of control itself. Given the size of the investment which a holding company may have in a subsidiary, it understandably has a considerable incentive to ensure that it is able to exercise a degree of influence over those that are appointed to the subsidiary's board. However, if the holding company is to be liable as a director, solely due to its potential ability to influence the directors of its subsidiary, this presents a substantial disincentive to what is arguably a legitimate practice where the ability to control is not in fact exercised.

III SECTION 126 - MEANING OF "DIRECTOR"

[11] The Companies Act 1993, s 15 ["*1993 Act*"].

In terms of restricting the administration of corporate groups as unitary operations, the more expansive definition of a director provided for by section 126 is the most significant change introduced by the 1993 Act. In order to assess its scope it is useful to refer to two recent New Zealand cases which highlight the ineffectiveness of the previous, more restricted, definition of a director. Both of these cases are decided under the 1955 Act and both are concerned with whether a shareholder can be held liable in respect of those directors they appoint to represent their interests, rather than the interests of the company as a whole.

Having established the inadequacies of the law under the 1955 Act consideration will then be given to what is meant by the phrase "may be required". The consequences of deemed directorship the holding company which does not in fact choose to exercise control over its subsidiary will then be discussed.

A *Kuwait Asia Bank EC v National Mutual Life*[12] ("*Kuwait Asia Bank*")

The company at the centre of the *Kuwait Asia Bank* case was AIC Securities ("AIC"). The case represented an attempt by AIC's creditors, National Mutual, to hold AIC's shareholder, the Kuwait Asia Bank, vicariously liable for the negligent acts of its employees whom it appointed as directors of AIC. National Mutual also argued that the Bank could be held directly liable as a director of AIC Securities in accordance with the definition of a director in the 1955 Act. National Mutual were, however, not successful in this latter respect because only a possible two out of the company's five directors could possibly be said to act in accordance with the instructions of the bank.[13]

The Privy Council ruled that shareholders owe no duty to creditors in respect of the directors that they appoint and the fact that the directors were also the shareholder's employees made no difference.[14] In the performance of their duties as directors, the employees of the Bank "were bound to ignore the interests and wishes of their employer".[15] It was held that no duty could be said to arise on the part of the bank as an employer simply because it could dismiss the employee, or as a shareholder simply because it could dismiss a director.[16]

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[12] [1990] 3 NZLR 513 ["*Kuwait Asia Bank*"].
[13] *Kuwait Asia Bank* above n 12, 534.
[14] *Kuwait Asia Bank* above n 12, 532.
[15] *Kuwait Asia Bank* above n 12, 533.
[16] *Kuwait Asia Bank* above n 12, 534.

The obvious practical problem with the reasoning of the Privy Council in this case is the failure to recognise the reality of the employer/employee relationship. Whether or not an employee is bound to ignore the demands made of them by their employer avoids the issue. The question should be whether the employee is in fact in a position to ignore the interests of their employer and secondly whether or not their employer has actually instructed them to act inconsistently with their duties to the company. In the analysis which will follow of what is meant by the phrase "may be required", it is suggested that it is these issues which section 126 of the 1993 Act now addresses.

B *Dairy Containers Ltd v NZI Bank Ltd*[17] (*"Dairy Containers"*)

In essence the claim made in *Dairy Containers* was the same as that in *Kuwait Asia Bank*. The difference though was that the shareholder, New Zealand Dairy Board ("NZDB"), exercised total control over the subsidiary company, Dairy Containers Limited ("DCL"). NZDB's total control of DCL, exercised through its employees on the board of DCL, was not, however, considered to be sufficient basis for deeming NZDB to be a director of DCL. Thomas J reasoned that the directors of DCL did not receive any instructions from NZDB in their capacity as directors, even though they were, as employees of NZDB, "standing (or sitting) in the shoes of NZDB at … [DCL's] board table".[18] Thomas J went on to make the tenuous distinction that, in any event, "[e]ven when a firm instruction from NZDB was made, it was directed at the company and not at the directors."[19] If, however, it could be said that DCL was accustomed to act in accordance with the directions of NZDB then it is difficult to envisage why the same could not be said of DCL's directors.[20]

The conclusion of Thomas J was that the appropriate categorisation of the relationship between the directors of DCL and NZDB was one of employee and employer. If NZDB was to be liable for negligence in respect of the operation of DCL then this could only be through its vicarious liability as an employer. In this respect, however, Thomas J felt constrained by the decision in *Kuwait Asia Bank* that an employer could not be held vicariously liable for the acts of their employee as a company director.[21]

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[17] [1995] 2 NZLR 30 ["*Dairy Containers*"].
[18] *Dairy Containers* above n 17, 91.
[19] *Dairy Containers* above n 17, 91.
[20] Karen Yeung "Corporate groups: legal aspects of the management dilemma" [1997] LMCLQ 208, 231 ["*Yeung*"].
[21] *Dairy Containers* above n 17, 97.

The problem with Thomas J's categorisation of the relationship between the relevant parties is that there is no reason why NZDB, simply because it is the employer of DCL's directors, should be liable to DCL's creditors. The doctrine of vicarious liability usually operates in the context of tortious conduct on the part of an employee. In so far as victims of torts are involuntary creditors and the employee is acting for the benefit of the employer, it may well be that the employer is a more appropriate party to bear the risk of the employee's conduct. This justification for the imposition of vicarious liability cannot, however, apply where a creditor voluntarily assumes a risk. Yet in providing credit to DCL, DCL's creditors did so voluntarily and fully aware that DCL was a limited liability company.

Provided, therefore, that NZDB has not interfered in the discharge by DCL's directors of their duties to the company, there is no reason why the mere existence of an employment relationship should make them any more liable to DCL's creditors than any other shareholder. Of course the contention was that NZDB had interfered in the management of DCL and effectively acted as its directors. If, though, this was true, then the defect in the law is not the inability to hold employers vicariously liable for their employee directors but rather the definition of who is a director. Again, as the following discussion should illustrate, it is exactly this problem which the wording of the phrase "may be required" in section 126 seeks to overcome.

C *Meaning of "May be Required"*

Included in the definition of a director under the 1993 Act is a person "in accordance with whose directions or instructions" a member of the board "*may be required* or is accustomed to act". Due to the advantages for a holding company in having at least the potential to influence the directors of its subsidiaries, the extent to which this influence means that those directors "may be required" to act in accordance with the holding company's instructions is crucial. In attempting to establish how this phrase may be interpreted by the courts, the two possible extremes of interpretation are first discussed in order to demonstrate that an approach which meets the deficiencies of the earlier case law is probably all that was intended.

Under the 1955 Act, other than those "occupying the position of director by whatever name called", the only other person who could be considered a director was "a person in

accordance with whose … instructions" a member of the board was accustomed to act.[22] In considering a definition of director similar to that in the 1955 Act, whereby a person will be deemed a director if a member of the board is accustomed to act in accordance with their instructions, Hodgson J of the Supreme Court of New South Wales, acknowledged that a holding company does not become a director of its subsidiary merely because it has the ability to control the composition of its subsidiary's board. [23] The law in this respect remains unchanged by the 1993 Act. The mere ability of a holding company to appoint or remove a subsidiary's director from the board does not lead to the conclusion that subsidiary directors can be required to act at the holding company's behest. There is nothing to prevent a subsidiary director who is faced with such an ultimatum from refusing to act and accepting dismissal. If it were the intention of the legislature that the mere ability to control the composition of the board was to be sufficient grounds to be deemed a director, then a definition along the lines of that in section 7 of the 1993 Act could easily have been adopted. Section 7 sets out the requisite degree of control necessary to satisfy the definition of a holding company under section 6.

At the opposite end of the spectrum the phrase "may be required" could have been intended to refer to the existence of a legal requirement for a director to act in accordance with another's instructions. Such a requirement would, however, be unenforceable and therefore cannot have been what was contemplated by the phrase "may be required". At common law company directors are considered to have duties of a fiduciary nature in respect of the company. Directors are bound to act "bona fide and in the best interests of the company". This duty is incorporated within the Act under section 131. As a matter of general principle therefore directors are regarded as being unable to "fetter their future discretion."[24] The argument is that a director cannot act bona fide or in good faith if they have already agreed with some third party as to how they will act.

