Corporate Groups: A Case for Protection of Unsecured Creditors

Do unsecured creditors of Corporate Group members require additional contractual or statutory protection?

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The refusal of corporate law to recognise a corporate group entity coupled with the limited liability of each corporate group member denies a level of protection to creditors. This denial is most keenly felt by unsecured creditors.

Contractarian theory suggests that unsecured creditors address this lack of protection by the inclusion of appropriate measures when contracting with the respective corporate group entities. In practice, no such additional protection is gained.

Rather, creditors' losses arise because: unsecured creditors are unaware of the corporate group boundary; directors fail to maintain the assets within the corporate group entity and parent entity shareholders enjoy double insulation from liability resulting from the limited liability of each corporate group entity and parent entity.

Theories of distributive justice require creditor protection to be provided in respect of the latter two circumstances. Current corporate law imposes joint liability on insolvent corporate group members to unsecured creditors in limited circumstances which provides little, if any creditor protection. This thesis recommends the imposition of joint and several liability on each corporate group entity and its respective parent company. Doing so obviates the parent entity's shareholders' double insulation from liability. However, joint and several liability should only be imposed in those circumstances, where there is a real possibility of exploitation in the form of debtor opportunism. Further, requiring mandatory disclosure to creditors of the corporate group constituents would ensure unsecured creditors have a better understanding of the limits of the group boundary.

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I The Issue

The refusal of corporate law to recognise a corporate group entity, coupled with the limited liability of each corporate group member denies a level of protection to creditors. This denial is most keenly felt by unsecured creditors. The present regulation of corporate groups means any increased business risk undertaken by the corporate group is borne by non-shareholder stakeholders, principally unsecured creditors of the corporate group.[1] The parent company and its constituent group members, although arguably better equipped to manage, do not bear such additional risk.[2] This leads to identifiable economic and social inefficiencies[3].

Corporate groups are generally defined by common share ownership.[4] In *Walker v Wimbourne,* [5] Mason J. defined a group as: 'the word 'group' is generally applied to a

number of companies which are associated by common or interlocking shareholdings ,allied to unified control or capacity to control.'[6]

The concept of a corporate group is an economic one. [7] However, the juristic entity is the individual registered company. Existing corporate law[8] focuses on the separate legal status

[1] Although non-shareholder stakeholders within the corporate group include employees, secured and unsecured creditors, this thesis concentrates on the position of unsecured creditors as it is considered that the former stakeholders are provided greater protection by the existing law.
[2] Additional risk refers to situations where management decides to diversify or expand product lines within the corporate group by creating a new corporate member whose creditors principally fund the new venture and thereby bear the majority of the associated risk.
[3] Social inefficiencies arise when the risk of loss associated with a project is borne by external creditors rather than the corporate group members resulting in acceptance of an investment with negative net present value as a beneficial use of capital.
[4] Corporate groups may be defined for tax purposes to include non-company entities such as partnerships or trusts, see s703-30 *Income Tax Assessment Act 1997 (Cth)*. This thesis adopts the definition of corporate groups which accords with Melvin Eisenberg 'Corporate Groups' in Michael Gilooly (ed), in *The Law Relating to Corporate Groups* (1993) 1,2 where Professor Eisenberg distinguished corporate groups as being 'two or more corporations that are affiliated in a manner that depends in significant part on stock ownership' rather than by agreement, as stock ownership is 'typically structural, not so easily terminated and is the kind of nexus with which corporation law is typically concerned'.
[5] (1976) 137 CLR 1
[6] (1976) 137 CLR 1,5 (Mason J.) .

and limited liability of the individual company and generally ignores the economic entity comprised by the corporate group. Much has been written of the gains and losses derived from manipulation of the group relationship and of the specific issues which corporate groups raise. [9] However, the key issue raised by the difference between the juristic and economic entities of a corporate group is with respect to the treatment of creditors. Specifically whether creditors are disadvantaged by the differing definitions? This thesis considers that unsecured voluntary creditors are disadvantaged. The non-alignment of juristic and economic entities within the corporate group allows for wealth transfers from creditors to shareholders[10] contributing to corporate group failure.

