CONTRIBUTION ORDERS – A CASE NOTE ON *LEWIS HOLDINGS v STEEL AND TUBE HOLDINGS*

JAMES TOCHER*

I Introduction

"Piercing seems to happen freakishly. Like lightning it is rare, severe, and unprincipled."[1] However, there is unanimity amongst academics that some form of piercing is appropriate in the parent-subsidiary context.[2] New Zealand was the first country in the world to introduce statutory 'contribution orders' into legislation, which are found in s 271(1)(a) of the Companies Act 1993.[3] These orders allow the court to pierce the corporate veil when a subsidiary is insolvent.[4] The section is related to 'pooling orders' under s 271(1)(b), which allow the combining of assets of related companies when they are all in liquidation. The section had never fully been explored until this case.[5] By considering the theoretical justifications for limited liability in the parent-subsidiary context, this essay concludes that the approach to s 271(1)(a) requires certainty, and the best means of achieving that is to establish distinct tests for the different sub-categories of piercing to be used as a guideline by judges in future cases.

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* Candidate for BA/LLB(Hons), University of Otago.

1 Kurt A Strasser "Piercing the Veil in Corporate Groups" (2004) 37 Conn L Rev 637 at 641.

2 Strasser, above n 1, at 637.

3 John H Farrar "Legal Issues Involving Corporate Groups" (1998) 16 C & SLJ 184 at 185.

4 Technically the section applies to any "related company" which is defined in s 2(3) of the Companies Act 1993.

5 There are a few earlier cases which use s 271(1)(a), but none of them discuss it for more than a few pages.

II Lewis Holdings Ltd v Steel and Tube Holdings Ltd[6]

Lewis Holdings Ltd ("Lewis") were owners of a property which was subject to a perpetually renewable ground lease originally granted under the Public Bodies Leases Act 1969. The lessee was Stube Industries Ltd ("Stube"), a wholly owned subsidiary of Steel and Tube Holdings Ltd ("Steel"). Stube was originally an operating subsidiary, but after a restructuring it was left without a business or employees; its sole purpose was as owner of the lease. The lease was perpetually renewable in 21-year periods. In 2009 the lease was renewed by accident, as the Public Bodies Leases Act stipulated that unless notice is given that renewal is not accepted, it is deemed to be accepted. Steel did not wish to continue paying for the lease, so in 2013 Stube was put into liquidation by a shareholders' resolution. Lewis sought an order under s 271(1)(a) of the Companies Act that Steel be required to pay the remainder of the lease to the liquidator.

MacKenzie J noted several factors under s 272(1)(a) which indicated that it was appropriate to pierce here: Stube did not hold formal board meetings;[7] Stube's directors were acting in their capacity as CEO and CFO of Steel;[8] there were no formal intercompany arrangements, such as contracting for the services of Steel's employees;[9] Stube's lawyer acted for Steel not Stube;[10] a proposed sale document of the property was in Steel's name;[11] Stube had no separate bank account and its transactions were accounted for by Steel;[12] and finally invoices for rent on the lease were sent directly to Steel.[13] Under s 272(1)(b) MacKenzie

[6] *Lewis Holdings Ltd v Steel and Tube Holdings Ltd* [2014] NZHC 3311, [2015] 2 NZLR 831.
[7] At [34].
[8] At [39].
[9] At [42].
[10] At [44].
[11] At [47].
[12] At [51].
[13] At [52].

J reused many of the same facts and arguments, and discussion under (c) and (d) was minimal.

III Analysis and Critique

MacKenzie J explicitly refrained from discussing the competing principles behind s 271, preferring a straight application of the guideline factors outlined in s 272 to the facts.[14] To assess his approach, it will be useful to first address those principles.

A General Justifications for Limited Liability

Ultimately we give limited liability to companies to encourage economic activity, by incentivising risk taking by shareholders. Holding shareholders liable for any losses resulting from their business ventures would act as a "very strong deterrent to investment".[15] This is exacerbated by the typical separation of ownership and control in modern corporations, as shareholders would have to constantly monitor risks taken by directors to know their investment is safe, which increases the cost of investment.[16] Monitoring the wealth of other shareholders to ensure they could assist you in paying the company's debts imposes a further cost.[17] Arguably, these transaction costs make the capital market less efficient, as more information would be required to make informed investments.

