R GLOBAL

Limiting Liabilities

Structuring holding companies to withstand insolvency

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Structuring holding companies to withstand insolvency

The concept of limited liability is one well known in the international corporate lexicon. Companies are organised to minimise their liability for the actions of related but legally separate entities, be they partners, suppliers or customers.

These divisions are generally fairly clear, but they become less so when applied to groups of companies, with subsidiaries and holding companies legally bound to each other via ownership. In these situations, under certain circumstances, a holding company and its directors may be held liable for the actions or performance of a subsidiary despite the fact the subsidiary is a separate business.

Insolvency is one such circumstance when liabilities within a group of companies are examined forensically. The insolvency or bankruptcy of a subsidiary will usually leave a range of creditors out of pocket and practitioners employed by those creditors will make every effort to recover losses, including exploring the potential liability of a holding company and its directors.

As a consequence, it is imperative that corporate structures are maintained using best practice techniques, prior to any future insolvency, to make it as difficult as possible for creditors to 'pierce the corporate veil' and make charges against assets held outside the insolvent business.

A good example of best practice technique, is the development of separate corporate governance, ensuring that different directors sit on the board of a subsidiary than sit on the board of a holding company. If it appears that the subsidiary is fully under the control of the parent company it is harder to resist liability for its actions.

Another would be the rigorous maintenance of board minutes, financial accounts, and appropriate documentation of intercompany transactions. This helps to rebuff accusations of preferential transactions.

Failure to adhere to these best practices can be easily tested under the insolvency laws of various jurisdictions around the world. The Instrumentality Test and the Identity Theory, for example, are used by courts in the US when deciding whether to pierce the corporate veil in pursuit of damages.

In the event of a subsidiary insolvency, the behaviour of holding companies and their directors can have a significant bearing on liability. In some jurisdictions, related party transactions (between a subsidiary and a holding company) made up to five years prior to the insolvency could be examined. If any are found to have been made at an undervalue, the holding company can, in some cases, be forced to repay the entire consideration received by the transferee for distribution to creditors.

As another example, if a subsidiary fails to meet its obligations to the tax authorities for sales tax or employee contributions, the directors of the holding company can be held personally liable if it can be determined that they influenced those decisions. In extreme cases, money used for mortgage payments or children's tuition fees has been reclaimed.

It is clear that correct corporate structuring and governance are required at the formation of a company group to avoid any future liability issues in the event of insolvency. The behaviour of directors and responsible employees during and immediately prior to an insolvency is also critical to the outcome of any liability claims outside the immediate legal entity.

The following feature draws upon the expertise of five insolvency practitioners from around the world who are members of IR Global. Each of them gives a unique perspective from his or her jurisdiction on the issues to consider when attempting to limit holding companies' liability during the insolvency of a subsidiary in a company group and further considers the possible damages and defences available should the worst happen.

The View from IR

Thomas Wheeler

Founder

Our Virtual Series publications bring together a number of the network's members to discuss a different practice area-related topic. The participants share their expertise and offer a unique perspective from the jurisdiction they operate in.

This initiative highlights the emphasis we place on collaboration within the IR Global community and the need for effective knowledge sharing.

Each discussion features just one representative per jurisdiction, with the subject matter chosen by the steering committee of the relevant working group. The goal is to provide insight into challenges and opportunities identified by specialist practitioners.

We firmly believe the power of a global network comes from sharing ideas and expertise, enabling our members to better serve their clients' international needs.

ITALY

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Massimo Boni is the founding partner of FPB Legal, an Italian business law firm with offices in Milan and Trieste, and focuses his practice on three main areas: corporate and commercial litigation; insolvency and corporate restructuring; corporate and commercial contracts.

Over the years, he has acted for Italian and foreign companies, but also international organisations (either UN or non-UN agencies), before Italian Courts and arbitrators or prominent international arbitration institutions.

Massimo has gained a significant expertise in the highly specialised field of corporate litigation, handling disputes among shareholders for winning the control of the company or among companies and their directors and statutory auditors for liability for mismanagement and fraud or among sellers and purchasers following M&A transactions.

Massimo is regularly involved in insolvency matter cases, either defending and representing companies, directors and auditors from claims brought by bankruptcy trustees (directors liability, claw-back actions, parent company liability, etc.) or counselling and representing distressed companies throughout their restructuring phase. He also assists Italian and foreign investors purchasing businesses and assets from insolvency procedures.

ENGLAND

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David is the Head of Dispute Resolution at Barlow Robbins, a leading UK law firm. His areas of practice include insolvency, professional negligence, commercial litigation, property disputes and inheritance disputes.

David regularly handles cases in the higher courts for clients of all sizes, including banks, insurers and educational institutions. He has handled more than 200 mediations across the UK with a success rate of over 90%.

David is a member of the Commercial Litigation Association, the Professional Negligence Lawyers' Association, the Institute of Directors, and the International Bar Association.