II History of Corporate Group Failure

The last two decades of the 20th century, followed by the beginning of the 21st century of corporate Australian history are illustrative of debtor opportunism made possible by the non-recognition of a corporate group boundary and the selective use of the separate legal entity notion within a corporate group setting.

Examples include the attempted retrenchment of Patrick Stevdores' Maritime Union of Australia employees following the alleged intra-group shuffling of funds, other assets and capital in the late

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[7] Hugh Collins, 'Ascription of Legal Responsibility to Groups in Complex Patterns of Economic Integration' (1990) 53 *The Modern Law Review* 731.

[8] The economics theory of the firm is based on the premise that a 'company is a network of explicit and implicit bargains, or a nexus of contracts', Michael C Jensen and William H Meckling, 'Theory of the Firm:Managerial Behaviour, Agency Costs, and Ownership Structure' (1976) 3 *Journal of Financial Economics* 305, 311-12 . Accepting that free markets are the most effective wealth creation system neo-classical economists see companies as an efficient means for a number of parties to contract within the market. Company Law provides then a set of default rules, a legal form, "the company", with a standardised set of default characteristics applying to every company.

[9] Examples are found in Dr Andrew Muscat, *The Liability of the Holding Company for the Debts of Its Insolvent Subsidiaries* (1996) summarized by John Farrar in 'Legal Issues Involving Corporate Groups'(1998) 16 *Company & Securities Law Journal* 184,189. For a comprehensive study of the US corporate group issues see Phillip I. Blumberg, *The Multinational Challenge to Corporation Law: The Search for a New Corporate Personality* (1993). For the position in the United Kingdom see Clive M Schmitthoff. & Frank Wooldridge, *Groups of Companies* 1991.

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

1990s. The lengthy and ongoing James Hardie asbestos compensation claims by tort creditors of James Hardie subsidiaries, Amaca and Amaba, against the holding company, James Hardie. Claims of Ansett employees in 2001 for their entitlements when Air New Zealand jettisoned its wholly owned subsidiary, Ansett Australia Pty Ltd[11] also provide abundant examples.

A *Corporate Groups Final Report*

Consideration of the need to protect creditors dealing with corporate groups was an objective of the first systematic and comprehensive review of the application of Australian corporate law to corporate groups.[12] This review resulted in the publication of the Corporate Groups Final Report in May, 2000. [13] Within the Final Report CASAC [14] recommended, (Recommendation 2), that wholly owned corporate groups be given the option to be regulated on the basis of one economic entity known as the 'enterprise approach'. [15] If directors of the ultimate holding company exercised such an option then:

The Corporations Law would treat the corporate group as one legal structure;

Directors of group companies could act in the overall group interest without reference to the interests of their particular group companies;

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[11] Frank Clarke and Graeme Dean *Indecent Disclosure Gilding the Corporate Lily* (2007) 130.

[12]The review was made by the Companies and Securities Advisory Committee (CASAC). The objectives of the Discussion Paper were to examine various means of resolving possible legal difficulties for corporate groups and their directors in carrying out their functions effectively. A second objective was to consider whether further safeguards were needed for those dealing with corporate groups, namely minority shareholders and outsiders including creditors. A Draft Proposals Paper was published in September 1999, including a summary of the issues raised, with accompanying recommendations. Public comment was invited regarding the draft recommendations which resulted in the publication of the Corporate Groups Final Report in May 2000.

[13] CASAC, *Corporate Groups Final Report* (2000) http://www.camac.gov.au/camac/camac.nsf/byHeadline/PDFFinal+Reports+2000/$file/Corporate_Groups,_May_2000.pdf. at 2nd January 2009. The Final Report contained 24 recommendations which can be summarised into four areas: methods of regulating corporate groups; directors of group companies; corporate group reconstructions; liquidation of group companies.

[14] CASAC was the precursor of the Corporations and Markets Advisory Commitee (CAMAC). The members of both CASAC and CAMAC were and are appointed respectively by the Federal Government based on their knowledge of the law, economics and accounting and their experience in business, company administration and financial markets.

