The Insolvent Subsidiary and Liability of the Parent Corporation in the USA, Argentina, and UNCITRAL[‡]

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Abstract

The increasing unacceptability of the concept of entity law and the emergence of the doctrine of enterprise law with respect to many aspects of the legal relationships of parent and subsidiary corporations particularly in insolvent situations is a very interesting issue. This change is very significant because it reflects a growing unwillingness on the part of the courts and legislatures to continue accepting the traditional view of corporate law when it no longer corresponds to the economic reality of the modern business enterprise in a complex industrialized international society. This paper examines the American case law and in particular the decisions that have imposed liability where a company is liable for the obligations of an insolvent subsidiary and by contrast the decisions that have denied liability. The paper also examines the position in Argentina within the Argentine law and the UNCITRAL recommendations in respect of liability issues within corporate groups in insolvency. Copyright © 2010 John Wiley & Sons, Ltd.

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‡This article was written with the financial support of the Consejo Nacional de Investigaciones Cientificas y Técnicas (CONICET), Argentina.

Int. Insolv. Rev. (2010)
Published online in Wiley InterScience
(www.interscience.wiley.com) DOI: 10.1002/iir.185

I. Introduction

Modern authors[1] have stressed the increasing unacceptability of the concept of entity law and the emergence of the doctrine of enterprise law with respect to many aspects of the legal relationships of parent and subsidiary corporations. This change is significant because it reflects a growing unwillingness on the part of courts and legislatures to continue accepting the traditional view of corporate law when it no longer corresponds to the reality of the modern business enterprise in a complex industrialized international society.

The increase in the scale of business operations reflects a number of factors. First, the economic basis of all the industrialized nations has greatly expanded. Furthermore, most large businesses of a certain size tend to outgrow their original national limitations. The large corporation is now typically a multinational enterprise doing business in many countries throughout the world. Finally, aggregate concentration (the share of a nation's corporate assets, sales, and income produced by large corporations) has increased.

To conduct economic undertakings of such magnitude, the large enterprise is inevitably driven to abandon the simple 20th century form of corporate organization and to develop a complex corporate structure. Today, large corporations almost universally conduct business through many subsidiary corporations, for tax, accounting, political or administrative convenience, or to avoid qualification under foreign corporate statutes. The parent and the subsidiaries constitute a corporate group, which collectively conducts the business of the enterprise throughout the world.[2] In some cases, the subsidiaries conduct truly separate businesses and most often the subsidiary is only a part or fragment of the larger business of its parent, which is collectively conducted by the various affiliates under common direction.

This change in the structure and conduct of the large business corporation is inevitably producing a decisive change in the way that the law deals with the individual constituent companies of the corporate group. Older legal concepts derived from a world of much smaller and simpler organized businesses have become hopelessly inadequate.

The old view, under which each corporation is generally treated as a separate legal entity with its own legal responsibilities, is gradually collapsing, particularly in situations where the corporation in question is part of a corporate group conducting an integrated enterprise. In many areas, a new concept, termed by Philip I. Blumberg as "enterprise law," is winning increasing acceptance as the desired method of analysis of the legal problems of parent and subsidiary corporations.

The new doctrine, which was introduced in American case law in 1939 and was suggested by Blumberg in the early 1980s, seeks to trace the decline of entity law and

1. See, among others, Phillip I. Blumberg, The Law of Corporate Groups, Problems in the Bankruptcy or Reorganization of Parent and Subsidiary Corporations, Including the Law of Corporate Guaranties, at xxxiv (Little, Brown and Co., Boston. 1985) [hereinafter Blumberg]. See, among many others, U.N. Transnational Corp. and Mgmt. Div., 1993 World Inv. Rep. Studies, cited in *Survey, Multinationals-Back in Fashion*, The Economist, Mar. 27, 1993.

2. For example, in 1982 the 1000 largest American industrial corporations had an average of 48 subsidiaries each. Mobil Oil Corporation, as an extreme example, operated in 62 different countries through 525 subsidiaries. See Blumberg, *supra* note 1, at 465–468.

DOI: 10.1002/iir

the emergence of enterprise law as the standard for application to corporate groups and their constituent corporations. Entity law, the view that each corporation is a separate legal personality, originally stemmed from philosophical roots. It was strongly reinforced by acceptance of the limited liability doctrine in the United States in the early 19th century, and in England several decades later. With the development of limited liability for shareholders, entity law became firmly established as the legal framework that preserved a well-defined line between the corporation conducting the enterprise and the shareholders who owned such enterprise.