The inability for directors to fetter their discretion is not, however, absolute. Both the English case of *Fulham Football Club Ltd v Cabra Estates*[25] and the Australian case of *Thorby v Goldberg*[26] hold that a director can fetter the exercise of their future discretion, where to do so was, in the directors' opinion, in the best interests of the company at the time they entered into the obligation in question. It is arguable, however, that the directors

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[22] *1955 Act* above n 6.
[23] *Antico* above n 9, 70.
[24] Thomas B Courtney "Fettering directors' discretion" (1995) 16 Co Law 227.
[25] [1994] 1 BCLR 363 ["*Fulham Football Club*"].
[26] (1964) 112 CLR 597.

in these cases are not in fact fettering their discretion at all but rather simply exercising their discretion in the present in respect of some future act. Nevertheless, in light of the doubt which Chadwick J in *Fulham Football Club* cast on the proposition that directors could not by express obligation fetter the exercise of their future discretion,[27] the law in this area is not entirely settled.

In terms of section 126, however, the suggestion that a director may be required to act in accordance with the directions or instructions of another implies more than a one off agreement to act in a particular way at some point in the future. The section appears to contemplate an ongoing arrangement which results in someone occupying the position of a director having to act at another's bidding when required to do so. Such an arrangement would be entirely inconsistent with the duty of a director to act bona fide in the performance of their functions; a duty which in New Zealand no longer arises simply as a result of a director's fiduciary like relationship with the company but as an express requirement of the 1993 Act. Since the duty of a company director to act in good faith is clearly set out in the 1993 Act it would be surprising if a contract negating its effect was to be upheld.

It is submitted therefore that the circumstances where a director can be required to act at the behest of another do not arise either simply by virtue of their appointment to represent the interests of a controlling shareholder or as a matter of legal obligation to fulfil their duties as directors in accordance with the instructions of another. It is considered that what was intended by the phrase "may be required" is the type of arrangement outlined by Thomas J whereby "[t]he very fact of the employment contract or the nature or understanding of the arrangement by which directors are appointed as "nominee directors" means that they have fettered their discretion to act independently."[28] The point is that as a matter of commercial reality "employee-directors do not undertake their responsibilities to the company of which they are a director without regard to the interests of their employer."[29] Thomas J here ,is not in any way proposing that such an arrangement between a shareholder and its nominee director is necessarily legally enforceable in respect of the nominee's exercise of their powers and duties as a director, but is simply recognising what he perceives to be the reality of the situation.

[27] *Fulham Football Club* above n 25, 375.
[28] *Dairy Containers* above n 17, 95.
[29] *Dairy Containers* above n 17, 94-95.

D *Effect of the 1993 Act on Deemed Directorship and Holding Company Liability*

In *Dairy Containers*, Thomas J categorised the relationship between NZDB and DCL as employer and employee. In *Kuwait Asia Bank* the Privy Council categorised the relationship between the Bank and ACI Securities' directors simply as that of shareholder and director. While Thomas J considered the resolution of the problem to lie in the vicarious liability of a shareholding employer for its nominee employee director, the Privy Council believed this to be inconsistent with the limited liability of shareholders under company law. Section 126(1)(b) rejects both of these approaches and would find all four parties to be directors.

It is submitted that the correct interpretation of section 126 is that for a holding company to be deemed a director of its subsidiary there must either be:

(a) a pattern of control whereby at least one director of the subsidiary acts in accordance with the instructions of the holding company; or

(b) the existence of some degree of exercisable influence on the part of the holding company in respect of a subsidiary company director.

In relation to (b), as has been demonstrated in the preceding discussion, the requisite degree of influence lies somewhere between the mere power to remove a director from office and a legal requirement to act in accordance with another's instructions. An example of such a relationship of influence would be that which exists between employer and employee.

Due to the employer/employee relationship in both the *Kuwait Asia Bank* and *Dairy Containers* cases there is no question that either the Bank or the NZDB would under the 1993 Act fail to be deemed directors of their subsidiaries. In this manner the status of the relationship between a holding company and its subsidiary is resolved as a matter of company law. The essential concern in each of these cases is the fact that a holding company is usurping the power of its subsidiary's directors in order to control the management of its subsidiary and effectively operate as a director. This is a broader problem than simply that of employee directors and is related to the existence of directors representing the specific interests of shareholders, in other words nominee directors, generally.

What is provided for by section 126 is that where a holding company wishes to run its subsidiary in this manner it must also be prepared to adhere to the duties which the 1993 Act imposes upon directors and incur whatever liability arises as a result of their breach. The reason that the NZDB should be liable to NZI Bank is not because its employees are directors of DCL but rather because it is no longer a shareholder making a passive investment but rather a shareholder taking an active part in its company's management and therefore effectively acting as a director. Likewise section 126 does not mean that a controlling shareholder faces unlimited liability in respect of the exercise of their power to appoint directors, as postulated by the Privy Council,[30] but simply that they cannot escape liability as a director by appointing a nominee director to act as a conduit for their instructions.

E *Consequences of Deemed Directorship for a Holding Company*

The conclusion of the previous discussion as to the meaning of the phrase "may be required" in section 126 was that where a holding company is able to exercise a degree of influence over the directors of their subsidiaries, such that those directors may be required to act in accordance with the instructions of the holding company, the holding company will be deemed a director of its subsidiary as a result. The effects of this provision are potentially extensive. In order to assess the true extent of the consequences of holding companies being deemed directors under these circumstances, it is necessary, however, to reach some conclusion as to the liability which a holding company faces as a deemed director. The following discussion represents an attempt to do this.

If the conduct of NZDB in *Dairy Containers* had meant that it could be considered a director of DCL under the 1955 Act this would have achieved significantly the same result as if it was held vicariously liable for the acts of its employees. It is submitted, however, that these two approaches have the potential to produce quite different outcomes. Unlike the application of the doctrine of vicarious liability, the mere fact that a controlling shareholder is deemed to also be a director does not necessarily entail any liability for breach of a nominee's duty. Where an employer is vicariously liable for the acts of their employee then they are accountable for any liability which their employee incurs. As a deemed director under section 126, however, an appointer of a nominee director is not liable for the acts of their nominee but only to the extent that they themselves have breached a duty to the company as set out in the 1993 Act.

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[30] *Kuwait Asia Bank* above n 12, 532.

Section 135 of the 1993 Act is entitled "reckless trading". It forbids a director from either (a) agreeing to; or (b) *causing or allowing* "the business of the company [to be] carried on in a manner likely to create a substantial risk of serious loss to the company's creditors." [Emphasis added].

The crucial phrase which is not open to ready interpretation in this section is that of "cause or allow". The question is to what extent a deemed director's inaction in relation to the company will still lead to them being held to have *caused or allowed* the business of the company to be conducted in the manner in which it is.

Section 135 aside, however, the duties of directors set out in the 1993 Act are worded in such a way that they would only appear to be applicable to positive acts undertaken by directors, as company agents, and not omissions. Consequently provided that a holding company does not actually exercise their power to require a subsidiary director to act, then, the fact that they are deemed a director under section 126 will be of little significance. This is of course unless, irrespective of their involvement in the affairs of the subsidiary, they can still held to be in breach of section 135.

It is proposed that the resolution of the issue which section 135 depends on whether or not a director, or more particularly a deemed director, is considered to be responsible in absentia for the affairs of the company. If they are responsible then a deemed director's failure to sufficiently monitor the operation of the company would amount to them causing or allowing the business of the company to be carried on in whatever way it actually is. Conversely, if a deemed director is not in fact expected to take any part in company management then it is difficult to see how, by distancing themselves from the company's affairs, it can be said that they have caused or allowed a company's business to be carried on either one way or another.

The standard of care expected of a director is set out in section 137. It provides that when a director is "performing duties as a director, [they] must exercise the care, diligence, and skill that a reasonable director would exercise in the same circumstances taking into account, but without limitation … [t]he position of the director and the nature of the responsibilities undertaken". The duty provided for by section 135 is a duty of a director. Therefore, in accordance with section 137 the standard of care expected of a director in the performance of section 135 is that of a reasonable director. In order to determine what is

the standard of the "reasonable director", and the extent to which a deemed director is expected to take an active role in the running of the company, specifically in relation to section 135, it is necessary to refer to the common law.

1 *The reasonable director at common law*

In the New Zealand case of *Grayburn v Laing*[31] Gallen J held that a director who was absent from a board meeting was entitled to assume that those directors who were present would adequately deal with whatever matters arose for resolution.[32] In Australia the standard of care expected on the part of directors has been the subject of judicial decision in several recent cases. As a result of the decisions in these cases, it can no longer be said that when facing impending trouble "the easiest and safest course for a director ... [is] to stay away from board meetings".[33] In light of this it is considered that *Grayburn* is of questionable authority.

