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SOME PROBLEM AREAS RELATING TO INSOLVENCY OF COMPANY GROUPS AND THEIR CONSOLIDATION: A COMPARATIVE STUDY

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CHAPTER 1: INTRODUCTION

1.1 Research Problem

Insolvency of company groups can be approached via two different theories, namely, the enterprise theory and the entity theory.[1] The former refers to the notion that a company and all of its subsidiaries are to be treated as a single unit in the case of insolvency and the latter refers to the notion that subsidiaries and related companies should be treated as separate entities and their separate legal personality is to be strictly maintained.[2] The dissertation seeks to determine whether provision should be made for the consolidated approach, as has been done in other jurisdictions, or whether the principles set out in *Salomon v Salomon*[3] should continue to find strict application in South African insolvency law.

The present Companies Act of 2008[4] recognises the existence of company groups and defines a group as a holding company and all of its subsidiaries.[5] It defines a holding company as a juristic person that controls a subsidiary in any of the manners found under sections 2(2)(a) or 3(1)(a) of the Act.[6]

The insolvency of company groups brings with it a number of complexities which are not evident in the insolvency of a single freestanding company. The main concerns are those of abuse of a holding company's position over its subsidiaries and the possible prejudice that may be suffered by creditors when one or more members of a company group enter insolvency proceedings.[7]

A number of jurisdictions including New Zealand, Australia,[8] Brazil[9] and Germany[10] have recognised the need for rules and guidelines for the insolvency of company

[1] Graulich TE, *Substantive Consolidation - A Post-modern Trend*, 14 American Bankruptcy Institute Law Review 527, 2006 at 529.
[2] Graulich TE, 2006 at 529.
[3] *Salomon v Salomon & Co Ltd* 1897 AC 22.
[4] Act 71 of 2008.
[5] S 1 Act 71 of 2008.
[6] S 1 Act 71 of 2008.
[7] Stevens RA, *The External Relations of Company Groups in South African Law: A Critical Comparative Analysis*, LLD, 2011 at 8.
[8] The In-house Lawyer, *How are groups of companies treated on the restructuring or insolvency of one or more members of that group? Is there scope for coordination between office holders?*, 2018, available at https://bit.ly/2W1WHL7 (accessed on 29 May 2018).
[9] Trench, Rossi & Watanabe, Brazil: Substantive Consolidation Under Brazilian Insolvency Law, Baker McKenzie, 2017, available at https://bit.ly/2T9TjMp (accessed on 29 May 2018).
[10] Bruder F, *Germany introduces legislation to facilitate corporate group insolvencies (Konzerninsolvenzrecht)*, 2017, available at https://bit.ly/2T4Uix9 (accessed on 29 May 2018).

groups. Part three of UNCITRAL's legislative guide has made suggestions as to how corporate groups should be approached on both domestic and international level.[11] Chapter V of the recast European Insolvency Regulation has also addressed the need for cooperation in group insolvency proceedings and has set out extensive rules for cross border insolvency proceedings involving members of company groups.[12]

The South African Insolvency system does not address the problem of the insolvency of company groups in its insolvency legislation.[13] It does not provide for the consolidation of assets in the insolvency of company groups or, perhaps less controversially, guidelines for insolvency practitioners involved in these procedures in the form of procedural consolidation.[14] There is only one provision in South African law in which the creditors of a non-insolvent debtor are prejudiced at the expense of the insolvent's creditors.[15] This can be found in section 21(5) of the Insolvency Act which provides for the rebuttable presumption that the assets of a solvent spouse married out of community of property should fall into the insolvent estate of the insolvent spouse.[16] This provision finds no application in corporate insolvency and it must also be noted that it has been criticised by various authors.

1.2 Assumptions

1. Company groups have become more prevalent over the years and account for a greater percentage of juristic persons.
2. There has been a trend towards the enactment of legislation to cater for the insolvency of company groups.
3. Not all jurisdictions have opted to allow for the substantive consolidation of company groups in insolvency.
4. Most jurisdictions have taken the softer approach which merely allows the procedural consolidation of insolvency proceedings.

[11] United Nations Commission on International Trade Law, UNCITRAL Legislative Guide on Insolvency Law, Part three: Treatment of enterprise groups in insolvency, 2012 at 19-79.
[12] *Official Journal of the European Union, Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings (recast)*, Chapter V.
[13] Stevens RA, *The External Relations of Company Groups in South African Law: A Critical Comparative Analysis*, LLD, 2011 at 370.
[14] Stevens RA, LLD, 2011 at 370.
[15] Stevens RA, LLD, 2011 at 373.
[16] S 21(5) of the Insolvency Act 24 of 1936.

5. Most jurisdictions will adopt a more favourable approach towards consolidation in business rescue proceedings.
6. Substantive consolidation should only be allowed in extreme cases and under clearly defined conditions.

1.3 Research Questions

1. What is the phenomenon of a company group, how is it characterised in company law and what challenges present themselves in insolvency?
2. What are the approaches taken in terms of international insolvency law with regard to the law of New Zealand and other foreign jurisdictions, how are they particular to their jurisdictions and how do other common law systems compare to each other and South Africa?
3. What is the approach taken in South Africa and how does it compare to that of the foreign legal systems that were analysed?
4. How does the approach change when one looks at the distinction between liquidation and the business rescue procedure?
5. What recommendations have been made by UNCITRAL, the World Bank and various authors with regards to substantive consolidation?
6. In conclusion, what lessons can be learnt for the South African insolvency system?

1.4 Motivation and objective

After being exposed to cross border as well as some foreign insolvency dispensations during my International Insolvency Course, I was alerted to the differences in approaches with regard to the insolvency of company groups. New Zealand's approach towards this problem, which allows for the pooling of assets in certain circumstances, specifically struck me as being in stark contrast with the South African dispensation. Upon further research it becomes clear that New Zealand is not the only country to have specific measures in place for the insolvency of company groups. Countries such as the USA, Ireland,[17] Germany[18] and Brazil[19] also provide

[17] Farrar J, *Piercing the corporate veil in favour of creditors and pooling of groups - a comparative study*, Bond Law Review, Volume 25, Issue 2, Article 6, 2013 at 33.
[18] Stevens RA, LLD, 2011 at 373.

for some sort of consolidation for the consolidation of company groups under certain circumstances. Even cross border dispensations such as the UNCITRAL[20] and the EU Recast regulations[21] have made suggestions and provision for cross border insolvency of company groups.

The objective of the dissertation therefore is to conduct comparative research to determine whether or not it could be advantageous for South Africa, who does not seem to make any provision for the insolvency of company groups, to adopt provisions similar to those dispensations that do provide for some sort of consolidation – either substantive or merely procedural – under specific circumstances.

1.5 Approach and methodology

A desktop approach is followed in conducting the dissertation which first and foremost sets out what a company group entails and what challenges they may present in the case of insolvency. This is followed by a comparative analysis of how company group insolvencies are approached in a select number of countries and these are compared to the South African approach. The South African approach to company groups is then discussed in light of the development in this area of the law and keeping in mind the international approach to company groups. In conclusion, the comparative research informs the possible lessons for the South African insolvency system and potential future reform. The dissertation is updated and refers to sources available on or before 10 October 2018.

1.6 Structure

The dissertation is structured as follows:

Chapter 1 introduces the research and sets the scene for the remainder of the dissertation. It explains the research problem, research questions, the motivation for the research and the objective, the approach and methodology used and how the dissertation is structured.

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[19] Trench, Rossi & Watanabe, Brazil: Substantive Consolidation Under Brazilian Insolvency Law, Baker McKenzie, 2017, available at https://bit.ly/2T9TjMp (accessed on 29 May 2018.
[20] United Nations Commission on International Trade Law, 2012 at 19-79.
[21] Chapter V of Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings.

Chapter 2 deals with the company group, its history and what challenges groups bring with specific reference to insolvency proceedings.

Chapter 3 contains a comparative analysis of how company groups are treated in other common law jurisdictions, namely, New Zealand, the United States of America and the United Kingdom.

The South African approach to company groups in insolvency is discussed in Chapter 4. It contains a brief discussion of the situation prior to the Companies Act of 2008, which is followed by the position after the Companies Act of 2008 came into force with reference to piercing of the corporate veil and recent case law.

Chapter 5 deals with international instruments and, more specifically, the recommendations made by UNCITRAL and the World Bank.

Chapter 6 is a summary of the preceding chapters and contains concluding remarks regarding the dissertation as a whole.

The dissertation ends with a bibliography showing the sources used in compiling it.

CHAPTER 2: THE COMPANY GROUP

2.1 What is a company group?

Although the company group has been defined differently by various authors, the essence of the definition remains unaltered. Jooste defines a group of companies as "two or more companies [that] are in a holding/subsidiary relationship with each other".[1] Eisenberg defines a corporate (company) group as "two or more corporations that are affiliated in a manner that depends in significant part on stock ownership".[2] The Companies Act simply defines a group of companies as "a holding company and all of its subsidiaries".[3]

It is clear from the above that the holding/subsidiary relationship is central to the concept of the company group. It is therefore important to have a clear understanding of what constitutes a holding company and a subsidiary. The Act defines a holding company as "a juristic person that controls that subsidiary as a result of any circumstances contemplated in section 2(2)(a) or 3(1)(a)".[4] The Act defines a subsidiary in a comprehensive manner:

> (1) A company is (a) a subsidiary of another juristic person if that juristic person, one or more subsidiaries of that juristic person, or one or more nominees of that juristic person or any of its subsidiaries, alone or in any combination-
>
> (i) is or are directly or indirectly able to exercise, or control the exercise of, a majority of the general voting rights associated with issued securities of that company, whether pursuant to a shareholder agreement or otherwise; or
>
> (ii) has or have the right to appoint or elect, or control the appointment or election of, directors of that company who control a majority of the votes at a meeting of the board; or
>
> (b) a wholly-owned subsidiary of another juristic person if all of the general voting rights associated with issued securities of the company are held or controlled, alone or in any combination, by persons contemplated in paragraph (a).[5]

Control, being an important element of the above definitions, is also defined in the Act.[6] Control exists when a "juristic person is a subsidiary of that first person" or, on the basis of the principle of the majority vote, when a person has control over the majority voting rights which may be exercised both directly or indirectly through voting on a board meeting.[7] It is important to note that the Act only recognises the right

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[1] Cassim FHI et al, *Contemporary Company Law,* 2011 at 179.
[2] Gillooly M, *The Law Relating to Corporate Groups*, 1993 at 1.
[3] S 1 Act 71 of 2008.
[4] S 1 Act 71 of 2008.
[5] S 3 Act 71 of 2008.
[6] S 2(2) Act 71 of 2008.
[7] Delport PA, *Henochsberg on the Companies Act, 71 of 2008*, 2018 at 32(4).

to appoint or elect or to control these two functions and therefore excludes the power to remove directors from the board.[8] The Act also makes provision for control outside the ambit of voting rights for a person who is able to "materially influence the policy of a juristic person in a manner comparable to a person who . . . would be able to exercise an element of control referred to" in the abovementioned scenarios.[9] The Act therefore extends the definition of control beyond strict majority voting power and recognises *de facto* control, which may be a result of *inter alia* veto rights, rights of first refusal or minority control due to shareholder apathy.[10]

Company groups may also assume different structures, namely, the wholly owned group where the holding company holds 100% of the shares of its subsidiary,[11] the publicly held group, where the holding company holds a controlling share of its subsidiary[12] and finally, the less prolific horisontal group in which each member of the group, consisting of around ten members, owns a small share in another member resulting in a large (30-50%) shareholding of the group in each member.[13]

Company groups have become the norm as opposed to the exception in our modern economy[14] and some of these groups today have even grown to the size of national economies.[15] Global Justice Now published a table in 2016 comparing the economies of countries with those of large corporations and placed a staggering 69 corporations within the top 100 in order of revenue produced.[16] However, the phenomenon of company groups is not a recent development.

2.2 Company groups historically

Company groups have been in existence for over a hundred years and will remain in existence indefinitely. The first examples of company groups can be found in the law of the United Kingdom (UK) and the United States of America (USA).

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[8] Delport PA, 2018 at 32(4).
[9] Delport PA, 2018 at 32(4).
[10] Delport PA, 2018 at 32(4).
[11] Gillooly M, 1993 at 4.
[12] Gillooly M, 1993 at 7.
[13] Gillooly M, 1993 at 9.
[14] Gillooly M, 1993 at xix.
[15] Blumberg PI, Strasser KA, Georgakopoulos NL, Gouvin EJ, *Blumberg on Corporate Groups*, Second Edition, Issue 1, 2004 at 1-4.
[16] Green D, *The world's top 100 economies: 31 countries; 69 corporations*, The World Bank, 2016, available at *https://blogs.worldbank.org/publicsphere/world-s-top-100-economies-31-countries-69-corporations* accessed on 23 July 2018.

Under early US common law companies were not allowed to hold shares in other companies.[17] However, in 1888 the practice of authorising companies to do so under charter commenced, and later New Jersey adopted provisions allowing companies to hold shares in other corporate entities.[18] The difficulty in merging or acquiring shares in companies, in states that had not yet imposed provisions allowing for shareholding in other companies, brought about the phenomenon of the holding company.[19]

The UK, like the US, also prohibited the holding of shares at first but in 1867 allowed it, provided that the MOI (Memorandum of Incorporation) of the company made provision for it.[20]

In South Africa, the Companies Amendment Act 23 of 1939 brought with it the definition of a subsidiary.[21] The aim of this part is to provide a brief overview of how groups of companies came into existence and when they started to feature in our economy.