He is also a member of the standing conference of Mediation Advocates and a mediator member of a number of mediation groups including the ADR Group, Expedite Resolution and Law South Mediators. He is actively involved in a number of charities and organisations, including as trustee.

A recent independent guide to the UK Legal Profession named him as a 'very good lawyer' who 'gets down to the heart of an issue'. Karen Schuman, Counsel of 1 Chancery Lane said that David has a 'calm authority' and can 'find the solution' in a difficult case.

CANADA EAST

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Fay is a partner at Torkin Manes, and head of the Banking, Finance and Insolvency Group. She acts extensively for institutional and private lenders and borrowers in a wide range of financing transactions, derivative products, factoring arrangements, asset securitisations and securitised loans.

She advises banks with respect to regulatory and other issues that may arise under the Bank Act, or other similar legislation, including a broad range of issues of concern, such as cost of borrowing disclosures, privacy, identification of clients, money laundering, electronic banking and other day-to-day issues affecting banks and other financial institutions.

Fay is involved in corporate restructurings, insolvency and related litigation

matters of all sizes. She offers expertise under the Bankruptcy and Insolvency Act, Companies Creditors Arrangement Act, Personal Property Securities Act, and Financial Administration Act.

Fay works closely with other members of her firm's Banking, Finance and Insolvency Group to assure clients that someone is always available to provide the advice they need, when they need it.

AUSTRALIA

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James was admitted as a solicitor in 1987, having completed a year in 1986 as associate to the then Chief Justice of the Supreme Court of Queensland, The Honourable DG Andrews. In his early years, he gained experience in a wide range of areas but quickly settled into litigation. By 1990, he was established as a commercial litigation lawyer with a keen interest in insolvency matters. He established James Conomos Lawyers on 1 July 1992 as a specialist practice in commercial litigation and insolvency.

Since 1990, he has practised as a solicitor primarily in commercial litigation, dispute resolution and insolvency matters. James has acted in and advised various parties in many insolvency administrations, both corporate and individual. He has advised a range of clients including financiers, insolvency practitioners, creditors and regulators.

James has also acted in hundreds of litigious matters, in a range of disputes from land valuation, contract disputes, breaches of fiduciary duties, fraud claims, building disputes and debt claims. He has acted in all courts throughout Australia, and represented his clients in many cases, some of which have changed the law.

U.S – WASHINGTON, D.C.

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Trevor (Ted) Swett is a Member in Caplin & Drysdale's Washington, D.C., office. He was elected to membership in 1989, having joined the firm as an associate in 1985. Mr. Swett has been recognised as a "Leading Lawyer" by Chambers USA, The Legal 500, and Benchmark Litigation for his work in Bankruptcy/Restructuring.

Mr. Swett's practice emphasises bankruptcy litigation related to corporate reorganisations and the prosecution and defence of civil cases involving allegations of financial misconduct. He has focused on the issues characteristic of complex asbestos-related bankruptcies and on asset recovery litigation involving theories of fraudulent conveyance, successor liability, and piercing the corporate veil. He also has substantial experience representing financial institutions in commercial litigation and taxpayers in litigation against the Internal Revenue Service.

In several major Chapter 11 reorganisations, he has acted for tort victims in litigation to impose liabiilty on the parents or affilates of bankrupt companies under theories of piercing the veil or the like.

Caplin & Drysdale is a leading provider of tax, tax controversy, and litigation legal services to corporations, individuals, and non-profits throughout the United States and around the world.

SESSION ONE – DANGEROUS STRUCTURES

How should a holding company structure be implemented in your jurisdiction to minimise liability in case of the insolvency of a subsidiary? What practices would be deemed dangerous?

Italy – Massimo Boni (MB) In Italy, as a general principle, holding companies are not liable for the insolvency of their subsidiaries and their relevant debts. More precisely, their liability is limited to the debts they may have vis-a-vis their subsidiary (company's capital still not paid-in, or commercial debts, etc.). However, under certain circumstances, this limitation of liability can be challenged.

In order to minimise such risk, holding companies should pay particular attention to the following specific topics.

The Board of Director should be granted autonomy in their decision-making and it is opportune, for example, that the holding and the subsidiary do not share the same persons as Directors.

Compliance is also key, in particular: i) corporate compliance, since sometimes subsidiaries tend to take it lightly (e.g. Board of Directors' meetings and decisions must be timely held and taken as well as timely recorded in the relevant company's book); ii) bookkeeping compliance, especially with regard to intercompany transactions; iii) compliance with other kind of provisions that may bring significant liabilities for the company and their Directors if breached, as provisions on data protection (e.g. so called GDPR), anti-money laundering, corporate responsibility under Law No. 231/2001, social security contributions, etc.

Furthermore, subsidiaries need to comply with certain disclosure duties with regard to the companies that exercise powers of 'direction and coordination' under Art. 2497 of Italia Civil Code on them. Subsidiaries must communicate this 'direction and coordination' to the Company Registry, disclose it in their correspondence and reporting certain data regarding the holding company and intercompany transactions in their financial statements.

Dangerous practices often regard intercompany financing and intercompany transactions.