When, at the end of the 19th century, American corporations were at last generally authorized to acquire other corporations' stock, operation through subsidiaries became possible for the first time, and business structures changed dramatically. The major corporate undertaking soon ceased to be conducted by a single corporation owned by ultimate investors. The typical major enterprise increasingly developed a highly complex structure with various parts of the business allocated to numerous subsidiaries according to function (sales, manufacturing, finance, or the like) or geography. The distinction between the subsidiary corporation and its shareholder—the parent—no longer corresponded to the distinction between the enterprise and the ultimate investor, that is, the concept on which entity law had been based. The parent and subsidiary together represents the enterprise. The old law of entity, reflecting the older world of simple business organizations, became anachronistic, particularly when the issues of substantive liability were not involved.

In the area of bankruptcy law, and to a lesser extent in procedure, the objectives and underlying policies of the law do not typically involve concerns of limited liability. In bankruptcy, the courts—especially in the United States—act as courts of equity with the overriding objective of achieving equality of distribution and fairness for creditors. Thus, it is to be expected that, when a bankruptcy involves one or more members of a corporate group, courts often treat transactions between the bankrupt debtor and its parent, controlling shareholder or affiliated corporation in a different manner as compared to transactions between separate (and entirely unrelated) legal entities. Increasingly, bankruptcy courts have applied enterprise law to transactions involving "insiders," abandoning entity law, in order to achieve the goals of equality of distribution and fairness for creditors. The shift towards enterprise law is particularly evident in the areas of equitable subordination and substantive consolidation. However, this new approach is less evident—but equally valid—in other areas of bankruptcy of corporate groups such as liability issues.[3]

The corporate fiction, the doctrine that a corporation represents a separate entity distinct from its shareholders with its own rights and obligations, is the very foundation of the limited liability doctrine. To disregard legal entity in order to achieve the underlying purpose of an applicable statute or judicial rule is much more likely to occur when the imposition of substantive obligations and the overriding of the principle of limited liability are not involved. Where the question is disregarding the corporate entity to impose contract or tort liability on the shareholder, judicial

3. See Blumberg, *supra* note 1, at xxxiv-xxxvi.

DOI: 10.1002/iir

resistance, as might be expected, is at its strongest. When a subsidiary (or controlled corporation) is bankrupt, under what circumstances will a court impose liability on its parent (or controlling shareholder) for the obligations of the bankrupt? In a bankruptcy court applying equitable principles, will the court be more inclined to impose liability upon a parent or controlling shareholder for the debts of a subsidiary than in a contract or tort action in a court of general jurisdiction? If fairness is indeed the guiding standard of the bankruptcy court, does it provide a greater impetus for the court to disregard the barriers of entity law in order to impose liability on affiliated companies in appropriate cases?[4]

That is the present state of the art. Consequently new roads should be found according to the economic integration of corporate groups such as the enterprise law approach suggested by American scholars.

This work studies the American case law, the Argentine Law, and the UNCITRAL recommendations of the current decade, regarding liability issues within corporate groups in insolvency and provides new comparative law-based approaches and principles for future regulations.

II. The American Case Law

A. Cases imposing liability

The review of American cases discloses at least about two dozen cases—not all in bankruptcy—that have upheld liability on a parent (or controlling shareholder) for the obligations of an insolvent subsidiary (or controlled corporation).[5] Most of these

4. See Blumberg, *supra* note 1, at 589–590. *See generally* Richard M. Cieri *et al.*, *Braking up is Hard to Do: Avoiding the Solvency-Related Pitfalls in Spin-off Transactions*, 54 Bus. Law. 533 (1999) (discussing impact of subsidiary's contingent liabilities on parent's solvency in context of spinoff transactions); Jonathan M. Landers, *A Unified Approach to Parent, Subsidiary and Affiliate Questions in Bankruptcy*, 42 U. Chi. L. Rev. 589, 606–628 (1975); Note, *Creditors' Rights Upon Insolvency of a Parent Corporation or Its Instrumentality*, 46 Harv. L. Rev. 823 (1933); J. A. Bryant, Jr, Annotation, *Liability of Corporation for Contracts of Subsidiary*, 38 A.L.R. 3d 1102, 1146–1154 (1971).