In *Commonwealth Bank v Friedrich*[34] it was held that a director is required, at the very least, to keep abreast of a company's affairs so as to be able to act appropriately when the company's solvency becomes doubtful.[35] A similar ruling was handed down in *Morley v Statewide Tobacco Services*[36] whereby it was considered that a director cannot simply rely on being provided with a minimal amount of information and ignore the possibility that they have not been told something of relevance or at the least fail to inquire further.[37]

The tenor of each of these judgments is that "the days of the sleeping, or passive, director are well and truly over".[38] Any lingering doubts as to whether Australian directors have a duty to actively seek out information pertinent to the well being of the company were emphatically dispelled by the New South Wales Court of Appeal in *Daniels v Anderson*.[39] In short, although directors do not need to actively scrutinise the day to day running of the

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[31] [1991] 1 NZLR 482 ["*Grayburn*"].
[32] *Grayburn* above n 31, 493.
[33] *Daniels v Anderson* (1995) 16 ACSR 607, 659.
[34] (1991) 5 ACSR 115 ["*Friedrich*"].
[35] *Friedrich* above n 34,126
[36] (1992) 10 ACLC 1233 ["*Morley*"].
[37] *Morley* above n 36, 1245.
[38] *Najjar v Haines* (unreported, NSW Court of Appeal, 26 November 1991) cited in *Morley* above n 36, 1246-1247.
[39] (1995) 16 ACSR 607 ["*Daniels*"].

company they "are under a continuing obligation to keep informed ... of corporate affairs and policies."[40]

One could surmise, therefore, that should this approach be followed in New Zealand, a director who simply failed to take part in the company's management could be said to have "caused or allowed" the business of the company to be carried on, in whatever way it ultimately ended up being operated. An abdication of responsibility of this nature plainly does not meet the level of care required of the reasonable director. The question is, though, whether the same is true of the deemed director.

2 *Reasonable deemed director*

In *Deloitte Haskins & Sells v National Mutual Life Nominees*[41] it was submitted that the standard to be applied to a non-executive director should be lower than that of an executive director and that a non-executive director should be able "to rely on the information placed before him [or her]." The basis of the claim against the non-executive director was his failure as a director of a company inviting funds for investment, to consider whether certificates or reports tabled before the board complied "with the terms of the trust deed, the net worth of assets and the collectability of loans". Gault J, with whom, McGechan J concurred, was of the view that in this context a director could not be absolved from responsibility simply because he held the position in a non-executive capacity.[42]

It is submitted that it is reasonable to make no distinction in the standard of care expected of non-executive as opposed to executive board members, in respect of matters which come before the board. However, the same reasoning does not apply to the deemed director, where their status as a director is only the result of their *ability* to require a board member to act. Under the 1993 Act it is not contemplated that such a person will take any part in board meetings, for if they did then the definition of a director under section 126(1)(a), as "[a] person occupying the position of director ... by whatever name called", would suffice. Nor is it anticipated that they will play any regular role in company affairs, for if this were the case then their power of influence would be represented by a pattern of acquiescence such that it could be said the director or directors in question were accustomed to act in accordance with their instructions, not simply may be required.

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[40] *Francis v United Jersey Bank* 432 A 2D 814, 821-823 (1981) cited with approval in *Daniels* above n 39, 666-667 ["*Francis v United Jersey Bank*"].
[41] (1991) 5 NZCLC 67,418 ["*Deloitte Haskins & Sells*"].

In *Trounce and Wakefield v NCF Kaiapoi Ltd & Onrs*[43] the "full and active participation of all directors" was considered essential "least in any way their collective wisdom is blunted in a way which may be detrimental to the shareholders they represent."[44] This statement is illustrative of the difference between directors proper and a deemed director. Directors are generally appointed to run the company. If they fail to fulfil this voluntarily assumed obligation[45] then the company's operation will suffer as a result. It is therefore not unreasonable to require that they actively participate in company management and seek out whatever information is necessary to appropriately fulfil their role. Alternatively the deemed director is not made a director for the purposes of administering the company's affairs but rather simply to ensure that those who control the management direction of a company cannot escape liability for breach of duty by operating through another.

In broadening the scope of the definition of who constitutes a director the 1993 Act has removed the difficulties of proof in establishing some sort of a pattern of control, which was required by the 1955 Act. In doing this, though, the bounds within which someone can now be categorised as a director, through having the mere ability to exercise a controlling influence over another, is no longer necessarily related in any way to the control these people exercise as a matter of fact over the company. It is considered that it is this context which must be borne in mind when assessing what is the standard expected of the deemed director. As section 137(c) states, "[t]he position of the director and the nature of the responsibilities undertaken by him or her" should be taken into account.

If this approach is adopted then the suggestion that a deemed director should, as a matter of course, keep themselves continually "informed about the activities of the corporation"[46] would not appear nearly as reasonable as it does for a director sitting on the board. Especially as this requirement is in turn related to the stipulation that directors should "attend board meetings regularly."[47] The deemed director will ordinarily never attend a board meeting and nor are they expected to.

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[42] *Deloitte Haskins & Sells* above n 41, 67,442-67,443.
[43] (1985) 2 NZCLC 99,422 ["*Trounce and Wakefield*"]
[44] *Trounce and Wakefield* above n 43, 99,430.
[45] *1993 Act* above n 11, s 152.
[46] *Francis v United Jersey Bank* above n 40.
[47] *Francis v United Jersey Bank* above n 40.

On the presumption therefore that regardless of their power to require a director to act, a deemed director never actually does so, it is proposed that there is nothing unreasonable in such a director effectively ignoring how the business of the company is carried on altogether. This being the case then there would be no potential for liability under section 135. If a deemed director is not required to actively monitor the business of the company then it cannot be said that they have caused or allowed the company to be run in any particular way. Nevertheless as soon as someone deemed to be a director does exercise the influence they have over either the board as a whole, or any individual board member, they can no longer assume a position of ignorance. As is the intent of the 1993 Act, there is no reason why the duties of a deemed director in these circumstances should not be the same as someone openly appointed to the position.

It is necessary to make one further qualification to the ability of a deemed director to take no part in the administration of the company. In the event that the director or the board over whom they stand in a position of power, seeks out their advice, they cannot absolve themselves of responsibility simply by saying or doing nothing. Due to the influence which a deemed director is capable of wielding, inaction in the face of a request for advice has to be viewed as an effective carte blanche sanction of whatever course of action is ultimately chosen. In choosing not to act the deemed director *is* acting and in turn *causing* or *allowing* the state of affairs which has been brought to their attention to continue.

3 *Deemed Director not Liable Unless Influence Exercised*

The "reasonable" deemed director is not, therefore, expected to take an active part in the management of the company. Section 137 provides that it is the standard of the reasonable director, bearing in mind "[t]he position of the director and the nature of the responsibilities undertaken", that is to be applied to section 135. If the reasonable deemed director is not expected to actively involve themselves in the affairs of the company then it does not follow that by not taking such an active role they have *caused* or *allowed* the business of the company to be carried on either one way or another. As the remaining directors' duties only appear to apply where a director actually performs powers or exercise duties as a director the simple fact of deemed directorship, as a result of a latent power to require a director to act, is of little significance. It is only where such a director exercises this power that they will expose themselves to the liability of a director.

It is maintained that this is the appropriate outcome of any imposition of director status. As was discussed in the introduction, above and beyond abuse of the corporate form, creditors assume the risk of business failure. Where a holding company's status as a director of its subsidiary is derived solely from an ability to influence its subsidiary, but it in no way exercises this power, then creditors cannot claim their loss was the fault of the holding company any more than they can blame shareholders generally.

Andrew Borrowdale, however, is of the opinion that the conclusion that a person deemed to be a director simply as a result of their ability to exercise a latent power, is only liable if they exercise this power, makes little sense. He considers that while this may be an appropriate approach where a person's status as a deemed director is as a result of their active influence over company management, but the same cannot be said where a person is held to be a director even if they take no interest in how the business of the company is conducted. What must have been intended, according to Borrowdale, is that latent controllers by this mode are to be vicariously liable for the breach of a director's duties by those directors over whom they hold sway.[48]

However, the duties provisions under the 1993 Act, as has been discussed, do not support Borrowdale's interpretation. It is submitted that all the 1993 Act seeks to achieve in expanding the definition of director is to overcome the difficulties of establishing an actual exercise of a pattern of control, as in *Dairy Containers*. By presuming that persons in a position of power over subsidiary company directors are directors, judicial decision making can then focus on whether there has been any actual exercise of control in breach of the duties of directors. If there has been such a breach then whoever has exercised the control in question can be held liable under the requisite directors duty. To the extent that this has not occurred creditors cannot complain in any event as the failure of the business must simply have been the consequence of general business risk, for which they have specifically contracted. The expanded definition of a director, introduced by the 1993 Act, is able to provide, therefore, a more appropriate correlation between liability for misuse of the company and its ultimate management.

