# Paying back the debt

**ANDREW MUSCAT: *The Liability of the Holding Company for the Debts of its Insolvent Subsidiaries*, Dartmouth Publishing Company, 1996, xlviii + 521pp.**

1997 finds Maltese company law in an interesting stage of its development. In force since January 1, 1996, the Companies Act, 1995 owes a great deal not only to the local Commercial Partnerships Ordinance of 1962, but also to recently enacted UK statutes, principally the Companies Act of 1985, which had in its own words consolidated the "greater part of the Companies Acts" then in force, and the Insolvency Act of a year later. The 1962 Ordinance had been broadly modelled on the UK Companies Act of 1948, which had itself consolidated UK company legislation to that date. For these reasons, the debt we continue to owe to our former colonial administrators in this field remains, for better or for worse, a considerable one.

This book pays back part of the debt. Dr Muscat's recently published study forms an important contribution to the development of UK company law in an area constantly in need of clarification and of new solutions to problems that keep arising in situations where a domineering parent company may be observed calling the tune to a number of satellite dependent subsidiaries. This phenomenon is hardly a new one, but Dr Muscat's approach is to take a comprehensive fresh and challenging look at the subject, including a detailed assessment of the current state of development of UK statute and case-law. In particular, he analyses the various remedies already available for the protection of third parties who may have dealt with such subsidiary and have suffered financial loss as a result of the latter's inability to settle its debts.

This exercise takes the author back to the very origins and first principles of UK company law, a journey which uncovers the background to developments which some of us, to our great loss, now take so much for granted. These include such critical issues in company law as the concept of separate juridical personality, limited liability, the protection of creditors, wrongful trading and the accountability of directors and shadow directors, the one-man company and the use of 'dummy' shareholders, and the often controversial technique of lifting the corporate veil.

The author traces the conversion of incorporation from a privilege of the few to a generally available right, the controversy that accompanied the introduction of limited liability in the early 1800s, and the impact of the House of Lords decision in the famous (or notorious) Salomon case which fortified the rule of separate legal personality for companies whose shares were basically held by a single person rather than by a number of partners.

He then proceeds to review critically the various attempts by the judiciary at lifting and piercing the veil of incorporation in order to combat the abuse of separate incorporation and limited liability, whereby a parent company protects its interests and assets by setting up and then controlling the corporate and business life of its subsidiaries, whose profits it takes but whose liabilities it disowns.

Andrew Muscat is the Head of the Department of Commercial Law at the University of Malta within the Faculty of Law. He recently acquired his Ph.D. from the University of London. Published towards the end of last year, this hardback is an updated and revised version of his Ph.D. thesis. The work constitutes a considerable volume and not only because of its 521 pages, but also because it is filled with analyses, ideas, relevant up-to-date information and case-law, and proposals for reform on its subject.

The title itself appears quite a mouthful, but it is precise and appropriate. Indeed, to the unsuspecting, the title of this work may give the impression that the book is only of specialised or limited interest.



## by David Fabri, LL.D.

One may have been excused for thinking that this book speaks only of groups of companies, of the legal relations between a holding company and its subsidiaries, the consequences of insolvent subsidiaries, and similar rather specialised (some might say obscure) subjects that are of practical use or of interest only to a limited few. Happily this is not the case, because while the parent-subsidiary phenomenon remains the main focal point of the book, Dr Muscat delves into the very roots of the issues involved, unearthing in the process some of the very fundamentals of company law.

To the more general reader, I would strongly recommend Chapter 3, significantly entitled "The Relevance of Ordinary Principles to the Question of Inter-Corporate Liability", which contains an interesting investigation of the historical evolution and interplay between the two concepts of separate legal personality and limited liability. The author rightly concludes that "however closely linked the two notions may be, it does not follow that limited liability is an inevitable consequence of separate personality. In other words, corporate personality does not necessarily exclude or limit the members' liability". The reader is invited to read this chapter and discover why.

Inevitably, the work traces the evolution of the use of companies as shareholders and as directors in other companies. It reveals that the original English company law statutes, largely enacted in the first part of the 19th century, raised no obstacles to this development, which effectively opened the way for the setting up of groups of companies as we know them today. Under the rules contained in the early statutes, any company irrespective of its ownership and control was considered a single and distinct person for all purposes of law, with no responsibility for any other company's debts, regardless of possibly intimate relationship of ownership or control between them. The only restriction required that the necessary power to acquire shares in other companies had to result from the Memorandum.

These features made the holding-subsidiary relationship possible and allowed groups of companies to evolve and flourish. It seems that the English legislators had failed to anticipate the extent to which companies would soon start holding the majority of shares in other companies, a development which eventually rendered the corporate group "the predominant form of doing business", at least in England. Created and developed to regulate the "single-company", English company law was soon found wanting and is indeed still considered largely inadequate in (a) regulating the general phenomenon of groups of companies as economic entities which merit attention in their own right, and (b) establishing the specific heads of liability that may be imposed on the holding company of a group for debts of insolvent subsidiaries. In this latter area, the book offers a number of quite radical and lucid proposals for reform.

Dr Muscat is not blind to the risks of over-regulation and of the financial cost implicit in an increased rule-book. His warning that "excessive regulation of the holding company may kill the goose that lays the golden egg" (p. 476) is a useful and topical one to ponder at the current stage of development of our corporate and financial services legislation, which particularly since 1994 has experienced a radical transition, involving a considerable amount of new laws and regulations.