2.3 Challenges presented in insolvency

Company groups present a number of corporate-law issues, not all of which are entertained in the dissertation. However, the issues and difficulties related to the insolvency of company groups are of particular interest. The element of control as referred to above ultimately allows for a company group to be managed as a single economic unit.[22] This makes it possible to conceal the economic reality of a group of companies and lends itself to possible abuse.[23] It is in fact this control or "power" of a holding company over its subsidiary that gives rise to the challenges associated with the group structure.[24] In essence, this could result in a subsidiary being run for a related company and not for its own benefit.[25]

Stevens places the problems related to company groups in two separate categories, namely, those internal to the group structure and those external to company

[17] Botha DH, *Groups in South African Law*, LLD, 1981 at 6-7.
[18] Botha DH, *Groups in South African Law*, LLD, 1981 at 7.
[19] Botha DH, *Groups in South African Law*, LLD, 1981 at 8.
[20] Botha DH, *Groups in South African Law*, LLD, 1981 at 8.
[21] Botha DH, *Groups in South African Law*, LLD, 1981 at 9.
[22] Botha DH, Recognition of the group concept in company law (1982) 15 De Jure 107 at 108.
[23] Cassim FHI et al, *Contemporary Company Law,* 2011 at 180.
[24] Botha DH, *Groups in South African Law*, LLD, 1981 at 3.
[25] Botha DH, *Groups in South African Law*, LLD, 1981 at 3.

groups.[26] The internal problems are those related to corporate governance and here two main problems can be identified, namely, the fiduciary duties of directors within a company group and, secondly, minority shareholders forming part of company groups.[27] The external problems, on the other hand, are those related to voluntary and involuntary creditors of a member of a company group and the problem of insolvency of one, multiple or all members of a company group.[28]

Finally, Stevens also mentions inter-group debts which arise as a result of inter-company transactions within a group of companies and between related companies.[29] These have both internal governance implications and external implications due to the contractual nature of these transactions.[30] The use of inter-company transactions may therefore be used to weaken a subsidiary's position without divulging this to the creditors of that company.[31]

Eisenberg proposes three different approaches to the problem of the rights of creditors of corporate groups.[32] These are, firstly, the denial of limited liability to holding companies;[33] secondly, the notion that the obligations of a subsidiary towards a holding company should have a weaker preference than the obligations to an external creditor;[34] and thirdly, allowing the court to consolidate the subsidiary.[35]

A number of legislative interventions in the South African Companies Act[36] such as the requirement for consolidated financial statements, auditor's rights to access financial statements of a subsidiary, requirements relating to the report contained in annual financial statements of a company, the requirement of shareholder approval where shares are issued to persons related or interrelated to the company,[37] the acquisition of shares in a company's holding company regulated under section 48 of the Act,[38] the prohibition of a company to pay a fine imposed on a director of a re-

[26] Stevens LLD at 7.
[27] Stevens LLD at 8.
[28] Stevens LLD at 8.
[29] Stevens LLD at 8.
[30] Stevens LLD at 8.
[31] Botha DH, *Groups in South African Law*, LLD, 1981 at 269.
[32] Gillooly M, 1993 at 10.
[33] Gillooly M, 1993 at 11.
[34] Gillooly M, 1993 at 12.
[35] Gillooly M, 1993 at 12.
[36] Act 71 of 2008.
[37] S 41(2)(b) of Act 71 of 2008.
[38] S 48 of Act 71 of 2008.

lated company as a result of a conviction of an offence, provided the conviction is not based on strict liability,[39] and finally, the requirements found under chapter four of the Act which regulates public offering of company securities and requires a registered prospectus.[40] Although the above measures seek to limit or avoid misconduct of related companies, none of them at first glance provides a direct solution for the situation in which there is mismanagement or fraud in a company group. For these situations, other jurisdictions such as those considered below have embraced substantive consolidation.

[39] S 78(3) of Act 71 of 2008.
[40] S 95 of Act 71 of 2008.

CHAPTER 3: A COMPARATIVE ANALYSIS OF COMPANY GROUPS

3.1 New Zealand

3.1.1 Introduction

New Zealand, like South Africa, has a common law legal system. New Zealand's Companies Act[1] is the primary governing source regarding liquidations. The primary goal of liquidation in New Zealand has been identified as being to collect and distribute assets for the benefit of secured debtors and thereafter to unsecured debtors. The focus is on three distinct themes, namely, the *pari passu* principle,[2] timely attention to applications for liquidation so as to avoid companies from trading under conditions of insolvency and ensuring that liquidations are efficient in order to maximise the availability of assets to creditors.[3]

3.1.2 Section 271(1) Orders

The provisions that are of specific interest for purposes of the dissertation are found under sections 271 and 272 of the Companies Act. Section 271 provides that where a court finds that it is just and equitable, it may make an order that a company related to a company that finds itself in liquidation is to pay the claims made in liquidation in their entirety or in part.[4] The court may also order that when two or more related companies find themselves in liquidation that liquidation is to proceed as if they were a single company. The court in this case may determine to which extent this is to be done and impose conditions as it deems fit.[5] The legislation also provides for further directions or orders of the court for purposes of facilitating the process[6] and notice to the liquidator and all creditors of related companies, unless the court makes an order to the contrary, for purposes of a section 271(1)(b) order.[7] A notice as provided for above must include a statement to the effect that the receiving party may

[1] The New Zealand Companies Act of 1993.
[2] See Keay A, Boraine A & Burdette D*, Preferential Debts in Corporate Insolvency: a Comparative Study*, , International Insolvency Review 10, 167-194, 2001 at 167: "The universal rule that applies when it comes to distributing assets in an insolvency administration is the *pari passu* principle, that is that there should be an equal and rateable distribution."
[3] Heath P and Whale MJ, *Insolvency Law in New Zealand*, 2nd Edition, 2014 at 459.
[4] S 271(1)(a) of the New Zealand Companies Act of 1993.
[5] S 271(1)(b) of the New Zealand Companies Act of 1993.
[6] S 271(2) of the New Zealand Companies Act of 1993.
[7] S 271A of the New Zealand Companies Act of 1993.

oppose a section 271(1)(b) order by means of a statement of defence.[8]

The Act does not specify what is meant by the words “just and equitable” although it does set out a number of factors which the courts must consider in ensuring that the above orders are in fact just and equitable. These factors are not a *numerus clausus* and the court may take into account other factors which it considers relevant. Section 272(1) sets out the factors for a section 271(1)(a) order, namely:

> (a) the extent to which a related company took part in the management of the company in liquidation;
> (b) the conduct of the related company towards the creditors of the company in liquidation;
> (c) the extent to which the circumstances that gave rise to the liquidation of the company are attributable to the actions of the related company; and
> (d) such other matters as the court thinks fit.[9]

Section 272(2) sets out the factors for a 271(1)(b) order, namely:

> (a) the extent to which any of the companies took part in the management of any of the other companies;
> (b) the conduct of any of the companies towards the creditors of any of the other companies;
> (c) the extent to which the circumstances that gave rise to the liquidation of any of the companies are attributable to the actions of any of the other companies;
> (d) the extent to which the businesses of the companies have been combined; and
> (e) such other matters as the court thinks fit.[10]

It is clear from the above factors that the Act intends for pooling orders to be used in specific instances. Despite allowing the court to consider further factors it may deem fit, the Act lays down factors which the court is obliged to consider and confines these orders to cases where separate legal entities are in one form or another not treated as such, and creditors are misguided as to the true state of affairs. Section 272(3) states that a mere reliance by the creditors of a company in liquidation on the fact that the company is or was related to another company is not in itself sufficient for an order under section 271.[11]

The factors which the court is required to take into account in making a section 272(2) order are discussed in the recent case of *Mountfort v Tasman Pacific Airlines of NZ Ltd.*[12] In this case, Airlines, the holding company, was responsible for over ninety-nine percent of the income of Regional, the subsidiary. Regional was allowed

[8] S 271A(3)(c) of the New Zealand Companies Act of 1993.
[9] S 272(1)(a)-(d) of the New Zealand Companies Act of 1993.
[10] S 272(2)(a)-(e) of the New Zealand Companies Act of 1993.
[11] S 272(3) of Act of the New Zealand Companies Act of 1993.
[12] *Mountfort v Tasman Pacific Airlines of NZ Ltd* [2006] 1 NZLR 104.

to run independently as far as the day-to-day operations were concerned[13] although management was headed by a general manager who managed both holding company and subsidiary and seemed to be on the holding company's payroll.[14] After a number of attempts to recapitalise Airlines, which was trading in a negative position, the chief financial officer of Airlines instructed Regional to transfer six-hundred and fifty thousand New Zealand dollars to Airlines.[15] This improved Airline's financial position at the expense of Regional, which had acquired what soon became bad debt.[16] Eight months later Regional became insolvent and continued to trade as such.[17]

The first factor, namely, the extent to which any of the companies was involved in the management of the other was found to have both a qualitative and a quantitative aspect.[18] The court elaborated on this aspect and said that it is not sufficient for a holding company to simply participate in the management of its subsidiary, as this in itself does not justify a section 272(2) pooling order.[19] Similarly, the participation in securities offered to a financial institution or the making of a cash sweep of a subsidiary are not in themselves justifications for a pooling order.[20] The court then analysed to what extent the subsidiary was dependent on its holding company and drew a distinction between two levels of dependency.[21] Although at an operational level the subsidiary was run independently from its holding company, when one looked at the companies at a policy level, the subsidiary was almost fully dependent on the holding company in terms of the business it received.[22] This dependency was used to ensure that the subsidiary continued to trade in a state of insolvency.[23] Where a holding company uses its authority over its subsidiary to continue trading in a state of insolvency, a pooling order becomes an appropriate measure and this is supported by the dependence on the holding company.[24]

The second factor refers to the conduct of any company towards the creditors of an-

[13] *Mountfort v Tasman Pacific Airlines of NZ Ltd* [2006] 1 NZLR 104 at [37].
[14] *Mountfort v Tasman Pacific Airlines of NZ Ltd* [2006] 1 NZLR 104 at [36].
[15] *Mountfort v Tasman Pacific Airlines of NZ Ltd* [2006] 1 NZLR 104 at [49].
[16] *Mountfort v Tasman Pacific Airlines of NZ Ltd* [2006] 1 NZLR 104 at [49].
[17] *Mountfort v Tasman Pacific Airlines of NZ Ltd* [2006] 1 NZLR 104 at [49] & [51].
[18] *Mountfort v Tasman Pacific Airlines of NZ Ltd* [2006] 1 NZLR 104 at [84].
[19] *Mountfort v Tasman Pacific Airlines of NZ Ltd* [2006] 1 NZLR 104 at [86].
[20] *Mountfort v Tasman Pacific Airlines of NZ Ltd* [2006] 1 NZLR 104 at [86].
[21] *Mountfort v Tasman Pacific Airlines of NZ Ltd* [2006] 1 NZLR 104 at [87].
[22] *Mountfort v Tasman Pacific Airlines of NZ Ltd* [2006] 1 NZLR 104 at [87].
[23] *Mountfort v Tasman Pacific Airlines of NZ Ltd* [2006] 1 NZLR 104 at [87].
[24] *Mountfort v Tasman Pacific Airlines of NZ Ltd* [2006] 1 NZLR 104 at [87].

other related company.[25] The discussion pertaining to this second factor refers to the above discussion and the court stated that the factors overlap.[26] Here, any action by the holding company which puts the creditors of the subsidiary at risk is considered.[27] In this case the cash sweep along with the forcing of the subsidiary company to trade in a state of insolvency did in fact result in the creditors being put at risk.[28] However, it is however questionable whether the legislature intended section 272(2)(a) and (b) to overlap. The court should rather have considered the extent to which the actions of the holding company misled the creditors of the subsidiary. If creditors are aware of the risks, a pooling order may not be justified. However, where creditors are misled as to the true state of affairs of the company of which they are creditors, a pooling order is justified.

The third factor refers to whether the liquidation of a company is attributable to the actions of its related company.[29] Here the fact that the holding company caused the subsidiary to trade in a state of insolvency by providing the subsidiary with bad debt was sufficient to prove this factor.[30]

The fourth factor, the extent to which the businesses of related companies have been combined, [31] was also briefly considered by the court.[32] The granting of credit by one related company to another is a strong indication of this factor being present.

The final factor, namely, any other factor the court may deem fit, is open-ended and the courts may use their discretion.[33] In this case the court considered the benefits one company enjoyed at the cost of the breaches of fiduciary duties of the related company and referred to the principle that "a party will not be permitted to take advantage of its own wrong".[34] In *Re Pacific Syndicates (NZ) Ltd (in liq)* the court took into account the fact that the granting of a pooling order could speed up the liquidation process, thereby avoiding further costs and maximising the return for creditors of

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[25] S 272(2)(b) of the New Zealand Companies Act of 1993.
[26] *Mountfort v Tasman Pacific Airlines of NZ Ltd* [2006] 1 NZLR 104 at [89].
[27] *Mountfort v Tasman Pacific Airlines of NZ Ltd* [2006] 1 NZLR 104 at [89].
[28] *Mountfort v Tasman Pacific Airlines of NZ Ltd* [2006] 1 NZLR 104 at [89].
[29] S 272(2)(c) of the New Zealand Companies Act of 1993.
[30] *Mountfort v Tasman Pacific Airlines of NZ Ltd* [2006] 1 NZLR 104 at [91].
[31] S 272(2)(d) of the New Zealand Companies Act of 1993.
[32] *Mountfort v Tasman Pacific Airlines of NZ Ltd* [2006] 1 NZLR 104 at [92].
[33] S 272(2)(e) of the New Zealand Companies Act of 1993.
[34] *Mountfort v Tasman Pacific Airlines of NZ Ltd* [2006] 1 NZLR 104 at [94].

both companies.[35]

It is also important to note that section 272(3) precludes a creditor of a company that finds itself in liquidation from relying on the fact that another company is, or was, related to the said company to justify a section 271 order.[36] Furthermore the court also stated that when a pooling order is granted, creditors should not be allowed to obtain a larger share than they would have should the misconduct not have occurred.[37] These principles serve as limits on the operation of pooling orders and ensure they are not abused.

3.1.3 Application of Pooling Orders

Mountfort v Tasman Pacific Airlines of NZ Ltd[38] showed that a court would be inclined to make a section 271 order where a company trades in a state of insolvency.[39] Further case law has shown that the court will also make a pooling order where complex inter-company debt exists and companies have failed to keep funds separate, thereby making it impossible, if not very laborious and costly, to assign the funds to each company;[40] where related companies operated as a single entity with intermingled management;[41] where creditors would arbitrarily benefit from a lack of a section 271 order;[42] where related companies have failed to differentiate between each other;[43] and similarly, where creditors are confused as to which company they had contracted with.[44]

3.1.4 The Drawbacks

These provisions, however, are not without drawbacks. Uncertainty exists as to how creditors who have claims against more than one of the consolidated companies should be treated and the manner in which interest should be dealt with when an insolvent company becomes solvent as a result of a pooling order.[45] With regard to the

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[35] *Re Pacific Syndicates (NZ) Ltd (in liq)* (1989) 4 NZCLC 64 757.
[36] S 272(3) of Act of the New Zealand Companies Act of 1993.
[37] *Mountfort v Tasman Pacific Airlines of NZ Ltd* [2006] 1 NZLR 104 at [28].
[38] *Mountfort v Tasman Pacific Airlines of NZ Ltd* [2006] 1 NZLR 104.
[39] *Mountfort v Tasman Pacific Airlines of NZ Ltd* [2006] 1 NZLR 104.
[40] *Re Pacific Syndicates (NZ) Ltd (in liq)* (1989) 4 NZCLC 64 757.
[41] *Re Dalhoff and King Holdings Ltd* (1991) 2 NZLR 296.
[42] *Re Dalhoff and King Holdings Ltd* (1991) 2 NZLR 296.
[43] *Goodson v Windgate Two Ltd* HC Wellington CIV-2008-485-1942, 11 February 2010.
[44] *Shephard v Carm Holdings Ltd (in liq)* HC Wellington CIV-2009-485-1332,16 September 2009.
[45] Ross M, International Company and Commercial Law Review, *Tangled webs: unravelling the*

latter problem, Chapman has shown the effect of this problem on cross-guarantees. These guarantees refer to the case where a lender lends to a company within a group on condition that cross guarantees are offered by the related companies within that group.[46] The intended effect of this arrangement is that where the group falls into liquidation the lender who becomes an unsecured creditor has a claim against the company subject to the loan and against each of the companies that offered a guarantee in respect of the loan.[47] The only limitation is that the lender may only recover up to the value of the loan. This arrangement sought to guarantee a better return in liquidation than in the case where the lender could only claim form the principal debtor.[48] The effect of a pooling order on these cross-guarantees is that claims for both the principal debt and the debt against the guarantors are reduced to one claim.[49] These problems will in all probability be clarified as case law develops on the granting of pooling orders.