[15] CASAC, *Corporate Groups Final Report* (2000) < http:// www.camac.gov.au/camac/camac.nsf/byHeadline/PDFFinal+Reports=20000/$file/Corporate Groups,May 2000.pdf. > at 2nd January 2009. The review commenced in 1998, prior to this time only piecemeal changes had been made to corporate legislation to deal with issues arising specifically in the corporate group context. For example, certain transactions entered into between Mr Christopher Skase and the Quintex group of companies had led to the introduction of related party provisions found in Chapter 2E *Corporations Act 2001* (Cth)

The holding company and each group company would be collectively liable for the contractual debts of all group companies, subject to any contrary agreement;

Group companies could merge merely at the discretion of the directors of the holding company;

ASIC would be given the power to provide appropriate relief from accounting and any other residual separate entity requirements. [16]

CASAC's support of the so-called enterprise approach relies on two considerations. First, the enterprise approach reflects the manner in which highly centralised corporate groups operate economically and organisationally. Second, the enterprise approach reflects the expectations of creditors. Specifically, creditors who have been led to believe they are doing business with the group as a whole and thus can rely on the overall group's creditworthiness.[17]

The CASAC Report, however, recognised the difficulty of applying single enterprise regulation principles to corporate groups, regardless of their organisational structure or governance autonomy. Thus, under Recommendation 2, wholly-owned corporate group members determine their inclusion in the consolidated corporate group[18]. Relief from accounting and other residual separate entity requirements were offered, thereby providing incentives to consolidate. [19]

To date, CASAC's Recommendation 2 has not been implemented. The previous coalition government adopted only 2 of the 24 recommendations, namely recommendations 22 and 23.

Recommendation 22: The Corporations Law should permit liquidators to pool the unsecured assets, and the liabilities of two or more group companies in liquidation with the prior approval of all unsecured creditors of those companies.

Recommendation 23: The Corporations law should permit the court to make pooling orders in the liquidation of two or more companies. This power should be based on the draft provision in the Harmer Report and:

. make clear that pooling orders do not affect the rights of external secured creditors

[16] CASAC, *Corporate Groups Final Report* (2000) < http:// www.camac.gov.au/camac/camac.nsf/byHeadline/PDFFinal+Reports=20000/$file/Corporate Groups,May 2000.pdf. > at 2nd January 2009, 32, 1.83- 1.84
[17] Ibid. 1.59-1.63
[18] By the resolution of their directors.
[19] CASAC above note 16, 39, Recommendation 2.

. permit individual external creditors to apply to have a pooling order adjusted to take their particular circumstances into account. [20]

However, the recent introduction of voluntary or court ordered pooling of insolvent companies in liquidation would appear to be introduced on the grounds of administrative efficiency, rather than for the protection of unsecured creditors.

> The obtaining of a voluntary pooling determination or granting of court ordered pooling does not mean the recognition of a separate corporate group entity with associated group liability. Rather, the joint and several liability arising among the companies within the pooled group and the administration of such liability on a joint basis is a means of reducing complexities within group insolvencies, and thereby enhancing returns to creditors.[21]

Delaying such statutory intervention until liquidation, may also reflect the ascendancy for consideration of creditors' interests over shareholders interest by company fiduciaries [22] arises only as the company approaches insolvency or is insolvent.[23]

No public comment on any other CASAC recommendation has been released, although various conjectures have been offered regarding recommendation 2's non-implementation.[24]

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[20] Partial adoption of pooling of insolvent group companies' assets and liabilities has only lately been adopted. See Division *8* of Part 5.6 of *Corporations Act* 2001(Cth) which was introduced by Corporations *Amendment (Insolvency) Bill 2007.* For a discussion of both voluntary and court ordered pooling provisions see Jennifer Dickfos, 'Improving outcomes for creditors: Balancing efficiency with creditor protections' (2008) 16 *Insolvency Law Journal* 84, 90-95. Recommendations 4,11,12,13,14,and 21of the Corporate Groups Final Report were framed as negative recommendations, requiring no change. As no change was implemented to this extent such recommendations can also be considered as adopted.

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

[22] Company fiduciaries include company directors, voluntary administrators and liquidators.

