

CORPORATE GROUPS AND THE CORPORATE VEIL IN CANADA: A PENETRATING LOOK AT PARENT-SUBSIDIARY RELATIONS IN THE MODERN CORPORATE ENTERPRISE

*Neil C. Sargent**

I. Introduction

It is almost forty years since Professor Adolf Berle wrote his seminal article entitled "The Theory of Enterprise Entity"¹ in which he attempted to articulate a general theory capable of systematizing the disparate rules governing "*de facto*" corporations and "piercing the corporate veil" under American corporation law. Berle argued that there were a steady and growing number of disputes before the courts for which the traditional concept of corporate personality was incapable of providing an appropriate solution because it failed to recognize the underlying factual relationships obtaining between the corporate economic entity and both its shareholders and outsiders such as employees or creditors.² In such cases the courts were forced to fashion *ad hoc* solutions by either recognizing the existence of corporate personality before it had been formally granted by the state (the "*de facto*" corporation cases) or, conversely, disregarding the corporate personality altogether (the veil piercing cases). From this evidence Berle deduced that the courts were increasingly beginning to regard the corporation as "an enterprise bounded by economics, rather than as an artificial mystic personality bounded by forms of words in a charter, minute books, and books of account."³

While this theory of "enterprise entity" has had a considerable influence upon American courts and legislators, it does not appear to have taken root to any great extent in Anglo-Canadian jurisprudence. Despite the efforts of Professor Berle and a handful of British and Canadian commentators,⁴ the traditional notion of corporate personality appears to have successfully resisted assimilation into the wider concept of enter-

* Associate Professor, Department of Law, Carleton University.

1. A.A. Berle, Jr., "The Theory of Enterprise Entity" (1947) 47 *Colum. L. Rev.* 343.

2. *Ibid.* at 345.

3. *Ibid.*

4. See, e.g., O. Kahn Freund, "Some Reflections on Company Law Reform" (1944) 7 *Mod. L. Rev.* 54; C.M. Schmitthoff, "Salomon in the Shadow" (1976) *J.B.L.* 305; C.M. Schmitthoff, "The Wholly Owned and Controlled Subsidiary" (1978) *J.B.L.* 218; Note, "Multinationals and the Antiquities of Company Law" (1984) 47 *Mod. L. Rev.* 87; F. Wooldridge, *Groups of Companies: The Law and Practice in Britain, France and Germany* (London: Institute of Advanced Legal Studies, 1981); T. Hadden, *The Control of Corporate Groups* (London: Institute of Advanced Legal Studies, 1983); D.D. Prentice, "Groups of Companies: The English Experience" in K.J. Hopt, ed., *Groups of Companies in European Law* (Berlin: De Gruyter, 1982) at 99-129. For a discussion of the limited application of the concept of "enterprise liability" in Canadian law, see I.R. Feltham, "Lifting the Corporate Veil" (1968) *L.S.U.C. Lectures* 305 at 320-325.; N.C. Sargent, "Through the Looking Glass: A Look at Parent-Subsidiary Relations in the Modern Corporation" in *Today's Challenge to Law* (Ottawa: Institute for Studies in Policy, Ethics and Law, 1984) at 49-88 [hereinafter ISPEL]; N.C. Sargent, "Beyond the Legal Entity Doctrine: Parent-Subsidiary Relation under the West German Konzernrecht" (1985) 10 *Can. Bus. L.J.* 327.

prise. Thus Canadian courts still continue to pay great respect to the sanctity of the corporate personality, often insisting that the corporate veil should only be lifted or pierced in order to prevent fraud or improper conduct, or where the corporate entity is merely a sham, *alter ego* or agent of its incorporators.⁵ Even when, in particular instances, the concept of enterprise is used to justify lifting the corporate veil, the court is often at pains to point out that this is done for exceptional purposes only, and that for all other purposes the corporate personality must be respected.⁶

This rather conservative approach to the problems raised by the theory of corporate personality is largely the result of the deference still accorded to the House of Lords' decision in *Salomon v. Salomon and Company*,⁷ which has tended to preclude the possibility of re-examining the corporate entity doctrine. Thus, most academic commentary on the nature of corporate personality continues to regard the corporate entity principle as the norm, and the veil piercing cases as exceptions.⁸ The difficulty with this approach is that it tends to obscure the underlying policy issues confronting the courts in determining whether or not to lift the corporate veil and disregard the corporate personality. As a result, courts have found it difficult to articulate a clear doctrinal basis for their decisions. The various bases which have been used are largely result-oriented and rarely assist as a guide to predicting when and under what circumstances another court will be prepared to lift the corporate veil in future cases. Even the terminology employed by the courts tends to highlight the exceptional nature of the phenomenon. The expressions "veil piercing" or "piercing under the corporate veil" have an almost mystical quality which suggests an activity undertaken at some peril.

The aim of this article is to examine one aspect of corporate organization pursuant to which the implications of the traditional corporate personality doctrine are thrown into very sharp relief, namely, the relations between parent, subsidiary and affiliated corporations within a corporate group. This is an area of corporate organization which has assumed in-

-
5. *Re Suburban Rapid Transit Company, Winnipeg Electric Company and Rural Municipality of Assiniboia* (1931), [1931] 2 D.L.R. 862, 39 Man. R. 402, (C.A.) [hereinafter *Assiniboia*]; *Patton v. Yukon Consolidated Gold Corp. Ltd.* (1934), [1934] 3 D.L.R. 400, [1934] O.W.N. 321 (C.A.); *Clarkson Co. Ltd. v. Zhelka* (1967), 64 D.L.R. (2d) 457, [1967] 2 O.R. 565 (Ont. H.C.) [hereinafter *Clarkson*]; *Rockwell Developments Ltd. v. Newtonbrook Plaza Ltd.* (1972), 27 D.L.R. (3d) 651, [1972] 3 O.R. 199, (C.A.); *M.N.R. v. Blackburn* (1976), [1976] 1 F.C. 554, 66 D.L.R. (3d) 191 (F.C.A.D.); *Kinookimaw Beach Association v. R. in Right of Saskatchewan* (1979), 102 D.L.R. (3d) 333, [1979] 6 W.W.R. 84 (Sask. C.A.); *390346 Ontario Limited v. Malidaw Holdings Limited* (1980), 31 N.B.R. (2d) 72 (Q.B.).
 6. See e.g., *Manley Inc. v. Fallis* (1977), 2 B.L.R. 277 at 280, 38 C.P.R. (2d) 74 (Ont. C.A.) *per* Lacourciere J.A. hereinafter *Manley*; *Nedco Ltd. v. Clark* (1973), 43 D.L.R. (3d) 714 at 721, 1973 6 W.W.R. 425 (Sask. C.A.) *per* Culliton C.J.S. [hereinafter *Nedco*]; *Covert v. Minister of Finance for Nova Scotia* (1980), [1980] 2 S.C.R. 774 at 797, 41 N.S.R. (2d) 181 *per* Martland J. [hereinafter *Covert*].
 7. (1896), 1897 A.C. 22, [1895-99] All.E.R. 33 (H.L.)
 8. Generally, see M. Woods, "Lifting the Corporate Veil In Canada" (1957) 35 *Can. B. Rev.* 1176; Feltham, *supra*, note 4; D.H. Bonham and D.A. Soberman, "The Nature of Corporate Personality" in Jacob S. Ziegel, ed., *Studies in Canadian Company Law*, vol. I (Toronto: Butterworths, 1967); P. Halpern, M. Trebilcock & S. Turnbull, "An Economic Analysis of Limited Liability in Corporation Law" (1980) 30 *U.T.L.J.* 117. More recently, see Bruce Welling, *Corporate Liability in Canada: The Governing Principles* (Toronto: Butterworths, 1984) esp. at 73-152.

creasing significance in view of the continuing trend towards corporate concentration, but which has received surprisingly little attention from Canadian legal scholars.⁹ Yet the phenomenon of group organization raises issues which are fundamental to the debate over corporate personality, since the essence of group organization involves the integration of individual corporate entities within a larger economic enterprise represented by the group as a whole.

The thesis of this article is that the traditional corporate entity doctrine provides an inadequate model for dealing with many of the jurisprudential issues posed by the creation of complex corporate groups which are often conceptually different from the problems that tend to arise within a single independent corporate entity. At issue in cases involving group organization is not simply whether the corporate entity is used as a "sham," "alter ego" or even as the agent of its corporate shareholders (although this is often the manner in which such cases are presented to the courts), but rather the extent to which the courts or the legislature should give effect to the underlying legal and economic relationships which exist between related corporations within a group. Difficult conceptual problems inevitably arise if the traditional legal understanding of the corporation is at odds with the reality of the nature of the group organization. To focus solely on the legal independence of the individual corporations within a group without also taking into consideration the legal, financial, commercial and managerial links which exist between related corporate entities obscures the reality of the group enterprise and leads to improper legal analysis. In such cases it is submitted that the courts should — and in fact, do on occasion¹⁰ — shift the focus for legal analysis to the level of the enterprise as a whole, rather than constrain themselves by application of the legal entity doctrine. It is suggested that this approach is more consistent with the reality of group organization, and furthermore, allows the courts and legislators to deal with the jurisprudential questions posed by group organization within a broader context than is presently permitted by the traditional legal entity doctrine.

The present discussion will not attempt a survey of the various methods used by the courts to pierce the corporate veil in relation to parent-subsidiary-affiliate cases. Rather, my analysis will concentrate on corporate group structure as a form of legal and economic organization, and the legal challenges posed by this form of corporate organization. Particular

9. For Canadian commentaries on parent-subsidiary relationships, see the references cited, *supra*, note 4.

10. For examples, see *Toronto v. Famous Players Canadian Corp.* (1935), [1935] 3 D.L.R. 685, aff'd [1936] S.C.R. 141, [1936] 2 D.L.R. 129; *De Salaberry Realities Ltd. v. M.N.R.* (1974), 46 D.L.R. (3d) 100, aff'd (*sub nom. De Salaberry Realities Ltd. v. R.*) (1976), 70 D.L.R. (3d) [706 hereinafter *De Salaberry*]; *Dominion Bridge Co. Ltd. v. The Queen* (1975), [1975] C.T.C. 263, aff'd [1977] C.T.C. 554 (F.C.A.D.) [hereinafter *Dominion Bridge*]; *Fern Brand Waxes Ltd. v. Pearl* (1972), 29 D.L.R. (3d) 662 1972 3 O.R. 829 (C.A.); *Nedco, supra*, note 6; *Pacific Rim Installations Ltd. v. Tilt-Up Construction Ltd.* (1978), 5 B.C.L.R. 231 (Co. Ct.); *Manley, supra*, note 6; *Covert, supra*, note 6; *Sask. Economic Dev. Corp. v. Patterson-Boyd Mfg. Corp.* (1980), [1981] 2 W.W.R. 40, 6 Sask. R. 325 (C.A.); *Canadian Utilities Ltd. v. Atco Ltd.* (1982), 2 S.C.R. 557, [1983] 1 W.W.R. 385 [hereinafter *Atco*]; *Dominion Stores Ltd. et als.* (1984), 8 C.L.R.B. Rep. (N.S.) 203, [1984] O.L.R.B. Rep. Sept. 1214 [hereinafter *Dominion Stores*]; *Olson v. Sprung Instant Greenhouses Ltd.* (1985), 41 Alta. L.R. (2d) 325 (Q.B.).

attention will be focussed on the problems of minority shareholders and creditor protection within a group, and the utility of the traditional model of corporate governance within a group context. My intention is not to find definitive answers to specific legal questions, but rather to direct attention to those areas of corporate and bankruptcy law wherein the traditional corporate entity doctrine fails to correspond to the actuality of group organization, and the jurisprudential problems created by this divorce of legal theory from economic reality.