3.1.5 Conclusion

Despite the apparently wide factors and discretion allowed to the court in section 272(a) and (b), case law has shown that pooling orders as provided for in section 271 have been granted in specific scenarios. The defining factor that seems to be necessary is that of a failure, in one way or another, to maintain the separate legal personality of related companies whether by incompetence, mismanagement or fraudulent activity.[50] New Zealand has pioneered the imposition of a pooling clause and has shown that its use can be effective and still respect the doctrine of separate legal personality of companies.[51] The set factors provided for by the Companies Act brought a degree of certainty with regard to pooling orders, although this certainty is not absolute. The issue of a creditor who has claims against more than one consolidated company and the position where a solvent company finds itself in insolvency proceedings due to a pooling order have not been addressed by the legislature.[52] These uncertainties will most probably be clarified through precedents.

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strands after a corporate group collapses, 1992 at 4.

[46] C Chapman, *Cross-Guarantees Drown in the Pool*, 9 Int'l Fin L Rev 16, 1990 at 16.

[47] C Chapman, 1990 at 16.

[48] C Chapman, 1990 at 16.

[49] C Chapman, 1990 at 16.

[50] Ross M, 1992 at 4.

[51] *Salomon v Salomon & Co Ltd* 1897 AC 22.

[52] Ross M, 1992 at 4.

3.2 United States of America

3.2.1 Introduction

The United States of America (USA), like New Zealand and South Africa, also has a common law system. It refers to corporate insolvency as "bankruptcy". The approach of the USA towards company groups or corporations is different to that of New Zealand that has opted to provide for substantive consolidation within its Companies Act. On the contrary, the US courts are not expressly empowered to grant consolidation orders through a statutory provision.[53] Despite the lack of a specific legislative basis, substantive consolidation has been used in dealing with related companies and the courts have made use of section 105 of the Bankruptcy Code which grants wide discretionary powers to the courts.[54] A distinction must also be drawn between administrative consolidation and substantive consolidation. The former is merely a manner in which the procedures of related companies are combined yet the assets and liabilities of the respected entities are kept separate.[55] Administrative consolidation is provided for in Rule 1015(b) of the Federal Rules of Bankruptcy Procedure and allows for the joint administration of two or more estates under certain conditions.[56] The latter refers to the pooling of assets and liabilities of companies that have been consolidated, allowing creditors to claim from the single pool.[57] Substantive consolidation has not been codified in the USA and as a result this doctrine has developed through precedent.[58]

3.2.2. Administrative Consolidation

Administrative consolidation, also known as procedural consolidation or even joint administration, has an effect on the procedural aspect of the bankruptcy and keeps the rights of creditors intact.[59] Rule 1015(b) allows the court to order a joint administration of estates in cases involving two or more related debtors where a joint petition or two or more petitions are pending in the same court against a debtor and an

[53] Farrar J, 2013 at 47.
[54] Ferriel JT and Janger EJ, *Understanding Bankruptcy*, 3rd Edition, 2013 at 880.
[55] Ferriel JT and Janger EJ, 2013 at 877.
[56] Ferriel JT and Janger EJ, 2013 at 878.
[57] Graulich TE, *Substantive Consolidation - A Post-modern Trend*, 14 American Bankrupcy Institute Law Review 527, 2006 at 527.
[58] Graulich TE, 2006 at 539.
[59] Ferriel JT and Janger EJ, 2013 at 878.

affiliate.[60] The notes of the advisory committee on the rules refer to the use of a single practitioner, a single docket, the combination of notices to creditors and other matters that would have the effect of reducing the cost and time necessary for the administration.[61] The rule also provides that the rights of creditors must be protected in making such an order.[62] This means that where a conflict of interests may arise as a result of having a single legal practitioner overseeing the liquidation of more than one debtor, a rule 1015(b) order may not be appropriate.[63] As mentioned above, however, the law of the USA also recognises substantive consolidation.

3.2.4 Substantive Consolidation

Substantive consolidation is not a recent development in the law of the USA. It first featured in *Sampsell v Imperial Paper & Color Corp*,[64] over seven decades ago, where the assets of an individual were consolidated with those of a corporation subsequent to a fraudulent transfer.[65] Substantive consolidation in the USA has only been codified in respect of spouses and courts rely on section 105 of the Bankruptcy Code which allows them a wide discretion to make “any order, process, or judgment that is necessary or appropriate to carry out the provisions of the bankruptcy code”.[66] The lack of clear guidelines on when and how the courts are to implement substantive consolidation has allowed the courts to use this freedom to develop their own principles over the years.

The early case law shows that the early forms of substantive consolidation required proof of fraud or the abuse of the corporate form.[67] In *Sampsell v Imperial Paper & Color Corp* the court justified the consolidation on two salient factors. Firstly, the corporation to which the assets were fraudulently transferred was a mere cloaking device with the intention of keeping assets beyond his creditors’ reach and secondly, the sole creditor of the corporation was aware of the fraudulent nature of the transfer.[68] In *Stone v Eacho*[69] the court ordered the consolidation of a company and its

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[60] Rule 1015(b) of the Federal Rules of Bankruptcy Procedure.
[61] Rule 1015 of the Federal Rules of Bankruptcy Procedure Notes of Advisory Committee on Rules, 2010.
[62] Rule 1015(c) of the Federal Rules of Bankruptcy Procedure.
[63] Ferriel JT and Janger EJ, 2013, at 878.
[64] *Sampsell v Imperial Paper & Color Corp* 313 US 215 1941.
[65] Graulich TE, 2006 at 527.
[66] S 105(a) of the Bankruptcy Code.
[67] Graulich TE, 2006 at 539.
[68] Graulich TE, 2006 at 539.

non-debtor subsidiary where credit was extended to the holding company.[70] The determining factors in this case were that the subsidiary had no existence of its own, it was undercapitalised and was a mere instrument of its holding company.[71] In *Todd Bldg Corp v Heller*[72] the court held that separate legal personality will not be upheld where doing so would cause the promotion of fraud or injustice.[73] *Soviero v Franklin National Bank*[74] further confirmed the court's power to consolidate affiliated corporations where assets were not treated separately and failure to maintain a separate legal existence was evident.[75] The required fraud or abuse implied that the basis for substantive consolidation was state law and more specifically the rules of veil-piercing or fraudulent conveyance.[76] This restriction was changed in later cases.[77]

The court deviated from the above approach in *Chemical Bank New York Trust Co v Kheel*[78] and for the first time allowed for substantive consolidation based on obscurity,[79] a hopeless commingling of the assets and liabilities of related companies.[80] This state of affairs was caused by the operation of eight debtor companies as a single unit by one owner.[81] In addition, corporate formalities customarily observed by independent entities were neglected, funds were transferred between the related companies, intercompany loans were effected, pledges were made on behalf of related companies and personal withdrawals and deposits were made by the owner of the group.[82] These factors, along with the fact that these movements were not adequately recorded, meant that the assets and liabilities of the companies had in fact been pooled.[83] The extent of the obscured state of affairs was that an exercise in establishing the individual position of the companies would potentially leave creditors with no return.[84] The court created a new factor to justify substantive consolidation

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[69] *Stone v Eacho (In re Tip Top Tailors Inc)* 127 F 2d 284 4th Cir 1942.
[70] Graulich TE, 2006 at 540.
[71] Graulich TE, 2006 at 540.
[72] *Todd Bldg Corp v Heller (In re Clark Supply Co)* 172 F 2d 248 7th Cir 1949.
[73] Graulich TE, 2006 at 540.
[74] 328 F 2d 446 2nd Cir 1964.
[75] Graulich TE, 2006 at 540.
[76] Graulich TE, 2006 at 542.
[77] Graulich TE, 2006 at 542.
[78] *Chemical Bank New York Trust Co v Kheel* 369 F 2d 845 2nd Cir 1966.
[79] See also *Flora Mir Candy Corp v RS Dickinson & Co* 432 F 2d Cir 1060, 1970 at 1063 where the level of obscurity required was stated to be "hopeless obscurity".
[80] Graulich TE, 2006 at 542-543.
[81] Graulich TE, 2006 at 542.
[82] *Chemical Bank New York Trust Co v Kheel* 369 F 2d 845 2d Cir 1966 at 874.
[83] *Chemical Bank New York Trust Co v Kheel* 369 F 2d 845 2d Cir 1966 at 874.
[84] Graulich TE, 2006 at 542.

along with a strict test requiring that the difficulty in untangling the commingled companies would render the exercise impossible and its cost would put creditors in a more prejudicial position than they would have been in had substantive consolidation been effected.[85] The court's reasoning is that it is more beneficial to improve the position of some creditors, where possible, than to entertain a costly and fruitless exercise which ultimately prejudices all creditors.[86] Despite this new addition, the court stressed the fact that substantive consolidation needs to be used in exceptional circumstances to avoid unfairly treating creditors who were not aware of the related nature of the companies.[87]

The principles laid down in *Chemical Bank New York Trust Co v Kheel* and those in the case law preceding it, were summarised into a brief two-pronged test in *Union Saving Bank v Augie/Restivo Banking Co* (*In re Augie/Restivo Banking Co*).[88] The first prong is "whether creditors dealt with entities as a single economic unit and 'did not rely on their separate identity in extending credit'" and the second is "whether the affairs of the debtors are so entangled that consolidation will benefit all creditors".[89] The implications of the first prong are twofold: firstly, there is an element of the creditor being misled as to the independence of the companies,[90] and secondly, substantive consolidation should not be imposed where a creditor objects to this and at the time of entering into an agreement with the debtor company, was aware of the interrelatedness of the entities.[91] The basis for the latter implication seems to serve as a protection for the creditor, who is aware of the circumstances and seeks to protect his ranking as creditor of the individual entity.[92] The second prong revolves around some form of consent by the creditors to engage in substantive consolidation. This requires, like *Kheel*, a benefit to all creditors due to the cost and complexity of disentangling the companies and a risk of eroding the return for creditors.[93] This test, as was the case with previous tests created by the courts, did not crystallise and was

[85] Farrar J, 2013 at 51.
[86] *Chemical Bank New York Trust Co v Kheel* 369 F 2d 845 2d Cir 1966 at 847.
[87] *Chemical Bank New York Trust Co v Kheel* 369 F 2d 845 2d Cir 1966 at 847.
[88] *Union Saving Bank v Augie/Restivo Banking Co (In re Augie/Restivo Banking Co)* 860 F 2d 515 2nd Cir 1988.
[89] *Union Saving Bank v Augie/Restivo Banking Co (In re Augie/Restivo Banking Co)* 860 F 2d 515 2nd Cir 1988 at 518.
[90] Graulich TE, 2006 at 544.
[91] Graulich TE, 2006 at 545.
[92] *Union Saving Bank v Augie/Restivo Banking Co (In re Augie/Restivo Banking Co)* 860 F 2d 515 2nd Cir 1988 at 520.
[93] Graulich TE, 2006 at 545.

once again subject to change.

The change came in *Eastgroup Properties v Southern Motel Association Ltd*[94] and *Drabkin v Midland Ross Corp* (*In Re Autotrain*).[95] The change in approach was the one that favoured a balancing test for the imposition of substantive consolidation, by allowing proponents for consolidation to fulfil the requirement by merely proving substantial identity and thereafter allowing dissenting creditors to prove reliance on the separate nature of the entities and prejudice caused by the consolidation.[96] The court engaged in a balancing exercise in order to determine whether the benefits of substantive consolidation outweigh its disadvantages.[97] It is argued that this approach is excessively flexible and widens the test to allow for substantive consolidation in cases where creditors relied on the separate identity of creditors.[98] This was not permitted by the tests previously formulated by the courts and such reliance was in fact fatal to substantial consolidation. This approach has received both praise and disapproval by authors. Graulich correctly highlights the flaws in the ambiguities and lack of legal certainty created by this approach.[99] This development, shortly after the enactment of the Bankruptcy Code, gave rise to the modern trend.[100]

The modern trend followed the move made by the *Eastgroup* line of cases which allows for a more liberal approach to substantive consolidation.[101] The *In Re Vecco* decision, in which the court allowed for substantive consolidation for the effective implementation of a plan of arrangement under Chapter 11 of the Bankruptcy Code, announced the liberal trend.[102] This announcement was made notwithstanding the clear possibility of the application of previously established law, as the subsidiaries of the parent company did not feature independence from their parent company.[103] The effects of this liberal trend were seen *In Re Murray,* where similarly, under a Chapter 11 plan of arrangement, debtors were allowed to sell their assets in their entirety.[104]

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[94] *Eastgroup Properties v Southern Motel Association Ltd* 935 F 2d 245 11th Cir 1991.
[95] *Drabkin v Midland Ross Corp (In Re Autotrain)* 810 F 2d 270 DC Cir 1987.
[96] *Drabkin v Midland Ross Corp (In Re Autotrain)* 810 F 2d 270 DC Cir 1987 at 277.
[97] *Drabkin v Midland Ross Corp (In Re Autotrain)* 810 F 2d 270 DC Cir 1987 at 277.
[98] Graulich TE, 2006 at 546.
[99] Tucker JM, *Substantive Consolidation: The Cacophony Continues*, 18 American Bankruptcy Institute Law Review 89, 2010 at 167.
[100] Graulich TE, 2006 at 547.
[101] Graulich TE, 2006 at 547.
[102] Graulich TE, 2006 at 547.
[103] Graulich TE, 2006 at 547.
[104] *In re Murray Industries Inc* 119 BR at 820 Bankr MD Fla 1990 at 826.