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

[24] Including: 1. Complications of drafting legislation to adopt a single enterprise regulatory regime within the Corporations Act meant that path dependency of no recognition prevailed; 2. Failure to offer adequate incentives to encourage corporate groups to consolidate meant that Recommendation 2 only offered what was already available to corporate groups under the ASIC class orders for cross-guarantees, or was more limiting in some respects. See Vicky Priskich, "CASAC's proposals for reform of the law relating to corporate groups', (2001) 19 *Company & Securities Law Journal* 362; 3. Increased liability exposure would impact on the corporate group's ability to borrow, restricting efficient capital raising, risk taking and diversification; 4. Recommendation 2 did not provide a satisfactory response to the long tail liability issues raised in the James Hardie Case and the Jackson Report as it specifically excluded a consolidated corporate group from being collectively liable for the torts of any group company merely by virtue of the consolidation.

III Position of Unsecured Creditors within Corporate Groups

Although the above historical illustrations concern involuntary creditors and a specific class of voluntary unsecured creditors, employees, [25] this thesis addresses the position of voluntary unsecured creditors. Specifically, whether the present regulation of corporate groups leads to inefficacious outcomes for unsecured creditors of corporate group members? The most efficacious outcome for unsecured creditors contracting with a corporate group member is to be measured by their attainment of the following:

1. To obtain payment in full of their debt;
2. To obtain such payment on time, (to be measured by full payment to be received within 90 days of a formal account being issued) ; and
3. To perpetuate the contracting relationship with the corporate group member, with one or more subsequent contracts being entered into by the same parties.

In exploring the position of unsecured creditors and the effect of the current regulation of corporate groups, the Fincorp Group of Companies and like corporate group failures will be used as case studies.

A *Case Study – Fincorp Group*

The Fincorp group[26] is constituted by 21 corporate entities. The group conducted a number of property development and investments by raising funds from the general public, One corporate group member, Fincorp Investments Ltd issued 'first ranking notes'[27] and 'unsecured notes'[28] to raise moneys from the public. Monies raised were then on lent to other companies in the group, which used the borrowings to develop properties and make property investments. Fincorp Investments Ltd's principal asset subject to the floating charge is

[25]Ibid. Clarke and Dean do identify other notable instances of classes of unsecured creditors of financially stressed corporate groups finding themselves caught up in financial hassles exacerbated by the group structure, such as Adsteam, Tricontinental, Qintex and Bond Corporation.
[26] The following details regarding the Fincorp group are summarised from Tony D'Aloisio Chairman, Australian Securities & Investments Commission to the Senate Standing Committee on Economics *Statement on Fincorp,* 30th May (2007) and Korda Mentha, *Fincorp Group of Companies, Report to Creditors* (2008).
[27] First ranking notes were secured by a floating charge over the assets of Fincorp Investments Ltd.
[28] Unsecured notes were issued without any charge or security,

'Loans Receivable' from the other companies. The floating charge does not extend to the properties purchased by the other companies. Rather these purchased properties were first mortgaged to the banks, such that the priority of repayment for the Fincorp group is: first mortgages; first ranking notes; then unsecured notes.

Although a full investigation of the Fincorp group collapse is not yet been completed,[29] preliminary investigations show that the continued development of the properties purchased by the Fincorp group cannot proceed without further injections of public money. However, the value of the properties will not support any further such borrowings and so the directors place the companies within the group into voluntary administration to avoid liability for insolvent trading.[30]

Under the respective deeds of company arrangement distributions to various creditors of the Fincorp group of companies are estimated as follows. Employees whose claims rank in priority[31] are likely to be paid 100 cents in the dollar. First ranking noteholders are likely to receive a distribution of approximately $0.53-$0.58 in the dollar, but unsecured creditors are unlikely to receive a distribution. The average investor in Unsecured Notes is 60 years old with an average investment of approximately $24,800.[32]The majority of such creditors, aside from the1,144 unsecured noteholders of Fincorp Investments Limited, who are owed $22.6m, are general trade creditors of Fincorp Financial Services Limited, who provided advertising/promotion or construction services to the Fincorp Group. Thus it is the small, unsophisticated, disparate, voluntary creditors who bear the burden of the corporate group company losses. Such unsecured creditors lack any contractual or statutory protections against such losses.