II. The Nature of Group Organization

The standard model of the corporation which is familiar to every law student is that of a small incorporated family business, much like that of the celebrated Mr. Salomon, who incorporated a company to which he transferred his now famous boot and shoe business. Mr. and Mrs. Salomon and their five children were the sole shareholders. The virtues of this model are its simplicity and flexibility. The corporation is a separate legal entity distinct in law from its shareholders, with full capacity to own property, to sue and be sued in its own name, and to contract its own debts and liabilities. The shareholders retain control over the business of the corporation through their power to appoint the board of directors and at the same time are insulated from any personal liability beyond the capital they originally subscribed in the event that the corporation becomes insolvent.

As Galbraith points out, however, the reality of the modern large business corporation departs sharply from this model.¹¹ Nowhere is this more apparent than with respect to the legal structure of the corporate enterprise. Most large business enterprises are in fact organized in the form of a complex network of interrelated corporations linked by common ownership and control ties, and often under the control of a single parent or holding corporation which is at the apex of the corporate pyramid and coordinates the financial and investment strategies for the group as a whole.¹² This mode of corporate organization frequently achieves its most developed form within the context of a large multi-national enterprise which may consist of a network of literally hundreds of corporations worldwide.¹³ However, the advantages of this form of corporate organization are not limited to the international sphere. Group structures appear to be common in all developed western legal systems.¹⁴

The prevalence of this form of corporate organization in Canada is apparent from an examination of various corporate directories, for exam-

-
11. J.K. Galbraith, *The New Industrial State*, 2nd ed. (New York: American Library, 1971) at 84.
 12. See Y. Hadari, "The Structure of the Private Multinational Enterprise" (1973) 71 *Mich. L. Rev.* 729 at 755. For graphic examples of this form of corporate organization involving a number of British owned multinational groups, see T. Hadden, *The Control of Corporate Groups* (London: Institute of Advanced Legal Studies, 1983) at Appendices I-IV.
 13. *Ibid.*
 14. See Hadden, *supra*, note 12 at 1; Wooldridge, *supra*, note 4; Hopt, ed., *Groups of Companies in European Law*, *supra*, note 4.

ple, Statistics Canada's *Intercorporate Ownership*¹⁵ which contains over 600 pages detailing the intercorporate ownership and control links among over 85,000 corporate entities in Canada. The significance of corporate group structures was also stressed in the Bryce commission report on corporate concentration.¹⁶ While eschewing any detailed investigation of the intercorporate links which exist within Canadian corporate groups, the report did note that in 1975, 22% of the leading non-financial corporations in Canada were wholly-owned subsidiaries of foreign-owned corporate parents,¹⁷ while a further 26% were members of corporate groups controlled by other corporate parents.¹⁸ Moreover, virtually all the corporations listed among the top 100 non-financial corporations in Canada were themselves parent corporations of networks of wholly-owned subsidiaries and affiliates.¹⁹ Further research indicated that the 361 leading Canadian non-financial corporations were linked directly or indirectly through ownership ties with approximately 5,305 companies.²⁰

The intercorporate relationships which exist within such large corporate groups are often extremely complex. For example, Canadian Pacific Ltd. is at the apex of a complex corporate pyramid consisting of over 180 Canadian subsidiaries and affiliates and a further 140 foreign subsidiaries and affiliates, many of which are held at five, six, seven or more removes from the principal holding company through a series of intermediate affiliates and holding corporations.²¹ Similarly, the group controlled by the Edward Bronfman Trust consists of a diverse network of over 170 corporations, many of which are large corporations in their own right (such as Noranda Inc.) and in turn themselves control over 140 subsidiaries and affiliates.²² The same is true of other large conglomerate groups in Canada.²³ On a more regional level, one of the largest privately held enterprises in Canada is the Irving Group which consists of over 160 separate corporations operating primarily in the Maritime provinces and Quebec. Over 75 of these corporations are wholly-owned by K.C. Irving Ltd. or through intermediate holding companies in the group.²⁴

This form of corporate organization is not unique to the largest corporations in Canada. Many privately-held small or medium-sized enterprises are also structured in the form of a group of related corporations

-
15. Statistics Canada, *Inter-Corporate Ownership*, 1984 (Ottawa: Minister of Supply and Services, 1985).
 16. Canada, *Report of the Royal Commission on Corporate Concentration* (Ottawa: Printing and Publishing Supply and Services Canada, 1978) (Chair: Robert B. Bryce) at 13.
 17. *Ibid.* at 288.
 18. *Ibid.* at 289.
 19. *Ibid.* at 288.
 20. *Ibid.* at 289. See also the Royal Commission on Corporate Concentration, *Enterprise Structure and Corporate Concentration* (Study No. 17) by S.D. Berkowitz, Y. Kotowitz & L. Waverman (Toronto: Institute for Policy Analysis, University of Toronto, 1977).
 21. *Supra*, note 15.
 22. *Ibid.*
 23. *Ibid.* See also the analysis of the corporate affiliations within the financial conglomerates controlled by Power Corporation and Argus Corporation in *Report of the Royal Commission on Corporate Concentration*, *supra*, note 16 at 169-173.
 24. *Supra*, note 15.

under the common control of the same individual or group of individual shareholders.²⁵ Indeed, Tom Hadden, one of the few explorers in this esoteric borderland between law and economics, notes that the traditional model of the corporation as a single independent operating company is now the norm for only the smallest family businesses.²⁶

Little research has been conducted regarding the reasons why group organization plays such a prominent role in Canadian corporate life. What evidence there is points to a variety of factors.²⁷ Frequently, the creation of complex group structures is a product of the process of corporate concentration. Alternatively, group structures may result from a process of internal expansion or reorganization of an existing corporate enterprise. Also, there may be a variety of legal, fiscal or commercial reasons for organizing an enterprise in the form of a number of related corporate entities under common control and management rather than operating through a single corporate entity.

One of the major advantages of the group structure is its flexibility. The legal structure of a corporate enterprise may be fashioned in such a way as to minimize legal or regulatory control over its activities, while still allowing strategic control to be exercised over investment, marketing or internal group financing decisions affecting the group as a whole.²⁸ At the same time, the principle of limited liability ensures that each corporation is insulated from any liability for the debts or obligations of any associated corporation, thereby reducing the financial risks for the enterprise as a whole in the event that any individual corporation becomes insolvent.²⁹

Fiscal considerations may also play a significant role in the formation of complex corporate structures. This is particularly evident in the context of a multinational group enterprise with operating subsidiaries in several different tax jurisdictions. By manipulating the terms of intercorporate sales, services and financial transactions between various affiliated corporations in different tax jurisdictions, it may be possible to ensure that a larger proportion of group profits are earned in low tax jurisdictions, thereby achieving substantial tax savings for the group as a whole. The implications of such transfer pricing techniques for national tax and competition authorities raise complex jurisdictional questions which cannot

-
25. See, e.g., the complex corporate structure reviewed by the court in *De Salaberry*, *supra*, note 10.
 26. Hadden, *supra*, note 4 at 1.
 27. But see Hadden, *ibid.* at 8-15; T. Hadden, R.E. Forbes & R.L. Simmonds, *Canadian Business Organizations Law* (Toronto: Butterworths, 1984) at 617-620; J.T. Burnett, "A Classic International and Mega Insolvency: A Case Study" in *Meredith Memorial Lectures, McGill University* (Toronto: De Boo, 1986) at 307-325. The best study of the use of complex holding company structures in the United States remains that of J.C. Bonbright & G.C. Means, *The Holding Company* (New York: McGraw Hill, 1932) esp. at 11-21 and 30-43.
 28. See Hadari, *supra*, note 12 at 760-761 and J.P. Griffin, "The Power of Host Companies Over the Multinational: Lifting the Veil in the European Economic Community and the United States" (1974) 6 *Law & Pol. in Int. Bus.* at 375-381.
 29. For example, see *Walkovszky v. Carlton*, 18 N.Y. 2d 414, 223 N.E. 2d 6, 276 N.Y.S. 2d 585 (Ct. App. 1966); *Clarkson*, *supra*, note 5; W.O. Douglas and C.M. Shanks, "Insulation From Liability Through Subsidiary Corporations" (1929-30) 39 *Yale L.J.* 193. See further text *infra*, V. Creditor Protection and Corporate Insolvency.

readily be resolved by reference to the traditional legal entity doctrine.³⁰ This has led to attempts at both national and international levels to formulate appropriate legal criteria governing the extra-territorial application of national laws to foreign affiliates within a multinational group.³¹

The flexibility of group organization may also pose difficult legal problems in the domestic sphere. In the labour law field, for example, labour tribunals have often been confronted with questions concerning the succession of collective agreement obligations in the event of a corporate reorganization or amalgamation involving related corporate entities.³² Similarly, regulatory officials in Canada and the United States have often been faced with complex legal and policy questions resulting from the use of a holding company device to combine both regulated and unregulated corporate activities under a single corporate umbrella which is not subject to regulatory control.³³

A recent example of this was the reorganization of the Bell Canada group in 1982. The stated objective of the reorganization was to improve managerial flexibility by removing several of the existing subsidiaries of Bell Canada Ltd. from the regulatory control of the C.R.T.C., thereby enabling them to enter into new fields of business without fear of regulatory intervention. Under the reorganization plan, shareholders of Bell Canada Ltd. were offered shares in a newly formed holding company (Bell Canada Enterprises Ltd.) in return for their shares in Bell Canada Ltd., which company thereby became a subsidiary of Bell Canada Enterprises Ltd. At the same time, certain of Bell Canada Ltd.'s former subsidiaries — including Northern Telecom Ltd. and Bell Communications Systems Inc. whose combined assets totalled over \$2 billion — became subsidiaries of Bell Canada Enterprises Ltd. and thus were beyond the regulatory purview of the C.R.T.C.

The complex issues raised by this corporate reorganization prompted the introduction into Parliament of proposed legislation to increase the regulatory powers of the C.R.T.C. to oversee all the communications-re-

30. See, e.g., *Dominion Bridge*, *supra*, note 10; *Spur Oil Ltd. v. The Queen* (1981), 42 N.R. 131, 1981 C.T.C. 336 (F.C.A.D.). See generally C.M. Schmitthoff, "Multinationals in Court" (1972) J.B.L. 103 at 106-111; E.J. Cohn and C. Simitis, "Lifting the Veil in the Company Law of the European Continent" (1963) 12 *Int. & Comp. L.Q.* 189; Griffin, *supra*, note 28; Wooldridge, *supra*, note 4; C.D. Wallace, *Legal Control of Multinational Enterprises* (The Hague: Martinus Nijhoff, 1983).