Under certain circumstances, financing from holding companies to subsidiaries is considered as shareholder financing then it should not be reimbursed before other creditors are paid.

In handling intercompany transactions, the 'compensatory advantages' principle should be always kept in mind. The advantages for the subsidiary must be actual and objective and its Directors must analytically disclose the economic rationale of such transactions. Both parties should be ready to carry out transactions to restore the balance of advantages and disadvantages should a liability for 'direction and coordination' be claimed.

Canada – Fay Sulley (FS) We set a company up to minimise director liability from the start and we have the shares of an operating company or subsidiary held by the holding company not by an individual, because it adds a layer of complexity which makes it harder to pierce the corporate veil.

There are certain rules that directors have to follow and we have a general blanket anti-money laundering regime here in Canada, but it's not something that directors are always aware of.

Directors can be held liable for various offences if they are aware that the company is insolvent. They cannot declare dividends and could be personally liable for the repayment of them if they do.

There are several other areas of director liability that need to be planned for around employees and tax.

With regard to an employee's remittances, when employees are paid, a certain percentage goes to the government as a withholding tax for income tax, unemployment insurance contributions and pension contributions. These are viewed as trust funds remitted to the government.

There is a portion that the employer is responsible for as well, and if they are not remitted then the director can be held personally liable.

This was a bigger problem a number of years ago, but now we have a payroll service that automatically deducts and remits the correct amounts.

Smaller companies do still often have a problem with this though and can get cut off from their payroll services if they are not remitting enough money to cover everything.

The other area where we have huge potential director exposure is VAT or sales tax. We have harmonised sales tax in Canada, along with GST and provincial sales tax in some areas. Any company that collects those taxes should hold them in trust and remit them to the government. If they fail to, they can be held personally responsible which can often cause the biggest problem for directors of insolvent companies.

We find that when directors get desperate they use those tax monies for operating purposes.

Directors are also liable for up to one year's worth of unpaid wages to employees. That can be a problem because a lot of companies allow vacation to accrue and carry over year-on-year. We recommend that companies don't allow vacation time to be carried over for this reason.

If a company is becoming insolvent, we advise directors to have weekly meetings to make sure that all the remittances are being made.

Finally, I would mention that we also advise directors or companies at the outset to take out directors and officers insurance. We have a lot of clients we recommend that for and we find that those policies not only handle the legal defence of directors being sued, but they also pay out to government and employees.

Using funds owed to third parties as general corporate funds is a huge red flag. Also paying dividends to shareholders during times of insolvency is a huge no-no. Any kind of distribution, whether it's a shareholder loan or a dividend, would be the director's responsibility to pay back.

U.S – Trevor (Ted) Swett (TS) We have 50 states in the US, each of which has its own corporate law, with which the federal law intersects. My comments are based on Delaware law, which provides widely prevailing (but not universal) norms for corporate matters.

Like any corporation, a holding company is a legal person presumptively separate from its subsidiaries. But the law ignores that distinction and pierces the corporate form if necessary to avoid injustice or abuse.

To uphold the separateness of parent and subsidiary, it may be helpful to have some officers and directors at the subsidiary level who are not also officers or directors of the parent. But this is a matter of prudence rather than a legal requirement.

A solvent subsidiary is meant to operate for the benefit of the parent company, and directors of a holding company generally are not liable for the parent's or subsidiary's obligations (absent personal guaranties). Directors do, however, have fiduciary duties of good faith, due care, and loyalty toward the holding company and can sometimes be held accountable by creditors of an insolvent subsidiary.

The failure of each company in the corporate group to maintain board minutes, financial accounts, and appropriate documentation of intercompany transactions presents a serious hazard, as does the failure of the board of directors to seek out material information pertinent to their decisions affecting subsidiaries, including professional advice when needed.

Red flags include any director's failure to disclose to the board all personal interests that conflict or compete with those of the holding company or any of its subsidiaries, and to refrain from participating in any corporate decision for which he is subject to such a conflict.

Any parent-company transaction with a subsidiary that is or may be insolvent is likely to be troublesome if it arguably elevates the interests of the parent or its directors above those of the subsidiary's creditors.

England – David Foster (DF) First of all, it's quite legitimate to have subsidiaries in the UK carry out certain functions and ring-fence assets. A holding company's liability is limited to paying any amount not paid out in the shares of the subsidiary.

Third parties don't have any recourse to the holding company unless the holding company has assumed contractual liability such as by guarantee or indemnity, or if the subsidiary has merely acted as an agent for the holding company. That can occur where the subsidiary is under the control of the holding company and not acting individually.

A few basic protections to implement include having processes to keep records of guarantees and indemnities. It is also important to be clear about who can make the arrangements for things like banking transactions.

It is dangerous to have identical boards and there is a need to ensure that the subsidiary has its own governance and decision making processes. It's a good idea to have non-executive directors on the board to make sure everything is being done properly.