The failure of the unsecured creditors of Fincorp Financial Services Limited to obtain any distribution arises in part because of the corporate group structure. The companies, who were

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[29] Seven of the 21 companies have executed Deeds of Company Arrangements, while the remaining 14 companies are continuing in liquidation. Korda Mentha, *Fincorp Group of Companies, Report to Creditors* (2008), 4.

[30] s588H (5) and (6) *Corporations Act 2001 (Cth)* Placing the companies into voluntary administration is a reasonable step to prevent the company from incurring debt while insolvent.

[31] S556 (1)(e) *Corporations Act* 2001 *(Cth)*.

[32] Tony D'Aloisio Chairman, Australian Securities & Investments Commission to the Senate Standing Committee on Economics *Statement on Fincorp,* 30th May (2007)*, 5.*

lent these monies under these loan arrangements had little or no equity capital to provide a buffer if investments ran into difficulties[33], resulting in the risk of failure being born by the unsecured creditors. Use of the corporate group model in this manner, is referred to later in the synopsis as providing double insulation of limited liability to holding company shareholders. Fincorp Financial Services had 'previously entered into a cross-collaterialised loan arrangement with Fincorp Investments, guaranteeing the payment of all Fincorp Investments intercompany loans.' [34] Under this agreement, any realised assets are paid to Fincorp Investments due to its position as a secured creditor of Fincorp Services. Use of such contractual protections by the corporate group make it difficult for the unsecured creditor to accurately assess the risk of investment as they have only partial knowledge of what amounts to the corporate group boundary, a problem highlighted below. Mandatory disclosure of the existence of such cross-collaterialised agreements to unsecured creditors would ensure unsecured creditors accurate determination of the assets to which they could lay claim for repayment of their funds, their risk assessment and may have altered their investment decision-making significantly.

B ***Unsecured Creditors Losses specific to Corporate Groups***

When dealing with Corporate Groups unsecured creditors may suffer loss for a number of reasons specific to Corporate Groups:

1. The unsecured creditors are unaware of the corporate group boundary. Their perception of risk and consequent advancement of credit, with little or no contractual protection is made with only partial knowledge.

2. Debtor opportunism as directors fail to maintain the assets within the corporate group entity on which creditors rely, leaving unsecured creditors without contractual recourse;[35]

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[33] Ibid.
[34] Korda Mentha, *Fincorp Group of Companies, Report to Creditors* (2008), 19.
[35] Henry Hansmann and Reinier Kraakman, *The Essential Role of Organization Law* (2000) 110 The Yale Law Journal 387,400-401. Hansmann and Kraakman identify the increased risk of debtor opportunism arising when assets of the business are fragmented. If a group company is threatened by insolvency, then it is possible that the holding company may shift that particular company's assets intra group to avoid their loss, thereby increasing the risk borne by creditors.

3. The limited liability of each corporate group entity and parent entity provides double insulation from liability of the parent entity shareholders.

The holding company's shareholders enjoy a double protection from trading liability, in that their investment in the holding company and any subsequent enterprise conducted by the holding company through a subsidiary of the group is limited to their initial investment.[36] By conducting a new venture through a corporate group subsidiary, holding company shareholders are the indirect recipients of any profits from the new venture. However, the combination of limited liability and the separate legal entity principles means any losses from the new venture are quarantined in the subsidiary, to be borne by the unsecured creditors of that entity. The holding company shareholders do not share in these losses. Although this is also true for an individual shareholder within a single company, he or she has made an initial investment to gain this immunity. The holding company shareholder makes an initial investment, but gains the same immunity as many times as there are subsidiaries of the Holding Company.

Such insulation from risk and liability gives rise to the perception of invulnerability by holding company shareholders. Hugh Collins ascribed this lack of group responsibility by corporate groups from the failure to recognise the corporate group as a single legal personality. [37] Similarly it has been argued that 'liability limitations artificially distance individuals from the real life effects of the enterprise in which they invest, thus decreasing their acknowledged personal responsibility'.[38] Within a corporate group with multiple companies each deriving the advantages of limited liability the holding company

[36] John Farrar 'Legal Issues Involving Corporate Groups' (1998) 16 *Companies and Securities Law Journal* , 184. As identified by John Farrar the strict application of Salomon to groups of companies, coupled with limited liability has led to a system of limited liability within limited liability which was never countenanced by the early legislation and has facilitated abuses. Farrar referred to Tom Hadden, 'The Regulation of Corporate Groups in Australia' 15 (1992) *University of New South Wales Journal* 61, 65 where Hadden identified the creation of separate companies for particular operations supplemented by the techniques of integrated financing as a means of avoiding liability to external creditors by relying on the limited liability of each constituent company within the group.