Limited liability also enables high risk projects because "even risk neutral investors, it is suggested, will not undertake projects at the risk of losing their fortunes".[18] The same is true of large scale projects,

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[14] At [22].
[15] Damien Murphey "Holding Company Liability for Debts of its Subsidiaries: Corporate Governance Implications" (1998) 10 Bond LR 241 at 251.
[16] Strasser, above n 1, at 637.
[17] Ibid.
[18] Murphey, above n 14, at 251.

which require large numbers of investors, only made possible by the efficient capital markets above. Both these potentially socially desirable outcomes would not occur but for the existence of limited liability companies. It has been said that "the limited liability corporation is the greatest single discovery of modern times…"[19]

These risky projects are achieved by "externalising some of the risk of loss to the company's creditors and other external stakeholders".[20] The justification is that creditors are the 'cheapest cost avoider' because of their capacity (in theory) to protect ex ante against risk of loss. Creditors are expected to self-protect against risk of non-payment by the company, for example, by charging more for their goods."[21] Further protection mechanisms include:[22]

> loan covenants that restrict the company's ability to sell or further pledge its assets, security over the corporation's major assets, retention of title clauses or personal guarantees from the directors.

Finally, "creditors are also expected to diversify away their risk of loss by dealing with many different debtor companies."[23]

However, not all creditors will be able to protect themselves against risk. Firstly, directors can increase the company's risk after a contract has been secured, providing no opportunity to incorporate it into their bargain.[24] Secondly, there might be a "lack of incentive to bargain due to the small size of the contract" because the "cost of obtaining

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[19] Bernard F Cataldo "Limited Liability with One-man Companies and Subsidiary Corporations" (1953) 18 LCP 473 at 473.
[20] Helen Anderson "Veil Piercing and Corporate Groups – An Australian Perspective" (2010) NZ L Rev 1 at 10.
[21] Anderson, above n 19, at 12.
[22] Ibid.
[23] Ibid.
[24] Anderson, above n 19, at 13.

information about the risk may be prohibitive".[25] Thirdly, "some trade creditors may lack the knowledge and expertise to make accurate assessments of risk and would be unable to calculate an appropriate premium to compensate for it."[26] Fourthly, smaller parties might lack the bargaining power to successfully negotiate good risk protection.[27] Employees fall into this category. Finally, "the involuntary tort creditor has no ability to self-protect ex ante against the risk of non-payment."[28]

Arguably though, limited liability is actually better for creditors. Firstly, in the typical case, where there are a lot of shareholders, there would be significant litigation costs involved in pursuing each of them individually.[29] Secondly, with unlimited shareholder liability fewer people would be willing to be shareholders, so companies would have less capital generally. "By encouraging equity investment, the limited liability doctrine actually makes it easier for all creditors to be compensated."[30]

The classic justification for limited liability is based on 'legal entity theory': [31]

> The corporation is a separate entity; hence the obligations incurred in the operation of the business are those of the corporation itself, and the shareholders are not personally liable on those obligations.

However, it is possible to have a separate identity, yet still have personal liability for shareholders, for instance when a personal guarantee is signed. Limited liability is just a "majoritarian default": a

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25 Ibid.
26 Ibid.
27 Ibid.
28 Ibid.
29 Murphey, above n 14, at 253.
30 Anderson, at 16.
31 Cataldo, above n 18, at 474.

"default rule that most people would agree to - it saves the majority the cost of having to negotiate such a term expressly."[32] Thus, all section 271(1)(a) does is reverse the default in particular circumstances, which requires us to examine said circumstances.

B Why Allow Limited Liability Subsidiaries?