The doctrine of vicarious liability favoured by Thomas J in *Dairy Containers* and Borrowdale above, is not, however, entirely redundant. The intention of a subsidiary's

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[48] A Borrowdale "Nominee Directors" in Harry Evelyn Anderson (ed) *Anderson's Company and Securities Law* (Brookers, Wellington, 1991), Company and Securities Law, para RD3.3.01(2) (updated 11 February 1998).

creditors in seeking to have a subsidiary's parent company deemed a director is so that they may have recourse to the assets of the parent company in satisfaction of their claim in respect of a breach of directors' duty. It is likely, however, that a nominee director would rarely receive their instructions directly from the holding company and would instead only communicate with a limited number of the parent company's directors, if any at all.[49] It is in this regard that the doctrine of vicarious liability is relevant. A holding company should be held vicariously liable for the acts of its employees in respect of the directions they give to a nominee subsidiary company director. In this respect the judgment of the Privy Council in *New Zealand Guardian Trust v Brooks*[50] is relevant as their Lordships were of the opinion that a company could be vicariously liable for the actions of *its* directors in the performance of their duties.[51] In relation to other company employees, as was observed by Thomas J in *Dairy Containers*, the vicarious liability of employers for the acts of their employees is a "basic canon of the common law".[52]

IV SECTIONS 131 AND 133

Section 131 of the 1993 Act effects a substantial change in the law. It provides that so long as a director acts in good faith and has unanimous shareholder consent the interests of a subsidiary's holding company may be preferred over and above those of the subsidiary. The notion that a company director can only act in the interests of the company has long been fundamental. In the words of Kirby P, "[i]t is a rule which has been described as "inflexible". It is one which must be "applied inexorably by the court"."[53] Nevertheless section 131 completely changes this.

There would be no difficulty in interpreting section 131 were it to operate in isolation. Its operation in conjunction with section 133 is, however, problematic. Section 133 simply states that "a director must exercise a power for a proper purpose".

The obvious question raised by section 133 is what constitutes a proper purpose. Unfortunately the answer to this question is not readily apparent. In the case law, as a general rule, the duty to act in what is believed to be the best interests of the company and

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[49] Neil Sargent "Corporate Groups and the Corporate Veil in Canada: A Penetrating Look at Parent-Subsidiary Relations in the Modern Corporate Enterprise" (1988) 17 Manitoba LJ 156, 165 ["*Sargent*"].
[50] [1995] 1 WLR 96 ["*New Zealand Guardian Trust*"].
[51] *New Zealand Guardian Trust* above n 50, 101.
[52] *Dairy Containers* above n 17, 93.
[53] *Darvall v North Sydney Brick & Tile Co. Ltd & Ors (No 2)* (1989) 7 ACLC 659, 662 ["*Darvall*"].

the duty to exercise powers for a proper purpose appear to function in conjunction with each other. It is only as a result of the permission granted under section 131 of the 1993 Act for subsidiary company directors to ignore the interests of the company that these two duties have been brought into direct conflict with each other. The obvious question which is raised by this conflict is whether a subsidiary can act in the interests of its holding company yet nevertheless for an improper purpose. This is extensively discussed in this part in relation to the provision of a guarantee by a subsidiary company in respect of the debts of its holding company.

As it was observed by the Law Commission, the lack of "underpinning objects" as a limit on the powers or capacity of the modern company make the proper purposes provision devoid of any objective criterion against which the purposes of the directors can be assessed.[54] As a consequence of this lacuna the Commission decided to leave out any reference to the duty for directors to exercise their powers for a proper purpose from its draft act. Nevertheless Parliament considered it to be a duty of equal importance to that which obligates directors to act in good faith and section 133 is the result.[55]

A *What is a "Proper Purpose"?*

One of the earliest authorities to make any sort of definitive statement as to the purposes for which a director can exercise their powers is *Hutton v West Cork Railway Co*.[56] In that case an injunction was sought to prevent the implementation of a resolution made by the Railway Company's directors to pay a gratuity to the company's managing director and other officials. The gratuity was alleged to be of no benefit to the company. Bowen LJ, for the majority, ruled in favour of the injunction on the basis that, regardless of whether or not the company's directors were acting bona fide, they could only spend the company's money for purposes which were reasonably incidental to the company's business.[57] This was not to say that a company could never make a gift but simply that where it does the company must benefit in some way. As Bowen LJ states:

> "The law does not say that there are to be no cakes and ale, but there are to be no cakes and ale except such as are required for the benefit of the company."[58]

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[54] Law Commission *Report No 9: Company Law Reform and Restatement* (Wellington, 1990) 120.
[55] Companies Bill 1990, Explanatory Note, Part VII, Clause 111, vi ["*Companies Bill*"].
[56] (1883) 23 Ch D 654 ["*Hutton*"].
[57] *Hutton* above n 56, 671.
[58] *Hutton* above n 56, 673.

Not only though was it beyond the power of the directors to pass such a resolution but it was also beyond the power of a general meeting of the company's shareholders.[59] The company was, in the absence of any corporate benefit or unanimous agreement from all interested parties, simply not capable of giving its money away.

In *Smith v Fawcett*,[60] Lord Greene MR stated that, where the articles of a company confer a discretion upon directors, then, in relation to that discretion, they must act bona fide in the interests of the company and not for any collateral purpose. The proposition was that for a director to appropriately exercise their discretion they must only have regard to those considerations which the articles permit them to take into account.[61] In this regard what is in the contemplation of Lord Greene, in assessing the duty of directors to exercise powers for a proper purpose, is much narrower than that in *Hutton v West Cork Railway*. All that is required, therefore, in order for a director to adequately discharge their obligation under the duty, is that their motivation in exercising a discretion, arising by virtue of a company's articles, be strictly confined to what the articles permit.

The more recent case of *Howard Smith Ltd v Ampol Ltd*[62] continues in the mode of *Smith v Fawcett* in holding that, in exercising a power under a company's articles of association, a director must act "for the purpose for which it is granted." However, the Privy Council, further reinforced the fundamental nature of this principle by stating that it is to prevail regardless of whether or not directors are acting bona fide in the interests of the company.[63] The High Court of Australia were of the same opinion in *Whitehouse v Carlton Hotel Pty Ltd*.[64] While the Court was satisfied that the director, of what was effectively a one man company, was acting bona fide in what he believed to be the best interests of the company,[65] nevertheless the disputed exercise of his powers as a director was for an improper purpose and consequently was held to be invalid.[66]

In *Howard Smith v Ampol* the correct approach proposed by the Privy Council in assessing whether a power has been exercised for a proper purpose is first to ascertain the nature of the power and the limits within which it may be exercised. Having done this a

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[59] *Hutton* above n 56, 666.
[60] [1942] 1 Ch 304 ["*Smith v Fawcett*"].
[61] *Smith v Fawcett* above n 60, 306.
[62] [1974] AC 821 ["*Smith v Ampol*"].
[63] *Smith v Ampol* above n 62, 821, 834.
[64] [1986-1987] 162 CLR 285, 293 ["*Whitehouse v Carlton*"].
[65] *Whitehouse v Carlton* above n 64, 292-293.
[66] *Whitehouse v Carlton* above n 64, 294.

court should then examine the substantial purpose for which the power in question was exercised and determine whether that purpose comes within the above limits. It was not suggested that this test was of any precision but rather simply a means of assessing which "side of a fairly broad line … the case falls."[67]

On the basis of these cases it is possible to distinguish two separate applications by the courts of the duty of directors to exercise their powers for "proper purpose". First, there are the more general limitations upon the corporate form and accordingly what directors can and cannot do in their management of the company. In this respect it is the general principles of company law which are determinative of whether a particular power was exercised for a proper purpose. Secondly, there is the duty's more restrictive usage as an objective assessment of whether a director is guilty of failing to use a particular power for the purpose for which it was given. Traditionally breach of duty in this sense has been determined on a case by case basis by reference to a company's objects. Yet given the tendency today for companies not to have general limits placed upon them through their incorporating documents, the 1993 Act itself and the common law, must again be the key points of reference.