[37] Hugh Collins, 'Ascription of Legal Responsibility to Groups in Complex Patterns of Economic Integration (1990) 53 *The Modern Law Review,* 731, 733. Collins labelled such failure as the capital boundary problem.

[38] Judith Freeman, 'Limited Liability: Large Company Theory and Small Firms' (2000) 63 *Modern Law Review*, 317,320 referring to T. Gabaldon, 'The Lemonade Stand: Feminist and Other Reflections on the Limited Liability of Corporate Shareholders' [992] *Vanderbilt Law Review* 1387, especially 1429; K. Hall, 'Starting from Silence: The Future of Feminist Analysis of Corporate Law' (1995) 7 *Corporate and Business Law Journal, 149.*

shareholders distance from the reality of enterprise investment and their consequent decreased personal responsibility for such investment is considerably increased.

IV Economic Theory of Corporate Law

Current economic analysis of corporate law supports the present boundaries of the corporate group and the limitation of liability of corporate group members on the grounds of efficiency: the transaction costs of stakeholders (including creditors) are minimised and shareholder returns maximised. However, given that unsecured creditors specifically suffer losses because of the interaction of these same principles within the corporate group it is appropriate to determine whether the present regulation of corporate groups is efficient. Efficiency is measured by whether risk within the corporate group is allocated to those most capable of bearing it; that optimal levels of risk taking are undertaken such that only corporate group ventures with net positive values to society are undertaken; and that transaction and monitoring costs within the corporate group are minimised.[39] Applying this measurement to the unsecured creditors' position: is it efficient for the unsecured creditors to be the bearers of loss? If unsecured creditors perceive a heightened risk of contracting with corporate group members the cost of extending such credit could rise, or the level of credit being offered may be rationed. Such changes could lead to the foregoing of viable business projects and the continued need for unsecured creditor funding. The Fincorp Group of Companies will be used as a case study for efficiency measurement purposes.

To determine if the adoption of Recommendation 2's enterprise principle would be more efficient, the position of unsecured creditors vis a vis other corporate group stakeholders will be determined and then compared to the existing scenario of the Fincorp case study.

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

V Lack of Unsecured Creditor Protections

Contractarian theory suggests that unsecured creditors address their lack of protection by:

the imposition of higher interest rates or harsher penalties when contracting with the respective corporate group entities; by restricting company activities such as dividend payouts, or the incurrence of further debt [40]; by obtaining contractual guarantees from other corporate group members to secure repayment of the debt; or by restricting their dealings to those corporate group members who have entered into a regulatory administered ASIC Deed of Cross-Guarantee or one of its earlier variants.[41] However, despite being promoted as a method of offering creditor protection as well as reducing financing costs by allowing creditors to deal with only one company in a closed group, empirical evidence appears to support the contrary: that the use of cross guarantees does not provide much protection. [42]

Having weighed the respective risks of contracting with the corporate group, a bargain is made between the creditor and company group member. It is not the function of the courts to reallocate risks implicitly adopted within the bargain made between the creditor and the limited liability company within the corporate group.[43] Such freedom of contract principles ensure efficiency as exchanges are facilitated between business firms and commercial entities

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[40] Ian M. Ramsay, 'Allocating Liability in Corporate Groups: An Australian Perspective (1999) 13 *Connecticut Journal of International Law* 329,363.

[41] In 1985 Henry Bosch, then Chairman of the National Companies Securities Commission (NCSC) initiated a Deed of Indemnity. By entering into a deed of cross-guarantee group companies form a "closed group" guaranteeing to meet the debts of one another.