Limited liability subsidiaries are a natural consequence of allowing corporations to own shares in other companies, combined with the effect of the *Salomon* principle, reflected in New Zealand in s 15 of the Companies Act. However, at the time *Salomon v Salomon* was decided, it was ultra vires for companies to own shares in other companies.[33] It is therefore worth considering the justifications for applying this doctrine to subsidiaries.

Subsidiaries are formed for a variety of different reasons.[34] A business acquired by a merger or takeover is kept separate to retain goodwill and other intangibles associated with the pre-existing corporate identity. Multinational corporations often incorporate domestic branches, usually required by the jurisdiction itself. Some subsidiaries separate one aspect of a business from the rest. This could be to avoid application of specific regulatory regimes to the whole business, to increase transferability of portions of the business, for tax advantages, to attract finance to part of the business without releasing control over the rest and finally for general advantages of decentralised management. This is especially useful for conglomerates (corporate groups involved in a variety of different industries). Finally there are non-trading subsidiaries which solely act as a legal owner of particular assets, for the purpose of

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[32] Anderson, at 10.
[33] Robert B Thompson "Piercing the Veil Within Corporate Groups: Corporate Shareholders as Mere Investors" (1999) 13 Conn J Int'l L 379 at 381.
[34] Murphey, above n 14, at 249.

securing finance, or for tax purposes. Banks can be more willing to lend if they receive priority over a particular subsidiary upon liquidation.[35]

Many commentators have argued that the theoretical justifications are not applicable to the subsidiary context. Unlike typical companies, subsidiaries have a high coincidence of ownership and control, which eliminates the 'agency costs' involved in investment, and the litigation costs involved in pursuing shareholders directly.[36] This is especially true given that the vast majority of subsidiaries are wholly-owned (based on an Australian statistic).[37] Additionally, funds can be gathered from a large group of shareholders at the parent level.[38] Furthermore, [39]

> a holding company is more likely to be profit maximising than risk averse. A holding company will also have more extensive resources and the capacity to diversify such risks because of its greater resources.

This calls into question whether the creditor is still the 'cheapest cost avoider' in the subsidiary context.

"Limited liability does remain a strong source of encouragement in corporate groups for the risk-taking necessary to pursue large-scale, high-risk projects."[40] The parent company can isolate itself from the risks of its subsidiary's business: [41]

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[35] Companies and Securities Advisory Committee *Corporate Groups: Final Report* (May 2000) at 3.
[36] Murphey, at 252.
[37] Anderson, above n 19, at 19.
[38] Murphey, at 252.
[39] Ibid.
[40] Edwina Dunn "James Hardie: No Soul to be Damned and No Body to be Kicked" (2005) 27 SLR 339 at 346.
[41] Cataldo, above n 18, at 488.

> a corporation which wishes to risk only a portion of its assets in a particular sphere of the business may form a subsidiary for this purpose and may, through the additional limited liability thus attained, dedicate only a portion of its assets to that particular segment of the business.

Limited liability for subsidiaries incentivises companies to start new businesses, perhaps in new fields or locations. It is unlikely that a stable company would otherwise risk its primary business engaging in risky new markets. Corporations hold substantial wealth and resources in modern society, making them prime candidates to start new businesses. Therefore limited liability subsidiaries contribute to economic growth, justifying its application to them.

The following quote from Easterbrook and Fischel illustrates the trade-off being made by the law:[42]

> If limited liability is absolute, a parent can form a subsidiary with minimal capitalisation for the purpose of engaging in risky activities. If things go well, the parent captures the benefits. If things go poorly, the subsidiary declares bankruptcy, and the parent creates another with the same managers to engage in the same activities. This asymmetry between the benefits and costs, if limited liability were absolute, would create incentives to engage in a socially excessive amount of risky activities. ... It does not follow that parent and affiliate corporations routinely should be liable for the debts of those in which they hold stock. Far from it. Such general liability would give small or unaffiliated firms a competitive advantage.

It is important to reach a balance between furthering the economic function of company law and preventing the above abuses:[43]

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[42] Anderson, above n 19, at 21.
[43] Strasser, above n 1, at 639.