It is far from clear, on a reading of the section alone, whether Parliament gave any thought to which of these meanings it intended section 133 to bear. In so much as these two approaches appear to complement each other there is no reason why, on the face of it, section 133 cannot be understood to incorporate both. If this is the case the following statement of Lindley MR in *Allen*s Case[68] would, despite the introduction of the 1993 Act, continue to be a useful summary of the restrictions which are placed on the powers of directors:

> "[Powers] must be exercised, not only in the manner required by law, but also bona fide for the benefit of the company as a whole, and … must not be exceeded."[69]

It is possible to elucidate three separate limitations on the exercise of directorial power from this succinct statement:

(a) directors can only exercise their powers for purposes consistent with the legal limits of what a company itself can do;

(b) directors must act for the interests or benefit of the company as a whole; and

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[67] *Smith v Ampol* above n 62, 835.
[68] (1900) 1 Ch 671 ["*Allen's Case*"].
[69] *Allen's Case* above n 68.

(c) directors can only exercise their powers for the purposes for which those powers have been granted.

In respect of the holding/subsidiary company relationship the crucial issue is the extent to which a director of a subsidiary, pursuant to section 131, is able to overlook the subsidiary company's interests, in favour of those of the holding company, effected by the ongoing requirement under section 133 for the powers of a director to be exercised for a proper purpose. In other words, while in satisfaction of (b) a subsidiary's directors can under the 1993 Act effectively take into account the interests of the group as a whole, what effect does this have on the legal limits of a subsidiary's operation under (a) and in turn the purposes for which a director's powers have been granted under (c).

Given that Parliament considered section 133 to be a duty separate from section 131, but of equal importance,[70] it is contemplated that the answer to the question as to the effect of section 131 upon section 133 would, initially at least, have to be that it has no effect. But it is difficult to believe that the outcome which this gives rise to represents the intention of Parliament in exempting holding and subsidiary companies from a strict application of section 131(1). As the following analysis of a subsidiary's ability to guarantee the debts of its holding company reveals, the treatment of corporate groups as a result of section 131(2) and (3) is not as lenient as an initial reading suggests.

B *"Bests Interests" and "Proper Purpose" - How do they Interrelate?*

That sections 131 and 133 operate as coexisting duties raises the prospect that while a company's directors may well fulfil their duty in respect of section 131, they will nevertheless be held liable for breach of duty under section 133. This is arguably the predicament that a subsidiary company's directors face in the event that they seek to guarantee the debts of the subsidiary's parent in a transaction from which the subsidiary is to derive no benefit whatsoever.

This is not to say that in all situations a subsidiary cannot obtain a benefit from guaranteeing its parent's debts. This was acknowledged by Brennan J in *Northside Developments Pty Ltd v Registrar-General and Others.*[71] On the contrary, due to the many advantages of inter-company financing within a group structure, such a transaction would probably often be of genuine benefit to the subsidiary. Where, however, the subsidiary

[70] *Companies Bill* above n 55.
[71] (1989) 2 ACSR 161, 185.

does receive some benefit from the transaction there is no conflict between variation of the traditional duty of directors only to look to the interests of the company to which they are appointed, which section 131 allows, and the requirement under section 133 that they act for a proper purpose. Yet conversely, in the case of a property owning company, for example, which has no conceivable present or future need to borrow money within the group, it is difficult to envisage how such a transaction could possibly be of benefit to the subsidiary.

The concern of the courts in approaching the question of when a company can legitimately guarantee the debts of another has been whether or not the company can be said to have derived any "commercial benefit" from the transaction. The reason for this is that where no such benefit is obtained, unless the company is a non-profit organisation, the transaction cannot be "reasonably incidental to the company's business." As is established by *Hutton v West Cork Railway Co*, this, in turn, amounts to the exercise of the directors' powers for an improper purpose. The guarantee is therefore void in so far as it affects those within the company and voidable in respect of third parties.[72]

1 Analogy between the giving of guarantees and the giving of gifts

The nature of a gratuitous guarantee is little different from a gift; the only difference is that the payment is contingent upon some future event. Prima facie, therefore, such a transaction is inconsistent with the broad principle enunciated in *Brady v Brady*[73] "that a company cannot give away its assets."[74] Nourse LJ did not, however, in his elucidation of this principle see anything wrong, in theory at least, with a company being authorised in its memorandum of association "to give away all its assets to whomsoever it pleases". Although in his opinion the dictates of the real world would preclude such a power ever being given.[75]

Under the 1993 Act companies no longer have memoranda or articles of association. The constitution now assumes the functions of these instruments which remain, but to the extent that the constitution contravenes or is inconsistent with the 1993 Act it is of no

[72] *Reid Murray Holdings Ltd (in liq) v David Murray Holdings Proprietary Ltd* (1972) 5 SASR 386, 403-404 ["*Murray Holdings*"].
[73] [1988] BCLC 20 (reversed in the House of Lords largely on factual grounds [1989] AC 755) ["*Brady*"].
[74] *Brady* above n 73, 38.
[75] *Brady* above n 73, 38.

effect.[76] This is significant due to the comprehensive coverage of nearly all aspects of corporate activity achieved by the 1993 Act.

The contention that a company cannot give away its assets is, according to, Nourse LJ part of "the wider rule, the corollary of limited liability, that the integrity of a company's assets … must be preserved for the benefit of all those who are interested in them, most pertinently its creditors."[77] One of the consequences of this rule is that the dispersion of a company's assets is strictly regulated.[78]

The dealing by a company with its assets under the 1993 Act is, as a general rule, limited by the solvency test. The question is whether section 133 was intended to be an additional check on the disposal of corporate assets even where the solvency test is satisfied and will be dealt with below.

Another case of significance in the area of corporate gifts is *Plain Ltd (Trustee) v Kenley & Royal Trust Co.*[79] This case involved a transaction which ultimately resulted in a company giving one of its shareholders a substantial mortgage without receiving any consideration in return.[80] While the company was still solvent after having exercised the mortgage its solvency was somewhat precarious as a result.[81]

Orde JA considered it central to the limited liability status of a company that "the capital upon which creditors are to depend for payment" should be kept unimpaired. The consequence of this is that, unlike an individual, a company cannot simply deal with its assets in whatever way it is inclined.[82] Under the 1955 Act, companies were not permitted to make any distributions to shareholders out of capital but could only do so from surplus profits. This was also the relevant rule in *Plain v Kenley*. Following the introduction of the 1993 Act, however, this distinction has been removed and in its place the solvency test is now used to keep the capital of the company intact so that the claims of creditors can be met.

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[76] *1993 Act* above n 11, s 31.
[77] *Brady* above n 73.
[78] *Brady* above n 73.
[79] [1931] 1 DLR 468 ["*Plain Ltd*"].
[80] *Plain Ltd* above n 79, 471.
[81] *Plain Ltd* above n 79, 476.
[82] *Plain Ltd* above n 79, 479.

The issue in *Plain v Kenley*, though, was not whether the shareholder distribution had been made out of capital as opposed to surplus profits of the company. While Orde JA suggests that the case could have potentially been resolved in this manner, due to the perilous proximity to insolvency of the company immediately following the transaction,[83] the rule which he proposes as determinative of the case is not restricted in its application to the making of a distribution by way of dividend.

The applicant claimed that in substance the transaction was really "a distribution of profits or surplus by way of dividend."[84] The problem was, however, that had the parties undertaken to pay a dividend it would have appeared in the company's books as such and come quickly to the attention of the company's creditors. Had this occurred, any further extension of credit would have been immediately reconsidered in light of the effect of such a considerable distribution upon the company's financial status.[85]

The circumstances in which the disputed payment was made could not, however, in the opinion of Orde JA be construed as a dividend payment.[86] The transaction failed therefore to come within the purposes for which the company was established and as a result constituted an "irregular exercise by the directors ... of their powers ... within the company".[87] The mortgage to the shareholder in question was consequently an illegitimate dealing by the company with its assets and constituted "a fraud upon the company and the company's creditors", "however honest its intention may have been".[88]

In light of *Plain v Kenley*, as well as *Hutton v West Cork Railway Company*, it appears that as a matter of general law, an attempt by directors to seek to have a company make a gratuitous payment, from which the company receives no benefit, is an exercise of their powers for an improper purpose. In respect of these two cases this principle is not dependent on the particular provisions existing prior to the 1993 Act in relation to the making of a distribution by a company. What it does depend on, though, is that there are such restrictions on the withdrawal of funds or assets from a company. Given that comparable restrictions do exist in New Zealand company law it is submitted that the application of these two authorities remains unchanged by the 1993 Act. Not only though

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[83] *Plain Ltd* above n 79, 480.
[84] *Plain Ltd* above n 79, 480.
[85] *Plain Ltd* above n 79, 482.
[86] *Plain Ltd* above n 79, 481-482.
[87] *Plain Ltd* above n 79, 479.
[88] *Plain Ltd* above n 79, 483.

does this principle continue to subsist under the 1993 Act but, it is argued, that specific provision has been made for its incorporation by the inclusion of section 133.

