

TOPIC 2B: LIFTING THE CORPORATE VEIL

✎ As per the SLE doctrine, only the company can be held liable to outsiders – this creates a ‘corporate veil’

✎ Generally, the courts are ‘not free to disregard’ the SLE doctrine ‘merely because it considers that justice so requires (*Adams v Cape per Slade LJ*). However, where the SLE doctrine is misused, in exceptional circumstances, courts have lifted the corporate veil (*Briggs v Hardie*)

1. Common Law

A. FRAUD/AVOIDING LEGAL OBLIGATIONS

- A court will lift the veil where the co is set up as a ‘device ... cloak or sham’ (*Gilford*)/ ‘dummy company’ with the intention to engage in fraud (*Re Darby*)
- Only catches extreme conduct – an attempt to avoid existing personal legal duty
- ❖ E.g. in *Gilford*, D left company and term of K meant that he could not compete with them. Formed new company in order to avoid personal liability – court willing to pierce the veil.
- ❖ E.g. in *Jones*, D didn’t was to follow through with sale of house so sold it to a company that he created for this purpose. Court pierced the veil and ordered SP.

B. ACTING AS AN AGENT

- Where the company acts as an agent of its shareholders, liability will then fall on its principal
 - This idea is hard to reconcile with the rejection of the agency argument in *Salomon*
- HOWEVER, the courts have found an agency relationship between shareholders and company in exceptional circumstances (*Smith, Stone & Knight*)
- Factors to look at: (*Smith, Stone & Knight*)
 - Were profits treated as profits of the holding company?
 - Were persons conducting the business appointed by the holding company?
 - Was the holding company the head and brain of the trading venture?
 - Did the holding company govern the adventure and decide what capital should be embarked?
 - Did the holding company make the profits by its skill and direction?
 - Was the holding company in effectual and constant control?
- ❖ E.g. in *Smith*, there was no rent paid, no tenancy agreement, no remuneration paid to directors for their capacity as directors of subsidiary and separate accounts were not kept
- ❖ E.g. in *DHN*, subsidiary had no business of its own and parent owned all of its shares

C. CORPORATE GROUPS

- Judicial reluctance to lift the veil for corporate groups – mere exercise of control over a fiduciary by a parent co is insufficient in a group situation (*Qintex*)

I. NEGLIGENCE CLAIMS

- Where it can be found that a parent company directed or controlled its subsidiary’s operations and provided the subsidiary’s management, the parent co may owe a DOC to subsidiary’s employees (*Wren*)
- Need to show a high level of control (*Young*)
- **POLICY:** holding company is best equipped to deal with tort + tort victim has little choice in who to use + doesn’t result in unlimited liability because reveals another co not a natural person (*Hardie*)

2. Statute

A. INSOLVENT TRADING FOR DIRECTORS

✍ Under *ss 588G (1) and (2)*, a [D] has a duty to prevent the company from incurring a debt whilst insolvent if there were reasonable grounds for suspecting insolvency.

I. DIRECTOR?

- [D] must have been a director at the time when the company incurs a debt *(a)*
- **s. 9:** A director is a person who:
 - is appointed to the position of director; *((a)(i))*
 - is appointed to the position of alternate director; *((a)(ii))*
 - unless the contrary intention appears, acts in the position of a director; *((b)(i))*
 - Known as 'de facto directors'
 - Applies where intended to be appointed but there was some defect
 - Also catches those who continue to be heavily involved even after their term ends (Austin)
 - Applies to persons given another title to avoid this provision e.g. manager *(Grimaldi)*
 - unless the contrary intention appears, the directors of the company or body are accustomed to act in accordance with the person's instructions or wishes *((b)(ii))*
 - Known as 'shadow directors'
 - Must show a pattern of conforming ('actuality of control') + that they influenced key decision makers (don't have to influence the whole board, just governing majority) *(Antico)*
 - Does not apply merely because the directors act on advice given by the person in the proper performance of functions attaching to the person's professional capacity *(Buzzle)*