The sole remaining asset, named “Chris-Craft,” was owned by the parent company which remained solvent. This asset was thereafter subject to a substantive consolidation order, which ultimately allowed the creditors of the subsidiaries to share in the asset of the solvent parent company at the expense of the shareholders of the parent company.[105] The modern trend is therefore a move towards benefitting unsecured creditors over the rights of shareholders of a solvent company.[106] The liberal trend does not ignore the factors which were considered important in the case law preceding this development, namely, commingling of assets and a lack of regard for the corporate form, but it includes factors such as common ownership, common board members, the existence of intercompany loans or guarantees and the use of a common integrated cash management system which are commonplace in company groups and should not have a decisive role in establishing whether substantive consolidation should occur.[107] The existence of intercompany guarantees is also contradictory in itself as a creditor who seeks an intercompany guarantee can be considered a creditor who was fully aware of the interrelated nature of the companies who sought the guarantee to protect himself.[108] This factor should therefore serve as a deterrent for substantive consolidation.[109] The existence of poorly recorded intercompany loans would be a more suitable factor to consider as this would have a bearing on the commingling of the company’s affairs and would not pose the problem of the informed creditor. However, in keeping with the mercurial nature of the law relating to substantial consolidation in the USA, the position changed once again.

In *Grupo Mexicano de Desarrollo SA v Alliance Bond Fund Inc*[110] the court had to decide whether a district court had the power to issue an interdict to prevent the dissipation of assets.[111] Grupo Mexicano had issued guaranteed notes to investors in order to provide for a large high interest debt and subsequently failed to pay interest on these notes.[112] The Mexican government intervened and issued government guaranteed notes to Grupo Mexicano who nevertheless embarked on a restructuring

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[105] Graulich TE, 2006 at 549.
[106] Graulich TE, 2006 at 549.
[107] Graulich TE, 2006 at 551.
[108] Graulich TE, 2006 at 551.
[109] Graulich TE, 2006 at 551.
[110] *Grupo Mexicano de Desarrollo S.A. v Alliance Bond Fund Inc* 527 US 308 (1999).
[111] Tucker JM, *Grupo Mexicano and the Death of Substantive Consolidation*, 8 American Bankruptcy Institute Law Review 427, 2000 at 438.
[112] Tucker JM, 2000 at 439.

exercise, along with cutting costs and an attempt to obtain new equity.[113] It later transpired and came to the knowledge of investors that Grupo Mexicano was not in possession of the government notes and had made use of these notes to settle other obligations. Investors then commenced legal action in order to obtain the abovementioned preliminary interdict to keep Grupo Mexicano from assigning the government notes.[114] The District Court allowed this interdict as it complied with the necessary requirements and this decision was upheld on appeal. The Supreme Court, however, disagreed and held that the District Court lacked jurisdiction to interdict the transfer of assets.[115] The court's reasoning for this decision has an effect on the law relating to substantive consolidation. The court discussed equity and stated that although it is a flexible construct, it remains limited to the traditional equitable relief.[116] In doing so it visited the Judiciary Act of 1789 and stated that a court in equity does not have the "authority to craft a 'nuclear weapon' of the law".[117] The court therefore was of the opinion that courts may not depart from the traditional notion of equity and that any such departure should rather be imposed by the legislature.[118] Substantive consolidation as an equitable remedy[119] therefore finds itself at risk in light of this decision.

One should consider the decision in *Grupo Mexicano* in light of the required existence of a corresponding remedy in 18th century English law.[120] The principles that can be identified are those of *Salomon v Salomon* and its strict application of separate legal personality.[121] Grupo Mexicano, therefore, forces one to look to section 105(a) of the Bankruptcy Code for a basis for substantive consolidation. Section 105(a) allows the court a discretion to "issue any order, process or judgment"[122] but only within the limits of the Bankruptcy Code and therefore consistent with it.[123] JM Tucker argues that section 105(a) of the Bankruptcy Code does not allow for the power to create rights that would not otherwise exist under the code.[124] The reason for this is that in light of section 1123(a)(5)(C) of the Bankruptcy Code, which pro-

[113] Tucker JM, 2000 at 439.
[114] Tucker JM, 2000 at 439.
[115] Tucker JM, 2000 at 440.
[116] Tucker JM, 2000 at 440.
[117] *Grupo Mexicano de Desarrollo S.A. v Alliance Bond Fund Inc* 527 US 308 (1999) at 332.
[118] *Grupo Mexicano de Desarrollo S.A. v Alliance Bond Fund Inc* 527 US 308 (1999) at 332.
[119] *In Re Vecco Construction Industries Inc* 4 B.R. 407 Bankr. E.D. Va. 1980 at 409.
[120] Tucker JM, 2000 at 445.
[121] Tucker JM, 2000 at 443.
[122] S 105(a) of the Bankruptcy Code.
[123] Tucker JM, 2000 at 448.
[124] Tucker JM, 2000 at 449.

vides for substantive consolidation under a Chapter 11 reorganisation plan, it is the section itself that allows for the remedy and not the equity powers of the federal court under section 105(a) of the Code.[125] He therefore concludes that section 105(a) does not grant the power to bankruptcy courts to impose substantive consolidation and that they are subject to *Grupo Mexicano*.[126] This line of reasoning has drastic implications for the doctrine of substantive consolidation in the USA as it ignores the case law development of substantive consolidation as set out in the previous paragraphs, which was an attempt to evolve as corporate structure has evolved through the years, and brings the development of the principle of equity back to 1789.[127] *Grupo Mexicano* therefore potentially led to the death of substantive consolidation in the USA.[128]

However, the recent *Owens Corning* case has kept the doctrine of substantive consolidation alive.[129] The facts were briefly as follows: Owens Corning, a Delaware corporation, and some of its subsidiaries had obtained credit of two billion dollars from a syndicate of banks.[130] The agreement included guarantees made by other subsidiaries of the holding company.[131] A consolidation order was thereafter applied for, and granted, in the District Court prior to a reorganisation plan.[132] The banks appealed this decision on the grounds that the decision of the District Court was incorrect and failed to understand "the reasons for, and standards for considering, [this] extraordinary remedy".[133] The court in setting out its decision first and foremost attended to the questions posed by Tucker who argued that the basis for the doctrine of substantive consolidation had been removed by the *Grupo Mexicano* case.[134] The court's stance on this matter turned on two determining factors.[135] Firstly, the *Sampsell* case was found to be binding precedent on the question of whether courts have the authority to order substantive consolidation.[136] Secondly, the court drew a dis-

[125] Tucker JM, 2000 at 449.
[126] Tucker JM, 2000 at 450.
[127] Tucker JM, 2000 at 450-451.
[128] Tucker JM, 2000 at 451.
[129] *In re Owens Corning* 419 F 3d 195 3d Cir 2005.
[130] *In re Owens Corning* 419 F 3d 195 3d Cir 2005 at 6-7.
[131] I*n re Owens Corning* 419 F 3d 195 3d Cir 2005 at 7.
[132] *In re Owens Corning* 419 F 3d 195 3d Cir 2005 at 8.
[133] *In re Owens Corning* 419 F 3d 195 3d Cir 2005 at 8.
[134] Tucker JM, *Substantive Consolidation: The Cacophony Continues*, 18 American Bankruptcy Institute Law Review 89, 2010 at 92.
[135] Tucker JM, 2010 at 94.
[136] Tucker JM, 2010 at 94.

tinction between Article I courts and Article III courts[137] and concluded that the limitation imposed by *Grupo Mexicano* does not apply to the former.[138] *Owens Corning* held that substantive consolidation should only be allowed under very specific circumstances.[139] The first instance is where before bankruptcy the companies disregarded their separate legal personalities to such an extent as to induce creditors to rely on a breakdown of such separateness and treat related companies as a single entity.[140] The second is where the exercise in unscrambling assets and liabilities of related companies would be prohibitive and prejudicial to all creditors.[141] The former requirement implies a "corporate disregard" which created "contractual expectations" in creditors that they were dealing with a single "indistinguishable entity".[142] Creditors in favour of substantive consolidation therefore should prove their reliance on the unity of the entities, while those contrary to consolidation should prove that it would negatively affect them as they relied on the separate nature of the entities.[143] The two requirements necessary for substantive consolidation were not satisfied in this case.[144] The court also settled some issues outside the ambit of the test, namely, allowing a priority to a creditor who would be prejudiced by the consolidation at a future date does not allow the court to bypass the test.[145] Secondly, the court stated that substantive consolidation should be used as a defensive remedy and not merely to gain an advantage or as a way to avoid proving difficult aspects in reorganisation proceedings.[146] Thirdly, the "deemed" consolidation which sought to enter into the negotiations of the reorganisation plan, as if substantive consolidation had occurred, and in this way eliminate the banks' guarantees,[147] curtailed the banks' rights both in the reorganisation plan as well as in bankruptcy and was in fact fatal to the applica-

[137] The judicial system of the USA uniquely features separate bankruptcy courts within a separate court system. Bankruptcy in the USA is considered a matter of federal law and therefore bankruptcy courts exist within the federal judicial system. Bankruptcy courts are in turn established as a unit of the district courts and are present in each federal judicial district. Judges of bankruptcy courts are not Article III judges but are considered Article I judges or referees.
See Felsenfeld C, *A comment about a Separate Bankruptcy System,* Fordham Law Review, Volume 64, Issue 6, 1996 at 2523-2527.
[138] Tucker JM, 2010 at 94.
[139] Tucker JM, 2010 at 91. See also *In re Owens Corning* 419 F 3d 195 3d Cir 2005 at 30-33.
[140] Tucker JM, 2010, at 91.
[141] Tucker JM, 2010, at 91.
[142] *In re Owens Corning* 419 F 3d 195 3d Cir 2005 at 39.
[143] *In re Owens Corning* 419 F 3d 195 3d Cir 2005 at 40.
[144] *In re Owens Corning* 419 F 3d 195 3d Cir 2005 at.
[145] *In re Owens Corning* 419 F 3d 195 3d Cir 2005 at 49.
[146] *In re Owens Corning* 419 F 3d 195 3d Cir 2005 at 49.
[147] *In re Owens Corning* 419 F 3d 195 3d Cir 2005 at 8.

tion.[148] *Owens Corning*, therefore, confirms that substantive consolidation is not dead, rejects the liberal trend and seems to be in support of the entity theory by narrowing the application of substantive consolidation to a very specific test. This was a definite step in the right direction after *Grupo Mexicano* planted a seed of doubt whether substantive consolidation was still "alive".

3.2.5 Conclusion

The law on substantive consolidation of the USA, lacking clear legislative rules, has relied on the evolution of the doctrine through the courts and the creation of precedent. This has proved to be a road marred with continuous change and a lack of legal certainty as to when the courts would impose this remedy. This stands in contrast to the law of New Zealand that has sections 271 and 272 which clearly set out the requirements for a pooling order and has not encountered the same difficulty than the courts of the USA with regard to arriving at an established set of factors to be considered for substantive consolidation. The courts of New Zealand merely concern themselves with the application of those factors and in future will have to clarify the issues of multiple claims and interest.[149] The existence and basis for this remedy has also been questioned both by academics and the courts, the conclusion being that substantive consolidation continues to exist as a remedy in American bankruptcy law, even after *Grupo Mexicano*. Recent case law confirms this and may be testament to the importance of substantive consolidation as an insolvency-specific remedy.[150] JM Tucker in fact refers to it as the "most important doctrine in corporate reorganization".[151] Finally, the tension between entity theory and enterprise theory seems to have been settled in favour of the former, (with the restrictive *Owens Corning* test) or at least for the time being.

3.3 United Kingdom

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[148] *In re Owens Corning* 419 F 3d 195 3d Cir 2005 at 49-50.
[149] See par 3.1.4.
[150] See *Donald R Lassman v Cameron Construction LLC (In Re Cameron Construction & roofing Co Inc)* 565 BR 1 2016 where a trustee acting in terms of Chapter 7 of the code sought an order for substantive consolidation with its non-debtor subsidiary that owned property used for the running of the debtor's business. The order was granted. See *Phaedra Spradlin v Beads and Steeds Inns LLC (In Re Matthew Lowell Howland and Meagan Larae Howland)* 6th Cir 2017 where a trustee sought to keep a related company from fraudulently transferring property to another by means of substantive consolidation. The court denied substantive consolidation because of a failure to satisfy the *Owens Corning* test.
[151] Tucker JM, 2010 at 89.

3.3.1 Introduction

The approach in the United Kingdom (UK) differs from that followed in New Zealand and the USA, where pooling or substantive consolidation has been entrenched in their law. The principle of limited liability established by *Salomon v Salomon*[152] originated from the UK courts and now serves as a cornerstone of English company law and of many other common law jurisdictions including South Africa.[153] Bowmer compares the UK position to that of the USA and in doing so highlights the strict application of *Salomon v Salomon* in the UK dispensation.[154] The UK therefore does not have a doctrine of substantive consolidation. However, it does provide for piercing the corporate veil in very specific and limited circumstances.[155]

3.3.2 Salomon v Salomon

The basic position in the UK is the one laid down in *Salomon v Salomon*,[156] an 1897 case which deals with insolvency and is the main reason why substantive consolidation has not gained traction in the UK.[157] In this case Salomon had incorporated a company whereby his family were the shareholders and each of the six family members held a single share. Salomon then sold his business to the company in exchange for twenty-thousand shares and a debenture of ten thousand pounds. He thereafter continued to run the business as its director. The debenture was issued to an outside party who paid an advance and was entitled to interest.[158] The company then defaulted on the interest, the debenture holder instituted proceedings to enforce his security and the company subsequently entered liquidation.[159] The liquidator claimed that the company was merely an agent of Salomon and that the function of the company was to defraud creditors which made Salomon personally liable to the company's creditors.[160] This piercing of the corporate veil was supported in the Appeal Court and thereafter denied in the House of Lords.[161] The reasoning for this de-

[152] *Salomon v Salomon & Co Ltd* 1897 AC 22.
[153] Bowmer S, *To pierce or not to pierce the corporate veil - why substantive consolidation is not an issue under English Law*, Journal of International Banking Law, 2000 at 2.
[154] Bowmer S, 2000 at 6.
[155] Bowmer S, 2000 at 3-4.
[156] *Salomon v Salomon & Co Ltd* 1897 AC 22.
[157] Bowmer S, 2000 at 6.
[158] *Salomon v Salomon & Co Ltd* 1897 AC 22 at 24.
[159] *Salomon v Salomon & Co Ltd* 1897 AC 22 at 24.
[160] *Salomon v Salomon & Co Ltd* 1897 AC 22 at 27 & 36.
[161] Bowmer S, 2000 at 2.

cision was that while Salomon held virtually all the shares in the company, there was no intention to defraud creditors.[162] Salomon had validly incorporated the company and in doing so allowed himself the advantages of separate legal personality.[163] With this judgment separate legal personality between a company and its shareholders was established even in the case of a "one-man company" and the principles have remained valid until today.[164]

3.3.3 Piercing the Corporate Veil

Piercing the corporate veil is a term that can be distinguished from that of consolidation of assets and liabilities, yet shares a similarity, in that both of these concepts undermine the legal fiction that is the corporate structure in one way or another.[165] In the USA some authors have distinguished substantive consolidation from piercing the corporate veil.[166] In doing so they state that substantive consolidation does not infringe upon limited liability but rather on corporate liability.[167] Corporate liability is a result of the corporate group and the idea that an entity within that group can have separate liability from its holding company or related entities whereas limited liability refers to the relationship between a company and its shareholders.[168] There is also a difference in tests and therefore a difference in the difficulty in obtaining these two remedies.[169] It has been submitted that piercing the corporate veil is more difficult, as an "alter ego" must be proved, as opposed to the less stringent factors mentioned earlier.[170] An important distinction is that piercing the corporate veil provides for a vertical relationship, where the creditors of a company may hold the shareholders personally liable for the debts of the company, or where, in a corporate group scenario, creditors of a subsidiary may access the assets of the parent company.[171] This implies that veil piercing is limited to a vertical relationship and can only operate "top-down".[172] Despite the shortfalls of piercing the corporate veil, as opposed to pooling or substantive consolidation, this remains the sole remedy in the UK for the abuse of

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[162] Bowmer S, 2000 at 2.
[163] *Salomon v Salomon & Co Ltd* 1897 AC 22 at 52 & 53.
[164] Bowmer S, 2000 at 2.
[165] Farrar J, 2013 at 54.
[166] Farrar J, 2013 at 54.
[167] Farrar J, 2013 at 54.
[168] Farrar J, 2013 at 54.
[169] Farrar J, 2013 at 54.
[170] See par 3.2 above, with specific reference to *In re Owens Corning.*
[171] Graulich TE, 2006 at 538.
[172] Graulich TE, 2006 at 538.

the corporate form with regard to company groups.