Before, however, any definitive statement can be made as to the operation of this principle in relation to the provision of guarantees in the holding/subsidiary company context, it is first necessary to refer to a recent Australian case which directly address the issue of subsidiary company guarantees for the debts of holding companies.

C *ANZ Executors and Trustee Company Ltd v Qintex Ltd.*[89]

ANZ v Qintex involved a pledge by a holding company to procure its subsidiaries to provide guarantees in respect of any outstanding sums owing in the event that it defaulted on a loan of A$100 million. ANZ were acting as trustees on the behalf of the investors. The holding company defaulted on the loan. It refused, however, to procure the necessary guarantees claiming that as its subsidiaries, which were either insolvent or verging on insolvency, would obtain no possible advantage from the guarantees then they would be unenforceable in any event. The contention was that this would be the position regardless of whether they were granted by directors' resolutions or a general meeting of the subsidiaries' shareholders.

Byrne J, sitting alone on the Supreme Court of Queensland, stated that there was no question that the subsidiaries have the power to grant the guarantees, the question is rather whether to do so would involve any impropriety.[90] The case should be distinguished from the earlier authorities whereby a company's ability to pursue certain activities was limited by its objects, as set out in its memorandum of association on incorporation.

The crux of Byrne J's judgment is found in the following statement from *Advance Bank Australia Insurances Ltd*[91] which he cites with approval:

> "The essential principle is that the powers, and the funds, of a company may be used only for the purposes of the company."[92]

In support of this, reference is made to *Hutton v West Cork Railway Co*, discussed above, as well as the earlier Australian case of *Reid Murray Holdings Ltd (in liq) v David Murray Holdings Proprietary Ltd.*[93]

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[89] (1990) 2 ACSR 307 ["*ANZ v Qintex*"].
[90] *ANZ v Qintex* above n 89, 314.
[91] (1987) 9 NSWLR 464.

Murray Holdings was a case in which a company provided a guarantee which could not be considered to be incidental to its business. Mitchell J, in concurring with the earlier dicta of Pennycuick J, thought that the "state of mind of the directors" was irrelevant in determining whether the giving of the guarantee constituted an exercise of the directors' powers for a proper purpose.[94] This being the case, and because the guarantee was not incidental to the business of the company the guarantee was held to be void; the recipient of the guarantee not being an innocent third party.[95]

In light of the insolvency of the holding company, irrespective of the execution of the guarantees, Byrne J was of the opinion that whether or not it would have been possible to establish that the guarantees were of benefit to the subsidiaries, had they been executed in the past, this could not be demonstrated in present circumstances. If, therefore, the holding company was now to be permitted to procure the guarantees from its subsidiaries then this would involve an improper use of corporate powers.[96] On this basis Byrne J found in favour of Qintex.

The judgment of Byrne J was later affirmed by the full Supreme Court of Queensland.[97] In the estimation of the Full Court it was an "inescapable consequence of treating the company … as an entity distinct from its members" that the company can only deal with its assets in a restricted manner. In return for the right to trade "in corporate form with limited liability", shareholders accept that they can only receive payments from the company as authorised by law. Apart from such distributions, ""the fundamental principle of company law" is that "the whole of the … [assets] of a company with limited liability, unless diminished by expenditure [for the purposes of the company] … shall remain available for the discharge of its liabilities"".[98]

Consistent with Orde JA in *Plain v Kenley*, the Full Court found the principle that the assets of a company can only be used for the purposes of the company to be a necessary

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[92] *Advance Bank Australia Insurances Ltd* (1987) 9 NSWLR 464, 493 in *ANZ v Qintex* above n 89, 314.
[93] *Murray Holdings* above n 72.
[94] *Murray Holdings* above n 72, 401.
[95] *Murray Holdings* above n 72, 403-404.
[96] *ANZ v Qintex* above n 89, 315.
[97] *ANZ Executors & Trustee Company Ltd v Qintex Australia Ltd (Recs and Mgrs apptd)* (1990) 2 ACSR 676 ["*ANZ v Qintex (full court)*"].
[98] *Davis Investments Pty Ltd v Commissioner of Stamp Duties (NSW)* (1958) 101 CLR 119, 132 per Kitto J cited with approval in *ANZ v Qintex (full court)* above n 97, 683.

corollary to the limited liability status of a company. As the Full Court considered that the principle is wider than that of unauthorised capital distributions[99] there is no reason why it should not be just as applicable to a solvent company as it was to the insolvent or near insolvent subsidiaries of Qintex. The only difference for a solvent company is that interested parties are less likely to complain or be able to complain, so long as creditors under the 1993 Act are only given standing in the event of the insolvency of the company.

The principle that "corporate property may be applied only for corporate purposes" was, therefore, in the opinion of the Full Court, a "judicial development achieved by making broad generalisations about the nature of corporate trading with limited liability and the conditions on which the legislature permitted it to proceed."[100] It was considered to be a fundamental rule and therefore determined the outcome of the case.[101] As the subsidiaries were to receive no benefit from the transactions in question, it could not be said that exercising the guarantee would amount to the use of the powers or funds of the company for company purposes. Qintex were therefore fully justified in refusing to procure its subsidiaries to exercise the guarantees despite their earlier undertaking to do so.

The outcome in *ANZ v Qintex* did not turn upon the proposition that a company can never provide a guarantee in the absence of some commercial benefit. As was stated by Slade LJ in *Rolled Steel Ltd v British Steel Corporation*[102] there is "no reason in principle why a company should not be formed for the specific purpose … of giving guarantees whether gratuitous or otherwise,"[103] it is just that a company can only do so if it can legitimately claim that this is one of the purposes for which it is set up.

However, as the New Zealand Law Society[104] and Dawson[105] note, a difficulty is created by the fact that, as the objects of the company are no longer set out upon its incorporation there is a lack of any obvious means of identifying what a company's purposes may be. Furthermore, under the 1993 Act, section 297, in making provision on insolvency for the treatment of transactions entered into by a company at an under value, would appear to expressly consider that a company can give its money away, provided that it is not

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[99] *ANZ v Qintex (full court)* above n 97, 684.
[100] *ANZ v Qintex (full court)* above n 97, 685.
[101] *ANZ v Qintex (full court)* above n 97, 686.
[102] [1986] 1 Ch 246 ["*Rolled Steel*"].
[103] *Rolled Steel* above n 102, 289.
[104] New Zealand Law Society *Submission to the Justice and Law Reform Select Committee on the Companies Bill 1990* (Wellington, 1990) 69-70.
[105] F Dawson "Commercial Benefit" (1991) 107 LQR 202, 208.

insolvent at the time or would become insolvent as a result of the transaction. Also, with the removal of the restriction on the payment of dividends to shareholders out of capital, the only substantive limitation on distributions is now the solvency of the company,[106] assuming of course that section 131 can be satisfied. Finally, section 136 provides the only restraint upon directors agreeing to the company incurring an obligation: they must believe "at [the] time on reasonable grounds that the company will be able to perform the obligation when it is required to do so." In light of this and section 133 aside, the general scheme of the 1993 Act appears to support the proposition that a company can do whatever it likes with its assets provided it remains solvent.

Nevertheless, Parliament has specifically enacted that directors have a duty to only exercise their powers for proper purposes; despite the view of the Law Commission that to do so was unnecessary. The Law Commission considered that the requirement that directors exercise their powers for proper purposes was predominantly treated by modern case law simply as a vehicle to protect shareholders from the dilution of their proprietary interests by directors. It argued that this issue could be better dealt with directly thus making the proper purposes principle redundant.[107]

As *ANZ v Qintex* demonstrates, however, such a duty upon directors continues to be of relevance in the modern context. The principle that the assets of a company can only be used for the purposes of the company was applied in that case irrespective of the modern trend in company law for a company not to be limited by its objects. The principles was also in no way dependent upon the manner by which company law places restrictions on the making of distributions to shareholders. Instead it was stated to be a necessary corollary of the separate entity status of companies and the protection provided to shareholders in being able to use the corporate form with limited liability.