II. SOLVENCY?

- A co is insolvent when they are unable to pay all their debts as they become due and payable *(s. 95A)*
- What debts are taken into account?
 - HC has broadly construed this to include all claims, liquidated or not and whether due, prospective or contingent *(Bank of Australia v Hall)*
 - Another way of defining it: 'all claims that are provable in the winding up'
- When are debts due and payable?
 - Must take into account all debts that are due in the 'immediate future' – this can include debts that are looming in the upcoming months – 90 day rule *(Hall)*
 - Strict legal approach states that leniency of creditors should not be taken into account unless it has a legal effect, such as where it creates an estoppel or involves variation of the original K *(Carrier)*
 - Cf. some decisions state that a more commercially realistic approach should be taken, so that an informal extension of time pushes back the debt due date *(Calzaturificio Zenith)*
- When is a debtor 'unable to pay' debts?
 - Unable to pay ≠ lack of liquidity *(Brooks)*
 - Funds that can be raised through sale or charge of its assets can also be taken into account
 - Funds, unsecured or otherwise provided by a third party are also able to be taken into account
- Presumptions of insolvency?
 1. Presumption that once insolvency is established, it continues.

- That is, if company is shown to be insolvent at a particular time in the last 12 months then it is presumed that insolvency continues
- 2. Presumption that if fails to keep financial records, then insolvent in that period
 - This presumption will not arise if the failure relates to minor or technical contravention, nor where the contravention resulted from a third party destroying, concealing or removing the records (*s. 588E (6)*)
- 3. Presumption that if insolvent in other proceedings, then insolvent for proceedings at hand
 - This relates to proceedings that are for the purpose of recovery

III. INCURRING OF DEBT?

- ✎ Debt incurred = co subjects itself to an unavoidable obligation to pay money at a future time (*Hawkins*)
- Debt must be incurred voluntarily
 - Does not include liability for sales tax (*Castrisios v McManus*)
 - Does include payroll tax (*CST v Pollock*)
- A debt may be incurred even though it is contingent and the amount is uncertain (*Plymin*)

NB. TIMING OF DEBT IS SUPER IMPORTANT!

Action of a company (s. 558G)	When debt is incurred
Paying a dividend	When dividend is paid for/declared (if consti allows declaration)
Making a share capital reduction	When the reduction takes effect
Buying back shares	When the buy-back agreement is entered into
Redeeming preference shares	When the co exercises the option
Issuing redeemable preference shares	When the shares are issued
Financially assisting person to acquire shares in co/holding co	When agreement, or, if no agreement, when assistance is provided
Entering into an commercial transaction	When transaction is entered into.

- ‘As [debt] may be classified as a debt, and [was incurred whilst the co was insolvent], given [time]/[rendered the co insolvent], *s 588(1)(b)* is satisfied’. *Ss 588G(1)(a)* and *(d)* may now also be considered satisfied, given the timing of [debt] and its nexus with [D’s] directorship.’

IV. REASONABLE GROUNDS FOR SUSPECTING INSOLVENCY?

✎ ‘[D] does not contravene *s 588G* just because co is insolvent at the time of [debt], there must also be reasonable grounds for suspecting insolvency (*ss 588G(1)(c)*).’

- **Suspecting** = positive feeling of misapprehension of trust (*Bacon*)
- Look at **Plymin** indicia of insolvency:
 - Incurring **substantial trading losses**
 - Suppliers paid well **outside trading terms** (see also ASIC Registry Guide 217)
 - Suppliers asking to be **paid cash** on delivery
 - Company issuing **post-dated cheques**
 - **Threatened legal proceedings re non-payment** of debts
 - **Overdue taxes**
 - **Inability to obtain further loan finance** from banks/raise further equity capital

- Bank transferring facilities to an entity for **high risk accounts** (occurred on facts)
- **Dishonoured cheques**
- **Special arrangements** with selected creditors
- Solicitors' **letters, summonses, judgments, or warrants issued** against the company
- **Inability to produce timely and accurate financial information** to display the company's trading performance and financial position and make reliable forecasts.
- Payments to creditors of **rounded sums**, which are not reconcilable to specific invoices