[42] Frank Clarke and Graeme Dean *Indecent Disclosure Gilding the Corporate Lily,* (1st ed.2007)161-163 Having conducted a survey of the ASIC Ascot Database for the period 1991-2002 Clarke et al identified that deed covenants have only crystallised in a few cases; potential benefits from deeds were heavily weighted in favour of participating group companies; and that to date courts had not had to adjudicate on an ASIC deed dispute. Reasons given for the non-operation of the deed are the popularity of voluntary administration procedures over liquidation in common law jurisdictions (the deed only crystallising in liquidation) and the difficulties of implementing the deed where cross-claim guarantees exist within the closed group. See earlier discussion regarding Fincorp Group.

[43] Courts are reluctant to alter commercial bargains. Such reluctance is evident in insolvency situations where the cardinal first principle of insolvency is the recognition of rights accrued by the parties prior to liquidation. See Roy Goode, *Principles of Corporate Insolvency Law, (*3rd ed.2005) 69-70. Exceptions do exist when the courts will intervene. For example, with respect to the granting of remedies in cases of oppression of minority interests under s233(1) *Corporations Act 2001 (Cth)* and in the courts power under s444F *Corporations Act 2001 (Cth)* to limit the rights of secured creditors where the enforcement of such rights would have a material adverse effect on a deed of company arrangement between creditors and the company.

who enter into legal obligations voluntarily, rationally and at arm's length. [44] However, limits are placed on the parties' contractual power where the agreements made are 'socially undesirable for reasons of inefficiency, inequity and other substantive objections'.[45]

In reality (proof of which is to be provided by creditor survey), unsecured creditors do not obtain additional contractual protection at the time of contracting with the corporate group member.[46] This may be the result of: (i) the transactions costs of doing so; (ii) lack of negotiating power of such creditors due to the level of competition and their inferior bargaining position; (iii) their perception of the debtor with whom they are negotiating; (iv) the refusal of the debtor to provide such protection; or (v) deficiencies in information regarding the corporate group members' finances.

Further support for unsecured creditors' inability to utilise contractual protections will be provided by the case study analysis of the Fincorp Group of Companies, referred to earlier.

Unsecured creditors lack any contractual protections when dealing with corporate group members, despite the corporate group structure increasing the opportunity of excessive risk taking on the part of the corporate group's holding company and its corporate members.

Any protection currently provided to unsecured creditors is largely statutory, ex post and involves the unsecured creditor incurring transaction costs. Transactions costs include legal costs,[47] and opportunity costs [48]of pursuing and recovering unpaid debts. An evaluation of the current protections afforded to an unsecured creditor of a corporate group member entity by the Corporations Law will be made within the thesis. Such evaluation will highlight the

[44] Benjamin E. Hermalin, Avery W. Katz and Richard Craswell, 'Law & Economics of Contracts' in A. Mitchell. Polinsky & Steven Shavell (eds) *The Handbook of Law & Economics* Vol1,(1st ed,2007)13.
[45] Ibid13.However, these reasons are not grounded in voluntariness or rational efficiency.
[46] For criticism generally of the argument that 'voluntary creditors can build the risk of insolvency into the interest they charge and can demand protection in the form of collateral, minimum capitalisation or some other protection' see Judith Freeman, 'Limited Liability: Large Company Theory and Small Firms', (2000) 16 *The Modern Law Review* 317, 330.
[47] Legal costs may include the costs of instigating a claim for insolvent trading against company directors under s588M(3) *Corporations Act* 2001 (Cth) where the Liquidator or Court gives consent. Alternatively, legal costs may be incurred applying to the court for variation of a pooling order under s579F(2) *Corporations Act 2001* (Cth).
[48] Opportunity costs will include revenue lost from time spent on pursuing debt collection activities.

weaknesses within the existing corporate law as well as the need for further reform recommendations.

Consideration should be given to the consequences to unsecured creditors of maintaining the present regulation of corporate groups. Certainly arguments exist to provide creditor protection on the grounds of distributive justice or social equity or group responsibility as previously noted. Such consideration helps answer the research question whether additional measures are required to protect unsecured creditors dealing with corporate groups.