All Companies Acts are, in the words of the Law Commission, "concerned with striking a balance between enabling use of the company form and regulating to prevent its abuse."[108] Under the 1955 Act in order for creditors to be sufficiently protected it was considered necessary to embargo the payment of a dividend to shareholders out of anything other than the profits of the company. Under this regime, however, the balance was perceived to be

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[106] *1993 Act* above n 11, s 52.
[107] Sir Owen Woodhouse *Company Law: Reform and Restatement: NZLC R9* (New Zealand Law Commission, Wellington, 1989) 120 ["*Law Commission*"].
[108] *Law Commission* above n 107, 5.

too heavily weighted in favour of creditors. The comprehensive use of the solvency test represents an attempt to redress this balance.

Under this new regime and provided that a company is solvent, the only risks which a creditor should face are those legitimately associated with the nature of the company's business. This ceases to be the case, however, once the assets of the company are no longer used solely for purposes which are reasonably incidental to the company's business. However, if shareholders in a company wish to limit their risk in the business by sharing the consequences of a loss with creditors, as is the case with limited liability, then it is only fair that they no longer be able to use the assets of the company for purposes other than that of the business in which they have invited creditors to share the risk. It is for this reason, it is submitted, that the requirement that directors only exercise their powers for proper purposes continues to be of significance despite the protection provided by the ongoing requirement that a company always be operated as a solvent enterprise.

Finally, it is important to note the distinction between the classification of the duty under section 133 in terms of the *Hutton v West Cork Railway Co* line of cases as opposed to that of *Smith v Fawcett*. In the latter, the basis for the breach of duty is the failure to adhere to the purposes for which the power in question has been given to the director. This involves a breach of authority on the part of directors and as such there exists the possibility of shareholder ratification at a general meeting. The *Hutton v West Cork Railway Co* cases, however, are concerned with the purposes for which the company itself can be used. It is, therefore, not possible for either directors or shareholders to exercise the power in question. As a result, where, in this regard, directors exercise their powers in breach of duty under section 133, the opportunity for shareholders, or the holding company, to subsequently ratify the actions of directors would not be available.

D Consequence of Meaning of Proper Purpose

Under section 131 a subsidiary company's directors would, when considering whether to guarantee the debts of the holding company, be able to consider the interests of the holding company. Under section 133, however, if, in light of *ANZ v Qintex*, the guarantee was of no benefit to the subsidiary, in that it was not reasonably incidental to the subsidiary's business, the subsidiary's directors would be unable to give the guarantee. In the absence of objects clauses it is proposed that the only means of establishing what is reasonably incidental to the company's business would be to look at the trading history of the

company. In this regard those responsible for the management of holding and subsidiary companies should give careful consideration to the structure of the group's subsidiaries in order to achieve maximum utilisation of the group's assets.

Nevertheless, in light of the sweeping modification made to the law by section 131, in enabling holding and subsidiary companies to operate increasingly as a single enterprise, it is proposed that the tension between sections 131 and 133 cannot have been parliament's intention. In this regard, it is proposed that either one way or another this conflict should be resolved. The final part to this paper discusses the direction which it is suggested any future reform should take.

V THE SUGGESTED LEGAL PARADIGM FOR HOLDING/SUBSIDIARY COMPANY GOVERNANCE

The corporate group is the universally preferred mode of business operation for any enterprise of a reasonable size.[109] Yet in terms of the regulation of management control within the corporate structure, the law has, until recently, obstinately maintained a myopic approach tailored to the regulation of a single company operating as a stand alone enterprise. The introduction, therefore, of a different operating regime for holding and subsidiary companies as a result of section 131 represents a significant change in thinking.

In the literature discussing the legal problems encountered with the corporate group there is universal agreement that a system of company law which refuses to recognise the reality of unitary management in the group context is doomed to forever remain out of touch with the business community.[110] The law must, however, not only be flexible in terms of providing a system of regulation which is appropriate for the management of single companies as well as corporate groups, but also for the multitude of different ways in which groups themselves choose to operate. As noted by Tom Hadden, "the flexibility and potentially infinite variety of the corporate group is one of its most significant characteristics".[111]

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[109] Clive M Schmitthoff and Frank Wooldridge (eds) *Groups of Companies* (Sweet & Maxwell, London, 1991) ix ["*Groups of Companies*"]; Tom Hadden "The Regulation of Corporate Groups in Australia" (1992) 15 UNSWLJ? 61, 64 ["*Corporate Groups in Australia*"].

[110] See, for example, Eric Gouvin "Resolving the Subsidiary Director's Dilemma" (1996) 47 Hastings L J 287, 321-322; Professor Klaus J Hopt "Legal Elements and Policy Decisions in Regulating Groups of Companies in *Groups of Companies* above n 109, 110.

[111] Tom Hadden "Regulating Corporate Groups: An International Perspective" in Joseph McCahey, Sol Picciolto and Colin Scott *Corporate Control and Accountability: Changing Structure and the Dynamics of Regulation* (Oxford University Press, Oxford, 1993) 343.

The tension between the strict requirement that directors must act in the interests of the company and the obvious advantages to be derived within a holding/subsidiary company relationship from the "synergies … [of] cross-corporate coordination"[112] had to be reconciled by the 1993 Act. Professor Hopt aptly recognises the crux of the matter in saying:

"A law cannot afford, at least in the long run … to live with a contradiction between law and reality. This … undermine[s] the credibility of the legal order as a whole."[113]

In this respect there was undoubtedly a significant contradiction between the suggestion that the directors of each company within a corporate group must not subrogate the interests of their company for the group on the one hand and the incentive of those who control corporate groups to maximise the returns of the enterprise as a whole on the other.[114] The question is though whether simply exempting directors of subsidiaries from strict adherence to their duty to act in the best interests of the company adequately resolves this conflict without creating new difficulties of its own.

Since the judgment of the House of Lords in *Salomon v Salomon & Co. Ltd*[115] it has been understood that a company is a separate legal entity from its shareholders. As a consequence creditors cannot pursue shareholders of the company in respect of an unsatisfied judgment against the company. The corollary of this principle has been the inability of directors of a company to strictly identify the interests of the company with those of shareholders. Section 131, however, removes the separate entity status of a company, in so far as it inhibits the ability of shareholders to use the company for their own interests as opposed to those of the company itself. But maintains the separate entity status of the company in the event that its creditors wish to have recourse to the shareholders assets, at least to the extent of the loss caused by the derogation of the company's interests. It is the position of this paper that such a one-sided change to the law now means that creditors or at least unsecured creditors must disproportionately bear the risk of company failure.

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[112] *Yeung* above n 20, 211.

[113] Buxbaum, Hertig, Hirsch and Hopt (eds) *European Business Law: Legal and Economic Analysis on Integration and Harmonisation* (de Gruyter, Berlin, New York, 1991) 243 quoted in Jennifer Hill "Corporate Groups, Creditor Protection and Cross Guarantees: Australian Perspectives" (1995) 24 Can Bus L J 321.

[114] Jonathan Landers "A Unified Approach To Parent, Subsidiary, and Affiliate Questions in Bankruptcy" (1975) 42 U Chi L Rev 589, 591.

[115] [1897] AC 22.

To the extent that a subsidiary company is capable of being operated contrary to its interests, creditors would have to assume, in assessing the risk associated with extending credit to the company, that the company is in a constant state of near insolvency. The reason is, that in the absence of a duty to act in the interests of the subsidiary, the only limitation on the actions of a company's directors in shifting assets around the group, are those which arise when the company's solvency is at issue. That is, of course, other than the duty to exercise powers for a proper purpose. The only surety unsecured creditors have, therefore, is that the subsidiary should be solvent; anything in excess of this is at the whim of group management.

Understandably, for a creditor with any bargaining power this would be an unsatisfactory scenario. Therefore, they would undoubtedly demand a guarantee from the subsidiary's holding company. The ability of institutional lenders to protect themselves is not, though, in any way disputed. The provisions within the 1993 Act designed to protect creditors would probably be wholly unnecessary if lenders with the ability to demand secured credit were the only parties with whom a company transacts. In the experience of Jonathan Landers, however, those creditors who have a high representation in cases of corporate insolvency are "involuntary, high-information-cost, and trade creditors" with little ability to protect themselves.[116] It is in relation to the effect upon these unsecured creditors that the consequences of section 131 must be considered.