In English law we have liabilities coming at us from two angles. The common law about piercing the corporate veil applies where people enter existing obligations and don't do what they should do. It can also apply where there is an assumption of responsibility.

The relationship between a subsidiary holding company and a third party might indicate that the holding company has assumed some responsibility for the subsidiary and the law will impose sanctions in that eventuality.

If the subsidiary is carrying out business in the same area as the parent and the parent has superior and specialised knowledge meaning it should have foreseen that the subsidiary was relying on that knowledge, then the parent company might be on the receiving end of a claim.

There are also problems for holding companies if they act as shadow or de facto directors of subsidiaries, so it's important to keep an eye on patterns of behaviour that show automatic compliance with the holding company's advice.

Austrailia – James Conomos (JC) The circumstances in which liability for insolvent trading is imposed on a holding company correspond to those in which a director is liable for insolvent trading. Under section 588V of the Australian Corporations Act 2001, a corporation which is a holding company contravenes the section if the following criteria are met:

- the corporation is the holding company of a company at the time when the company incurs a debt.
- the company is insolvent at that time, or becomes insolvent by incurring that debt, or by incurring at that time other debts including that debt.
- at that time, there are reasonable grounds for suspecting that the company is insolvent, or would so become insolvent, as the case may be.

The circumstances in which the liquidator of a subsidiary can claim against the holding company are:

- a corporation has contravened section 588V in relation to the incurring of a debt by a company
- the person to whom the debt is owed has suffered loss or damage in relation to the debt because of the company's insolvency

Fay Sulley pictured at the 2018 IR Annual Conference in Toronto

- the debt was wholly or partly unsecured when the loss or damage was suffered
- the company is being wound up.

Any such proceeding has a statutory limitation period of six years from the beginning of the winding up.

The 2016 case of Giovanni Maurizo Carrello (as liquidator of Perrinepod Ltd (in liq)) v Perrine Architecture Pty Ltd [2016] WASC 145 demonstrates the application of both sections 588V and 588G (liability for directors).

The plaintiff was the liquidator of Perrinepod Pty Ltd (PPL) and the first defendant, Perrine Architecture, was the holding company of PPL. Mr and Mrs Perrine, the second defendants, formed Perrine Architecture in 1989 and were the sole directors and shareholders at all times.

PPL was formed in 2007 with the purpose of marketing a construction system designed by Mr Perrine. The Perrine's were directors of PPL from its formation along with two other directors. By 2008, PPL only had three directors, two of which were the Perrine's. PPL was ordered to be wound up in insolvency on 1 March 2012.

The plaintiff asserted that; The Perrine's failed to prevent PPL incurring debts while insolvent; and that Perrine Architecture, as holding company of PPL, was liable for the insolvent trading of PPL.

As directors of Perrine Architecture and of PPL, the Perrine's were liable for insolvent trading under section 588M of the Corporations Act whilst Perrine Architecture would be liable under section 588W.

To limit holding company liability, a business should enter into joint venture arrangements; or retain a shareholding of less than 50 per cent in the subsidiary company.

SESSION TWO - DAMAGES AND DEFENCES

What kind of damages can be claimed from holding companies or their directors in the event of the insolvency of a subsidiary? What defences are available to mitigate these?

USA – TS Let's talk first about piercing the corporate veil to get at the parent and impose responsibility on the parent.

First, the subsidiary's insolvency does not, in itself, justify piercing, but a classic case for piercing arises when the parent has stripped value out of a financially troubled subsidiary.

There will be questions about whether or not, at the time of the contested transaction, the subsidiary was technically insolvent, but if the parent strips out intercompany accounts, takes dividends or removes value when the subsidiary is financially troubled, then the case invites piercing the veil under predominant tests.

A widely recognised test known as the Instrumentality Theory, allows the piercing of the veil if the parent exercises a high degree of domination and control over the subsidiary, then uses its control to commit a fraud or wrong thereby proximately causing injury to the complaining party.

An alternative might be the Identity Theory, when the failure to observe the corporate distinction internally is so complete that the court finds there was no distinction in fact, but an integrated entity responsible for all corporate obligations.

The take away point is that the limited liability of shareholders is a strong presumption but not an absolute one. Courts have power to pierce the veil to avoid injustice or inequity.

There is also the doctrine of breach of fiduciary duty, where directors may become liable for breaching duties of care, good faith and loyalty owed to their corporation. This may involve indirect harm caused to a parent company stemming from losses inflicted on subsidiaries.

Creditors of an insolvent company may bring a suit derivatively in the name and right of the company to hold insiders accountable to the corporation. When the injured corporation is a subsidiary, its creditors may sue the parent company and its directors "double derivatively" in the name and right of the parent.

A holding company and its directors may also be held liable for aiding and abetting breaches of fiduciary duty at the board level of the subsidiary, if a plaintiff can show that these defendants knowingly and substantially assisted in breaches of duties that the subsidiary's directors owed to the subsidiary.