The Insolvency Act of 1986 of the UK allows for the piercing of the corporate veil in two very distinct circumstances, namely, fraudulent trading[173] and wrongful trading.[174] The former makes piercing the corporate veil possible when creditors are being defrauded and allows for the personal liability of parties who are aware of this fraudulent activity.[175] The latter scenario allows for a contribution order against a director or a party who has been a director where a company has entered liquidation while before the liquidation the director was aware or should have been aware that liquidation could not be avoided.[176] It must be noted that where a director takes every step to minimise the potential loss to creditors, a contribution order will not be granted.[177] However, these provisions have not been drafted with corporate groups in mind. Case law is therefore important to understand further scenarios in which the corporate veil can be pierced.[178]

Creasey v Breachwood Motors Ltd[179] is an example of a case where the court pierced the corporate veil. In this case an insolvent company transferred its business to a related company with common directors and shareholders,[180] along with all of its assets.[181] The appellant then sought a court order to pierce the corporate veil and claim from the transferee company.[182] The court pierced the corporate veil on the ground that it was necessary to do so in the interests of justice.[183] Piercing the corporate veil therefore may be available where a company has been used for an improper purpose.[184]

Adams v Cape Industries[185] revisited the principles of *Salomon v Salomon*[186] and the possible justifications for piercing the corporate veil. In *Adams*, two UK asbestos

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[173] Insolvency Act of the UK of 1986, s 213.
[174] Insolvency Act of the UK of 1986, s 214.
[175] Insolvency Act of the UK of 1986, s 213(1).
[176] Insolvency Act of the UK of 1986, s 214(2).
[177] Insolvency Act of the UK of 1986, s 214(3).
[178] Bowmer S, 2000 at 3-4.
[179] 1992 2 BCC 638.
[180] Griggs L, *A Note on the Application of Enterprise Theory to the Problem of Phoenix Companies*, 2 Macarthur Law Review 53 1998 at 65.
[181] Bowmer S, 2000 at 4.
[182] Griggs L, 53 1998 at 65.
[183] Griggs L, 53 1998 at 65.
[184] Bowmer S, 2000 at 4.
[185] 1991 1 All ER 929.
[186] *Salomon v Salomon & Co Ltd* 1897 AC 22.

companies owned a company in the USA through which their products were marketed.[187] Two hundred and five plaintiffs brought claims against the USA company for damages resulting from the exposure to the harmful substance in the production of insulation materials.[188] Damages were subsequently awarded in the Texas courts against the American company which did not hold any assets in the USA and for this reason the amounts recovered were not substantial.[189] The plaintiffs, dissatisfied with the result, then attempted to enforce the judgment in England under the common law.[190] The plaintiffs based their argument on the fact that the holding company operated and was therefore present in the USA through the American subsidiary.[191] The defence contested this and argued that presence in the USA was not sufficient to establish jurisdiction and that the judgment had been obtained fraudulently.[192] The court held that there was in fact no presence through the subsidiary and the judgment was not obtained fraudulently but was rather contrary to natural justice and public policy because of its failure to assign liability individually with regard to each plaintiff.[193] The appeal was then brought in respect to the court's finding on the two issues.[194] The dissertation is only concerned with the court's findings with regard to the presence of the holding company and whether the corporate veil could be pierced.[195] The court took into account the three scenarios in which veil piercing could occur.

The first is where companies are treated as a single economic unit.[196] The basic principle laid down by the court is that each company in a company group is to be regarded as a separate entity with separate rights and liabilities. The court then went on to state that in certain circumstances the single economic unit argument may prove successful seemingly, however, in terms of statutory provisions like those mentioned above.[197] The court then highlighted the importance of *Salomon v Salomon* and the fact that a court may not disregard the principles established by it

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[187] *Adams v Cape Industries* 1991 1 All ER 929 at 929.
[188] *Adams v Cape Industries* 1991 1 All ER 929 at 929.
[189] *Adams v Cape Industries* 1991 1 All ER 929 at 929.
[190] *Adams v Cape Industries* 1991 1 All ER 929 at 929.
[191] *Adams v Cape Industries* 1991 1 All ER 929 at 929.
[192] *Adams v Cape Industries* 1991 1 All ER 929 at 929.
[193] *Adams v Cape Industries* 1991 1 All ER 929 at 929.
[194] *Adams v Cape Industries* 1991 1 All ER 929 at 929.
[195] *Adams v Cape Industries* 1991 1 All ER 929 at 930.
[196] *Adams v Cape Industries* 1991 1 All ER 929 at 1016.
[197] *Adams v Cape Industries* 1991 1 All ER 929 at 1019. See footnotes 154 & 155.

"merely because it considers it just to do so".[198]

The court considered agency and stated that where an express agreement of agency existed between a holding company and its subsidiary the corporate veil could be pierced.[199] In the case in question the court recognised the fact that there was an agreement of agency between the holding company and its subsidiary, but that this agreement was limited to specific functions.[200] The court therefore found that a substantial amount of the business of the subsidiary was independent of a contract of agency and the subsidiary was not bound to contractual obligations entered into by the holding company.[201] The business of the subsidiary was therefore held to be its own independent business.[202]

Thirdly, the court looked at piercing the corporate veil and mentioned the principle that the corporate veil may only be pierced where a company is a mere façade to hide the true state of affairs.[203] The plaintiffs' argument was that the American subsidiary was a mere façade in order to trade in asbestos in the USA while maintaining its assets in the holding company, thereby effectively limiting its liability for possible claims such as the one in question.[204] The court, in considering relevant case law, noted that although courts may recognise that a holding company and a subsidiary are a single entity, judges have been reluctant to endorse and apply these arguments.[205] The court also stated that there is an inherent right to use the company structure to ensure that liability falls on one member of a company group as opposed to another.[206] The principles of *Salomon v Salomon* therefore will apply where there is a lack of special considerations.[207]

Adams v Cape Industries confirms that the corporate veil may be pierced in the case of companies being treated as an economic unit, the existence of a general express agreement of agency or a company being a mere façade.[208] However, it must be

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198 *Adams v Cape Industries* 1991 1 All ER 929 at 1020.
199 Bowmer S, 2000 at 4.
200 *Adams v Cape Industries* 1991 1 All ER 929 at 1029.
201 *Adams v Cape Industries* 1991 1 All ER 929 at 1029.
202 *Adams v Cape Industries* 1991 1 All ER 929 at 1029.
203 *Adams v Cape Industries* 1991 1 All ER 929 at 1022.
204 *Adams v Cape Industries* 1991 1 All ER 929 at 1022.
205 *Littlewoods Mail Order Store Ltd v McGregor* 1969 3 All ER 855 at 860.
206 *Adams v Cape Industries* 1991 1 All ER 929 at 1026.
207 *Adams v Cape Industries* 1991 1 All ER 929 at 1026.
208 Bowmer S, 2000 at 4.

noted that this was not an insolvency case and therefore its value in persuading the UK to adopt an insolvency-specific remedy like substantive consolidation is minimal at best.[209] *Re Polly Peck International plc*[210] is more recent, and perhaps more relevant to the approach towards the insolvency of company groups.[211]

Re Polly Peck International[212] was concerned with the application of *Salomon v Salomon*[213] with regard to corporate groups.[214] In this case the arrangement was that the parent company, Polly Peck International, had a subsidiary which was a special purpose vehicle ("the SPV") with the sole purpose of raising funds. The SPV issued bonds, the proceeds of which were lent to Polly Peck International.[215] Upon the entering of administration by the parent company two separate claims were lodged against it, one by the SPV claiming in terms of the guarantees for the loans extended to the parent company and another by the bondholders who claimed for the same funds with respect to the bonds issued by the SPV.[216] The critical factor was that the two separate claims were for the same amount and therefore an application was made by the administrator to deem Polly Peck International and the SPV the same entity, essentially substantive consolidation being the goal.[217]

The court had to determine whether the two separate claims for the same debt was in fact possible or whether the rule against double proof[218] precluded the SPV from instituting its claim.[219] In doing so, it considered three factors: firstly, whether the SPV was acting as an agent or a nominee of Polly Peck International, secondly, whether the SPV constituted a mere façade, and, thirdly, whether the Polly Peck group acted as a single economic unit.[220]

The court in considering the first factor noted the fact that in *Salomon v Salomon*[221]

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[209] Bowmer S, 2000 at 5.
[210] *In Re Polly Peck International plc (In Administration) (No 3)* 1996 2 All ER 433.
[211] Bowmer S, 2000 at 5.
[212] *In Re Polly Peck International plc (In Administration) (No 3)* 1996 2 All ER 433.
[213] *Salomon v Salomon & Co Ltd* 1897 AC 22.
[214] Bowmer S, 2000 at 5.
[215] Bowmer S, 2000 at 5.
[216] Bowmer S, 2000 at 5.
[217] Bowmer S, 2000 at 4-5.
[218] See *In Re Oriental Commercial Bank, ex p European Bank* 1871 LR 7 Ch App 99, LJJ at 103-104, where double proof was described as when "there is only to be one dividend in respect of what is in substance the same debt, although there may be two separate contracts."
[219] *In Re Polly Peck International plc (In Administration) (No 3)* 1996 2 All ER 433 at 433-434.
[220] *In Re Polly Peck International plc (In Administration) (No 3)* 1996 2 All ER 433 at 445-448.
[221] *Salomon v Salomon & Co Ltd* 1897 AC 22.

the court rejected the argument that the company was a mere agent or nominee of the controlling shareholder and that the shareholders holding nominal shares were merely dummies.[222] The contention in the case at hand was that in light of a number of factors, agency could be inferred from the facts. These factors included the incorporation of the subsidiary for the single purpose of issuing bonds, no separate management existed between the parent and its subsidiary, a small amount of paid-up capital existed, it did not and could not pay the costs of its transactions, it did not have appropriate book keeping and a normal bank account, the on-loan was not negotiated independently and did not serve a commercial purpose and creditors could not rely on the fact that the SPV would pay its debts only on Polly Peck which stood as surety.[223] Despite the above factors, the court placed great importance on the formal documents with regard to the bond issues, namely, the public bond issue agreement, the guarantee agreement and thirdly the prospectus.[224] The court concluded on the question of agency that the formal documents clearly set out the intentions of the entities and that even “blatant and reprehensible cutting of corners” cannot have the effect of changing the nature of the formal agreements.[225]

The court briefly considered the question of the SPV being a mere façade.[226] The court took into account *inter alia* the case of *Adams v Cape Industries*[227] and in doing so mentioned that the use of a subsidiary to trade in asbestos is inherently different from the use of an SPV in its function of issuing bonds.[228] Mention was also made of the fact that a façade refers to a form of attempting to evade existing obligations or to cause deception.[229] The suggestion made by the court therefore is that the manner in which the SPV operated was considerably more transparent in comparison to the *Adams v Cape Industries* decision and therefore the SPV was not merely a façade.[230]

The attempt made under the third factor was essentially to obtain a substantive consolidation of Polly Peck and its subsidiary. The submission was that the economic

[222] *Salomon v Salomon & Co Ltd* 1897 AC 22.
[223] *In Re Polly Peck International plc (In Administration) (No 3)* 1996 2 All ER 433 at 445-446.
[224] *In Re Polly Peck International plc (In Administration) (No 3)* 1996 2 All ER 433 at 446.
[225] *In Re Polly Peck International plc (In Administration) (No 3)* 1996 2 All ER 433 at 446.
[226] *In Re Polly Peck International plc (In Administration) (No 3)* 1996 2 All ER 433 at 447.
[227] *Adams v Cape Industries* 1991 1 All ER 929.
[228] *In Re Polly Peck International plc (In Administration) (No 3)* 1996 2 All ER 433 at 447.
[229] *In Re Polly Peck International plc (In Administration) (No 3)* 1996 2 All ER 433 at 447.
[230] *In Re Polly Peck International plc (In Administration) (No 3)* 1996 2 All ER 433 at 447.

nature of the group should have been considered and not the legal nature.[231] The judge accepted the economic reality that creditors in all probability relied on the credit rating of Polly Peck when purchasing the bonds as the myriad of possibilities, in terms of the loaning-on of the funds could not have been foreseen by the creditors.[232] The court once again revisited *Adams v Cape Industries*[233] and stated the principle that the court may not divert from the principles laid down in *Salomon v Salomon* "merely because it considers that justice so requires".[234] The court therefore denied the single economic unit argument and stated that while it did not possess the authority to create a new exception in law, it did not find any injustice that needed to be remedied from the insolvency of a large corporate group such as the one in question.[235]

In Re Polly Peck International therefore succeeded in recognising the difference that may exist between the economic and legal reality within a group structure.[236] However, it failed to recognise the possible implications of the insolvency of a corporate group like Polly Peck International and upheld the principles created by *Salomon v Salomon*[237] and *Adams v Cape Industries*.[238] The legal reality within a corporate group therefore remains favoured over the economic reality that may exist.[239]

3.3.4 Conclusion

The principles arising from *Salomon v Salomon*[240] originated from the UK over one hundred years ago and it comes as little surprise that the country in which the case originated is the country that refuses to divert from its precedent.[241] The UK therefore has opted to keep strictly with the entity theory and contrary to New Zealand and the USA has not developed a doctrine of substantive consolidation with regard to corporate groups. As a result, the UK must rely on the doctrine of piercing the corporate veil in situations where a related company is a mere façade, a general express

[231] *In Re Polly Peck International plc (In Administration) (No 3)* 1996 2 All ER 433 at 448.
[232] *In Re Polly Peck International plc (In Administration) (No 3)* 1996 2 All ER 433 at 448.
[233] *Adams v Cape Industries* 1991 1 All ER 929.
[234] *Salomon v A Salomon & Co Ltd* 1897 AC 22 All ER Rep 33 at 1895–9
[235] *In Re Polly Peck International plc (In Administration) (No 3)* 1996 2 All ER 433 at 448.
[236] *In Re Polly Peck International plc (In Administration) (No 3)* 1996 2 All ER 433 at 448.
[237] *Salomon v Salomon & Co Ltd* 1897 AC 22.
[238] *Adams v Cape Industries* 1991 1 All ER 929.
[239] *In Re Polly Peck International plc (In Administration) (No 3)* 1996 2 All ER 433 at 448.
[240] *Salomon v Salomon & Co Ltd* 1897 AC 22.
[241] Bowmer S, 2000 at 6.

agreement of agency exists or related companies are treated as a single economic entity.[242] Piercing the corporate veil, however, does not amount to substantive consolidation or pooling as stringent requirements[243] must be complied with in order to be able to pierce the corporate veil; it is not an insolvency-specific remedy and it is limited in its operation.[244]

[242] Bowmer S, 2000 at 4.
[243] See par 3.2 above with specific reference to *In re Owens Corning.*
[244] Graulich TE, 2006 at 538.