5. See Blumberg, *supra note* 1, at. 591–597. The cases are: *Consol. Rock Prods. Co. v. Du Bois*, 312 U.S. 510, 523–524 (1941); *FDIC v. Sea Pines Co.*, 692 F.2d 973 (4th Cir. 1982), *cert. denied*, 461 U.S. 928 (1983); *Baltimore & Ohio Tel. Co. v. Interstate Tel. Co.*, 54 F. 50 (4th Cir. 1893); *Norfolk & W.R.R. v. Wasserstrom*, 1991 U.S. Dist. LEXIS 12969 (E.D. Pa. 1991); *FDIC v. Martinez Almodovar*, 671 F. Supp. 851 (D.P.R. 1987); *FDIC v. Allen*, 584 F. Supp. 386 (E.D. Tenn. 1984); *Long v. McGlon*, 263 F. Supp. 96 (D.S.C. 1967); *Palmer v. Stokely*, 255 F. Supp. 674 (W.D. Okla. 1966); *Henderson v. Rounds & Porter Lumber Co.*, 99 F. Supp. 376 (W.D. Ark. 1951); *In re Plantation Realty Trust*, 232 B.R. 279 (Bankr. D. Mass. 1999); *In re* Mass, 178 B.R. 626 (M.D. Pa. 1995); *In re Keene Corp.*, 164 B.R. 844 (Bankr. S.D.N.Y. 1994); In re Hillsborough Holdings Corp., 144 B.R. 920 (Bankr. M.D. Fla. 1992) (denying motion for summary judgment); In re Farley, Inc., 1992 Bankr. LEXIS 1801 (Bankr. N.D. Ill. 1992) (denying motion for summary judgment); *In re* Velis, 123 B.R. 497 (D.N.J. 1991); *In re Major Funding Corp.*, 126 B.R. 504 (Bankr. S.D. Tex. 1990); *In re Jarax Int'l, Inc.* 122 B.R. 793 (Bankr. S.D. Fla. 1990); *In re Haugen Constr. Serv., Inc.*, 104 B.R. 1013 (Bankr. ND. 1989); *In re Charnock*, 97 B.R. 619 (Bankr. M.D. Fla. 1989); *In re Landbank Equity Corp.*, 83 B.R. 362 (E.D. Va. 1987); *In re BDW Assocs., Inc.*, 75 B.R. 909 (Bankr. W.D. Pa. 1987) (noting sister controlled companies); *I*n re F & S Cent. Mfg. Corp., 70 B.R. 569 (Bankr. E.D.N.Y. 1987); In re B & L Labs., Inc., 68 B.R. 264 (M.D. Tenn. 1986); *In re Botten*, 54 B.R. 707 (Bankr. W.D. Wis. 1985); *In re Jones*, 50 B.R. 911 (Bankr. N.D. Tex. 1985); *In re Telemark Mgmt.* Co., 47 B.R. 1013 (W.D. Wis. 1985); *In re Ozark Rest. Equip. Co.*, 41 B.R. 476 (Bankr. W.D. Ark. 1984), *rev'd*, 61 B.R. 750 (W.D. Ark. 1986), *aff'd*, 816 F.2d 1222 (8th Cir. 1986), *on demand*, 74 B.R. 139 (Bankr. W.D. Ark. 1987); *In re Tennessee Pools & Recreation, Inc.*, 36 B.R. 602 (Bankr. M.D. Tenn. 1983); *In re D. H. Overmyer Telecasting Co.*, 23 B.R. 823, 930 (Bankr. N.D. Ohio 1982); *In re Typhoon Indus., Inc.*, 6 B.R. 886 (Bankr. E.D.N.Y. 1980); *Ayr Composition, Inc. v. Rosenberg*, 619 A.2d 592 (N.J. Super. Ct. App. Div. 1993); *Rounds & Porter Lumber Co. v. Burns*, 225 S.W. 2d 1 (Ark. 1949). But *cf.* In re Mission of Care, Inc., 164 B.R. 877 (Bankr. D. Del. 1994) (stating sister corporation denied recovery of payments allegedly made on behalf of debtor). *In re Haugen*, 998 F.2d 1442 (8th Cir. 1993); *Kimberly Coal Co. v. Douglas*, 45 F.2d 25, 27 (6th Cir. 1930); *First Huntington Nat'l Bank v. Guyan Mach. Co.*, 5 S.E. 2d 532 (W. Va. 1939). Three additional cases have upheld objections to the discharge in bankruptcy of a controlling shareholder and imposed liability for the debts of the controlled corporation: *In re Long*, 35 B.R. 949 (Bankr. S.D. Ohio 1983); *In re Harron*, 31 B.R. 466 (Bankr. D. Conn. 1983); *In re Wade*, 26 B.R. 477 (Bankr. N.D. III 1983); *see also In re Alport*, 144 F.3d 1163 (8th Cir. 1998); *In re Haakenson*, 159 B.R. 875 (Bankr. D.N.D. 1993); *In re Fitzgerald, De Arman & Roberts, Inc.*, 129 B.R. 652 (Bankr. N.D. Okla. 1991); *Fentress v. Triple Mining, Inc.*, 635 N.E.2d 102 (Ill. App. Ct. 1994). *But cf. In re Criswell*, 52 B.R. 184 (Bankr. E.D. Va. 1985); *In re Hillsborough Holdings Corp.*, 176 B.R. 223 (Bankr. M.D. Fla. 1994); *In re Hillsborough Holdings Corp.*, 166 B.R. 461 (Bankr. M.D. Fla. 1994); *In re Hillsborough Holdings Corp.*, 150 B.R. 817 (Bankr. M.D. Fla. 1993) (granting a motion for additional discovery); *In re Hillsborough Holdings Corp.*, 144 B.R. 920 (Bankr. M.D. Fla. 1992); *In re Emeral Oil Co.*, 61 B.R. 656, 660 (Bankr. W.D. La. 1984).