31. See Griffin, *supra*, note 28; Wallace, *ibid.*; Robert Thompson, "United States Jurisdiction Over Foreign Subsidiaries: Corporate and International Law Aspects" (1983) 15 *Law and Pol. in Int. Bus.* 319.

32. See, e.g. *Walters Lithographing Company Ltd., et al.* (1971), [1971] O.L.R.B. Rep. July 406; *Industrial-Mine Installation Ltd.* (1972), [1972] O.L.R.B. Rep. Oct. 1029; *Dominion Stores Ltd.*, *supra*, note 10. Most Canadian jurisdictions explicitly provide labour boards with discretionary jurisdiction to find that two or more businesses are related employers for labour relations purposes. See *Labour Code*, R.S.B.C. 1979, c. 212 s. 37; *Canada Labour Code*, R.S.C. 1970, c. L-1, as am. S.C. 1972, c. 2, s. 133; *Labour Act*, R.S.A. 1980, c. L-1, as am. s. 133 & 133.1; *Labour Relations Act*, C.C.S.M., c. L-10, as am. s. 50, *Labour Relations Act*, R.S.O. 1980, c. 228, as am. s. 1(4); *Labour Act*, R.S.P.E.I. 1974, c. L-1, as am., s. 7(3). See generally, G.W. Adams, *Canadian Labour Law* (Aurora, Ont.: Canada Law Book, 1985) at 423-431.

33. See Bonbright & Means, *supra*, note 27 at 149-222 & 319-336; R.C. Clark, "The Regulation of Financial Holding Companies" (1979) 92 *Harv. L. Rev.* 789. See also *Atco*, *supra*, note 10.

lated activities of the group.³⁴ This legislation was motivated by concerns that the corporate reorganization might have an adverse impact on telephone rates charged to Bell Canada subscribers as a result of transfer pricing agreements entered into between Bell Canada Ltd. and its unregulated affiliates. This proposed legislation in turn highlights a crucial problem which is central to the debate concerning the regulation of group activities, namely: To what extent should it be left to the controllers of a group enterprise to determine the scope of regulatory control over that group's activities simply by juggling the intercorporate ownership links between related corporations in the same group?

It should be apparent from this brief survey that there exists a significant gulf between the traditional legal model of the corporation as an independent legal entity and the economic reality of group organization. From a legal perspective a group has no separate existence under Canadian law. Each corporation in a group must be managed as an independent entity, even if wholly-owned and controlled by another corporation.³⁵ In practice, however, this legal model often bears little or no relation to the realities of corporate control within an integrated corporate group. Consequently, Landers argues that corporate decision-making within a multi-corporate enterprise will normally be directed towards the overall return on investment for the enterprise as a whole, rather than for each individual subsidiary.³⁶ Indeed, there may be good commercial or fiscal reasons for operating an individual subsidiary at a loss or as a dormant company.³⁷ Moreover, as Prentice points out, there is no compelling reason why the internal managerial or financial organization of a group should correspond with its formal legal structure.³⁸ In fact, subsidiaries may be incorporated for purely legal or fiscal purposes and may enjoy no real existence separate from that of their parent corporation other than in name.

Even within a more decentralized group where individual subsidiaries operate as independent profit centers, there may be little correlation between the internal managerial and control structure of the group and the formal legal model of the independent profit centres. Through its power to appoint the members of the board of directors of each subsidiary, a parent corporation will often be in a position to influence the management and investment policies of its shareholders. In such circumstances,

34. Bill C-19, *An Act Respecting the Reorganization of Bell Canada*, first reading December 20, 1984, second reading April 15, 1985.

35. See *Charterbridge Corp. Ltd. v. Lloyds Bank Ltd.* (1968), [1970] 1 Ch. 62, [1969] 2 All E.R. 1185; *Assiniboia, supra*, note 5; *Lourho Ltd. v. Shell Petroleum Co. Ltd.* (1980), [1980] Q.B. 358, [1980] 2 W.L.R. 367 (C.A.), aff'd (1980), [1980] 1 W.L.R. 627, 124 Sol. J. 412 (H.L.).

36. J.M. Landers, "A Unified Approach to Parent, Subsidiary & Affiliate Questions in Bankruptcy" (1975) 42 *U. Chi. L. Rev.* 589 at 591; also Hadden, *supra*, note 4 at 8-19 & Appendices I-IV.

37. Landers, *ibid.* at 591; Hadden, *ibid.* at 9-18.

38. Prentice, *supra*, note 4 at 103.

the ability of each individual subsidiary to operate as a truly independent economic unit is at best likely to be limited.³⁹

It is sometimes contended that this theoretical gulf between the legal model of the corporation as an independent entity and the economic interdependence which results from group organization may be more apparent than real. Thus, many corporate theorists tend to regard parent, subsidiary and affiliate relationships as simply a variant of the typical one person corporation situation with which the courts are already familiar.⁴⁰ It is arguable, however, that the flexibility and opportunities for abuse which are inherent in multi-corporate group structures may give rise to complex jurisprudential problems which are not susceptible of analysis under the traditional legal entity model. For example, the ability of related corporate entities to transfer assets within the group by means of intercorporate loans or transfer pricing techniques may create risks for minority shareholders and/or creditors in the event of a corporate insolvency.⁴¹ Similarly, the functional integration of individual subscribers and affiliates within a wider group enterprise poses a challenge to the traditional legal model of corporate accountability and control, particularly where the interests of minority shareholders and creditors are at stake.⁴² The limitations of the corporate entity doctrine also become apparent when courts are faced with attempts by a group enterprise to circumvent regulatory or contractual constraints on its activities by restructuring its organization.⁴³

Faced with such issues, continued judicial reliance on the traditional legal entity doctrine as a tool for analysis amounts to a form of legal myopia. This raises the question of whether existing legal principles can be adapted to deal with the legal challenges posed by group organization, or whether in fact there is a need for a new legal paradigm which takes into account the economic interdependence that is at the heart of group organization.

III. Corporate Control and the Traditional Model of Corporate Governance

A board of directors in the embattled and entangled eighties finds itself in a complex system that the original concepts of in-

-
39. See Hadden, *supra*, note 4 at 14–16. See also T.W. Walde, "Parent-Subsidiary Relations in the Integrated Corporate System: A Comparison of American and German Law" (1974) 9 *J. Int. L. and Econ.* 455 at 485–488; Landers, *supra*, note 36; (But cf. R.A. Posner, "The Rights of Creditors of Affiliated Corporations" (1976) 43 *U. Chi. L. Rev.* 499).
 40. See, e.g., C.A. Masten, "'One Man Companies' and Their Controlling Shareholders" (1936) 14 *Can. B. Rev.* 663; Bonham and Soberman, *supra*, note 8; H.W. Ballantine, "Separate Entity of Parent and Subsidiary Corporations" (1925) 14 *Calif. L. Rev.* 12 at 20; Welling, *supra*, note 8 at 127–140.
 41. Per Hadden, *supra*, note 4 at 15–18 and A.A. Berle, Jr., "Subsidiary Corporations and Credit Manipulation" (1927–1928) 41 *Harv. L. Rev.* 874.
 42. Hadden, *ibid.* at 12–14 and 20–22. See further text *infra*, III. Corporate Control and the Traditional Model of Corporate Governance.
 43. *Supra*, text at notes 32–33 and the cases cited therein.

corporation did not envision when the ground rules for corporations were established. Most statutory guidelines are antiquated with respect to prescribing the true nature of governance. Many states still charge the board with the "managing function," rather than directing or governing. And this difference is more than semantic. The authors of existing laws and regulations were not faced with the complexities and interdependencies that pertain to institutions as they now exist.⁴⁴

This quotation from an American corporate theorist is illustrative of the growing interest among academics in both the nature and composition of boards of directors, and the role of the board in a corporation's legal fabric. Writers like Mace⁴⁵ and Eisenberg⁴⁶ have examined the nature and function of corporate boards with a view to developing a normative model of corporate governance. Reform of the board has also been widely regarded as a means of achieving greater accountability and control over corporate decision-making, thereby securing a greater measure of corporate social responsibility.⁴⁷ To a large extent, however, recent debates over the role of the board have continued to view the corporation as an independent entity and have not focussed much attention on the position of directors of subsidiary and affiliate corporations within corporate group structures. This approach perhaps reflects a widespread but rarely articulated perception that the position of directors of subsidiary corporations is atypical and need not correspond to the received model of corporate governance.⁴⁸

This perception is confirmed by T. W. White's recent study of the role of directors in corporate decision-making in Canada.⁴⁹ White sought to obtain data on the composition of boards of directors, how they actually function, and their role in corporate decision-making in both large and small corporations by examining a sample group of 28 corporations drawn from a study group of 528 manufacturing corporations from South-

-
44. Robert K. Mueller, *The Incomplete Board: The Unfolding of Corporate Governance* (Lexington, Mass.: Lexington Books, 1981) at 36.
45. Myles L. Mace, *Directors: Myth & Reality* (1971).
46. M.A. Eisenberg, *The Structure of the Corporation: A Legal Analysis* (Boston: Little, Brown, 1976).
47. See A. Chayes, "The Modern Corporation and the Role of Law" in E.S. Mason, ed., *The Corporation in Modern Society* (Cambridge, Mass.: Harvard University Press, 1960) 25 at 38-45; E.V. Rostow, "To Whom and For What Ends is Corporate Management Responsible?" *ibid.* at 46; V. Budney, "The Independent Director: Heavenly City or Potemkin Village" (1981-82) 95 *Harv. L. Rev.* 597; R. Haft, "Business Decisions by the Board: Behavioural Science and Corporate Law" (1981) 80 *Mich. L. Rev.* 1. See also the discussion of the role of directors in the *Report of the Royal Commission on Corporate Concentration*, *supra*, note 16 at 291-309.
48. This view is acknowledged in the Report of the *Royal Commission on Corporate Concentration*, *supra*, note 16 at 295: "If a company is a wholly owned subsidiary there is much less reason for concern about the composition of its board. Many such subsidiaries operate, in effect, as branches or divisions of the parent company and, where such subsidiaries are small, then boards of directors are little more than a formality."
49. T.H. White, *Power or Pauns: Boards of Directors in Canadian Corporations* (Don Mills, Ont.: C.C.H. Canadian Ltd., 1978). For an earlier study of the boards of 64 large Canadian corporations see W.J. McGougall and G. Fogelberg, *Corporate Boards in Canada: How 64 Directorates Function* (London, Ont.: School of Business Administration, University of Western Ontario, 1968). (I note, however, that this study failed to differentiate corporations which were wholly or partly-owned subsidiaries within a larger corporate group).

western Ontario with ten or more employees. The corporations comprising the sample were selected according to size, ownership and status.⁵⁰ Detailed interviews were conducted with both senior management personnel and members of the board of directors concerning the operations of each corporation, the role of the board, the interactions between the board and management, and the impressions of both senior managers and directors respecting the effectiveness of the board of directors.