VI Means of Providing Creditor Protection

Three alternative means exist to provide protection to unsecured creditors dealing with a corporate group:

1. Recognise the group's economic entity as its juristic entity;

2. Require mandatory disclosure of the constituents of the corporate group to unsecured creditors, so as to provide a better understanding of the limits of the group boundary to unsecured creditors;

3. Impose joint and several liability on each corporate group entity and its respective parent company so as to obviate the parent entity's shareholders' double insulation from liability. However, joint and several liability, should only be imposed in those circumstances, where there is a real possibility of exploitation from debtor opportunism.

Research Questions

To determine whether the present regulation of corporate groups leads to efficacious outcomes for unsecured creditors or if further statutory protections are required the following questions will be addressed.

1. Does the corporate group structure (as opposed to the corporate form per se) impose losses on unsecured creditors?
2. Do unsecured creditors in fact seek further contractual protections when dealing with corporate group entities?

3. Are there any statutory protections afforded to unsecured creditors when dealing with corporate group members and, if so, how effective are such protections?
4. Should the juristic and economic treatment of companies recognised as forming a corporate group be the same; and does doing so lead to a more efficacious outcome for corporate unsecured creditors.
5. Does the imposition of joint and several liability on a parent and subsidiary company lead to a more efficacious outcome for corporate unsecured creditors.
6. Does mandatory disclosure to unsecured creditors of the corporate group's constituency (and material significant movements in assets within and outside the corporate group by its constituents) provide adequate protection to creditors?

Methodology

Case studies of the Fincorp Group and similarly structured insolvent corporate groups will be analysed to determine the source of unsecured creditors' losses within closely controlled, wholly-owned vertical corporate groups. Namely, is the source of unsecured creditors' losses the corporate group structure as opposed to the corporate form. Whether unsecured creditors of corporate group members seek contractual protections at the time of contracting will be answered by conducting interviews of unsecured creditors. A preliminary focus group will determine the feasibility of this measure. The evaluation of any statutory protections afforded to unsecured creditors will require an analysis of the existing case law and *Corporations Act* 2001 provisions. Whether any or all of the suggested protective measures provide adequate protection to unsecured creditors contracting with corporate group members will be determined by modelling such protections based on the Fincorp Case Study. Comparisons of the respective outcomes for unsecured creditors, and the effectiveness of such protections to mitigate creditor's losses can be drawn.

Significance of the Research

Eight years after CASAC released its recommendations, the popularity of corporate groups has not waned, nor has the number of corporate group collapses, or the losses of such corporate group's unsecured creditors. The study is considered worthwhile since no reasons were published by CASAC or the Federal Government as to why the majority of

recommendations of the Corporate Group Final Report were not adopted. Thus, whether to adopt the enterprise principle to regulate corporate groups or shift liability within the Corporate Group to provide protection to unsecured creditors as a stakeholder group are still issues to be canvassed and determined. The analysis to be undertaken is of value as previous economic analysis of corporate law, including the CASAC report, have not specifically been directed to corporate groups, but rather provided an economic analysis of those corporate laws applying to a single company. [49] Previous studies have been restricted in discussing the particular problems existing within corporate groups, but were lacking any concurrent economic analysis of the laws applying to such corporate groups.[50] Finally, CASAC made its recommendations prior to the current work being undertaken by the United Nations Commission on International Trade Law (UNCITRAL)[51] regarding corporate groups' insolvency. This thesis shall address each of these restrictions.

[49] For example see Michael Whincop, 'Painting the Corporate Cathedral: The Protection of Entitlements in Corporate Law' [1999] *Oxford Journal of Legal Studies,* 19; Michael Whincop, 'Form, Function and Fiction: A Taxonomy of Corporate Law and the Evolution of Efficient Rules' (2001) 24 *U.N.S.W.L.J.* 85 and John Armour, & Michael Whincop, 'The Proprietary Foundations of Corporate Law', (2007) 27 *Oxford Journal Of Legal Studies* 429. Especially the former two articles for an economic analysis of Australian company law.

[50] Clive M. Schmitthoff and Frank Wooldridge, (eds) *Groups of Companies* 1991 and Michael Gillooly, (ed) *The* Law *Relating to Corporate Groups* 1993

[51] The UNCITRAL formulates and regulates international trade in cooperation with the World Trade Organization.