A key defence for all corporate fiduciary claims is the Business Judgment Rule. This is the fundamental principle that courts will not review the merits of a business decision honestly made by an informed board of directors that acted in good faith and without conflicts of interest. If a plaintiff overcomes that standard, then the defendant directors can avoid liability only by showing that the contested transaction was entirely fair to the company both in process and in substance.

There is a liability on the part of the directors for illegal dividends or stock redemptions and capital transactions that don't meet the requirements of the corporate law, with respect to maintaining the capital of the subsidiary.

Those who receive fraudulent transfers out of the subsidiary, whether it's the parent itself, or the parent's principals or directors, may be liable on a fraudulent transfer theory for disgorgement of the benefits and making whole the subsidiary. They may also be held liable for restitution on equitable grounds in cases of unjust enrichment.

It is important not to lose sight that the parent and its directors may also be held liable if they personally commit a tort against a creditor or a competitor of a subsidiary. An example might be malicious interference with a contract.

Italy - MB In very short terms, there are two kinds of possible liability for parent companies under Italian law.

The first one is liability for abuse of legal personality, which is the liability that a holding company can be subject to when it exercises such a full control on the subsidiary that the later can be considered as a mere tool, or agent, in the hands of the holding. In this case, Italian law foresees a direct liability of the holding company for all debts and liabilities of the subsidiary. In case the subsidiary goes bankrupt, bankruptcy can be extended to the parent company.

The second one is regulated by Art. 2497 et seq. of the Italian Civil Code and is not connected to an abuse of legal personality, but to an abuse of power to direct and coordinate subsidiaries. Such power of direction and coordination is legitimate and does not allow piercing the corporate veil provided that it is exercised according to: 1) the laws; 2) the company by-laws; 3) the principle of correct business management. On the contrary, in case of misuse of such power, a holding company can be held accountable for damages. The holding company's directors and other subjects taking advantage of the wrongdoing, are jointly liable with the holding company.

A company is considered a controlling company under Art. 2497 when has the power to control the decision-making of the subsidiary, or can exercise a dominant influence on it, either in force of its participation in the subsidiary' company capital or through a specific contractual power (e.g. particular agreements between the parent company and the subsidiary) or even de facto.

Liability for unlawful 'direction and coordination' is not a direct liability for the indebtedness of the subsidiary, but for the (indirect) damages the holding company caused to the creditors and to (other possible) shareholders of the subsidiary.

Shareholders are entitled to claim damages for loss of value and of remuneration of their participation. The exact content of these general concepts is debated; however, the underpinning idea is that the shareholders are damaged because of the loss of value and dividends of their participation in the subsidiary due to the illegitimate transfer of money, assets or the likes from the subsidiary to the holding without proper consideration.

Creditors can claim damages under Art. 2497 when a transaction between the holding company and the subsidiary diminishes the subsidiary assets, since, under Italian law, the latter are considered a general guarantee granted to the creditors by the debtor (the subsidiary in this case) for the reimbursement of its debts.

In the case of bankruptcy of the subsidiary, the bankruptcy trustee is entitled to sue holding companies, its directors and auditors for the aforementioned kind of liabilities.

The main defences against these kind of actions are based on the affirmation of the substantial autonomy of the subsidiary and the denial of liability because the parent company and its directors acted in compliance with the law, the bylaws and relevant decisions were reasonable according to the business judgement rule.

In particular with regard to the liability for unlawful 'direction and coordination,' there is also the compensatory advantages defence. The holding company or its directors are not liable even in case certain intercompany transactions or decisions can be judged as detrimental for the subsidiary, if the overall result of the direction and coordination activity brings advantages that fully compensate the disadvantages.

England – DF We don't have the compensatory advantages rule in the UK, but we do have section 212 of the Companies Act 1986, which allows a liquidator, contributor or creditor to the company's capital to bring a misfeasance claim against a subsidiary or a parent. The court can order repayment and restoration on account of misappropriated money or property and can compensate the misfeasance or fiduciary breach of duty by contributing to the company's assets.

Pursuing directors, including de facto and shadow directors can be done in the following cases;

- misfeasance or breach of fiduciary duty claims against anyone in the company.
- fraudulent trading by any person who was party to the fraud of creditors.
- wrongful trading, where a successful wrongful trading action can impose personal responsibility on directors if they knew there was no reasonable chance of avoided insolvency.

Unjust enrichment principles enable disadvantaged subsidiaries to be protected since the personal assets of directors can be attacked and tracing can occur. In such cases, a spouse's assets need to be protected.

As a defence, if the directors can show they took every step to minimise loss to creditors they can often be allowed to continue restructuring a business.

There are also defences available under misfeasance claims, if an officer can show they acted reasonably. Otherwise, having good accountants and financial advisors is advised, as is a good business plan with forecasts.

You can defend a preferential transaction claim, if it was not made at the relevant time, which is generally six months before an insolvency, or two years for a connected person. Where a transaction is being made at an undervalue, it should have been entered into within two years of the onset of insolvency if it is going to be challenged.