Nearly half of the 172 directors interviewed were employees of the same corporation, while a further 21.8% were employees of the corporation's parent.⁵¹ The majority of the remaining outside directors were associated with law firms, other manufacturing enterprises or financial institutions. More than half of the directors consulted were also members of at least one other corporate board.⁵²

Consistent with earlier studies by Mace⁵³ and McDougall and Fogelberg,⁵⁴ White found that the legal responsibilities of directors under the traditional legal model often did not correspond to the *de facto* allocation of managerial responsibilities within most of the sample group. This was particularly evident in the case of boards of directors of subsidiary corporations, especially where the parent corporation was foreign-owned.⁵⁵ The research disclosed that two-thirds of independent or parent corporation boards exercised some degree of control over corporate decision-making.⁵⁶ But only 25% of the boards of subsidiaries exercised the same degree of control.⁵⁷ Moreover, White noted a tendency for corporate control within a parent-subsidiary context to be exercised through managerial links rather than through the subsidiary corporation's board.⁵⁸

He reported:

Control of subsidiaries by parents is considerable, but it usually tends to be exercised through management links rather than by the subsidiary's directorate. In subsidiary corporations in our sample there is at least one senior manager in the parent who is responsible for subsidiary operations. The chain of command from the parent to the subsidiary is through this responsible authority in the parent to his subordinate who heads the subsidiary. This link is the control coupling for the parent, a bypass

50. Twelve of the corporations in the sample group were parent or independent corporations, and the remaining sixteen were subsidiaries (fourteen of them wholly-owned). In addition, 50% were Canadian-owned, and the remaining 50% were foreign-owned. White, *ibid.* at 30.

51. *Ibid.* at 33.

52. *Ibid.* at 32-33.

53. *Supra*, note 45.

54. *Supra*, note 49.

55. White, *supra*, note 49 at 46.

56. *Ibid.* at 46.

57. *Ibid.*

58. *Ibid.* at 51.

around the subsidiary's board which in most instances is little more than a legally-prescribed structural adornment.⁵⁹

This divorce between the legal model of corporate governance and the actual role of boards of directors of subsidiary corporations does not necessarily give rise to problems in cases where each subsidiary is wholly-owned and there are no minority shareholder interests to consider.⁶⁰ Indeed, the complexity of group organization requires that a clearly defined managerial hierarchy be established in order to co-ordinate group strategy and ensure the most efficient use of resources within a group. Serious conflicts of interest may arise, however, if the interests of a subsidiary diverge from those of its parent corporation, or where there is a group of minority shareholders whose interests do not coincide with those of the group. In such situations the directors of a subsidiary corporation may be placed in an invidious position. On the one hand, if the directors subordinate the interests of the subsidiary to those of the group they risk breaching their fiduciary duties to the corporation and possibly inviting an action brought by minority shareholders.⁶¹ On the other hand, failure to comply with the instructions of a parent corporation is likely to disrupt the decision-making process within the group, and could ultimately lead to the suspension or dismissal of the recalcitrant directors.

The lack of publicity given to conflicts of this nature tends to obscure the frequency with which they arise. In fact, the New York Stock Exchange, in a study published in 1965, reported that one of the three most common conflict of interest situations affecting directors of listed corporations resulted from their owning shares in one or more subsidiaries.⁶² No doubt comparable conflicts would arise in situations where the directors of a parent corporation held seats on the boards of one or more of the subsidiaries in the group. Similarly, studies on the impact of direct foreign investment in Canada have illustrated the potential conflicts of interest which may arise between the economic concerns of a Canadian subsidiary and those of its foreign-owned corporate parent.⁶³

59. *Ibid.*

60. See the *Report of the Royal Commission on Corporate Concentration*, *supra*, note 16 at 306.

61. *Selangor United Rubber Estates Ltd. v. Cradock* (No.3) (1968), [1968] 1 W.L.R. 1555, [1968] 2 All E.R. 1073 (Ch.) [hereinafter *Selangor*]; *Scottish Co-operative Wholesale Society Ltd. v. Meyer* (1958), [1959] A.C. 324, [1958] 3 W.L.R. 404, [1958] 3 All E.R. 66 at 88 (H.L.) [hereinafter *Scottish Co-operative*]; *Abbey Glen Property Corp. v. Stumborg* (1976), 65 D.L.R. (3d) 235 at 278, [1976] 2 W.W.R. 1 (Alta. S.C.). See also *Rustop Ltd. v. White* (1979), 36 N.S.R. (2d) 207, (*sub nom. Clarkson Co. Ltd. v. White*) 102 D.L.R. (3d) 403, 64 A.P.R. 207 (N.S.C.A.) [hereinafter *Rustop*], where the directors were held to have breached their fiduciary duty to the corporation in respect of intercorporate transactions prior to bankruptcy in an action brought by the insolvent corporation's trustee in bankruptcy. See also *Re Weber Feeds Ltd.* (1979), 30 C.B.R. (N.S.) 97 (Ont. C.A.).

62. New York Stock Exchange, *The Corporate Director and the Investing Public*, cited in McDougall and Fogelberg, *supra*, note 49 at 13. See also the *Report of the Royal Commission on Corporate Concentration*, *supra*, note 16 at 306-309.

63. See, e.g., G. Williams, *Not For Export: Towards a Political Economy of Canada's Arrested Industrialization* (Toronto: McClelland & Stewart, 1983) and J.I.W. Corcoran, "The Trading With the Enemy Act: The Impact of the Amended Foreign Assets Control Regulations on Canadian Corporations Owned by Americans" (1970) 16 *McGill L.J.* 460.

The reasons for this lack of publicity can only be speculated upon. No doubt a major factor is the desire of corporate executives to preserve confidentiality respecting internal corporate affairs. Accordingly, policy disputes between a parent corporation and its subsidiary's board will often be resolved in private and will not excite much public interest or comment unless there is some vocal opposition by an outside group (such as employees, creditors or minority shareholders) that is adversely affected by the issue. In addition, this situation may reflect the limited role which boards of subsidiary corporations actually play in formulating or reviewing strategic policy decisions affecting the subsidiary.

On occasion, however, such disputes do come before the courts. A case in point is the decision of the Quebec Superior Court in *Carrington Viyella Overseas (Holdings) Ltd. v. Taran*⁶⁴ (the "Consoltex" case). The facts leading up to this litigation were complex and arose out of policy disagreements between the Canadian resident directors of Consoltex Canada Ltd. (a Montreal based textile company) and its two majority shareholders (Carrington Viyella PLC of the United Kingdom and Toyoba Co. Ltd. of Japan) over losses incurred by the company and the possibility of merger between Consoltex and an American corporation (Park Place Inc.). The Canadian resident directors — led by a Mr. Taran, the president and chief executive officer of the corporation — called an informal directors' meeting with the aim of forcing Mr. Owen, a nominee of the majority shareholders, to resign as deputy chairperson of the board and cease negotiations concerning the possible merger. In response to this action Carrington Viyella PLC and Toyoba Co. convened a special meeting of shareholders to remove Mr. Taran and two of the other Canadian resident directors from the board.

The directors challenged the legality of the special shareholders' meeting on the grounds that the meeting had been improperly convened, and that the majority shareholders had exercised oppression by intervening in the internal affairs of the corporation. In turn, the majority shareholders alleged that the Canadian resident directors, who controlled a majority of the board, had acted oppressively in calling a meeting of the board of directors which non-resident directors could not attend. After a lengthy hearing lasting 20 days, the Quebec Superior Court ruled that the majority shareholders had been oppressed by the minority.⁶⁵ The majority shareholders were therefore within their rights to convene the special shareholders' meeting, although the original notice of meeting should have specified why they wished to remove the Canadian directors. As a result, the shareholders' meeting was allowed to proceed and the chief executive officer and two other directors were ousted from the board. One of several unusual features of this case was the defensive tactic adopted by the Canadian resident directors to prevent their removal from the board. Often, in a dispute of this nature over corporate policy, replacement of the directors

64. (24 February 1983), Montreal 500-05-022164-824 (Que. Sup. Ct.). For a discussion of this case see D. Kaufman, "Oppression Remedies: Recent Developments" in Lazer Sarna, ed., *Corporate Structure, Finance and Operations*, vol. 3 (Toronto: Carswell, 1984) 67 at 99-100.

65. Kaufman, *ibid.* at 99.

of a subsidiary corporation would be regarded as being within the prerogative of a parent corporation.⁶⁶ In the absence of legal intervention by an outside group such as minority shareholders or creditors, this kind of occurrence would not normally result in much controversy.

This divorce between the legal role of corporate directors and the actual role played by boards of directors of subsidiary corporations also casts doubt on the utility of certain statutory requirements. The *Canada Business Corporations Act*⁶⁷ and several provincial business corporations statutes require that a majority of the board of directors of a corporation be resident Canadians, and that a majority of the resident Canadian directors be present at any meeting of the board to transact business. These statutory provisions were enacted in response to concerns about the degree of control exercised by foreign parent corporations over their Canadian subsidiaries. By requiring a majority of the members of the board of directors to be resident Canadians the legislation attempts to ensure that a Canadian perspective will be represented on the boards of foreign-controlled corporations, and that a majority of the board members will be subject to the jurisdiction of Canadian courts.⁶⁸

However, in view of the fact that the structure of managerial decision-making within an integrated corporate group will often bypass the subsidiary's board altogether,⁶⁹ it is doubtful whether these statutory requirements accomplish their intention. Even where the subsidiary's board does play a role in corporate decision-making, the absence of any statutory mandate requiring accountability to any outside constituency other than the corporation's shareholders undermines the presumptive aims of the legislation. This perhaps reflects legislative ambivalence about intervening in the "private" sphere of corporate government to achieve public policy-oriented goals. Consequently, the legislative initiative to reform the makeup of boards of directors along the lines discussed has been regarded as mere legal formality,⁷⁰ rather than a constructive response to the complex legal issues posed by the formation and organization of multinational corporate groups.⁷¹

IV. Protecting the Interests of Minority Shareholders

If the limits of the traditional model of corporate governance are apparent in dealing with parent-subsidiary relationships, the analytical and practical problems of minority shareholder protection within a group

66. See, e.g., Hadden, Forbes & Simmonds, *supra*, note 27 at 634.

67. S.C. 1974-75-76, c. 33 at ss. 100(3), 109(3) and 109(4).

68. See Hadden, Forbes & Simmonds, *supra*, note 27 at 198.

69. See White, *supra*, note 49 at 51.

70. *Ibid.* at 36.

