Parent company made to pay its subsidiary’s debts

Directors beware – unless you are careful to maintain a subsidiary’s independence, the parent company may be liable for the debts of its subsidiary.

That is the effect of a recent High Court decision invoking a rarely used provision in the Companies Act.

We analyse the judgment and draw some practical advice from it.

Section 271

Section 271(1)(a) of the Companies Act 1993 (the Act) has been used only rarely and is unique to New Zealand law, although Ireland has a similar provision.

It creates an exception to the principle that a company is a legal entity in its own right and that its shareholders are only liable for the company’s debts to the extent of their shareholding. Section 271 allows the Court to order the parent company of a company in liquidation to pay to the liquidators the whole or a part of all or any claims made against the subsidiary.

The case

In Lewis Holdings Ltd v Steel & Tube Holdings Ltd (to read the case online) the liquidators successfully obtained an order under Section 271 where:

- Lewis Holdings leased a property to Stube Industries Ltd (Stube), a wholly owned subsidiary of Steel & Tube Holdings Ltd (Steel & Tube)
- the rent and rates under the lease were invoiced to and paid by Steel & Tube, and
- decisions for Stube, including a decision to renew the lease for a further 21 year term, were made on the advice of Steel & Tube’s legal counsel, without Stube obtaining independent legal advice.

When Stube was put into liquidation, Lewis Holdings filed a proof of debt as the unpaid landlord. The liquidators then
sought an order under section 271(1)(a) that Steel & Tube be required to pay the whole of the claim (it being the only claim in the liquidation).

The decision

Several factors led the Court to hold that the separate legal entity which was Stube was “devoid of any capacity to conduct its own affairs”:

- The subsidiary was being run essentially as a “division” of the parent company.
- Decision-making considered the group as a “single unit” rather than identifying the subsidiary’s interests as distinct.
- The evidence of the CEO and CFO of the parent company, both of whom were directors of the subsidiary company, was that “they treated the [leased] property both as to its benefits and liabilities as something that lay with [the parent company]”.
- The subsidiary company did not, where it ought to have, obtain independent legal advice before entering into major transactions.
- The subsidiary had no employees of its own, and used the parent company’s employees and letterhead to conduct business.
- The subsidiary company was treated for accounting purposes as a division of the parent company, it had no separate bank account and invoices for rates and rent were addressed to and paid by the parent company.
- Although the constitution allowed the directors to take into account the interests of the parent company (as provided for in section 131(2) of the Act), the Court found that the directors were still required to make a distinction between the interests of the company and of the subsidiary when making decisions.

The Court acknowledged that it is common practice for a parent company to be involved in the management of its subsidiary, including appointing high-level managers to the subsidiary’s board. However, in this case, the level of involvement had been so large as to compromise the subsidiary’s independence.

The circumstances that gave rise to the subsidiary’s liquidation were entirely attributable to the parent company because, having created a 21 year obligation on Stube by renewing the lease, it then withdrew the funding it had previously provided to pay the rent and rates.

The Court also gave some weight to the argument that as the parent company was publicly listed and had a company solicitor, it should have conducted the group’s affairs in a way that gave effect to each entity’s separate legal personality, rather than treating the group “as a single economic enterprise”.

Chapman Tripp comments

Directors must be careful to ensure that a subsidiary’s interests are kept distinct and that appropriate legal and financial arrangements are made if there is to be a sharing of liabilities between companies within a group.

This includes:

- ensuring that the subsidiary’s interests are regarded as distinct from the interests of the parent company or other companies within the group during decision making
- running the subsidiary as a separate company rather than as a division of the parent company, with its assets and liabilities treated as its own rather than as the assets and liabilities of the parent company
- maintaining appropriate separation of company records and resolutions
- ensuring that liabilities are being invoiced to and paid by the appropriate company, and
- ensuring the subsidiary company receives independent legal advice to protect its own interests and that formal legal agreements exist for the provision of financial support from the parent company to the subsidiary.

Failure to take these steps will create a risk that a Court will hold the parent company liable for the debts of its wholly owned subsidiary.
Footnotes

Our thanks to Nupur Upadhyay for writing this Brief Counsel.