DOI: 10.1002/iir

have relied on the "piercing the corporate veil" jurisprudence in a greater or lesser degree, that is to say, according to the "entity law," not following the "enterprise law" approach. "Piercing the corporate veil" jurisprudence is the traditional safety valve in entity law under which, in "exceptional" cases, liability may be imposed on a parent or controlling shareholder for the debts of its subsidiary.[6]

In summary, in these cases the courts upheld the following doctrines and emphasized the following factors:

(1) The fundamental unfairness of mortgaging an unencumbered property of an insolvent subsidiary to secure the debt of the parent.
(2) When a corporation becomes insolvent, those in control (often called "insiders") have a fiduciary duty to creditors and may not divert corporate assets for their own benefit to the detriment of creditors.[7]
(3) Intrusive managerial interference exercised by the parent over the subsidiary.
(4) Inadequate capitalization of the subsidiary by the parent.
(5) The "piercing the corporate veil" doctrine especially in these situations: the lack of "meticulous regard to corporate forms;" the commingling of assets and operations; the parent's assumption of all management functions of several components of the corporate group, resulting in the conduct of the enterprise as a single unified operation; the alter ego doctrine: a relationship that has been established so that the corporate form could be disregarded; the labeling of the bankrupt corporation as a mere agency or department for the advancement of the parent's own interests.
(6) Complete identity in action of the two companies, with all the subsidiary's transactions under the parent's direction.
(7) The trust fund doctrine pointing to the subsidiary's distribution of all its assets.
(8) The insolvency of the debtor from its inception, with a gross undercapitalization (in the case a capital amounting to $1000 and debt to $109.000).
(9) Intra-group transactions manipulated by the parent to the detriment of the debtor consisting of inside sales at low or no mark-ups and no interest payments on deferred receivables (money that is owed to a business and has not yet been received).
(10) Corporate formalities not always respected.
(11) The characterization of the debtor and the affiliated as mere instrumentalities of the controlling shareholder.
(12) When the control was so pervasive that a unity of interest existed, it was inequitable to treat the parties as separate entities.
(13) Intermingling of assets.
(14) Corporate funds deposited in the shareholders' personal accounts and corporate debts paid out of other personal accounts.
(15) The cancellation of inter-company indebtedness owed by a sister company that was a second-tier subsidiary of the debtor's controlling shareholders. This constitutes a fraudulent transfer by the debtor under Section 67d (2) of the American Bankruptcy Act.
(16) The instrumentality rule, that is to say, finding the controlling shareholders "alter egos" of the subsidiary liable for the improperly cancelled indebtedness.

6. *See* Blumberg, *supra* note 1, at 596.
7. The common law fiduciary obligation of the controlling shareholder to creditors arising from the subsidiary's insolvency is the basis for the cause of action, not bankruptcy law.

DOI: 10.1002/iir

(17) The manipulation of the bankrupt company's affairs to the advantage of its own controlling shareholders, by virtue of which the shareholders' interest in the corporation is not to maximize its profits but to operate it as a source of supply at below market prices and below costs.
(18) The depletion of the insolvent's estate, by diverting its assets to the parent or for its benefit.
(19) The fact that in the subsidiary's reorganization proceedings, the parent emerged as the only secured creditor with a mortgage on the debtor's fixed assets, and that the proposed arrangement would have yielded unsecured creditors whose claims would have been affected in an amount ranging from 15 to 20 per cent.
(20) An affiliate of three dissolved sister companies was found liable for them because the corporations had operated as a single unit under the common management of the sole shareholder and shared the same office with the same telephone. The affiliates were found to be mere instrumentalities and alter egos.
(21) The inherent fundamental unfairness to a creditor of a controlling shareholder's appropriation of its subsidiary's assets after the subsidiary had become insolvent.
(22) The bankruptcy doctrine of fraudulent conveyance of an intra-group transaction whether or not the technical requirements of the Uniform Fraudulent Conveyance Act or the bankruptcy laws are satisfied.
(23) The existence of preferential transfers within the bankruptcy proceedings.