71. For a critique of this legislative approach to reform of the board see R.W. Dickerson, J.L. Howard and L. Getz, *Proposals for a New Business Corporations Law for Canada*, vol. 1 (Ottawa: Information Canada, 1971) at para. 9.

context are perhaps even more intransigent. At common law, no distinction is made between the position of minority shareholders within a corporation which remains functionally independent and a corporation which is part of a larger group. Yet it is clear that the tension between majority control and the need for minority protection, which is inherent under the traditional corporate model, can become even more acute in a group context in view of the risk that the interests of a subsidiary corporation will be subordinated to the wider economic interests of the group enterprise. Indeed, it can be argued that the economic integration of a subsidiary corporation within a larger group enterprise may pose a fundamental challenge to the theoretical framework supporting the principle of majority rule which rests on the premise that both majority and minority shareholders ultimately share a common interest in the successful operation and profitability of the corporate entity.⁷²

During the past fifteen years, in Canada the traditional common law "rights-oriented" model of minority protection has been largely supplanted by a more modern statutory scheme of procedural remedies designed to protect minority shareholders from oppressive or unfairly prejudicial conduct on the part of the majority.⁷³ The effect of these statutory reforms, according to Welling, is that "majority rule is no longer an absolute in Canadian corporate law; it is conditioned by statute-based minority protection remedies which, in a broad range of areas, permit discretionary judicial intervention."⁷⁴

Despite the specific extension of these provisions to include affiliated corporations,⁷⁵ these statutory reforms make no attempt to provide a conceptual framework for analysis in resolving parent-subsidiary disputes. Instead, it is left to the courts to work out the limits of judicial intervention based on the existing concepts of unfairly prejudicial or oppressive conduct with little direction from the legislature.⁷⁶ Few analytical difficulties are likely to arise in clear cases of abuse by the majority,⁷⁷ such as diverting corporate assets to another corporate entity controlled by the majority, or deliberately running down the business of a partly-owned subsidiary.⁷⁸ In such circumstances, minority shareholders will have access to a wide range

72. See H. Wiedemann, "The German Experience with the Law of Affiliated Enterprises" in Hopt, ed., *Groups of Companies in European Law*, *supra*, note 4 at 22 (noting that this is the premise underlying the differential treatment of the interests of minority shareholders in a "Konzern" under West German law). See also Sargent, "Beyond the Legal Entity Doctrine: Parent-Subsidiary Relation under the West German Konzernrecht," *supra*, note 4 at 331-355.

73. See Welling, *supra*, note 8 at 497.

74. *Ibid.* at 604.

75. See, e.g. the *Canadian Business Corporations Act*, *supra*, note 67, ss. 222(1), 231, 232(1), 234(2).

76. See Dickerson, Howard and Getz, *supra*, note 71 at para. 477 and Welling, *supra*, note 8 at 526-537. See also M.A. Waldron, "Corporate Theory and the Oppression Remedy" (1982) 6 *Can. Bus. L.J.* 129 at 137-152 (noting that lower level courts have adopted a liberal approach in interpreting the scope of these statutory provisions) and Kaufman, *supra*, note 64.

77. Note, e.g., *Re Little Billy's Restaurants (1977) Ltd.* (1983), 45 B.C.L.R. 388, 21 B.L.R. 246 (S.C.); *Selanor*, *supra*, note 61.

78. See *Scottish Co-operative*, *supra*, note 61.

of statutory remedies. Greater difficulties of proof are likely to occur, however, where the conflict arises as a result of corporate policies designed to optimize the profitability of the group enterprise as a whole rather than maximize the profitability of each individual subsidiary.⁷⁹ As Prentice notes, the concepts of "unfairly prejudicial treatment" or "oppression" are not particularly apt when dealing with many situations which frequently arise within a parent-subsidary context, and yet, which give rise to legitimate fears on the part of minority shareholders.⁸⁰

For example, the dividend policy pursued by corporate management may be influenced by the financial needs of other corporations in the group or by the fiscal position of its parent corporation, rather than by the best interests of the subsidiary itself.⁸¹ Similarly, transfer pricing techniques used to allocate profits between affiliated corporate entities, the use of intercorporate loan guarantees as a means of internal corporate financing,⁸² and even the allocation of tax losses, pension plan surpluses or investment opportunities among related corporations in a group may all pose risks for minority shareholders in the event that the interests of an individual subsidiary are subsumed to those of the group as a whole.⁸³ The difficulty facing a court in situations like these is that there may be little or no evidence of exploitative conduct on the part of the majority. On the contrary, the decisions in question may be economically rational and consistent with good management practice of achieving the most efficient allocation of resources within a group. From the perspective of minority shareholders, however, such conduct may appear to be clearly detrimental to the subsidiary insofar as it reduces its profitability and deprives it of sufficient funds to finance further expansion.⁸⁴ The courts lack adequate analytical tools for resolving conflicts of this nature. From a strictly theoretical perspective, the courts are required to consider the exclusive interests of a subsidiary without regard to the broader interests of the group. In practice, however, the traditional reluctance of courts to intervene in what are viewed as internal corporate management disputes, coupled with the difficulty of obtaining information on intercorporate transactions within a group and the requirement of proof of fraudulent or oppressive conduct, act as effective disincentives to minority shareholder suits and ensure that few such cases come before the courts. Consequently, Canadian courts

79. *Per Walde, supra*, note 39.

80. Prentice, *supra*, note 4 at 117.

81. For example, see *Levien v. Sinclair Oil Corp.*, 261 A.2d 911 (Del. Ch. 1969), modified 280 A.2d 717 (Del. S.C. 1971) [hereinafter *Levien*].

82. See *Rolled Steel Products (Holdings) Ltd. v. British Steel Corp.* (1982), [1982] Ch. 478, 1982 3 W.L.R. 715, 1982 3 All E.R. 1057 (Ch.) [hereinafter *Rolled Steel*].

83. *Per Hadden, supra*, note 4 at 15-18 and Prentice, *supra*, note 4 at 113. See also Note, "Corporate Fiduciary Doctrine in the Context of Parent-Subsidiary Relations" (1964-65) 74 *Yale L.J.* 338 [hereinafter *Yale*].

84. Note, e.g., the decision of Fulton J. in *Jackman v. Jackets Enterprises Ltd.* (1977), 4 B.C.L.R. 358, 2 B.L.R. 335 (S.C.). See also *Rolled Steel, supra*, note 82.

have rarely had to address themselves to the complex conflicts of interest which arise out of parent-subsidiary relationships.⁸⁵

By way of contrast, in the United States the courts have long recognized the existence of a fiduciary duty owed by a majority shareholder to minority shareholders. Accordingly, American courts have accumulated considerable experience in resolving disputes concerning the legitimacy of a parent corporation's dealings with its subsidiaries or affiliates.⁸⁶ However, in seeking to apply standards of "fairness" to complex fact situations involving the utilization of assets within a group enterprise, or the allocation of consolidated tax savings or corporate opportunities, American courts have experienced analytical difficulties similar to those facing Canadian courts in like circumstances.⁸⁷ One commentator attributes this to the fact that the American fiduciary duty test was originally developed to prevent exploitative conduct within an independent corporate entity and is not readily amenable to protecting minority shareholders against the kind of risks associated with corporate conflicts of interest within an integrated corporate group.⁸⁸ Walde observes:

Today minority interests are not threatened so much by fraudulent behaviour but by the interdependence of the subsidiary in the parent's organization and the correct application of a rational, profit-maximizing decision process which inherently disfavours the minorities. It is not so much greedy robber barons who have to be checked; it is the [integrated corporate system] which can claim that its profit maximizing serves the public interest by optimizing resource allocation even though it is in conflict with the minority investors' interests.⁸⁹

He further suggests that the difficulties experienced by the courts in applying the fiduciary duty doctrine to parent-subsidiary relationships are in part due to the complex nature of intercorporate relationships within an integrated corporate group.

85. For an exceptional case dealing with the legitimacy of intercorporate relationships within a complex group enterprise, see *Woltherspoon et al. v. Canadian Pacific Ltd.* (1979), 92 D.L.R. (3d) 545, 22 O.R. (2d) 385 (H.C.), rev'd (1982), 129 D.L.R. (3d) 1, 35 O.R. (2d) 449 (C.A.); leave to appeal to the Supreme Court of Canada granted June 22, 1982, 37 O.R. (2d) 73.

86. See *Southern Pacific Co. v. Bogert*, 250 U.S. 483 (1919); *Pepper v. Litton*, 308 U.S. 295 (1939) [hereinafter *Pepper*]; *Blaustein v. Pan American Petroleum & Transport Co.*, 293 N.Y. 281, 56 N.E. 2d 705 (Ct. App. 1944) [hereinafter *Blaustein*]; *Mayflower Hotel Stockholders Protective Comm. v. Mayflower Hotel Corp.*, 173 F.2d 416 (D.C. Cir. 1949); *Case v. New York Central Ry.*, 15 N.Y.2d 150, 204 N.E.2d 643, 256 N.Y.S.2d 607 (Ct. App. 1965) [hereinafter *Case*]; *Meyerson v. El Paso Natural Gas Co.*, 246 A.2d 789 (Del. Ch. 1967) [hereinafter *Meyerson*]; *Getty Oil v. Skelly Oil Co.*, 255 A.2d 717 (Del. Ch. 1969), rev'd 267 A.2d 883 (Del. 1970); *Levien*, *supra*, note 81; *Trans World Airlines, Inc. v. Summa Corp.*, 374 A.2d 5 (Del. Ch. 1977); *Schreiber v. Bryan* 396 A.2d 512 (Del. Ch. 1978). Generally, see Walde, *supra*, note 39; Yale, *supra*, note 83; Note, "The Fiduciary Duty of Parent to Subsidiary Corporation" (1971) 57 *Va. L. Rev.* 1223; J. Bautz Bonanno, "The Protection of Minority Shareholders in a Konzern under German and United States Law" (1977) 18 *Harv. Int. L.J.* 151.

87. See, e.g., the decisions in *Case*, *Levien*, and *Blaustein*, *ibid.* Further, note the comments in Yale, Walde at 465-485, and Bonanno at 165-171, *ibid.*

88. Walde, *ibid.* at 473.

89. *Ibid.* at 465-466.

Each test [of fairness] is devised for control of simple transactions in the traditionally independent corporation. In the modern [integrated corporate system], with its steady flow of goods and services, its interactions and instructions between members of the corporate group, and the absence of comparable market values for the goods exchanged, no suitable test is available. The factor producing this disability common to all the tests, however, may be the basic premise on which the tests are based, *viz.*, the concentration of judicial scrutiny on a single corporate transaction.⁹⁰

As a result, judicial reliance on "arms-length" or "independent-transactor" tests to assess the fairness of intra-group transactions is often at odds with the reality of corporate interdependence and control within an integrated group, and thus is inadequate to protect minority interests.⁹¹ As Walde points out, each test of fairness presupposes the existence of an identifiable corporate interest on the part of a subsidiary which will be protected by the courts.⁹² However, the more closely a subsidiary is integrated into the economic matrix of a group enterprise, the more difficult it becomes for a court to identify a definable corporate interest against which to measure the conduct of a parent corporation or the expectations of minority shareholders. It is therefore precisely in those situations where the interests of a subsidiary are most completely subsumed under and identified with those of the group enterprise that the courts will experience the greatest difficulty in formulating appropriate standards for protecting minority interests.⁹³

The absence of clear standards against which to judge the fairness of intra-group transactions means that the initial allocation of the burden of proof of fairness or unfairness will often be determinative of the issue at hand.⁹⁴ This is well illustrated by the litigation in *Levien v. Sinclair Oil Co.*,⁹⁵ a leading case on the fairness standard in parent-subsidiary relationships. Sinclair Oil Co. was a holding company which owned 97% of the shares of its Venezuelan subsidiary (Sinven) and nominated all of Sinven's directors. From 1960 to 1966, Sinclair Oil caused Sinven to pay out dividends in considerable excess of the subsidiary's earnings⁹⁶ in order to ease its own cash flow problems and finance expansion of other subsidiaries located in different jurisdictions. Minority shareholders of Sinven brought a derivative action claiming that Sinclair Oil was in breach of its fiduciary duty and requiring it to account for damages sustained by Sinven as a result of the loss of corporate opportunities caused by the payment of excessive dividends.