Canada – SFS Our biggest defence here is Canada is the Legitimate Business Decision defence. Directors have to show there is a legitimate business reason for a decision and any other business person would have made the same decision, whether it's to continue in business, order goods, pay employees, pay the rent, or enter into new contracts. If you go through a whole litany of things, the court and creditors will take a look at whether they were all legitimate decisions under the circumstances.

I will highlight fiduciary duties at the subsidiary level and at the holding company level.

Our fiduciary duties are owed to shareholders. There was a case in Canada about 15 years ago called the People's Jewellery Case, where the court held that directors do not have a fiduciary duty to creditors. Despite this, we still have remedies in provincial statute.

There is the Derivative Remedy which Ted highlighted and also the Oppression Remedy. If any shareholder or creditor or otherwise proper person thinks the business of the company was carried on in a way that was prejudicial to their interest, they can sue the directors personally.

I was involved in a recent case where a lawyer was named as a party defendant in the case of oppression, where the lawyer helped carry out the director's orders. The judges held there was no way the law firm could be held responsible for what happened.

The idea that the lawyers could be grouped in with directors in the actual law suit is important, so we have to be careful what legal advice we give to directors after insolvency.

We don't have fraudulent trading, but there is case law where directors have been sued personally for ordering goods and services when they knew the company would have no funds available to pay for those ordered.

If I have a meeting with clients who are concerned about the viability of their company I will say, if you order goods and services after today, please set aside funds to pay for it. Shareholders don't necessarily get involved in insolvency, since they are bottom of the list of creditors. If a company goes insolvent, unless directors have wrongly enriched themselves, shareholders don't often sue directors.

We have the same look back rules as the UK – once a company is insolvent under our statutory law, we will look back 12 months to see what was done. Any intercompany payments in that period will be reviewed and could be clawed back. For related company transactions, we can go back as far as five years.

We have a section of our income tax act that is very harsh on unpaid taxes. In Section 160 of the income tax act, if the government believes a director didn't pay withholding taxes or other taxes, they can go after directors personally. They can also look at what happened to the director's money, and, if they used it to pay living expenses or a mortgage they can recoup the money.

There are cases now where governments have gone after students for the repayment of tuition fees that directors have paid for their children to go to university. This has become a real area of concern for directors in Canada during the last few years.

Australia – JC Section 588V of the Australian Corporations Act 2001 is not a civil penalty provision and does not trigger any compensation remedies under Pt 9.4B (or any other provision of that Part). Further, a company that contravenes it is not guilty of an offence.

However, section 588W provides that a liquidator may recover for loss resulting from insolvent trading by the subsidiary from the holding company under the following circumstances.

- a corporation has contravened section 588V (1)
- the person to whom the debt is owed has suffered loss or damage in relation to the debt because of the company's insolvency
- the debt was wholly or partly unsecured when the loss or damage was suffered; and
- the subsidiary company is being wound up
- When the requirements are satisfied, the liquidator may recover from the holding company an amount equal to the amount of the loss or damage suffered as a debt due to the subsidiary
- Any proceedings to recover loss in this manner have a limitation period of six years.

The measure of compensation liability to which a holding company is exposed is expressed as the amount of the loss or damage suffered in relation to the debt, because of the subsidiary's insolvency, by the person to whom the debt was owed.

Where a payment order is made against a holding company under section 588 W and the court is satisfied that, at the time the subsidiary incurred the debt, the person who suffered the loss or damage knew that the subsidiary was insolvent or would become insolvent by incurring that or other contemporaneous debts, the court may order that the compensation paid to the subsidiary is not available to pay that debt unless all the company's unsecured debts have been paid in full.

There are defences provided under section 588X of the Corporations Act, being:

- the holding company directors had reasonable grounds to expect that the subsidiary company was solvent (able to pay its debts when due and payable) when it incurred the debts
- that a competent and reliable person was providing information in respect of the subsidiary company's solvency
- the holding company director did not take part in the management of the subsidiary company because of illness or some other good reason
- the holding company took all reasonable steps to prevent the subsidiary company from incurring the debt.

Section 588GA also creates a 'safe harbour' for directors to protect them from personal liability, and from the potential civil penalty exposure if section 588G (2) applies.

The provision protects directors from personal liability for debts incurred by an insolvent company if, after a director 'starts to suspect' that the company may become or is insolvent, the director starts developing a course of action that is 'reasonably likely to lead to a better outcome' for the company than the immediate appointment of an administrator or liquidator.

In order for the safe harbour to apply, the debt incurred by the company needs to be 'directly or indirectly' in connection with that course of action taken by the director.

The provision sets out several factors that may be considered when determining whether the steps taken by the director were reasonably likely to lead to a better outcome for the company.

SESSION THREE - BANKRUPTCY TRUSTEES

If a subsidiary goes bankrupt, can a receiver or bankruptcy trustee pierce the corporate veil and sue the holding company, making it liable for a subsidiary's debts, or even claim for damages?