B. Cases denying liability

In contrast with the foregoing decisions imposing liability on the insolvent subsidiary, trustees in bankruptcy and creditors of an insolvent subsidiary (or controlled corporation) have been unsuccessful in their efforts to impose liability upon the parent corporation (or controlling shareholder) in the overwhelming majority of cases.[8] These decisions have typically analyzed the issue by referring to "piercing the corporate veil" jurisprudence and have inquired whether the subject case was an "exceptional case" calling for a remedy. As it can be noted, these decisions are firmly involved in the entity law approach with its rules and exceptions.

As the American law is a reasonable and accurate reflection on the economic integration and the ethical demands of the control power over the subsidiaries, these principles could be adopted by the courts or by positive legal texts in countries pertaining to the European Civil Law System.

III. The Insolvency Law Concerning the Matter in Argentina

The Argentine insolvency law[9] concerning the corporate groups is an example of a quite developed law on corporate groups in insolvency within the context of the European Civil Law System. This is true, especially pertaining to the substantive and procedural provisions on the "extension of the bankruptcy proceedings" and

8. *See* the cases in Blumberg, *supra* note 1, at 597–598.

9. This article contains citations to the Argentine Bankruptcy Act. The author has provided an unofficial translation for the cited provisions of the act.

DOI: 10.1002/iir

also—as of the first time in a positive legal text in a country with the Civil Law System—on the "piercing the corporate veil" doctrine. The two institutions are applicable—specifically or by analogy—to corporate groups in insolvency.

A. The Bankruptcy Act system. Extension of the bankruptcy proceedings

In 1969 there was a Bankruptcy Act Draft in Argentina (Section 168) that promoted the automatic extension of the bankruptcy proceedings in the case of bankruptcy of a subsidiary corporation versus the parent. Because of its rigidity, it was rejected by the authors and failed to be enacted as the Bankruptcy Act.[10]

Nevertheless, the 1972 Bankruptcy Act nearly copied the provisions of Sections 99 and 101 of the 1967 French Bankruptcy Act (and the subsequent Sections 180 and 182 of the 1985 French Bankruptcy Act), called "the extension of the bankruptcy proceedings" in English. The 1983 Bankruptcy Act increased extension up to three cases and issued additional provisions regarding other details related to the consequences of the extension. It also allowed for the extension of the bankruptcy to any individual or corporation. Later, the 1995 Bankruptcy Act put this provision under Section 161.[11] Some of these rules are applicable to corporate groups specifically and to others by analogy.

For some authors, like Manóvil, this extension of bankruptcy may be considered a type of liability[12]. I agree with him on this point.

In itself, the extension of bankruptcy proceedings is not a repressive civil penalty but a case of tort liability that requires of all its configuring elements. The most relevant of these elements is the causation link between the conduct displayed and the insolvency, both in its chronological aspect and in its quantitative and qualitative aspects.

In my opinion it is much more reasonable to have a good system of parent liability than to have an extension of the bankruptcy proceedings, especially pertaining corporate groups: the former is more accurate and proportional to the harm caused within a group.

10. The text of Section 168 of the Draft was: "Bankruptcy of a controlled company results in bankruptcy of the controlling company, a controlling company being defined as a company that directly or through another controlled company, holds interest, for any title whatsoever, in excess of 50% of the voting stock necessary to adopt decisions." *See* 29 *El Derecho 917* (1969).

11. The text of Section 161 of the 1995 Bankruptcy Act reads: "Bankruptcy shall extend: (1) To any person who under the appearance of acting for the debtor has carried out actions in its personal interest and has disposed of property as if it were its own, in fraud of its creditors. (2) To any controlling person of the debtor, whenever it has unduly deviated the corporate interest of the controlled company, submitting it to a unified direction in interest of the controlling company or the economic group thereof. For the purposes of this section, the term controlling person shall mean: (a) Any person who directly or through a controlled company, holds interest, of any kind, that grants the necessary votes to adopt decisions; (b) each of the persons who acting jointly hold interest in the proportion specified in a) above and are liable for the conduct described in the first paragraph of this subsection. (3) Any person as regards which property is commingled and cannot be separated so that it prevents a clear delimitation of its assets and liabilities or the majority thereof". This Section is complementary to Section 172 of the 1995 Bankruptcy Act which reads: "Whenever two or more persons compose an economic group, even evidenced by control relations but without the features contemplated in Section 161, the bankruptcy of one of such persons will not extend to the others."