> A decision by corporate law to allow shareholders limited liability is a decision to allow them, as investors, to allocate some of the risks of doing business to third parties. Piercing the veil rules are one of the traditional ways that courts have supervised that risk allocation decision.

In New Zealand s 271 serves that purpose, by establishing limited liability as the default position, but allowing particular circumstances where it will be ignored. The question then remains how these circumstances ought to be determined.

C The United States Approach

John Matheson argued that a broad consideration of factors is likely to result in "results-oriented decisions", which raises concerns of legal certainty.[44] In his paper, he performed a statistical analysis of United States veil piercing cases to determine the relative weight judges were placing on particular factors. They can be divided into factors of form and factors of substance, which align with the two key criteria used in United States piercing cases. Form is whether "the subsidiary [had] a separate existence", and the substance is "wrongful conduct".[45]

Factors of form include: "overlap" of personnel, property and business; "commingling of funds"; and "non-existent" or "non-functioning" directors, officers and records.[46] The two issues of substance are 'misrepresentation' and 'undercapitalisation'. 'Misrepresentation' is where a creditor acts under the assumption that they are dealing with a parent company, when they are legally only actually dealing with a subsidiary. This could be anything from outright fraudulent representations to unclear situations where the parent's conduct, such

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[44] John H Matheson "The Modern Law of Corporate Groups: An Empirical Study of Piercing the Corporate Veil in the Parent-Subsidiary Context" (2009). 87 NCL Rev 1091 at 1100.
[45] Strasser, at 640.
[46] Matheson, above n 43, at 1124.

as making direct payments, blurs the line. Fraud is close to a sufficient condition, with piercing occurring in 92.3 per cent of cases where it was present.[47] 'Undercapitalisation' occurs when a subsidiary is not given sufficient financial support from its parent to establish a functioning business. This could come in a number of different forms, including initially establishing a subsidiary with insufficient assets, or removing assets from a subsidiary rendering them financially unviable.[48]

D Certainty vs Flexibility

It is unclear from MacKenzie J's judgment whether form or substance was the primary factor, as he discusses both the substance of the undercapitalisation abuse at [81] and of the misrepresentation abuse at [71], as well as the lack of separate commercial identity at [39]. This results from merely following the guidelines in s 272(1). Those guidelines are mandatory considerations; however, they do not provide for how much weight is to be given to the various factors. So while MacKenzie J's judgment was particularly useful in providing details for companies on which matters of form would be required (for example, his discussion of overlapping employees/directors at [41]), it does not elaborate on how those factors compare to the substantive abuses. This leaves open two questions: would the result have been different if Stube held formal meetings and kept its dealings separate, but still had no capital? And, what if they had the same issues of form, but they were a fully capitalised trading company which nevertheless became insolvent?

MacKenzie J's approach allows for greater flexibility, but at the cost of certainty. In support of his position, Robert Thompson has argued that the "safe limits of a reasonable field of action" are still well defined.[49] Bernard Cataldo claims that "rigid rules and fixed formulas are futile in

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47 At 1128.
48 At 1130.
49 Thompson, above n 32, at 395.

this area of hazy equities and judicial retrospections."[50] Conversely, Baragwanath J recognised the need for "commercial certainty" under s 271(1)(b).[51] Uncertainty in approach might hinder corporate lending and other corporate dealings.[52]

A certain approach ensures that the law serves some meaningful preventative function. This section is designed to prevent abuses of the corporate form, but corporate groups have a profit incentive to push the boundaries as much as they think they can get away with. Leaving the section vague might give us a feeling of satisfaction by achieving 'justice' in individual cases, but it really results in a lottery, where some companies play it safe and others push a bit too far. Both scenarios result in loss to society: reduced beneficial risk taking in the former, and excessive social harm in the latter. Outlining clear standards enables the market to react, and ideally the majority of companies will toe the line of balance, which the courts have set up, for how much social harm society is willing to accept in order to receive the benefits of risky entrepreneurialism.