England – DF You need to be fairly cautious about saying yes in a situation like this: there are a lot of questions that need to be considered in some detail. The main area to focus on is around the area of directors' responsibility in the various companies and, broadly, there are six or seven particular areas of misfeasance that the directors may have fallen foul of.

They are;
If they fail to act within their normal powers
If they haven't promoted the success of the company
If they haven't exercised independent judgment
If they haven't exercised reasonable care and diligence
If they haven't avoided conflict of interest
If they have accepted benefits from third parties
If they have not declared any interest in the proposed transaction

There is relief and a defence is possible, particularly where the director has acted honestly and reasonably, and, if the circumstances of the case mean it's fair to excuse them from liability.

One particular case showing how a court can apply this defence was that of D'Jan of London, where a director had failed to properly fill in an insurance form as a result of which the company lost money. The director held 99 per cent of the shares and the court felt that he had failed in his duty and yet, while they did make an order against the director, they reduced the amount due which would go to the company's creditors.

The other interesting principle we have in the UK is called the Duomatic Principle, where there can be a defence to director liability if it can be shown that shareholders who have a right to attend and vote in a general meeting, would have or did consent to what was happening. If the shareholders have actually ratified the relevant misfeasance or breach of fiduciary duty, then that is quite an interesting defence.

In terms of foreign multi-jurisdictional claims, the Principle of Comity exists between states around their accepted rules of mutual conduct. This means practically, that if you issue in one jurisdiction there is often no point in issuing in another which is really beneficial for creditors not to waste time and money in issuing in other jurisdictions. As such, it may be appropriate to go for an injunction in the foreign jurisdiction to stop those second proceedings and ask for recognition of process where you have started proceedings.

U.S – TS The trustee, which in the US is usually the bankrupt company itself, may prosecute for the estate any claims belonging to the bankrupt subsidiary against the parent company and its directors. These include such causes of action as restitution for unjust enrichment and recouping illegal dividends.

In some states, this category also includes a claim by the subsidiary to remedy abuses of the parent by piercing the subsidiary's own veil, so as to hold the parent responsible for the subsidiary's debts. In other states veil-piercing claims belong to individual creditors, not to the subsidiary.

Under the Bankruptcy Code, case law also recognises that the bankruptcy court may decree substantive consolidation of the bankrupt company and other entities. In rare cases, this can include merging a non-bankrupt parent company into a bankrupt subsidiary, thus effectively forcing the assets and liabilities of the parent into the bankruptcy estate.

This extraordinary remedy is available only if (1) the parent and subsidiary so disregarded their separate identities that creditors relied on the two companies as one, or (2) the companies' assets and liabilities were so thoroughly co-mingled that disentangling them would be prohibitively expensive and would harm the creditors of both companies.

The bankruptcy trustee also has special powers under the Bankruptcy Code to pursue avoidance claims and clawback remedies against insiders for preferential transfers made up to one year before the bankruptcy. This includes loan repayments and liquidation of inter-company accounts, by which the parent gained advantage as a creditor outside of the ordinary course of business.

These avoidance powers also apply to fraudulent conveyances, or transfers made by the insolvent subsidiary to the parent without receiving reasonably equivalent value in exchange, or ones intended to hinder, delay, or defraud the subsidiary's creditors.

A holding company and its directors cannot avoid suit merely because that company is not incorporated or otherwise present in a district where the bankruptcy is filed or because the directors reside elsewhere.

James Conomos pictured at the 2017 IR Annual Conference in Berlin

A summons and complaint for a bankruptcy adversary proceeding may be commenced by personal service or first-class mail anywhere in the United States. Service outside the US is also permitted by various means, including internationally recognised procedures.

Canada – FS Trustees in Canada are appointed either by a creditor, who brings an application to court to appoint a receiver, or, sometimes, under a general security agreement or debenture saying that the company is insolvent.

An unsecured creditor can bring an application for bankruptcy and a third-party trustee will be appointed and, of course, the company can make a voluntary assignment to bankruptcy in which case the company chooses the trustee.

Canadian trustees can prosecute anything, if they think that there was an unfair advantage given to directors, shareholders or creditors of the company. We have preference claims that are very similar to unjust preference claims in the UK and the US, where a trustee in bankruptcy can go to a creditor and say;

'You know in the last two months prior to bankruptcy you were paid CAD100,000 while nobody else got any money, so you have to give us that money back.'

There are a lot of lawsuits for return of what we call unjust preference claims to creditors.

A trustee will also look to reclaim any money paid to directors or related parties within a year of bankruptcy. They can look at contracts between a company and any related party, including lease and rental arrangements.

Trustees see rental arrangements as a possible way of stripping money out of a company. They can go after the company that owns the real estate and force them to pay back some of the money if the rental wasn't on the same terms as it would have been if it was a third party arrangement.

One thing to highlight, is that the rights of bankruptcy trustees are subordinate to the rights of the secured creditor. So, if you are a secured creditor who has appointed a receiver for example, a receiver will liquidate the assets and collect the money from the insolvent company before a bankruptcy trustee can become involved.