CHAPTER 4: THE SOUTH AFRICAN APPROACH

4.1 Introduction

South Africa, like the UK, does not make provision for the pooling or substantive consolidation of company groups when they enter insolvency or business rescue proceedings.[1] South Africa also looks to *Salomon v Salomon*[2] as the precedent for separate legal personality of companies and the principle was later confirmed by section 19(2) of the Companies Act.[3] Section 19(2) states that "[a] person is not, solely by reason of being an incorporator, shareholder or director of a company, liable for any liabilities or obligations of the company except to the extent that [the] Act or the company's Memorandum of Incorporation provides otherwise."[4] This provision keeps the obligations and liabilities of the company separate from those of its shareholders, confirming the principle of separate legal personality established by *Salomon v Salomon*.[5] However, the South African legislature has recognised the evolution of the corporate structure and in doing so started inserting provisions in its company governing legislation to deal with the holding company and its subsidiary.[6] The development of the approach towards company groups in South Africa therefore can be tracked through the development of the Companies Acts through the years.[7]

4.2 Company Groups Prior to the Companies Act of 2008

The evolution of the terms "holding company" and "subsidiary" is a good starting point for determining how company groups were approached prior to the new Companies Act. These terms were introduced in South African law by an Amendment Act in 1939.[8] In 1952 another amendment[9] modified the definitions of these terms and is deemed to have expanded on the control of the relationship between holding com-

[1] Mckinnell J, Successful Business Rescue of the Moyo Group, 2014, available at https://bit.ly/2RSPa1S (accessed on 29 May 2018).
[2] *Salomon v Salomon & Co Ltd* 1897 AC 22.
[3] S 19(2) of Act 71 of 2008.
[4] S 19(2) of Act 71 of 2008.
[5] *Salomon v Salomon & Co Ltd* 1897 AC 22 at 52 & 53.
[6] S 115 of the Companies Amendment Act 23 of 1939.
[7] The Companies Act 46 of 1926, the Companies Amendment Act 23 of 1939, the Amendment Act 46 of 1952, the Companies Amendment Act 82 of 1992 and the Companies Act 71 of 2008.
[8] S 115 of the Companies Amendment Act 23 of 1939.
[9] The Amendment Act 46 of 1952.

panies and their subsidiaries.[10]

In 1973 the Companies Act underwent significant reform and due to the Van Wyk de Vries Commission the approach towards company groups also changed.[11] The Companies Act of 1973,[12] following the recommendations of the commission, separated the provisions dealing with disclosure from those dealing with prevention of abuse and made control irrelevant in the ambit of disclosure.[13] The relationship between the holding company and its subsidiary, on the basis of the shares held, became the determining factor in disclosure provisions while control remained the key factor in provisions concerning abuse.[14] After difficulties with this development the legislature reverted to the definition of the 1952 Act one year later.[15]

The 1992 Companies Amendment Act made a further change, making voting rights or the ability to appoint or dismiss directors central to the definition.[16] Membership once again became necessary, regardless of the fact that majority voting rights are held.[17]

Some difficulty is therefore evident in the early stages of the development of the Companies Act in dealing with company groups. The early addition of the relevant terms in the 1939 Amendment Act shows that the concept of the group structure has been recognised for almost eight decades.[18] This has ultimately culminated in the most recent version of the Act, the Companies Act of 2008.[19]

4.3 Company Groups after the Companies Act of 2008

The new Companies Act once again modified the definition of the holding company and subsidiaries as explained earlier.[20] The concept of the group of companies is briefly defined as "a holding company and all of its subsidiaries".[21] The new Act also

[10] Stevens RA, 2011 at 144. See *Unisec Group Ltd and Others v Sage Holdings Ltd* 1986 3 SA 259 (T).
[11] Stevens RA, 2011 at 144.
[12] The Companies Act 61 of 1973.
[13] Stevens RA, 2011 at 144.
[14] Stevens RA, 2011 at 145.
[15] Stevens RA, 2011 at 145.
[16] The Companies Amendment Act 82 of 1992.
[17] Stevens RA, 2011 at 146.
[18] S 115 of the Companies Amendment Act 23 of 1939.
[19] Act 71 of 2008.
[20] See ss 1 & 3 of Act 71 of 2008 and par 2.1 above.
[21] S 1 of Act 71 of 2008.

defines the concept of the inter-related juristic person[22] something which is also present in the Companies Act of New Zealand and is referred to in the pooling clause discussed earlier.[23] The concept of related and interrelated persons in section 2 of the Act is defined as follows:

> (1) For all purposes of this Act—
> […]
> (b) a juristic person is related to another juristic person if—
> (i) either of them directly or indirectly controls the other, or the business of the other, as determined in accordance with subsection (2);
> (ii) either is a subsidiary of the other;
> (iii) a person directly or indirectly controls each of them, or the business of each of them, as determined in accordance with subsection (2).[24]

It must also be noted that the legislature has seemingly added a limitation to the application of the Act with regard to related and interrelated persons.[25] Section 2(3) states that where parties can prove that they acted independently from each other, a court, the Companies Tribunal or the Panel may exempt the party from the application of a provision which finds relevance from the relationship between them.[26]

The new Companies Act, therefore, sets a basis for the regulation of these business arrangements and with it came certain regulations for company groups. These regulations can be found in the ambit of loans within company groups requiring stricter procedure and in doing so protecting creditors,[27] financial assistance for acquisition of shares in related companies,[28] the solvency and liquidity test which prior to the 2011 amendment appears to be drafted specifically with company groups in mind[29] and the statutory piercing of the corporate veil.[30] The solvency and liquidity test is set out in section 4(1) of the Act and prior to the Companies Amendment Act of 2011[31] was worded as follows;

> 4(1) For any purpose of this Act, a company satisfies the solvency and liquidity test at a particular time, if considering all reasonably foreseeable financial circumstances of the company at that time—
> (a) The assets of the company or, if the company is a member of a group of companies, the aggregate assets of the company, as fairly valued, equal or exceed the liabilities of the

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[22] S 2(2)(a)-(c) of Act 71 of 2008.
[23] Ss 2(3) & 271 of the New Zealand Companies Act of 1993f; see chapter 3 above.
[24] S 2(1)(c) of Act 71 of 2008.
[25] S 2(3) of Act 71 of 2008.
[26] S 2(3) of Act 71 of 2008.
[27] Stevens RA, 2011, pg 157.
[28] Stevens RA, 2011, pg 158-160.
[29] Stevens RA, 2011, pg 167.
[30] Stevens RA, 2011, pg 170-171.
[31] S 2(a) of Act 3 of 2011.

> company or , if the company is a member of a group of companies, the aggregate liabilities of the company, as fairly valued.[32]

In the draft phase of the new Act a proposition had been put forward to change the wording of the above test from "aggregate" to "consolidated," which change would have made the test less onerous for company groups.[33] However, the legislature did not make the proposed change.[34] The wording of the solvency and liquidity test prior to its amendment was potentially confusing and instead of enhancing the protection of creditors it left an opening for abuse.[35] The use of the word "aggregate" seems to be redundant and the use of the words "group of companies" suggests that the assets and liabilities of the entire group should be used to test solvency and liquidity.[36] This wording may lend itself to abuse as an insolvent company could pass the test as a result of the solvent state of its related companies, exposing creditors and requiring intervention by the Companies and Intellectual Property Commission (CIPC) or the Takeover Regulation Panel.[37] Jooste submits that the intention of the legislature was that a member of a group would only pass the solvency and liquidity test if each individual company within the group also passed the test.[38] The Companies Amendment Act of 2011 later altered the wording of the solvency and liquidity test. The amended test reads as follows:

> 4(1) For any purpose of this Act, a company satisfies the solvency and liquidity test at a particular time if, considering all reasonably foreseeable financial circumstances of the company at that time—
> (a) the assets of the company, as fairly valued, equal or exceed the liabilities of the company, as fairly valued.[39]

The legislature therefore opted to remove the wording specifically dealing with groups of companies that were present in the former version of the Act.[40] This development shows that the legislature's attempt to include company groups in the solvency and liquidity test was unsuccessful and that it therefore reverted to a simplified test.

[32] S 4(1) of Act 71 of 2008.
[33] Gilfillan B *Getting to grips with the new Companies Act*, 2010, available at https://bit.ly/2FDiL9N (accessed on 01 September 2018).
[34] S 4(1) of Act 71 of 2008.
[35] Jooste R, *Issues Relating to the Regulation of 'Distributions' by the 2008 Companies Act*, Volume 126, Part 4, SALJ, 2009 at 641.
[36] Jooste R, 2009 at 641.
[37] Jooste R, 2009 at 641-642.
[38] Jooste R, 2009 at 641.
[39] S 4(1) of Act 71 of 2008.
[40] S 4(1) of Act 71 of 2008.

The amended version of the test is to be preferred. The solvency and liquidity test finds application in a number of sections, namely, the provision of financial assistance to purchase the company's securities,[41] the making of distributions as authorised by the board,[42] the capitalisation of shares,[43] the transfer of uncertificated securities,[44] mergers,[45] and perhaps most importantly from an insolvency point of view, the granting of loans or other financial assistance to directors "of a related or inter-related company, or to a member of a related or inter-related corporation".[46] The abuse of this section could therefore have far-reaching consequences.

The developments in terms of the solvency and liquidity test show the legislature's clear intention to deal with company groups, despite the later amendment.[47] Stevens is of the opinion that the new Companies Act represents a positive change for the regulation of company groups and their abuse, while there are still areas in which it can be improved, one of them being the insolvency of subsidiary companies.[48] I agree with this statement. The new Companies Act and the manner in which it currently regulates company groups sets a good basis for these improvements.

4.4 Piercing the Corporate Veil

The Act also makes provision for piercing of the corporate veil under specific circumstances. This remedy, as previously mentioned, does not amount to substantive consolidation but serves to show the alternative remedies available to creditors. Piercing the corporate veil can be done on two bases in South African law.[49]

The first manner in which the corporate veil may be pierced is by means of statute.[50] In terms of section 20(9) of the Act provides that in case of unconscionable abuse of a company's juristic personality the court may order that the company is to be deemed not to be a juristic person in terms of the rights duties or liabilities of the

[41] S 44 of Act 71 of 2008.
[42] S 46 of Act 71 of 2008.
[43] S 47 of Act 71 of 2008.
[44] S 53 of Act 71 of 2008.
[45] S 113 of Act 71 of 2008.
[46] S 45(2) of Act 71 of 2008.
[47] S 2(a) of Act 3 of 2011.
[48] Stevens RA, 2011 at 171-172.
[49] Delport PA, *Henochsberg on the Companies Act, 71 of* 2008, 2018 at 106(3). See also Delport P, *New Entrepreneurial Law*, 2014 at 15-17.
[50] Delport PA, 2018 at 106(3). See also Delport P, *New Entrepreneurial Law*, 2014 at 15-17.

company or a member where non-profit companies are applicable.[51] Section 20(9) was tested in *Ex Parte Gore NO and Others*.[52] In this case the liquidators of forty-one companies attempted to pierce the corporate veil so that their assets would be deemed to be the assets of the holding company.[53] The basis on which the relief was sought was that the distinction between the separate legal personalities of the holding company and its subsidiaries was not upheld and the group's business was effected through the holding company and as a single entity.[54] The fact that investor funds were transferred across related subsidiaries without maintaining proper records of the transfers was an important factor that the court took into consideration.[55] In coming to the decision to pierce the corporate veil the court considered foreign law including that of the UK[56] and Australia.[57] The court also mentioned that unconscionable abuse is a lesser form of abuse than gross abuse, which makes this remedy easier to apply, and includes terms such as sham, device or stratagem.[58] The term interested person was also discussed by the court and although it was not defined, a direct and sufficient interest seems to be required.[59] This remedy does not substitute the common law piercing of the corporate veil but rather works in conjunction with it.[60] The court in this case confirmed the possible application of section 20(9) to an abuse of the corporate form but left terms such as interested person and unconscionable abuse largely undefined.

Section 22 of the Act also makes provision for the piercing of the corporate veil.[61] Section 22 deals with reckless trading and when read with section 77(3)(a)-(b) allows for liability to be extended to directors where they cause the continued running of a business under a state of insolvency, recklessly, with gross negligence and an intention to defraud any person, referred to by the Act as reckless trading.[62] Thirdly, other statutes may also provide for the piercing of the corporate veil and the imposition of

[51] S 20(9) of Act 71 of 2008.
[52] [2013] 2 All SA 437 (WCC).
[53] *Ex Parte Gore NO and others* [2013] 2 All SA 437 (WCC) at 437.
[54] *Ex Parte Gore NO and others* [2013] 2 All SA 437 (WCC) at 437 & 442.
[55] *Ex Parte Gore NO and others* [2013] 2 All SA 437 (WCC) at 442.
[56] *Ex Parte Gore NO and others* [2013] 2 All SA 437 (WCC) at 446-448.
[57] *Ex Parte Gore NO and others* [2013] 2 All SA 437 (WCC) at 445.
[58] *Ex Parte Gore NO and others* [2013] 2 All SA 437 (WCC) at 452.
[59] *Ex Parte Gore NO and others* [2013] 2 All SA 437 (WCC) at 453.
[60] *Ex Parte Gore NO and others* [2013] 2 All SA 437 (WCC) at 453.
[61] S 22 of Act 71 of 2008.
[62] Ss 22 & 77(3)(a)-(b) of Act 71 of 2008.

liability on directors need not be discussed for present purposes.[63] The provisions regarding the statutory piercing of the corporate veil do not seem to have been enacted with company group structures in mind but merely for purposes of piercing the corporate veil with regard to directors. The value of this remedy in terms of abuse of corporate structures is therefore not evident at first glance. The common law provides further clarity as to when the corporate veil may be pierced.