90. *Ibid.* at 480.

91. *Ibid.* at 469. See also *Yale*, *supra*, note 83 at 339-340 and *Bonanno*, *supra*, note 86 at 168-169.

92. *Walde*, *ibid.* at 473-484.

93. *Ibid.* See also *Bonanno*, *supra*, note 86 at 168-169.

94. See Note, "The Fiduciary Duty of Parent to Subsidiary Corporation," *supra*, note 86 at 1225 (noting that in 36 of the 39 cases considered, the party carrying the burden of proof lost!)

95. *Supra*, note 81.

96. Between 1960 and 1966, Sinven paid out \$108 million in dividends (i.e., \$38 million in excess of its earnings during that period). *Ibid.* at 917 [cited to 261 A.2d 911].

The Delaware Chancery Court held that Sinclair Oil owed a fiduciary duty to Sinven and that, because of the control exercised by Sinclair Oil over the appointment of its subsidiary's directors, the relationship between the two corporations should be governed by the intrinsic fairness test. Under this test the onus was placed on Sinclair Oil to prove that its transactions with Sinven were objectively fair. It was not able to discharge this burden, and accordingly, the court found in favour of the plaintiffs.⁹⁷

On appeal, the Delaware Supreme Court held that despite the existence of a fiduciary duty owed by Sinclair Oil to Sinven, the intrinsic fairness standard should only be applied where — in addition to control exercised by a parent corporation over its subsidiary — there is also evidence of “self-dealing” by the parent.⁹⁸ The Court indicated that “[s]elf-dealing occurs when the parent, by virtue of its domination of the subsidiary, causes the subsidiary to act in such a way that the parent receives something from the subsidiary to the exclusion of, and detriment to, the minority stockholders of the subsidiary.”⁹⁹ Since minority shareholders had also received a proportionate share of the excessive dividends paid by Sinven, there was no evidence of self-dealing by Sinclair Oil. Consequently, it was held that the lower court should have applied the business judgment rule rather than the intrinsic fairness test. Under the business judgment rule, in the absence of clear evidence of conduct amounting to fraud or gross or palpable overreaching by the parent corporation, the court will not intervene to challenge the business judgment of the parent in its dealings with its subsidiary.¹⁰⁰ Since the payment of dividends was in strict compliance with Article 170 of the *Delaware Corporations Code*, and it could not be established that Sinclair Oil had appropriated any corporate opportunities belonging exclusively to Sinven, the Delaware Supreme Court dismissed this part of the plaintiffs' claim.¹⁰¹

The limitations of the fiduciary duty approach in dealing with parent-subsidary disputes have led some commentators to conclude that an alternative approach to minority shareholder protection within an integrated corporate enterprise is needed; in particular, one which focusses on the subordinate position of minority shareholders as a class, rather than on the fairness of individual transactions.¹⁰² This view is based on the premise that minority shareholders within a group are in a functionally different

97. *Ibid.* at 925.

98. *Supra*, note 81 at 720 [cited to 280 A.2d 717].

99. *Ibid. per* Wolcott C.J.

100. See *Meyerson, supra*, note 86 and *Walde, supra*, note 39 at 471.

101. The Court, however, did find some evidence of self-dealing with respect to an exclusive supply contract which Sinclair Oil had caused Sinven to enter into with another of its wholly-owned subsidiaries (International), under which International agreed to purchase a certain minimum of crude and refined oil products from Sinven at fixed prices. Accordingly, this transaction was subject to judicial scrutiny under the intrinsic fairness test and Sinclair Oil was held liable to account to Sinven for damages incurred as a result of breach of the supply agreement by International. *Levien, supra*, note 98 at 723.

102. *Walde, supra*, note 39 at 491; *Yale, supra*, note 83; *Berle, supra*, note 1 at 355.

position than those in an independent corporation and should therefore be treated differently.¹⁰³ Walde, for example, argues that minority shareholders in a group are effectively circumstanced as involuntary creditors who do not, however, enjoy the options of cancelling their loans or participating in the profits of the group as a whole.¹⁰⁴ He therefore advocates giving minority shareholders the right to share in group profits — either by an option to exchange their shares in a subsidiary corporation for shares in its parent, or through a form of preferred or guaranteed dividend — based on the financial position of the subsidiary prior to the acquisition of control by its parent.¹⁰⁵

An alternative recommendation — and one which is more consistent with the procedural remedy approach¹⁰⁶ to minority shareholder protection recently adopted in Canadian business corporations legislation — would be to extend the scope of the statutory veto or appraisal rights accorded to minority shareholders of subsidiary corporations. At present, the application of these rights is restricted to proposed changes that would fundamentally alter a corporation's constitution or business (for example, an amalgamation with another corporation, or a sale of all or substantially all of a corporation's assets).¹⁰⁷ These statutory provisions are designed to obviate the need for judicial review of the fairness or legitimacy of fundamental corporate changes effected by the majority, provided that dissenting minority shareholders are given the opportunity to be bought out at a fair price. However, it is arguable that the acquisition of control over a corporation through a purchase of its shares is likely to result in no less fundamental a change to the business of the corporation than the acquisition of control through a purchase of its assets. Following this reasoning, minority shareholders should be entitled to a statutory appraisal right from the date of acquisition of control by another corporation, regardless of the means by which control is acquired. This would then place the onus on the acquiring corporation to ensure that appropriate provision is made to protect the interests of minority shareholders at the time of acquisition of control

103. Walde, *ibid.*; Berle, *ibid.* Judicial support for this view can be found in the following cases: *Re Hellenic and General Trust Ltd.* (1975), [1976] 1 W.L.R. 123, [1975] 3 All E.R. 382 at 385-386 (Ch.D.) *per* Templeman J.; *Re Standard Manufacturing Co.* (1984), 5 D.L.R. (4th) 697, 45 Nfld & P.E.I.R. 159 (Nfld. S.C.T.D.). See also *Carlton Realty Co. Ltd. v. Maple Leaf Mills Ltd.* (1978), 93 D.L.R. (3d) 106, 22 O.R. (2d) 198 at 205 (H.C.) *per* Steele J.; *Alexander v. Westeel Rosco Ltd.* (1978), 93 D.L.R. (3d) 116, 22 O.R. (2d) 211 at 221 (H.C.) *per* Montgomery J.

104. Walde, *ibid.* at 491.

105. *Ibid.* This proposal is broadly analogous to the statutory protection accorded to minority shareholders in a contractual Konzern under Articles 304 and 305 of the *West German Stock Corporation Law* of 1965. See Walde, *ibid.* at 495-499; Sargent, *supra*, note 72 at 340-343; Wiedemann, *supra*, note 72 at 34-35.

106. The terminology is borrowed from Welling, *supra*, note 8 at 497.

107. See, e.g., the *Canada Business Corporation Act*, *supra*, note 67, s. 184; *The Manitoba Corporations Act*, S.M. 1976, c. C-40, s. 184; *The Alberta Business Corporations Act*, S.A. 1981, c. B-15, s. 184; *The British Columbia Company Act*, R.S.B.C. 1979, c.59, s.231; *The Ontario Business Corporations Act*, S.O. 1982, c.4, s.184; *The Saskatchewan Business Corporations Act*, R.S.S. 1978, c. B-10, s.184; *The New Brunswick Business Corporations Act*, S.N.B. 1981, c. B-9.1, s.131. Generally, see J. Magnet, "Shareholders' Appraisal Rights in Canada" (1979) 11 *Ottawa L. Rev.* 100.

in order to prevent the expenses associated with a large-scale exercise of their appraisal rights.¹⁰⁸

The "put" provisions of section 188 of the *Ontario Business Corporations Act*¹⁰⁹ provide minority shareholders with a form of appraisal remedy once 90% of the shares of a target corporation has been acquired. Under subsection 188(2), whenever 90% or more of a class of securities is obtained by an acquiring shareholder or its associates or affiliates, the target corporation is required to send a notice to minority shareholders setting out the offer price and the basis upon which it was arrived at. Minority shareholders may then elect to accept the offer price, or apply to have the fair value of the shares determined by the court.¹¹⁰

Undoubtedly, some would contend that extending the reach of these provisions to cover situations where a controlling interest is acquired with less than 90% of the shares would have a significant and potentially deleterious impact on the market for corporate control. However, in view of the risks associated with being a minority shareholder within a larger corporate group, particularly where there is no functioning outside market for their shares, it is arguable that this is an appropriate price to pay for corporate control in a highly concentrated economy such as Canada's.¹¹¹

V. Creditor Protection and Corporate Insolvency

Another significant area of tension between the traditional legal entity model and the reality of economic interdependence of group organization appears in connection with corporate insolvency and creditor protection. The separate legal personality of each of the corporations within a multi-corporate group enterprise has as its corollary the fact that each corporation will be effectively insulated — in legal if not in economic terms — from the debts and liabilities of any associated corporations.¹¹² Creditors of an insolvent subsidiary are therefore only entitled to look to the assets of the subsidiary to satisfy their claims and normally have no recourse to the assets of the parent or any other associated corporation within the group.

In theory, this would allow a parent corporation to wind up an insolvent subsidiary to the detriment of unsecured creditors, even if the group

108. This is the argument underlying the *de facto* merger doctrine in the United States. See, e.g., *Applestein v. United Board and Carton Corp.*, 33 N.J. 72, 161 A.2d 474 (1960); *Farris v. Glen Alden Corp.*, 393 Pa. 427, 143 A.2d 25 (1958); *Rath v. Rath Packing Co.*, 257 Iowa 1227, 136 N.W.2d 410 (1965). See generally Ed G. Ruland, "Corporations — Corporate Combination — De Facto Merger and Stockholders Appraisal Rights" (1960) 14 *Sw. L.J.* 276.

109. *Supra*, note 107.

110. *Ibid.* per ss. 118(2) and 118(3).

111. See Hadden, *supra*, note 4 at 35 (noting that the principle that minority shareholders should be given the right to be bought out after a partial or mandatory bid has proven to be both acceptable and workable in the case of takeovers governed by Rule 34 of the *City Code on Take-Over and Mergers*). Note also Prentice, *supra*, note 4 at 113–115, and more generally, M.A. Weinberg, M.V. Blank and A.L. Greystoke, *Take-Overs and Mergers*, 4th ed. (London: Sweet & Maxwell, 1979) at 118–156.