12. See Manóvil, *Grupos de sociedades en el derecho comparado,* Abeledo-Perrot, Buenos Aires, 1998, at 1113, 1117. [Hereinafter Manóvil].

DOI: 10.1002/iir

This institution has been applied—specifically or by analogy—on approximately 38 cases of insolvent corporate groups, dealing with substantial and procedural issues in Argentina since 1970 up to now.

B. The Companies Act system

In Argentine law, the Companies Act number 19.550, as amended in 1983, contains four provisions concerning the above-discussed matter, applicable to corporate groups in insolvency, by analogy. The first two provisions are paragraphs 1 and 2 of section 54; the third is paragraph 3 of section 54; and the fourth is section 274. These provisions are applicable both in the case of a *de facto* or shadow director, and in the case of *de jure* director.[13]

1. Section 54, Paragraphs 1 and 2 of the Companies Act number 19.550 as amended in 1983

Sections 54.1 and 54.2 were introduced in 1983.[14] Both sections are applicable to individuals and to any type of corporation.[15] The rule refers to either continuous or sporadic corporate governance, and also to shareholders, dominant shareholders, and non-shareholder dominant parties. Any type of control is included: *de facto* or *de jure*, internal or external, direct or indirect.[16]

The requisites of the rule are: (a) damage against the subsidiary caused by a shareholder or a dominant or parent corporation, including non-shareholder dominant parties. Section 54.1 embraces all kinds of damage to tangible and intangible assets that are caused by fraud or fault, by act or omission, actual business, general policies, and liability in tort, including damage to business opportunities; and (b) unfairness or negligence in the corporate governance.

The consequence is a compensation of the losses to the subsidiary or the subsidiary's creditors, or the restitution of the resources and undue profits of the businesses. To compensate for the damages (in kind or money), the Civil Code regulations are applicable. As in German law, compensations with benefits and advantages (e.g., the frequently invoked benefit of being a member of the group) are specifically excluded, unless such advantages result from the same causation link.[17]

So far, there is almost no case law on this provision regarding insolvent corporate groups in Argentina.

13. See Manóvil at 671–672; *see also* Juilio César Otaegui, Concentración Societaria, Abaco, Buenos Aires 1984, at 446.

14. Section 54.1 of the Companies Act reads: "The members or those who not being members exercise control over the company shall be jointly and severally liable for any damage sustained by the company due to their willful misconduct or negligence, such members not being entitled to allege offsetting thereof against any profits they might have brought to the company due to their actions." Section 54.2 of the Companies Act reads: "The party or controlling party who uses assets or property of the company for its own business or the business of a third party shall be liable for bringing back to the company the profits arising therefrom and shall solely bear any losses incurred."

15. See Manóvil, *supra* note 8, at 682.

16. See id. at 683–684.

17. See id., at 685–696.

DOI: 10.1002/iir

2. The "ineffectiveness of the corporate personality"—the piercing the corporate veil doctrine: Section 54, Paragraph 3 of the Companies Act number 19.550 as amended in 1983

The "piercing the corporate veil" doctrine was also introduced as Section 54.3 of the Companies Act[18] in 1983. This formal statute was the first of its kind within the European Civil Law System.[19] This provision embraces diverse cases of imputation: duties and rights of the company to the partner or controlling party and actions and duties of the controlling party or partner towards the company. It also includes the "friendly"[20] disregard of the legal personality in favor of the company, the partners or the controlling entity, by analogy. Many years earlier, the Argentine civil and commercial jurisprudence accepted the doctrine of piercing the corporate veil without any duly enacted statutory provision, like many European countries.