There are, however, two claims that a trustee in bankruptcy can pursue for the benefit of the estate and not just for the benefit of the secured creditor.

One is the unjust preferences I just talked about and the other one is fraudulent conveyance actions, where some of the assets of the company were conveyed, prior to the insolvency or bankruptcy, at an undervalue.

A trustee in bankruptcy could assert that claim independently of the secured creditor, since fraudulent conveyance claims and fraudulent preferences claims are seen as representative actions for the benefit of all creditors, not just secured creditors.

I'd like to wrap up by saying that we also have something in our Bankruptcy and Insolvency Act called Section 38 claims.

If a trustee in bankruptcy does not have funds in the estate to pursue claims against directors or related parties, or even third parties, they can ask the courts for an assignment of that claim under Section 38 and creditors can pursue those claims independently of the trustee.

Italy – MB Discussing this topic, two preliminary observations should be made. First, some recent legislative reforms in Italian bankruptcy law have made it harder for the bankruptcy trustee to start clawback actions. Second, the economic and financial crisis that still affects the Italian economy, often leaves the insolvent subsidiaries with few, if no, assets. These two factors, inter alia, constitute a big push for bankruptcy trustees to look to other possible sources for recovering money and pay the debts of the bankrupt company.

One of the main strategies of bankruptcy trustees for doing this is filing claims for liability of directors' and auditors, while another option is claiming liability of holding companies.

As mentioned before, in the case of abuse of legal personality, a holding company could be considered directly responsible for subsidiary indebtedness and the bankruptcy be extended to it. These claims can lead to very complicated legal issues, especially if the holding company is a foreign company because there are also issues with regard to jurisdiction and applicable law.

In the case of liability for direction and coordination, the damages that the bankruptcy trustee can claim are the ones suffered by the other shareholders (loss of value of their participation) and the creditors (loss of subsidiary's assets as guarantee of payment).

With regard to intercompany financing, all monies remitted to the holding company within one year prior to the declaration of bankruptcy must be refunded by the holding company, while, in general, the holding company, being a shareholder, is subordinated to all the other creditors of the subsidiary.

Damages that bankruptcy trustees can claim from the holding company and its directors generally include the surplus of indebtedness generated in case the parent company worsened the subsidiary's financial situation, for example through unjustified intercompany transactions, or keeping the subsidiary operative without taking care of, or delaying, a proper restructuring.

Bankruptcy trustees can also claim damages connected to a specific wrongdoing, for example, if money were funnelled upward to the holding company via a certain unjustified transaction, or if the subsidiary sold goods, services or other assets at below market price to the holding company, or to another company in the same group.

Australia – JC Ordinarily a trustee cannot sue a holding company unless the court is prepared to pierce the corporate veil.

One issue with the historical position is the tension between the use of the phrases 'lifting the veil' and 'piercing the veil'. While the principle of lifting the veil had an established set of common law principles, the courts are rather disinclined to describe a set of principles for the act of piercing the corporate veil. Hence the case law is relatively piecemeal and is not rigid in its application being more fact than principle based.

Australia adopted the UK veil piercing laws in Electric Light and Power Supply Corporation Ltd v Cornack (1911) 11 SR (NSW) 350. This was developed in the cases of Lipman v Jones and Adam v Cape which established three different grounds on which a court may elect to pierce the corporate veil: fraud, agency and group of companies.

The most relevant ground for trustee's seeking to pierce the veil to claim debt will be the group of companies' ground. The ground of fraud was raised in the case of Re Edelsten ex parte Donnelly, but was ultimately unsuccessful.

The trustee of Dr Edelsten's estate in bankruptcy commenced an action claiming that certain property owned by the VIP Group of companies had been obtained by Edelsten before the bankruptcy had been discharged. The trustee argued that the companies had been incorporated and used for the purpose of evading a legal obligation or perpetrating a fraud.

Subsidiaries may typically fall under the ground of 'group enterprises' where the parent company and subsidiaries are operating in such a manner as to make each individual entity indistinguishable. An argument that a subsidiary and parent company form a 'group enterprise' can be made where there are overlapping directors, officers, and employees or where there is a partnership between companies in a group.

A court may pierce the corporate veil on the grounds of 'group enterprises' where there exists a sufficient degree of common ownership and common enterprise.

Courts will typically not pierce the veil on the grounds of control alone. Rogers AJA, in Briggs v James Hardie & Co Pty Ltd (1989) 16 NSWLR 549 examined a 'group enterprises' argument that the plaintiff (a former employee of a subsidiary company who had contracted asbestosis) was entitled to pierce the corporate veil to sue the parent company, because it had the capacity to exercise complete dominion and control over its subsidiary and had in fact exercised that capacity. This argument was dismissed as entirely too simplistic.

Rogers CJ, in Qintex Australia Finance Ltd v Schroders Australia Ltd, noted that the development of the rigid application of the separate legal entity principle to corporate groups is problematic, often resulting in a divergence between the realities of commercial life and the applicable law.

IR Members pictured at the 2017 IR Annual Conference in Berlin

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