In *Cape Pacific v Lubner Controlling Investments (Pty) Ltd* the court referred to the maxim *plus valet quod agitur quam quod simulate concipitur*, which means that the law regards substance rather than form, and confirmed the principles laid down in *Salomon v Salomon*.[64] The court suggested that the corporate veil may be pierced where a company is misused in order to commit fraud or dishonesty or is used for an improper purpose.[65] The court also stated that this remedy should be available where not effecting it would result in unconscionable injustice and no other remedy is available.[66] However, on the other hand, the "piercing of the corporate veil should necessarily be precluded if another remedy exists".[67] The common law therefore mirrors section 20(9) of the Act[68] and requires some form of improper use of the company.

Ex Parte Gore provides some comfort in knowing that the unconscionable abuse of the corporate group form can be remedied through the statutory piercing of the corporate veil. The use of the terms unconscionable abuse or injustice, however, do not provide certainty as to what is required to pierce the corporate veil. The courts also do not seem to have arrived at a settled rule regarding instances when the corporate veil will be pierced and therefore this doctrine may prove difficult to use.[69] Stevens also calls *Ex Parte Gore* a clear cut case and therefore one in which the court could have come to the same result merely through the use of established principles.[70]

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[63] S 34 of the National Environmental Management Act 107 of 1998.
[64] *Cape Pacific v Lubner Controlling Investments (Pty) Ltd* 1995 4 SA 790 (A).
[65] *Cape Pacific v Lubner Controlling Investments (Pty) Ltd* 1995 4 SA 790 (A) at 33.
[66] *Cape Pacific v Lubner Controlling Investments (Pty) Ltd* 1995 4 SA 790 (A) at 36.
[67] *Cape Pacific v Lubner Controlling Investments (Pty) Ltd* 1995 4 SA 790 (A) at 37.
[68] S 20(9) of Act 71 of 2008.
[69] Stevens RA, *The Consolidation of Assets and Liabilities within Company Groups*, DQ 119, 2014 at 127.
[70] Stevens RA, *The Consolidation of Assets and Liabilities within Company Groups*, DQ 119, 2014 at 121.

4.5 The *Steyn, Botha* and *Zwarts* Cases

Janse van Rensburg v Steyn,[71] *Janse van Rensburg v Botha*[72] and *Zwarts v Janse van Rensburg*[73] are three unreported cases in which the court allowed the consolidation of assets subsequent to a pyramid scheme being operated through four different companies and a partnership.[74] Through the operation of this scheme investments made by the public were diverted into the various entities which failed to maintain proper records of the allocation of the investments to each investor.[75] The owner also made transfers of assets and liabilities between the entities, further ignoring the separate legal personality of the entities.[76] All three cases were heard on the same day. This was a unique occurrence and one which is important for present purposes.

In *Steyn* the court had to establish why the debtors were being consolidated as a single consolidated entity.[77] The court considered section 29 of the Insolvency Act and stated that in order to make use of this provision to set aside a voidable preference, a plaintiff must be able to demonstrate that a specific debtor was responsible and that the liabilities of the entity exceeded its assets.[78] This was in fact impossible given the extent of the scheme's operations and the fact that the now consolidated entity was not the same entity that made the disposition.[79] The court stated that the order made by the high court removed these difficulties as it deemed the scheme to have been conducted under a single entity, it authorised the administration of the separate entities to be conducted as a single consolidated estate, declared that the state of insolvency arose in 1999 and finally no longer required that the insolvency practitioners assigned assets to each entity.[80]

In *Botha* the court dealt with an appeal against the decision of Fabricius AJ in the

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[71] *Janse van Rensburg NO and others v Steyn* 2012 JOL 29195 (SCA).
[72] *Janse van Rensburg NO and others v Botha* 2012 JOL 29421 (SCA).
[73] *Zwarts v Janse van Rensburg NO and others* 2012 JOL 29500 (SCA).
[74] Stevens RA, *The Consolidation of Assets and Liabilities within Company Groups*, DQ 119, 2014 at 120.
[75] Stevens RA, *The Consolidation of Assets and Liabilities within Company Groups*, DQ 119, 2014 at 120.
[76] Stevens RA, *The Consolidation of Assets and Liabilities within Company Groups*, DQ 119 2014 at 120.
[77] *Janse van Rensburg NO and others v Steyn* 2012 JOL 29195 (SCA) at 2.
[78] *Janse van Rensburg NO and others v Steyn* 2012 JOL 29195 (SCA) at 2.
[79] Stevens RA, *The Consolidation of Assets and Liabilities within Company Groups*, DQ 119, 2014 at 120.
[80] *Janse van Rensburg NO and others v Steyn* 2012 JOL 29195 (SCA) at 12.

High Court.[81] It was held in the High Court that a court does not have the power to create a statutory entity unless it is provided for by statute and that, by consolidating the entities that formed part of the scheme, the court had acted beyond its powers.[82] As a result of this the consolidation order was not binding and a section 29 voidable preference could not be proved.[83] The court also discussed the use of different names for the entities which formed part of the scheme and stated that these names were not of any significance and may have been mere alter egos of the owner.[84] Once again the court found that the failure to assign the debt to specific entities was not material to the application to set aside the section 29 voidable preference as a debtor-creditor relationship existed between Botha and the consolidated entity.[85]

In *Zwarts* the court did not repeat the decisions made in *Steyn* and *Botha* as it merely had to establish the relationship of the investor and the scheme itself.[86] The court held that the investment made by Zwarts was made through an agent of the scheme[87] and that a debtor-creditor relationship therefore existed between the investor and the scheme.[88]

The court in the above three cases effected a consolidation order similar New Zealand's pooling orders and the substantive consolidation orders of the USA.[89] Stevens is of the opinion that the court in making these decisions found its basis in the doctrine of the piercing of the corporate veil.[90] This view is informed by the fact that there is no provision in South African law for substantive consolidation or pooling. As cussed earlier[91] the only manner in which this can occur is by the piercing the corporate veil. The use of the term "alter ego" in *Botha* suggests the use of the doctrine.[92] The court's approach in deciding these three cases is therefore unclear and it was

[81] *Janse van Rensburg NO and others v Botha* 2012 JOL 29421 (SCA) at 4.
[82] *Janse van Rensburg NO and others v Botha* 2012 JOL 29421 (SCA) at 4.
[83] *Janse van Rensburg NO and others v Botha* 2012 JOL 29421 (SCA) at 4.
[84] *Janse van Rensburg NO and others v Botha* 2012 JOL 29421 (SCA) at 7.
[85] *Janse van Rensburg NO and others v Botha* 2012 JOL 29421 (SCA) at 12.
[86] *Zwarts v Janse van Rensburg NO and others* 2012 JOL 29500 (SCA) at 1.
[87] *Zwarts v Janse van Rensburg NO and others* 2012 JOL 29500 (SCA) at 4-5.
[88] Stevens RA, *The Consolidation of Assets and Liabilities within Company Groups*, DQ 119, 2014 at 120.
[89] Stevens RA, *The Consolidation of Assets and Liabilities within Company Groups*, DQ 119, 2014 at 120.
[90] Stevens RA, *The Consolidation of Assets and Liabilities within Company Groups*, DQ 119, 2014 at 121.
[91] See par 4.4 above.
[92] Stevens RA, *The Consolidation of Assets and Liabilities within Company Groups*, DQ 119, 2014 at 121.

perhaps a missed opportunity to introduce substantive consolidation as a remedy into the South African legal system.

4.6 *City Capital v Chavonnes*[93]

City Capital v Chavonnes heard in November 2017 was an appeal from the Western Cape High court.[94] The *court a quo* ordered that five companies which had been wound up were to be treated as a single entity.[95] This was brought as an application under section 20(9).[96] Section 22 concerning reckless trading,[97] section 141(2)(c) concerning voidable transactions, failure by management to perform their obligations, reckless trading, fraud or any other contravention of the laws relating to the company[98] and section 141(3) which allows the court to make any order applied for or that the court deems fit in discontinuing business rescue proceedings and placing the company in liquidation,[99] were used in support of the application.

The grounds on which the section 20(9) application was brought were that the five companies has been part of a syndication scheme that was unsustainable and had been used for purposes of defrauding the public and, secondly, that the use of the companies amounted to unconscionable abuse of their separate juristic personality.[100] The court also took note of the fact that the separate entities were run as a "single indivisible commercial enterprise," allowing funds to flow between the entities and failing to maintain the financial independence of the entities.[101]

The court discussed the statutory piercing of the corporate veil and the term "unconscionable abuse".[102] It was argued that unconscionable abuse must be given its ordinary meaning and was found to include acts such as fraud, the use of a company

[93] *City Capital SA Property Holdings Ltd v Chavonnes Badenhorst St Clair Cooper and others* 2018 4 SA 71 (SCA).
[94] *City Capital SA Property Holdings Ltd v Chavonnes Badenhorst St Clair Cooper and others* 2018 4 SA 71 (SCA) at 72.
[95] *City Capital SA Property Holdings Ltd v Chavonnes Badenhorst St Clair Cooper and others* 2018 4 SA 71 (SCA) at 71.
[96] S 20(9) of Act 71 of 2008.
[97] S 22 of Act 71 of 2008.
[98] S 141(2)(c) of Act 71 of 2008.
[99] S 141(3) of Act 71 of 2008.
[100] *City Capital SA Property Holdings Ltd v Chavonnes Badenhorst St Clair Cooper and others* 2018 4 SA 71 (SCA) at 75.
[101] *City Capital SA Property Holdings Ltd v Chavonnes Badenhorst St Clair Cooper and others* 2018 4 SA 71 (SCA) at 76.
[102] *City Capital SA Property Holdings Ltd v Chavonnes Badenhorst St Clair Cooper and others* 2018 4 SA 71 (SCA) at 81.

for dishonest or an improper purpose or where the company is used as a mere façade to conceal the true facts.[103] The use of controlled entities by their controlling companies for a dishonest or improper purpose, while treating a group of companies as a single entity, would fall under the definition of unconscionable abuse.[104] The court also referred to *Ritz Hotel v Charles of the Ritz Ltd & another*[105] in which the court referred to English law and stated that there was a tendency to pierce the veil and treat subsidiaries with separate legal personality, that found themselves under the control of the parent company, as a single entity.[106]

The central issue in *City Capital v Chavonnes* was not the order to treat the separate legal entities as one but rather the appointment of the liquidator.[107] However, the court has demonstrated in this fairly recent case that the doctrine of piercing the corporate veil can, and will, be used to consolidate separate related legal entities where unconscionable abuse is present.[108] The court also made it clear that the sustainability of a corporate group, fraudulent practices and a failure to maintain separate financial affairs are of importance in a section 20(9) application.[109]

4.7 Conclusion

South Africa has acknowledged the existence of company groups within the Companies Act and the problems that they may present with regard to abuse. However, South Africa has not gone as far as New Zealand or the USA with regard to creating an insolvency-specific remedy for company groups, and the doctrine of piercing the corporate veil therefore must be used in order to remedy abuse. This approach is similar to that of the UK, which also prefers to maintain the strict application of *Salomon v Salomon* and make use of the doctrine of piercing the corporate veil in case of

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[103] *City Capital SA Property Holdings Ltd v Chavonnes Badenhorst St Clair Cooper and others* 2018 4 SA 71 (SCA) at *81*.

[104] *City Capital SA Property Holdings Ltd v Chavonnes Badenhorst St Clair Cooper and others* 2018 4 SA 71 (SCA) at *81*.

[105] 1988 3 SA 290 (A).

[106] *DHN Food Distributors Ltd v Tower Hamlets London Burough Council* [1976] 1 WLR 852 (CA) at 860B.

[107] *City Capital SA Property Holdings Ltd v Chavonnes Badenhorst St Clair Cooper and others* 2018 4 SA 71 (SCA) at 71.

[108] *City Capital SA Property Holdings Ltd v Chavonnes Badenhorst St Clair Cooper and others* 2018 4 SA 71 (SCA) at 81-82.

[109] *City Capital SA Property Holdings Ltd v Chavonnes Badenhorst St Clair Cooper and others* 2018 4 SA 71 (SCA) at 75-76.

the insolvency of company groups.[110] *Ex Parte Gore* has shown that the doctrine can in fact be used in the ambit of company groups in order to impose liability on a holding company.[111] The more recent case of *City Capital v Chavonnes* has confirmed the use of the doctrine of piercing the corporate veil and suggests that English law should be considered for guidance.[112] This provides some protection to creditors but not to the extent that a pooling provision would provide in cases that are not as clear-cut as the South African courts have heard to date.[113] Finally, the trio of cases in which the anomalous consolidation order was allowed, was a missed opportunity either to develop the doctrine of piercing the corporate veil or introduce substantive consolidation.

[110] See chapter 3.3.4.
[111] [2013] 2 All SA 437 (WCC).
[112] *City Capital SA Property Holdings Ltd v Chavonnes Badenhorst St Clair Cooper and others* 2018 4 SA 71 (SCA).
[113] Stevens RA, *The Consolidation of Assets and Liabilities within Company Groups*, DQ 119, 2014 at 121.