112. See Douglas and Shanks, *supra*, note 29.

as a whole remains fully solvent. In practice, however, this rarely occurs because permitting an individual subsidiary to fail through lack of adequate financing could damage the financial credibility of the group too.¹¹³ Thus a subsidiary incurring losses may be "hived-off" to another corporate purchaser. Alternatively, attempts may be made to rescue a financially strained subsidiary by an internal infusion of funds from other corporations within the group, or through external sources of financing which are guaranteed by the parent or another associated corporation.¹¹⁴ The effect of such rescue attempts may be to extend the financial weakness of one subsidiary to other associated corporations, thereby potentially endangering the financial stability of the group as a whole.¹¹⁵

On occasion, the unthinkable does happen (somewhat to the embarrassment of the legal profession and the chagrin of unsecured creditors) and either one or more subsidiaries or the entire group of corporations may be forced into liquidation. In this situation the tension between the operation of the legal entity doctrine and the expectations of creditors may become particularly acute. On the one hand, creditors may assume that the assets of the group as a whole should be available to meet their claims, especially when an insolvent corporation has been operated as a part of an integrated enterprise. This impression may be reinforced by corporate publicity which advertises a particular corporation as part of a larger group enterprise.¹¹⁶ On the other hand, as Burnett points out, the group's allocation of realizable assets available to creditors may be based upon external considerations having little to do with the latter's claims in the event of bankruptcy.¹¹⁷

The difficulties facing creditors of an insolvent subsidiary may be further exacerbated by the internal financing and accounting practices adopted within a group. Thus, the use of intercorporate loans as a means of transferring resources within a group may have the effect of further reducing the assets available to meet the claims of outside creditors insofar as it permits related corporations to claim alongside other creditors on the winding up of a subsidiary.¹¹⁸ Internal group financing practices are not *per se* improper. Indeed, they are the natural consequence of treating a group as an integrated financial unit. It is clear, however, that such modes

113. See Hadden, *supra*, note 4 at 18.

114. Hadden, *ibid.*

115. See B.A.K. Rider, "Report Shows How Insolvent Companies are Kept at the Creditors' Cost" (1982) 2 *Co. Lawyer* 274.

116. A prosaic example of this is the entry in the *Ottawa-Hull Telephone Directory* (1986) for the Boyd Group of Companies. The entry includes numbers for the executive office and four other corporate entities within the group (*viz.*, Boyd Moving and Storage Ltd., Admiral Travel Agencies Ltd., Boyd International Freight and Forwarding Ltd. and Cartier Supply and Rentals Ltd.) as well as the names of three corporate officers who presumably occupy executive positions in all the corporations within the group enterprise. See also the *Report of the Review Committee on Insolvency Law and Practice* (1982), Cmmd. (U.K.) at 435.

117. Burnett, *supra*, note 27 at 9.

118. See, e.g., *Re Southard & Co. Ltd.* (1978), [1979] 1 W.L.R. 546, [1979] 1 All E.R. 582, *aff'd* (1979), [1979] 1 W.L.R. 1198, [1979] 3 All E.R. 556 (C.A.) [hereinafter *Re Southard* cited to W.L.R.] .

of internal corporate financing may pose significant risks for outside creditors which are not typically present within the context of a truly independent corporation.¹¹⁹

The limitation of the strict legal entity approach in situations involving group insolvencies has attracted considerable attention in the United Kingdom because of a number of recent cases in which a parent corporation sought to wind up an insolvent subsidiary.¹²⁰ In *Re Southard & Co. Ltd.*,¹²¹ for example, a parent corporation had first placed its wholly-owned subsidiary into voluntary liquidation at an extraordinary general meeting of shareholders, and then sought a compulsory winding up order against it. At issue was whether or not the Court should exercise its discretion to refuse the order where the petition was opposed by a minority of unsecured creditors. The Court did refuse the winding up order on the ground that the parent corporation had not established that it would lead to a more expeditious or economical realization of the subsidiary's assets.¹²² However, the right of the parent corporation to place its subsidiary into voluntary liquidation was not questioned. Templeman L.J. observed:

English company law possesses some curious features, which may generate some curious results. A parent company may spawn a number of subsidiary companies, all controlled directly or indirectly by shareholders of the parent company. If one of the subsidiary companies, to change the metaphor, turns out to be the runt of the litter and declines into insolvency to the dismay of its creditors, the parent company and the other subsidiary companies may prosper to the joy of the shareholders, without any liability for the debts of the insolvent subsidiary.¹²³

It should also be noted that the right of the parent corporation to rank *pari passu* with other creditors was not disputed.

Broadly speaking, the Canadian judicial response to multi-corporate bankruptcies has been similar to that of the English courts. In *Clarkson Co. Ltd. v. Zhelka*,¹²⁴ the Court declined to lift the corporate veil and make the assets of a corporation available to the creditors of its controlling shareholder despite evidence of undercapitalization and a complex series of intercorporate transactions (involving transfers of assets for little or no con-

119. *Report of the Review Committee on Insolvency Law and Practice*, *supra*, note 116 at 440-444; Hadden, *supra*, note 4 at 18. See also the recent decision of the Superior Court of Quebec in *Re 125258 Canada Inc. and the Royal Bank of Canada* (2 May 1986), [unreported] (concerning the validity of the practice of "ceding" intercorporate indebtedness between multiple set-offs at the end of each fiscal year). Note further, Burnett, *supra*, note 27 at 9-11.

120. See the *Report of the Review Committee on Insolvency Law and Practice*, *ibid.* at 434-444; House of Commons, *Parliamentary Debates* (Hansard), vol. 979 at cols. 1249-1272 (1980); Note, "Multinationals and the Antiquities of Company Law," *supra*, note 4; Wooldridge, *supra*, note 4 at 103-113; Prentice, *supra*, note 4 at 104-112.

121. *Supra*, note 118. See also *Re Sarflax Ltd.* (1978), 1979 Ch. 592, 1979 2 W.L.R. 202 (Ch.D.).

122. *Re Southard* (1978), *supra* note 118 at 552 (*per* Brightman J.).

123. *Re Southard* (1978) *supra*, note 118 at 1208.

124. *Supra*, note 5.

sideration) which was apparently designed to avoid potential claims by creditors. Thompson J. commented:

No doubt his creditors are disappointed at their inability to have access to his corporate assets and particularly where he himself is reaping some financial benefit therefrom. But that must of necessity be, so long as the legislature provides for and encourages the formation of private corporations. Without such, of course, enterprise and business adventure would be shifted. Limited liability is one of the landmarks of incorporation.¹²⁵

The legislative response to the problems posed by multi-corporate bankruptcies is equally muted. Honsberger points out that federal bankruptcy legislation does not address the reality of modern methods of doing business through complex corporate structures.

The *Bankruptcy Act* is, on the whole, well designed to detect and punish fraudulent conduct on the part of individual debtors and to set aside fraudulent transactions. The *Act*, however, has not kept up with the realities of modern methods of doing business through the use of limited liability corporations. Very often the creditors of a corporation may be defeated by the conduct of those acting in the name of the corporation, which conduct falls short of a criminal or bankruptcy offence.¹²⁶

Some protection may be afforded to creditors by sections 78-79 of the *Bankruptcy Act*¹²⁷ which deal with reviewable transactions entered into prior to bankruptcy. Under section 79, directors and shareholders of a bankrupt corporation may be held personally liable to creditors where the corporation has paid a dividend or purchased or redeemed any of its shares within twelve months of the date of bankruptcy if, at that time, the corporation was insolvent. Moreover, the onus of proof that the corporation was not insolvent at the time the dividend was paid, or the shares purchased or redeemed, is on the director or shareholder.¹²⁸ In addition, section 78 gives courts the power to review the adequacy of any consideration given or received in respect of a non-arm's length transaction between a bankrupt corporation and other related persons occurring within twelve months of the date of bankruptcy. (Section 4 of the *Bankruptcy Act* contains a lengthy definition of related persons similar to that found in the *Income Tax Act*).¹²⁹ Under subsection 78(2), if it is found that the consideration given or received conspicuously diverges from what fair market values (as determined by the court) would dictate, judgment may be given against any party privy to the transaction to account for the difference in value.

125. *Ibid.* at 577 [cited to O.R.]

126. J.D. Honsberger, "Solvency and the Corporate Veil in Canada" (1972) 15 C.B.R. (N.S.) 89 at 94-95. See also Halpern, Trebilcock and Turnbull, *supra*, note 8 at 121.

127. S.C. 1970, c. B-3.

128. *Ibid.* at ss. 79(5).

129. R.S.C. 1970-71-72, c. 63, s. 256.

Notwithstanding the potential importance of these provisions with respect to situations involving multi-corporate bankruptcies, in practice little use is made of them.¹³⁰ Instead, most challenges to the validity of transactions entered into prior to bankruptcy appear to be brought under sections 73–74 the *Bankruptcy Act* — or similar provincial legislation¹³¹ — which deal with fraudulent preferences or conveyances. These provisions apply to transactions wherein a bankrupt corporation fraudulently prefers one creditor at the expense of another, or fraudulently seeks to shield assets from the claims of a particular creditor. The aim is thus to secure parity of treatment between individual creditors rather than to increase the pool of assets available in the event of insolvency.¹³² Moreover, as Prentice observes, these provisions focus on the motives of the debtor as opposed to the status of the creditor or the nature of the intercorporate relationships between affiliated corporations in bankruptcy.¹³³ Consequently, the legislation does not address several of the practical problems involved in multi-corporate bankruptcies, namely: (1) the ability of a parent corporation to manipulate the timing and situs of bankruptcy in order to minimize the risks to group assets; and (2) a corporate capital structure which favours initial thin capitalization of a subsidiary and allows intercorporate claims in the event of insolvency.¹³⁴

The continued deference to the legal entity doctrine which characterizes Anglo-Canadian bankruptcy law can be contrasted with the approach taken in other jurisdictions. In New Zealand, for example, the *Companies Amendment Act, 1980*¹³⁵ provides that in appropriate circumstances, where there is evidence of abuse by a parent corporation or commingling of assets, a court may require related corporations to account for any deficiency on the part of an insolvent subsidiary or order the pooling of assets of two or more insolvent corporations in a group.¹³⁶ This statutory power

130. A search through the *Canadian Abridgment* and the *Canadian Bankruptcy Reports (New Series)* uncovered only four reported cases in which judgment was given to a trustee in bankruptcy under either of these two sections, namely: *Rustop*, *supra*, note 61 (re s.78); *Re Allied Agencies Ltd.* (1982), 109 A.P.R. 308, 53 N.S.R. (2d) 308 (*sub nom.* *H.R. Doane Ltd. v. Acadia Auto & Indust. Supplies Ltd.*) 43 C.B.R. (N.S.) 282 (S.C.T.D.) (re s.78); *Re Claubert Products Corporation Ltee.* (1983), 51 C.B.R. (N.S.) 38 (Que. S.C.) (re s.78); *Re Imperial Broadloom Co.* (1981), 40 C.B.R. (N.S.) 84 (Ont. S.C.), *rev'd* (1982), 43 C.B.R. (N.S.) 199 (Ont. S.C.) (re s.79).