E Separating Form and Substance

The emphasis on one of either form or substance is hard to place, because company law is contractual in nature, usually only concerned with form, but this section is equitable, which typically means disregarding form to find the substance behind it. Academics have also disagreed: Thompson argued for a focus on substance to avoid "splitting hairs" over form,[53] while Justice Learned Hand argued for form.[54] Some United States judges only relied on one of either form or

[50] Cataldo, above n 18, at 496.
[51] *Mountfort v Tasman Pacific Airlines of NZ Ltd* [2006] 1 NZLR 104 at [67].
[52] Vicky Priskich "CASAC's proposals for reform of the law relating to corporate groups" (2001) 19 C & SLJ 360 at 371.
[53] Thompson, above n 32, at 395.
[54] Cataldo, above n 18, at 494.

substance in deciding whether to pierce, disregarding the other entirely.[55] The archetypal case of form-based "single factor" piercing is where a "subsidiary has no assets or personnel of its own and has no independent business objective, or no independent decision-making authority."[56] For cases of substance only, if a parent is "evading pre-existing duties, misrepresenting the entity or assets available to perform contractual duties, as well as draining or commingling the available assets" then "the court does not require a finding of lack of separate existence."[57] Both these results appear to be justified, however they utilise distinct reasoning: formalities are only "tangentially related" to the existence of substantive wrongdoings.[58]

Given that separate considerations exist when piercing for form or substance, it would be clearest to address these separately. They actually match up nicely with s 272(1). Paragraph (a) – "the extent to which the related company took part in the management of the company in liquidation" – covers matters of form. Paragraph (b) – "the conduct of the related company towards the creditors of the company in liquidation" – covers matters of substance. MacKenzie J did not use them in this manner, instead he essentially decided the case under (a), and then repeated the same reasoning in a rephrased manner under (b). However, treating (a) and (b) as two alternative limbs for applying s 271(1)(a), either of which are sufficient on their own to justify using the section, would result in clearer precedents.

I have intentionally excluded reference to (c) – "the extent to which the circumstances that gave rise to the liquidation of the company are attributable to the actions of the related company". MacKenzie J's consideration of (c) was limited to saying "STH … passed a

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55 Strasser, above n 1, at 642.
56 At 643.
57 Ibid.
58 At 656.

shareholders' resolution to appoint a liquidator."[59] Therefore the causation requirement appears redundant, as if all that is required is that the parent places the company into liquidation, then voluntary liquidation will always be attributable. For involuntary liquidation, if either (a) or (b) are satisfied, then necessarily the parent can be regarded as the cause of the liquidation, as either they were effectively in control or their misconduct left them insolvent. The one exception might be cases of misrepresentation.

Additionally, the presence of (d) which allows consideration of "such other matters as the court thinks fit" seems to indicate against a restrictive interpretation of the court's discretion. Therefore, the suggested approach of treating (a) and (b) as separate self-sufficient limbs should only be seen as a guideline for judges, which can be followed in the majority of cases, but which courts would be free to depart from it if the particular facts required. This might seem to twist the natural meaning of the mandatory considerations, however having a guideline is not restrictive, and does not prevent considering all four paragraphs; but, the certainty of having it is better than using pure discretion in every case, without explanation of how the different factors were weighed against each other.

F Form – s 272(1)(a)

The suggested test for piercing under this 'limb' would be 'total control' by the parent, or in MacKenzie J's words, when the subsidiary is "devoid of any capacity to conduct its own affairs".[60] This stems from the concept of the price of limited liability.[61] To be recognised as a separate legal entity a subsidiary must be treated like one – to have what MacKenzie J called a "separate commercial existence".[62] All the factors

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[59] At [86].
[60] At [65].
[61] Cataldo, above n 18, at 484.
[62] At [32].

which MacKenzie J discussed in *Lewis Holdings* are good indicators going towards the ultimate test above, although none should be decisive in and of itself. Other factors include those used in the US case law above. 'Total control' is as opposed to "normal legal incident of shareholdership".[63] In other words, the court should be looking for behaviour outside the usual realms of what would be expected of natural person shareholders. The key thing to note is that this should be independent of any matters of asset stripping or misrepresentation. If a company is treated as a façade by the parent company, then it should be treated as such by the court; however, as in all veil piercing cases this is likely to be rare. Stube would probably meet this test, because it completely lacked any formal independent existence.