CHAPTER 5: INTERNATIONAL INSTRUMENTS

5.1 Introduction

International instruments such as those issued by UNCITRAL and the World Bank can be useful in that they provide legislative guidelines or even "soft law" in the form of a model law. Countries may take these suggestions into account and adopt legislation which is in line with these suggestions. UNCITRAL has been largely successful in the drafting of the UNCITRAL Model Law on Cross-border Insolvency which has been adopted in 44 states in 46 jurisdictions.[1] South Africa is one of these countries and has enacted the Cross Border Insolvency Act[2] which has not yet come into force due to the insertion of a reciprocity clause.[3] UNCITRAL also publishes legislative guides and recommendations and in doing so published guides and recommendations with regard to the treatment of enterprise groups in insolvency.[4]

5.2 UNCITRAL

UNCITRAL has made suggestions regarding the domestic consolidation of corporate groups.[5] It therefore supports substantive consolidation and provides a legislative outline on how it should be regulated.[6]

The guide notes that circumstances that would justify an order for substantive consolidation are where the affairs and operations of members of a group are so integrated that to unravel the assets and liabilities of the separate entities would be impossible or prejudicial to all creditors.[7] The guide also lists the various elements that should be analysed by a court in reaching a just and equitable decision, namely, consolidated group financial statements, the use of a single bank account for multiple members, common ownership and interests, difficulty in untangling assets and liabilities, the sharing of expenses, the extent to which intra-group loans were ef-

[1] UNCITRAL *UNCITRAL Model Law on Cross-Border Insolvency (1997)*, 2018, available at https://bit.ly/23ecrZB (accessed on 30th October 2018).
[2] Act 42 of 2000.
[3] S2(2) of Act 42 of 2000.
[4] United Nations Commission on International Trade Law, *UNCITRAL Legislative Guide on Insolvency Law, Part three: Treatment of enterprise groups in insolvency*, 2012.
[5] Stevens RA, *The Consolidation of Assets and Liabilities within Company Groups*, DQ 119, 2014 at 128.
[6] United Nations Commission on International Trade Law, *UNCITRAL Legislative Guide on Insolvency Law, Part three: Treatment of enterprise groups in insolvency*, 2012 at 71 & 72.
[7] United Nations Commission on International Trade Law, 2012 at 60.

fected and the transfer of assets between related companies without proper records, the level of capitalisation, the appointment of common directors and joint board meetings, common premises, fraudulent treatment of creditors, the extent to which creditors are encouraged to deal with the group as a single entity and the extent to which substantive consolidation would be beneficial to creditors or to the outcome of a reorganisation.[8] Although the guide mentions all of these factors, it recognises the practice, as mentioned earlier,[9] that courts will not necessarily make use of all of them.[10]

The guide also makes a suggestion with regard to the treatment of secured creditors and states that where these creditors are external to the group, security interests should crystallise upon the commencement of insolvency proceedings and that to extend the interests to a consolidated estate would enhance the interests of the creditor.[11] The guide therefore takes the stance that a secured creditor may not gain an advantage at the expense of other creditors where substantive consolidation is ordered.[12]

UNCITRAL advocates thorough legislative drafting of the rules for substantive consolidation and suggests that the following provisions be inserted in domestic insolvency legislation:

(a) The purpose of substantive consolidation;
(b) the deviation of the principle of limited liability;
(c) the circumstances required for substantive consolidation;
(d) exclusions from substantive consolidation;
(e) how substantive consolidation may be applied for;
(f) the effect of an order for substantive consolidation;
(g) how security is treated;
(h) the recognition of priorities;
(i) the meetings of creditors;
(j) the treatment of voidable transactions and time periods;
(k) modifications to an order of substantive consolidation;

[8] United Nations Commission on International Trade Law, 2012 at 62.
[9] See paras 3.1 and 3.2 above.
[10] United Nations Commission on International Trade Law, 2012 at 62.
[11] United Nations Commission on International Trade Law, 2012 at 66.
[12] United Nations Commission on International Trade Law, 2012 at 66.

(l) competent courts; and
(m) required notices.[13]

UNCITRAL therefore suggests that the provision be drafted into legislation as has been done by New Zealand but with more detail than the pooling clause of New Zealand.[14]

5.3 The World Bank

The World Bank proposal is less comprehensive than that of UNCITRAL with regard to how enterprise groups should be treated. It contains a number of suggestions with regard to the domestic and international treatment of enterprise or company groups.[15]

The World Bank submits that procedural coordination should be provided for in relation to the insolvency of more than one member of the group and that the extent to which coordination is effected should be left to the discretion of the courts.[16]

Substantive consolidation, on the other hand, should be restricted to two circumstances, namely (a) the intermingling of assets or liabilities to such an extent that their unravelling would cause "disproportionate expense or delay";[17] and (b) where the members of the group are involved in a fraudulent scheme or activity and no legitimate business purpose exists.[18] A court should be able to exclude certain claims and assets from the effect of the consolidation order and there should be provision for secured transactions, priorities, creditor meetings and avoidance actions.[19] The World Bank also states that claims amongst the related companies should be extinguished and that the legislation should disclose this along with the fact that consolidated entities will be treated as a single entity and claims will treated as being against a single insolvent estate.[20]

In addition, the World Bank states that the system should provide for post-

[13] United Nations Commission on International Trade Law, 2012 at 71-74.
[14] Ss 271& 272 of the New Zealand Companies Act of 1993.
[15] The World Bank, *Principles for effective insolvency and creditor/debtor regimes*, 2016 at 27-28.
[16] The World Bank, *Principles for effective insolvency and creditor/debtor regimes*, 2016 at 27.
[17] The World Bank, *Principles for effective insolvency and creditor/debtor regimes*, 2016 at 27.
[18] The World Bank, *Principles for effective insolvency and creditor/debtor regimes*, 2016 at 27.
[19] The World Bank, *Principles for effective insolvency and creditor/debtor regimes*, 2016 at 27.
[20] The World Bank, *Principles for effective insolvency and creditor/debtor regimes*, 2016 at 27.

commencement finance and ensure that the priority of post-commencement finance, granted to a corporate group member, is made clear.[21] Reorganisation plans should also receive attention and solvent companies should be allowed to participate in the reorganisation of insolvent members of company groups.[22] It is also submitted that there should be provision for a single insolvency practitioner for more than one member of a corporate group and that such a provision should deal with issues such as conflicts of interests, communication and cooperation.[23] Furthermore, avoidance actions whereby members of corporate groups effect transactions amongst themselves or with a related person should be subject to the court's discretion to set aside these transactions depending on the circumstances.[24]

5.4 Conclusion

Both of the abovementioned instruments acknowledge the problems pertaining to the insolvency of company groups. UNCITRAL has even gone so far as to make recommendations on the contents of the proposed provisions.[25] UNCITRAL proposes that substantive consolidation of corporate groups be thoroughly regulated by legislation, clearly going a step further than New Zealand. The World Bank, on the other hand, makes very broad suggestions with regard to the procedural and substantive consolidation of company groups, merely suggesting what a legal system should provide for, but without going into extensive detail.[26]

[21] The World Bank, *Principles for effective insolvency and creditor/debtor regimes*, 2016 at 27.
[22] The World Bank, *Principles for effective insolvency and creditor/debtor regimes*, 2016 at 27.
[23] The World Bank, *Principles for effective insolvency and creditor/debtor regimes*, 2016 at 27.
[24] The World Bank, *Principles for effective insolvency and creditor/debtor regimes*, 2016 at 27.
[25] United Nations Commission on International Trade Law, 2012 at 71-74.
[26] The World Bank, *Principles for effective insolvency and creditor/debtor regimes*, 2016 at 27.

CHAPTER 6: SUMMARY AND CONCLUSION

6.1 Summary

The dissertation was drafted with the goal of comparing the South African approach to company groups within the ambit of insolvency to other common law jurisdictions and international instruments.[1] The company group is a construct that has been around for over a century and will remain for many more. However the insolvency of companies within company groups may pose certain difficulties and this corporate form is susceptible to abuse.[2]

The question posed, was whether South Africa could learn from other jurisdictions and international instruments ultimately to afford further protection to creditors. The South African dispensation currently follows the approach taken by the UK.[3] This approach is different from that of New Zealand. New Zealand has opted to insert a pooling clause in their Companies Act.[4] This clause allows for the consolidation of assets and liabilities where groups of companies fail to maintain their separate legal personality as a result of mismanagement or fraud.[5] It also provides for factors that a court must take into account when making such orders and therefore clarifies the application of the provision.[6] Case law has further clarified the scenarios in which a court would be inclined to grant a pooling order, which shows that the provision does in fact serve its purpose.[7] However, difficulty has been encountered in the application of pooling orders where creditors have claims against more than one of the pooled companies and in the case of interest.[8] The advantage of the pooling clause of New Zealand is the legal certainty regarding which factors will be taken into account by a court when considering and granting such an application.

The USA has dealt with the question of consolidation in a different manner than New Zealand. The courts in the USA were responsible for the development of the law on

[1] See par 1.3.
[2] See par 2.2 & 2.3.
[3] See par 3.3.4 & 4.7.
[4] S 271 of the the New Zealand Companies Act of 1993.
[5] Ross M, *Tangled webs: unravelling the strands after a corporate group collapses*, International Company and Commercial Law Review, 1992 at 4.
[6] S 272(2)(a)-(e) of the New Zealand Companies Act of 1993.
[7] See par 3.1.3.
[8] Ross M, 1992 at 4.

substantive consolidation.[9] Allowing the courts to create law on substantive consolidation has created ample confusion and has led to different approaches taken over the years and in different circuits.[10] The certainty offered by a statutory provision providing for the factors that a court will consider is lacking in the USA. This is, therefore, not an approach that would be beneficial to the South African system as it creates legal uncertainty and ultimately may dissuade investment. The USA also provides for procedural consolidation under section 105 of the Bankruptcy Code[11] which provides for a less invasive and potentially cost-effective and efficient manner of dealing with the insolvency of company groups. This is a good provision to have in insolvency legislation and comes with merely one condition, namely, that there is no conflict of interests arising from such exercise.

Other jurisdictions have diverted from the strict application of separate legal personality.[12] A move towards enterprise theory would therefore be beneficial to the current state of affairs of South Africa. The UK, and of course South Africa, have opted to follow strictly the arguably outdated principles laid down in *Salomon v Salomon* and rely heavily on the doctrine of piercing the corporate veil. The use of the corporate veil doctrine brings with it the danger that some forms of abuse in the insolvency of company groups will not fall under its strict requirements.[13] It has also been submitted that the doctrine will only function top-down and may not find application where companies are related horisontally or bottom-up.[14] It must also be taken into account that *Salomon v Salomon* was a decision that came before the epiphany of the company group. Therefore, while the principle is one of great importance in the company law of certain common law jurisdictions, its strict application may no longer be appropriate.[15]

The Companies Act of 2008 has set the basis for the regulation of company groups in South Africa.[16] However, the doctrine of piercing the corporate veil remains the only statutory provision that may be of use in the insolvency of company groups.[17]

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[9] See par 3.2.4.
[10] See par 3.2.4.
[11] Ferriel JT and Janger EJ, *The Law Relating To Corporate Groups,* 2013 at 880.
[12] See par 3.1 & 3.2.
[13] See par 3.3.3.
[14] See par 3.3.3.
[15] See par 3.1 & 3.2.
[16] See par 4.3.
[17] See par 4.4.

The South African case law confirms this to a large extent, although the grounds on which consolidation was effected in the *Steyn, Botha* and *Zwarts* cases were not entirely clear.[18] *City Capital v Chavonnes* was clearly based on a section 20(9) application, piercing the corporate veil, and therefore confirms the reliance on the doctrine in the insolvency of company groups.[19]

Stevens has suggested that is not clear when the South African doctrine of piercing the corporate veil will apply in both statutory and common law piercing.[20] He suggests that a system of pooling similar to that of New Zealand should be implemented along with a presumption in favour of the order provided that the statutory factors are present.[21] This suggestion is informed by section 21(5) of the Insolvency Act[22] which provides for a presumption that the assets of a solvent spouse married out of community of property should fall within the estate of the insolvent spouse unless it can be proved that those assets do in fact belong to the solvent spouse.[23] The onus to prove that pooling should not occur therefore would fall on the holding company in this construct.[24] Stevens notes that this would merely amount to a limitation of the principle of limited liability and that the separate legal personality of companies within a company group would remain the default position.[25] The difficulties presented by securities held by creditors and whether claims against a main debtor should survive pooling are to be resolved through a discretionary approach of the court.[26] Stevens believes these provisions should be inserted in the Companies Act.[27]

Finally, the suggestions made by the World Bank and UNCITRAL were considered.[28] UNCITRAL's suggestions towards legislating substantive consolidation are extensive

[18] See par 4.5.
[19] See par 4.6.
[20] Stevens RA, *The Consolidation of Assets and Liabilities within Company Groups*, DQ 119, 2014 at 128.
[21] Stevens RA, *The Consolidation of Assets and Liabilities within Company Groups*, DQ 119, 2014 at 128.
[22] The Insolvency Act 24 of 1936.
[23] S 21(5) of the Insolvency Act 24 of 1936.
[24] Stevens RA, *The Consolidation of Assets and Liabilities within Company Groups*, DQ 119, 2014 at 128.
[25] Stevens RA, *The Consolidation of Assets and Liabilities within Company Groups*, DQ 119, 2014 at 128.
[26] Stevens RA, *The Consolidation of Assets and Liabilities within Company Groups*, DQ 119, 2014 at 128.
[27] Stevens RA, *The Consolidation of Assets and Liabilities within Company Groups*, DQ 119, 2014 at 128.
[28] See chapter 5.

and cover a greater number of factors in comparison with the pooling clause of New Zealand.[29] UNCITRAL also discusses the suggested clauses to be inserted in legislation and the position of secured creditors in that they may not gain an advantage over other creditors as a result of the consolidation.[30] The World Bank does not go into detail and merely suggests what a legal system should provide for, including procedural consolidation, substantive consolidation, post-commencement finance, avoidance actions, insolvency representatives and reorganisation plans.[31] The World Bank only mentions two circumstances in which substantive consolidation should be allowed, namely, intermingling of related companies and fraudulent activity.[32]

6.2 Conclusion

The scope of a dissertation of this kind makes it impossible to discuss all the jurisdictions in which some sort of consolidation or pooling has been allowed. Having considered the legal position in New Zealand, the UK and the USA it is concluded that substantive consolidation should not be over regulated and should not be allowed to become as difficult to apply and as narrow as the doctrine of piercing the corporate veil. Creating a presumption in favour of substantive consolidation would have a negative impact on the risk-taking incentive that limited liability companies provide to entrepreneurship and business.[33] Substantive consolidation therefore should have limited application but should be able to find application more readily than the doctrine of the piercing the corporate veil.

The most favourable approach for South Africa is to implement legislation similar to that of New Zealand's pooling clause[34] with the added certainty of how secured creditors, priority creditors, creditors with claims against more than one company involved in the consolidation proceedings, creditors meetings and interest will be treated in such cases. All of the factors suggested by UNCITRAL should be included in the provisions and a court should be allowed to use its discretion in considering

[29] See par 5.2.
[30] See par 5.2.
[31] See par 5.3.
[32] See par 5.3.
[33] Stevens RA, *The Consolidation of Assets and Liabilities within Company Groups*, DQ 119, 2014 at 128.
[34] Ss 271 & 272 of the New Zealand Companies Act of 1993.

any additional factors it deems fit.[35]

The adoption of a provision allowing for substantive consolidation would not only enhance the protection for creditors, but also ensure that South Africa does not follow in the turbulent development of the American doctrine of substantive consolidation, nor remain trapped in the strict application of *Salomon v Salomon,* a case described by Milo as a historical accident.[36] However, the importance of *Salomon v Salomon* must not be disregarded merely because of its age and the legislature must acknowledge and guard against the inherent problems that arise from the company group structure.[37]

> "The great thing in the world is not so much where we stand, as in what direction we are moving" – Oliver Wendell Holmes

[35] See par 5.2.
[36] Milo D, *The Liability of a Holding Company for the Debts of its Insolvent Subsidiary: Is Salomon Still Alive and Well?* 115, SALJ, 1998 at 340-341.
[37] Milo D, *The Liability of a Holding Company for the Debts of its Insolvent Subsidiary: Is Salomon Still Alive and Well?* 115, SALJ, 1998 at 343.

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