If unsecured creditors continue to provide credit to a company despite the fact it may be operated contrary to its own interests, the usual indicators of credit worthiness, such as "the debtor's history of payment and its tangible assets," [117] are now even more defective than they ever were before. Where a company is acting in its own interests, even if it is marginally solvent, the risk for investors simply relates to the business in which the company is engaged. Section 131, however, enables a company to operate for reasons contrary to its own interests and the promotion of its business. This presents an additional risk to credit providers in respect of the advancement of those other interest. Yet even sophisticated creditors are unable to predict that risk since it is dependent on the extent to which the holding company wishes to subordinate the interests of the subsidiary to its own. Given that the risk is the holding company itself the only way of minimising this risk is by the taking of a personal guarantee from the holding company in respect of its subsidiary's

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[116] Jonathan Landers "Another Word on Parents, Subsidiaries and Affiliates in Bankruptcy" [1976] 43 U Chi L Rev 527, 540 ["*Another Word*"].
[117] *Another Word* above n 116, 531.

debts. Those creditors who have the bargaining power to seek a personal guarantee will do so. Those, however, who do not have such leverage will be unable to.

The legislative policy adopted by the 1993 Act invites consideration of best qualified to bear this risk, the holding company or the subsidiary company's unsecured creditors. In such an assessment, for any given transaction the determining factor is which party is able to avoid the risk at the least cost.[118] There can be little dispute that if the risk in question is the possibility of the holding company using its subsidiaries for its own interests the appropriate risk bearer should be the holding company. Section 131, however, by enabling a subsidiary to act in the interests of its holding company, which does not compensate its subsidiary for any consequential detriment, shifts this risk onto the subsidiary's creditors. A means, therefore, is needed to enable a holding company to utilise its subsidiaries to promote the interests of the group while at the same time not shifting the risks of the group disproportionately onto the creditors of either one subsidiary or another.

To achieve this, the process of reform must first remove the ability for directors of a subsidiary, to act in the interests of the holding company, despite a conflict with the subsidiary's interests. What is suggested, therefore, is the removal of those changes introduced by section 131 of the 1993 Act and a return to the previous position under the common law. However, where it cannot be said that a director has in fact given separate consideration to the interests of the subsidiary, then liability for breach of this duty should only be consequent upon an objective finding that the transaction in question was not in fact in the interests of the subsidiary. The reasoning of the Supreme Court of New South Wales Court of Appeal in *Equiticorp v BNZ* is adopted here.[119]

Secondly, section 162 should be modified so that a holding company is able to indemnify the directors of its subsidiary, via the subsidiary's constitution, for breach of their duties as directors to the subsidiary, when acting in the interests of the holding company. In the case of a subsidiary which is not wholly owned by the holding company the inclusion of such a provision within the subsidiary company's constitution should be dependent upon the holding company first obtaining the unanimous consent of the subsidiary's minority shareholders. Additionally, section 126 should be altered so that where a holding company does provide for the indemnification of its subsidiary company's directors it is deemed to

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[118] Ian Ramsay "Holding Company Liability for the Debts of an Insolvent Subsidiary: A Law and Economics Perspective" (1994) 17 UNSWLJ 529, 439.
[119] See text above at n 5.

be *exercising powers or performing duties* as a director of its subsidiary in the event that the subsidiary's directors act contrary to the interests of the subsidiary in favour of the holding company.

Finally, a subsidiary company should not be able to maintain against a third party, that an obligation of the company is unenforceable, simply because the subsidiary's directors exercised their powers for the purposes of the subsidiary's holding company, as opposed to the subsidiary itself. This would involve changing section 18 of the 1993 Act, which relates to the enforceability of transactions entered into by the company, and also the consequences of transacting with the company at an undervalue under section 297.

Merely because legislative mandate is not provided for the subsidiary company's directors to operate the subsidiary for the benefit of the group, rather than the interests of the subsidiary alone, does not, as the case law demonstrates, prevent subsidiary company directors from doing so. Moreover, the efficiencies of group coordination dictate that this is an appropriate use of the pooled resources of companies operating within a holding and subsidiary company framework. Nevertheless, care must be taken so that the risk of group business activity is not shifted onto the creditors of subsidiary companies.

The extended definition of a director introduced by the 1993 Act recognises the reality that a holding company may well be the true director of a subsidiary, rather than solely those who sit on the subsidiary's board. It also, however, acknowledges that simply because a holding company has a controlling shareholding in its subsidiary, this does not necessarily entail that it will adopt an interventionist approach to its subsidiary's management.[120] What it does provide is that, where a power imbalance exists over and above the holding company's ability to remove a director from the board, the holding company will be presumed to be a director. However, the duties which this position entails are only assumed once the holding company actually exercises its power in respect of the subsidiary director/s.

If a holding company is capable of exercising such a degree of influence over its subsidiary's directors it is unreasonable to nevertheless hold those directors liable for a breach of duty where it arises as a result of the holding company's exercising its influence.

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[120] DD Prentice "Some Comments on the Law Relating to Corporate Groups" in Joseph McCahey, Sol Picciolto and Colin Scott *Corporate Control and Accountability: Changing Structure and the Dynamics of Regulation* (Oxford University Press, Oxford, 1993) 371.

Furthermore, if it can be said that it is the holding company which is acting as a director in respect of that breach, then the subsidiary's creditors will be able to seek recourse from the holding company for the loss which they suffer as a result under section 301. For the purposes of creditor protection, therefore, there is no need to continue to hold subsidiary director's liable.

Yet in order for creditors to be compensated where they do suffer loss as a result of a breach of directors' duties it is necessary that the holding company be in a position to make such payments. It is for this reason that the subsidiary company's directors should not be absolved from liability altogether, but instead be dependent upon indemnification from the holding company. In this way the subsidiary's directors have an incentive to ensure that the subsidiary's creditors will not be affected by the breach of duty in favour of the holding company.

The creditors of the holding company are protected by the requirement that the indemnification can only be in respect of breach of duty where a subsidiary's directors are acting in the holding company's interests. Correspondingly, the holding company is only deemed to be exercising powers or performing duties as a director, again, where the subsidiary's directors are acting in the holding company's interests. These provisions ensure, therefore, that the holding company is receiving a parallel benefit in return for the potential liability to which it is exposing itself, should the subsidiary become insolvent and the holding company be subject to an order for payment under section 301. From the point of view of the holding company's creditors, the transaction should be little different from any other commercial arrangement. In addition, of course, the holding company's directors will themselves still have to operate in accordance with their duties to the company.

Should the holding and subsidiary companies' directors choose not to enter into this statutory scheme then as far as creditors of either company are concerned this should make little difference. To the extent that a holding company directs its subsidiary it will continue to be deemed a director under section 126 and in turn incur liability to the extent that it breaches its duties that it owes as a director to its subsidiaries. The only difference would be that a subsidiary's directors would remain liable for their breaches of duty.

The final suggested change simply overcomes the contradiction which would arise were a holding company permitted to utilise its subsidiaries to its advantage, yet third parties

transacting with the group could have their transactions set aside on the basis of this disadvantage from the subsidiary's perspective.

VI CONCLUSION

This paper has discussed two key statutory changes introduced by the 1993 Act which affect the management of holding and subsidiary companies. Section 126 broadens the scope of the definition of director. Section 131 broadens the interests which a subsidiary company's directors can take into account. While it is concluded that section 126 represents a salutary reform to the law. Section 131 is considered to be lacking in coherence, not only in terms of the fundamentals of company law but also in respect of the remaining duties of directors under the 1993 Act.

The difference in these two approaches to regulatory reform lies in the extent to which they seek to achieve a correlation between liability and control. Despite the expanded scope of the definition of a director under section 126, nevertheless, due to the framework of the duty provisions within the Act, a deemed director is only liable in respect of the exercise of their control. In contrast, under section 131, while the directors of a subsidiary are able to consider the interests of the holding company no corresponding provision is made to cater for the additional risk which this places upon the subsidiary's creditors.

It is the thesis of this paper that only a genuine correlation between liability and control will result in the effective regulation of corporate groups. Until this is achieved the regulatory regime will continue to place unreasonable costs upon either the members of the group or the parties with which they transact.

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