G Substance - s 272(1)(b)

The suggested test for piercing under this 'limb' depends on whether it is a case of undercapitalisation or misrepresentation. For undercapitalisation, it would stifle business if parents always had a perpetual duty to recapitalise their subsidiaries, which is why it cannot be sufficient simply that the subsidiary is insolvent. The required level of capitalisation must be related to the purpose for which the subsidiary was established – for instance, Damien Murphey talks about the "minimum level of resources" which a company needs to fulfil its function.[64] This test would permit a parent to allow a trading subsidiary to fail, but would prevent the establishment of non-trading subsidiaries unless they are continually financed, even if they have adequate formalities. This is because the trading company would have sufficient assets to run an independent business if properly capitalised, whereas the non-trading company would always be dependent on the parent (unless it had been given room to use that asset to gain income of its own). This fits with the justification for allowing limited liability. It is an

[63] Cataldo, at 494.
[64] Murphey, above n 14, at 254.

abuse to artificially sever liabilities using subsidiaries, but there is economic gain from independent trading subsidiaries. In *Mountfort* Baragwanath J noted that "cash sweeps" will not be wrong if both companies are solvent, as this is a usual part of business practice.[65] Stube would classify as undercapitalised using this test as it was a non-trading company which was left to fail.

For misrepresentation, there are the obvious cases of fraud (holding out as though the creditor is dealing with the parent when they are not), which should always be covered. However, for less clear cases the test should be related to the expectations of the contracting party. Kurt Strasser argues that contractual principles are relevant when dealing with piercing in contracts cases.[66] This aligns with the justification for limited liability that creditors voluntarily assume risk. If a party is fully aware that they are dealing with a limited liability subsidiary, they ought not to have any expectation that the parent will cover their liabilities, so courts should not pierce the veil. Doing so would alter the risk assumptions which a party makes when they decide to contract.[67] Creditors should not be able to get a better deal through the courts than what they bargained for.[68]

In *Lewis Holdings* it was clear who was being dealt with, but it was unclear what the risk implications were of that. Lewis was transacting directly with Steel, rather than Stube, meaning Lewis could reasonably claim they expected Steel to stand behind the contract. Parties' expectations need not be purely legal if the conduct of the parent is to disregard those legal distinctions in its interactions with the creditor. However, s 272(3) does require the reliance to be based on more than the mere fact the companies were related.

[65] *Mountfort*, above n 50, at [86].
[66] Strasser, above n 1, at 657.
[67] Priskich, above n 51, at 370.
[68] Strasser, above n 1, at 654.

This leaves the issue of torts cases, where different considerations apply.[69] Hansmann and Krakmann argue that such cases should be dealt with as a torts problem, not a company problem.[70] Other academics argue that limited liability generally is not applicable to torts claims.[71] However, this is a complex issue, and this case was not a torts case, therefore it is appropriate to leave this issue for another day.

IV Conclusion

There are theoretical arguments both for and against granting limited liability to subsidiaries, but Parliament has decided to allow it. The role of the courts, therefore, is to interpret s 271 in line with Parliament's position: limited liability as the default, with specific exceptions. It would further the purpose of the section to have clear and certain criteria for when it applies. The approach suggested recognises that there are distinct situations requiring different legal tests. Those tests are based on the justifications for limited liability, which fits with the role of s 271 in providing the limitation on limited liability. *Lewis Holdings* seems to be a clear case where s 271 would apply, because it independently satisfies all three of the suggested tests. This allowed MacKenzie J to simply conclude on the facts without addressing each of these factors distinctly, which missed an opportunity to clarify the law in this under-litigated section, thereby leaving uncertainty for parents of subsidiaries which match some but not all of the factors in this case.

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[69] At 658.
[70] Dunn, above n 39, at 350.
[71] Strasser, at 638.