131. See, e.g., *The Fraudulent Conveyances Act*, R.S.M. 1970, c. F160, C.C.S.M. c. F160; *The Fraudulent Conveyances Act*, R.S.Nfld. 1974, c. 29; *The Fraudulent Preferences Act*, R.S.B.C. 1979, c. 143; *The Fraudulent Preferences Act*, R.S.A. 1980, c. F-18; *The Fraudulent Preferences Act* R.S.S. 1978, c. F-21; *The Fraudulent Conveyances Act*, R.S.O. 1980, c. 176; *The Assignments and Preferences Act*, R.S.O. 1980, c. 33; *The Assignments and Preferences Act*, R.S.N.B. 1973, c. A-16; *The Assignments and Preferences Act*, R.S.N.S. 1967, c. 16.

132. See Prentice, *supra*, note 4 at 108.

133. *Ibid.*

134. *Ibid.* See also Burnett, *supra*, note 27 at 30 and Landers, *supra*, note 36 at 596.

135. *New Zealand Companies Amendment Act*, 1980, No. 43, s. 30. See also the *Report of the Review Committee on Insolvency Law and Practice*, *supra*, note 116 at 434–439.

136. This power is similar to the broad discretion exercised by french bankruptcy courts under Article 446 of the *Code de Commerce*, 1955, which permits a liquidator or the court to treat a parent corporation and one or more of its subsidiaries as a single entity for the purpose of making the parent liable for the subsidiary's debts. See Wooldridge, *supra*, note 4 at 113–124; Cohn and Simitis, *supra*, note 30 at 205–210.

is broadly analogous to the equitable jurisdiction of bankruptcy courts in the United States. Traditionally, American judges have displayed more willingness to lift the corporate veil in multi-corporate bankruptcy cases than have Anglo-Canadian courts.¹³⁷ For example, in *Taylor v. Standard Gas and Electric Co.*¹³⁸ the United States Supreme Court enunciated the celebrated "Deep Rock" doctrine, holding that where there is evidence of undercapitalization or total domination by a parent corporation to the prejudice of its subsidiary's interests, considerations of justice and equity may require that claims by a parent or affiliated corporation be subordinated to claims of other creditors.¹³⁹ In other cases, where there has been evidence of a complete commingling of assets and no separation of functions between related insolvent corporations, for purposes of bankruptcy the courts have been prepared to disregard the corporate veil altogether and treat both corporations as a single consolidated enterprise.¹⁴⁰ Landers points out, however, that such cases remain exceptional.¹⁴¹ For the most part, in the absence of evidence that a parent corporation has somehow abused its position at the expense of its subsidiary, the courts continue to treat related corporations as distinct entities in bankruptcy proceedings.

In Landers' view, although this *ad hoc* approach taken by the courts seeks to temper the strict application of the legal entity doctrine in hard cases where there is abuse by a parent corporation, it fails to take sufficient account of the business realities underlying corporate management decisions in multi-corporate groups.¹⁴² He suggests that, normally, the dominant motive underlying corporate decision-making within a multi-corporate enterprise is to maximize the profitability of the group as a whole, and that the profitability of individual subsidiaries may be largely irrelevant except insofar as it contributes to this goal.¹⁴³ Accordingly, corporate practices which may appear to be detrimental to a subsidiary — for example, artificially depressing prices charged for goods and services supplied to related corporations, or providing interest-free intercorporate loans to related corporations — may in fact be economically rational and consistent with good business practice. Yet at the same time, creditors of constituent corporations bear the risks of these enterprise-wide strategies which may result in individual failures or bankruptcies. Landers therefore advocates the adoption of a single enterprise approach to address the problem of creditor protection in group insolvencies. Under this approach, claims arising out of intercorporate loans by affiliated corporations within a

137. See G. Ashe, "The Corporate Entity in Bankruptcy: Subordination-Consolidation-Merger" (1974) 18 C.B.R. (N.S.) 1; Landers, *supra*, note 36.

138. 306 U.S. 307 (1939).

139. See Charles Rembar, "Claims Against Affiliated Companies in Reorganization" (1939) 39 *Colum. L. Rev.* 907; Douglas and Shanks, *supra*, note 29; Landers, *supra*, note 36.

140. See, e.g., *Consolidated Rock Products Co. v. Du Bois*, 312 U.S. 510 (1941); *Stone v. Eacho*, 127 F.2d 284 (4th Cir. 1942); *Soviero v. Franklin Nat. Bank of Long Island*, 328 F.2d 446 (2d Cir. 1964); *Commerce Trust Co. v. Woodbury*, 77 F.2d 478 (8th Cir. 1935).

141. Landers, *supra*, note 36 at 597-598.

142. *Ibid.* at 603-604.

143. *Ibid.*

group would be automatically subordinated to the claims of arm's length creditors.¹⁴⁴ In addition, Landers suggests that there is little justification for the application of the limited liability doctrine as between parent and subsidiary corporations, at least not where both corporations are operated as part of an integrated whole.¹⁴⁵ Consequently, unless the subsidiary is effectively operated as an independent economic unit, its creditors should be able to pierce the corporate veil in order to claim against the assets of its parent. Where both corporations are insolvent, Landers argues that the bankruptcy proceedings should be consolidated, with all outside creditors entitled to claim *pro rata* against the consolidated pool of assets.¹⁴⁶ Exception would be made in the case of "reliance creditors" who specifically relied upon the separate legal personality of a corporation in extending credit.¹⁴⁷

Support for Landers' "enterprise approach" can be found in the provisions of the West German *Stock Corporation Law* of 1965, which contains a detailed regime governing parent-subsidiary relationships within a group or "Konzern".¹⁴⁸ Under the West German legislation, a corporation which enters into a "contract of domination" with its subsidiary becomes liable for all the debts and obligations of the subsidiary, and is also obliged to compensate the subsidiary for any losses sustained during the duration of the contract.¹⁴⁹ From the point of view of the parent corporation, the benefit of such a contract is that the parent obtains an unfettered right to manage the subsidiary in accordance with the interests of the group. It also permits both corporations to be treated as a consolidated enterprise for tax purposes.¹⁵⁰ Yet even in the absence of a contract of domination, a parent corporation still remains liable to compensate its subsidiary for any losses incurred as a result of its detrimental influence.¹⁵¹

The West German approach to group liability has significantly influenced the debate regarding harmonization of the company laws of member states within the European Economic Community. The proposed *Ninth Draft Directive*¹⁵² on corporate group structure largely replicates the provisions of the *Stock Corporation Act* of 1965 relating to group liability, even to the extent of providing a separate contractual regime for parent-subsidiary relationships based on the West German contract of domination. However, the proposal, as it currently stands, has proven to be quite controversial because it goes considerably further than the laws of most

144. *Ibid.* at 599-604.

145. *Ibid.* at 619 and 625-626.

146. *Ibid.* at 631.

147. *Ibid.* at 630, 633 and 641.

148. For discussion of the West German approach see Sargent, *supra*, note 4; Wiedemann, *supra*, note 72; Wooldridge, *supra*, note 4.

149. *Stock Corporation Law*, 1965, Articles 302 and 303.

150. Sargent, *supra*, note 4 at 336.

151. *Stock Corporation Law*, 1965, Articles 311 and 315.

152. European Economic Community, *Draft Proposal for a Ninth Directive on Links between Undertakings and in Particular on Groups* (1980).

other member states in imposing liability on a parent corporation for the debts and obligations of its subsidiary.¹⁵³

One of the major objections to the proposed *Ninth Draft Directive* is that it may be inappropriate to situations in which the corporations in a group are not all operated on an integrated basis. Hadden points out that, typically, most joint venture subsidiaries are intended to operate as independent entities, and special provision is made in the joint venture agreement to both limit the liability of corporate parents and ensure that the subsidiary is not integrated into the management or financial orbit of either participating group.¹⁵⁴ Alternatively, a group organization may consist of a number of independent companies operating under the auspices of a common financial holding company which exercise little or no control over corporate management or finance decisions made at the level of the individual subsidiaries. In such circumstances, the principle of enterprise liability may defeat the economic rationale behind limited liability by increasing the risks to shareholders and creditors of one or more corporations within the group in the event of the failure of an unrelated group enterprise.¹⁵⁵

An intermediate approach, suggested by John T. Burnett,¹⁵⁶ would adopt two different rules for creditors depending upon whether an insolvent corporation was in fact operated as part of an integrated enterprise, or whether it was managed as an independent economic unit. In the former case, intercorporate claims would be subordinated to the claims of arm's length creditors, and the assets of each member of the group would be available to satisfy the debts of an insolvent subsidiary or pooled in the event of a total collapse of the group.¹⁵⁷ In the latter case, the normal legal entity principle would prevail, with the court retaining discretion to review transactions entered into prior to bankruptcy or to lift the corporate veil in situations where there is evidence of fraud or undercapitalization.¹⁵⁸

Although Burnett's proposal affords a compromise between the "entity" and "enterprise" approaches, it yet invites a further problem, namely, that of determining whether a particular insolvent corporation should be treated as part of an integrated group or as an independent entity. Given the almost infinite variety of forms of internal organization within different groups, this determination could prove a very difficult task, particularly in view of the reluctance of Canadian bankruptcy courts

153. Sargent, *supra*, note 4 at 357.

154. Hadden, *supra*, note 4 at 36.

155. *Ibid.* See also Posner, *supra*, note 39 at 510-515; Hadden, Forbes & Simmonds, *supra*, note 27 at 641.

156. Burnett, *supra*, note 27 at 31-34.

157. *Ibid.* at 31.

158. *Ibid.* at 32.

to examine the *de facto* control relationships between different corporate entities.¹⁵⁹

VI. Conclusion

It is clear from this survey that the legal issues raised by the formation of corporate group structures poses a significant challenge to the traditional legal entity model underlying current corporate theory. The question that remains, however, is how we should modify our present conceptual framework to cope with the jurisprudential problems posed by the formation and operation of complex corporate group structures.

Several possible solutions have been examined. For example, the approach adopted under West German law — which is presently being considered by the E.E.C. as a model for the harmonization of Common Market company laws¹⁶⁰ — requires the creation of a separate legislative regime governing the formation and internal organization of corporate groups which is meant to operate in addition to the existing rules of corporate law that remain applicable to independent corporations. Alternatively, following the example of American jurisprudence, it could be left to the courts to work out *ad hoc* solutions to particular problems on a case by case basis.

Whichever approach is regarded as preferable, it is clear that the problems posed by group organization warrant further investigation, not only in the context of corporate and bankruptcy law, but also in other related areas such as labour and tax law. Ultimately, any legal response will require a balance to be struck between the legal independence of each constituent corporate unit on the one hand, and the economic and financial interdependence which characterizes group organization on the other. Recognition of this fact might in itself provide an important first step in bringing about a realignment of nineteenth century legal theory with the complex reality of large scale corporate organization in the latter part of the twentieth century.

159. See, e.g., *Re A. Zimet and Woodbine Summit Ltd.* (1982), 21 B.L.R. 89, 44 C.B.R. (N.S.) 136 (Ont. S.C.); Note also F.M. Schlesinger, "Some Aspects of Arm's Length, Intercorporate Relationships and Corporate Control in Canadian Taxation and Bankruptcy Law" (1972) 15 C.B.R. (N.S.) 105 at 125-135.

160. *Supra*, note 152.