V. AWARE OF GROUNDS OR SHOULD HAVE BEEN AWARE?

- ✍ 'As per **s 588G (2)**, it is not enough that there be reasonable grounds to suspect insolvency, [D] must be aware or should have reasonable been aware of those grounds.
- **'Aware of such grounds'** = subjective test on the balance of probabilities
- **'Reasonably aware of such grounds'** = objective test which imports a standard of a D of reasonable competence and diligence, seeking to properly perform duties and be reasonably informed
 - Look at whether duties performed properly, a regular list of creditors exists and director is seeking to be reasonably informed (*Plymin*)
- ✍ 'Given ___, there were therefore reasonable grounds for suspecting insolvency, and [D] ought to have been aware of such grounds. **S 588G(1 + 2)**'s requisite elements would therefore likely be established'.

VI. FAILURE TO PREVENT COMPANY INCURRING DEBT

- It need not be established that [D] failed to take particular steps, such as prevent incurring of debt or stop trading (*Plymin*) – inactivity is caught (*Pylmin*), as is activity (*Poolman*)
- 'On balance, [D] has failed to prevent the co incurring the debt and has therefore contravened **s 588G(2)**'. [D] may/may not be exculpated under **s 588H**, however...

VII. DEFENCES

- ✍ If ASIC is able to establish all of the above elements, [D] should seek to rely on a defence in **s. 588H**

1. Reasonable grounds to expect solvency (**s. 588H (2)**)

- Defence to prove that at the time the debt was incurred, [D] had **reasonable grounds to believe that the company was solvent and would remain solvent**
- Onus on [D] to prove reasonable grounds (*Plymin*)
- Higher standard than 'mere hope or possibility' or 'suspecting' (*Poolman*)
- Must satisfy 'necessary commitment to an involvement with the management of a co in financial difficulties' for the defence to be available (*Spigelman CJ in DCT*)
- ❖ E.g. in *McLellan*, no RG based on company's stock inventory. Court said it was not reasonable that the stock could be sold in time to affect the payment of debts.

N.B. this defence *will rarely be made out* because in order to make out cause of action must show that D was aware of insolvency grounds of reasonably should have been aware

2. Reasonable reliance (**s. 588H (3)**)

- Defence if D had reasonable grounds to believe, and did believe
 - (a) that a **'competent and reliable person was responsible'** for providing financial info, and
 - (b) the D expected, **on the basis of that info**, that the co was solvent and would remain so
- ❖ E.g. in *McLellan*, no RR despite accountant claiming company was insolvent. A was not given specific role to provide such advice – merely employed to give general accountancy advice

3. Illness or other good reason for non-management (s. 588H (4))
 - Defence to show that at the time when the debt was incurred, it is proved that because of **illness or for some other good reason**, X did not take part in the management of the company
 - Total failure to participate is not a reasonable ground for non-management (*DCT v Clark*)
4. Took all reasonable steps to prevent incurring of debt (s. 588H (5))
 - Defence to show that X took **all reasonable steps** to prevent the incurring of debt including:
 - Any action the person took with a view to appointing an administrator of the company;
 - When that action was taken; and the results of that action
5. Acted honestly having regard to circumstances of the case (s. 1317S (2))
 - Defence where there are proceedings for a contravention for a civil penalty and the person has:
 - i. **acted honestly**; and
 - ii. having regard to regard to all the circumstances of the case, the person **ought fairly to be excused** for the contraventionthe court may relieve person wholly/partly from a liability to which they would be otherwise subject
 - ❖ E.g. in *McLellan*, defence made out b/c sought to take action to increase sales, relied on external advice, sought investors to provide further capital and monitored company assets
 - ❖ E.g. in *Hall*, defence made out b/c active steps taken to increase sales, corresponded with ATO about tax liabilities and relied upon advice

VIII. CONSEQUENCES OF BREACH

- Liquidator may apply for compensation order against director (s 588M)
- Creditor may take action if liquidator consents or fails to sue (s 588R-U)
- Criminal penalty applies where director acted dishonestly (s 588G(3))
- ASIC may bring action for breach of a civil penalty provision (s 1317E)
- Comp order for losses may be made when Court makes CPO (s 588J) or in criminal proceedings (s 588K)