Earlier, in a footnote to a discussion on the philosophy and the objectives of company law (p. 141), he complains that "unfortunately, company law is actually becoming more and more regulatory. The sheer length of the C.A. 1985 and related primary and subsidiary legislation has made the subject virtually unmanageable". Seeing that the English Companies Act of 1985 was one of the principal sources of the provisions of our Companies Act, 1995, this is a real danger which we must watch out for.

Although the book is primarily concerned with the position prevailing in English law, it continuously refers for comparative law purposes to American law, because in the author's words, this is the most "naturally or functionally comparable" legal system (p. 43). One searches in vain for any hints or notes relating to the legal situation in Malta, which is of course beyond the intentions of the work. In any event, to my knowledge, Maltese law does not seem to have made any significant contribution to the development of legal principles in this area. Dr Muscat's original study makes up for this.

In reality, it is rather difficult to gauge to what extent the corporate group may be considered a predominant form of undertaking in modern local business practice. The relevant data required for this purpose may not be easily available. Insofar as the law itself is concerned, the 1962 Ordinance expressly permitted the appointment of companies as directors in other companies. Section 97 defined the holding-subsidiary relationship and prohibited a subsidiary from holding shares in its parent, and from providing financial assistance for the purpose of acquiring such shares. Section 127 further prohibited a subsidiary (not being a private exempt company) from giving a loan or other financial assistance to a director of its parent. The Ordinance also required the accounts of a parent to disclose the amount of fees and emoluments, if any, received by its directors from a subsidiary.

One may therefore broadly state that the Ordinance contained only a few scattered references to the holding-subsidiary relationship. The Ordinance recognised this relationship but kept back from attempting to regulate it in any exhaustive manner.

The new Companies Act introduces a number of new rules and provisions directly concerned with the holding-subsidiary relationship. A number of provisions clearly accept, indeed assume, that a company may hold any amount of shares in another, and may also serve as its director. The so-called "interpretation section" (section 2) now contains definitions of such indicative terms as consolidated accounts and group company, together with a full page explanation of the notion of parent company and subsidiary undertakings.

The Act has introduced significant new regulations concerning group accounting and it may now be briefly and generally stated that subject to a few exceptions, wherever a group exists, the directors of the parent company are obliged to prepare consolidated financial statements. These statements are expected to give "a true and fair view of the assets, liabilities, financial position and profit or loss of the undertakings included therein as a group" [section 171 (3)]. The directors' report too is now obliged to explain the principal activities of subsidiaries and to incorporate "a fair review of the development of the business of the company and its subsidiaries".

However, the Act does not contain any provisions which specifically deal, in principle or in detail, with the question of a parent's liability for the debts of its subsidiary. Possibly the Act could not successfully do this in the absence of a more comprehensive regulatory framework dedicated to corporate groups. Such a law of groups has been introduced with apparently mixed results in Germany.

It may here be pointed out for the sake of completeness that the concept of a group of companies is in fact given a degree of legal recognition also in our fiscal legislation, especially the Income Tax Act and the Duty on Documents and Transfers Act. The former provides for capital gains exemption for intra-group transfers of shares or other assets and for group loss relief; the latter Act allows certain exemptions from duty for transactions involving the transfer of shares in a restructuring exercise within a group of companies as defined in the Act itself, and for certain intra-group transfers of immovable property.

For those of us interested in consumer protection, there are at least two areas in this work which may be highlighted. The first relates to the possible liability of a parent for the wrongful trading by a troubled subservient subsidiary which continues to trade to the detriment of persons dealing with it, including consumers. Dr Muscat's conclusion here is more or less negative because "despite the wide array of rules at its disposal, the law still fails to adequately remedy the abuse and unfairness that can flow from the subservient subsidiary situation" (p. 202). The second refers to a brief but interesting note on American product liability cases featuring famous brand names as Chrysler Corporation and Remington Arms (pp. 431-2), where a parent company has been held liable for damages caused to an end-user by a subsidiary.

In typical understatement, Dr Muscat describes his effort as a "modest contribution", which he hopes may "kindle the debate" on the whole question of whether, when and how a holding company can be attributed liability for the debts of its insolvent subsidiary (p. 483).

What is perhaps the most striking feature of this effort is the author's refusal to take anything for granted, and this refers in particular to concepts and principles which in time may have assumed an aura of fossilised respectability and apparent immutability.

This book seeks to present a useful fresh analysis and appraisal of the objectives and philosophy of company law from three perspectives – legal, social and economic. Indeed, one of the critical themes running through the work is a relentless concern with the various forms of abusive manipulation of the corporate form and of group structures to the detriment of creditors and society. It also stands to the credit of this study that it never considers the moral dimension and implications of its subject-matter as too remote or of only minor relevance:

"... in the commercial context at least, justice and fairness demand both the supremacy of substance over the form or colour of things – of reason over quibbles and quillets – as well as the provision of adequate remedies for losses or injuries caused by others. The truth is that ordinary people readily recognize injustice or unfairness... The gap between commercial morality and the law has to be closed. New and higher standards of law become imperative in response to the demands by the community for higher standards of just and fair dealing." (pp. 140-141).

*Dr Fabri lectures on financial services and consumer legislation at the University of Malta*