With regard to the interpretation of the legal wording of the statue: (a) it embraces a performance as well as an act; (b) overall, what is discussed is not the existence of the company, but rather, its performance; (c) the objectives outside those of the company referred to are related to the notion of the final "*causa*" of the company, and this is related to the joint entrepreneurial risk which is always appraised in connection to a specific case; (d) to "conceal" does not mean to hide, as it is the same whether the penalized action is public or hidden; (e) the "mere" means to which the rule refers to is not a synonym of a fictitious or straw company, as it is irrelevant does not matter whether the penalized conduct is the only conduct displayed by the company; (f) "ordre public" (mandatory rules) must be understood in its strict sense as not embracing merely imperative rules; (g) the infringement of good faith must also embrace the hypothesis of acts against morals and moral custom frequently included in bad faith. Moreover, application of the rule of no proof of subjective element is necessary to constitute the legal basis of ineffectiveness.[21]

It has also been said that the norm is applied to any kind of partner, shareholder, or controlling party, either direct of indirect, internal, or external. Also, the ineffectiveness in steps or stages is possible. Third parties have legal standing to claim the ineffectiveness of the legal personality. Liability imposed by section 54.3 is independent of the declaration of ineffectiveness of the legal personality (or legal entity) in itself. Section 54.3 is not restricted to the true right holders, or to those that benefit from the unlawful conduct. Further, it is not limited to only those who performed the conduct, but rather includes every person that, by action or omission, made it

18. Section 54.3 of the Companies Act reads: "Any actions of the company that is beyond its corporate purposes, or is a mere sham to violate the law, public order or to impair the rights of third parties, shall be directly attributed to the members or controlling parties who made such action possible, they shall be jointly and severally liable for damages arising therefrom."

19. See Manóvil, *supra* note 8, at 1009. Uruguay has similar provisions in sections 189, 190 and 191 of the Companies Act number 16.060 as amended 1989. The 1989 Uruguayan law embraced a larger scope of group situations, as it does not limit the extension or transfer of imputability to partners, shareholders and controlling parties.

20. Manóvil refers to the practice of following the German doctrine "Freundlicher Durchgriff." Manóvil, *supra* note 8, at 1015–1017 and 1229.

21. See Manóvil, *supra* note 8, at 1229–1230.

DOI: 10.1002/iir

possible. Yet, the corporation is not liable. All those who suffered the damage are entitled to compensation. The damages to be compensated are not only those resulting from the unlawful action of the corporation, but also from the declaration of ineffectiveness.[22]

The judgment declaring that the juristic personality (legal entity) is not opposable can be detrimental to third parties acting in good faith. For the same reason, the bankruptcy or insolvency proceedings are not opposable to third parties that obtained the declaration of ineffectiveness of the legal personality in order to transfer the legal entitlement to assets. When the imputation of legal relationships is transferred, the foregoing happens with its assets and liabilities. The compensation of credits and debts between the third party and the person to whom the imputation is transferred to becomes enforceable.[23]

So far there has been no case law regarding this institution in the field of insolvent corporate groups in Argentina.

3. The liability of the administrators and directors of a corporation: Section 274.1 of the Companies Act number 19.550 as amended in 1983

Section 274.1 of the Companies Act governs the liability of the administrators and directors of a corporation,[24] and it can be applied by analogy to the administrators or directors of the dominant or subsidiary corporation[25] under the standard of section 59.[26]

Except where a domination contract has been celebrated, (e.g., in the German corporate groups law) the administrators of the subsidiary must act in the interests of the corporation that they manage as provided in all other regulations. In the case of a conflict with the interests of the parent corporation, it is their duty to favor the interests of the corporation they manage, that is, the subsidiary. When judging the due conduct of the managing board of the subsidiary in relation to the instructions or directives imposed by the parent corporation, a distinction must be made according to whether or not those instructions were imparted by the formal organic channels. The common rules of liabilities for directors are applied, and where applicable, so are the rules of liabilities in the insolvency proceedings system.[27]

22. *See* Manóvil, *supra* note 8, at 1230.
23. See *ibidem.*
24. Section 274.1 of the Companies Act reads: "Directors shall be jointly and severally liable vis-à-vis the company, the shareholders and third parties for any misperfomance of office, under the criterion of Section 59, as well as from any violation of the law and the by-laws and for any damage arising from their willful misconduct, abuse of office or gross negligence."
25. *See* Manóvil, *supra* note 8, at 747 *et seq.*
26. Section 59 of the Companies Act reads: "The managers and representatives of the company must act with loyalty and with the diligence of a good businessman. Those who fail to comply with their duties shall be unlimitedly and jointly and severally liable for any damages arising from their actions or omissions."
27. *See* Manóvil, *supra* note 8, at 760–776.

DOI: 10.1002/iir

IV. The United Nations Commission on International Trade Law (UNCITRAL) Legislative Guide and Recommendations

A. Liability of the dominant corporation

In 2004, the Working Group V (Insolvency Law) of the United Nations Commission on International Trade Law[28] issued the Legislative Guide on Insolvency Law and other recommendations on the insolvency of corporate groups in this decade. Regarding the liability issues on the insolvency of corporate groups this document highlights the advisability of the following considerations: the extent to which management, business and finances of the companies are intermingled; the conduct of the related company towards the creditors of the insolvent company; the expectation of creditors in the sense that they were dealing with one economic entity rather than two or more group companies; and the extent to which the insolvency is attributable to the actions of the related group company.[29]

Based on these considerations, a court may decide on the degree to which a corporate group has operated as a single enterprise and, in some jurisdictions, may order that the assets and liabilities of the companies should be consolidated or pooled. In particular the recommendation mentions that that order would assist in reorganizing the corporate group, or that a related company contributes financially to the insolvent estate, insofar that contribution would not affect the solvency of the contributing company. Contribution payments would generally be made to the insolvency representative administering the insolvent estate for the benefit of the estate as a whole.[30]

The Working Group V (Insolvency Law) of the United Nations Commission on International Trade Law, on its Thirty-fifth Session in Vienna, 17–21 November 2008, (as also on its 31st Session in Vienna, 11–15 December 2006[31]) suggested three remedies to the insolvency of enterprise groups: the extension of liability, the contribution orders and the substantive consolidation. The extension of liability may involve "piercing the corporate veil," especially the parent's corporation veil. Apart from the control relationship and the abuse of that power on the part of the dominant corporation, another relevant factor to be considered is the conduct of the parent towards the creditors of the insolvent subsidiary.[32]

From the typical point of view of "entity law," many laws recognize circumstances in which exceptions to the limited liability of corporate entities are applicable. Some of them adopt a prescriptive approach and the circumstances are strictly limited.

28. The United Nations Commission on International Trade Law (UNCITRAL) is a subsidiary body of the General Assembly. It prepares international legislative texts for use by States in modernizing commercial law and non-legislative texts for use by commercial parties in negotiating transactions.

29. See United Nations, Working Group V (Insolvency Law), *Legislative Guide on Insolvency Law*, Part II, V. Treatment of Corporate Groups in Insolvency, §88, at 278. (www.uncitral.org as of 21 July 2009).

30. See *id.* § 88, at 278.

31. See United Nations General Assembly, Working Group V (Insolvency Law), Thirty-first session Vienna, 11-15 December 2006 www.uncitral.org A/CN.9/WG.V/WP.74/Add.1 - Treatment of corporate groups in insolvency at 8–11. (as of 21 July 2009).

32. See United Nations General Assembly, Working Group V (Insolvency Law), Thirty-fifth session Vienna, 17–21 November 2008 www.uncitral.org A/CN.9/WG.V/WP.82/Add.3 - Treatment of enterprise groups in insolvency, at 3. (as of 21 July 2009).

DOI: 10.1002/iir

Other laws adopt a more expansive approach and courts are granted broad discretion in evaluating the circumstances of a particular case on the basis of specific guidelines.

The circumstances adopted by many countries and emphasized in the UNCITRAL recommendations, under which liability within corporate groups might be extended, are frequently included, but are not limited, to the following:[33]

(1) Failing to observe regulatory requirements, such as keeping regular accounting records of a subsidiary (France).
(2) Wrongful trading, where directors, including shadow directors of an entity have a duty to monitor, for example, whether the entity can properly continue carrying on business in the light of its financial condition and are required to apply for insolvency within a specified period once the entity has become insolvent (France, United Kingdom, Russia).
(3) Misrepresentation of the real nature of the enterprise group, leading creditors to believe that they are dealing with a single enterprise, rather than with a member of a group.
(4) Failure to follow the formalities of treating group members as separate legal entities, including disregarding the limited liability of subsidiaries (USA) or confusing personal and corporate assets.
(5) Artificial fragmentation of a unitary enterprise into several entities for the purposes of insulating the single entity from potential liabilities (USA).
(6) Permitting or directing a group member to incur debts when it is or is likely to become insolvent.
(7) Misrepresentation of the real relationship with the group component, by inducing the creditors into believing that they are dealing with the guarantee of the whole group.
(8) Exploitation or abuse by one group member (namely the parent), including the operation a subsidiary continually at a loss in the interests of the controlling entity (Argentina, Australia, South Africa, France, Brazil).
(9) Fraudulent conduct by the dominant shareholder, including fraudulently siphoning off a subsidiary's assets or increasing its liabilities (France), or conducting the affairs of the subsidiary with an intent to defraud creditors (Liechtenstein).
(10) Operating a subsidiary as the parent company's agent, trustee, or partner (Australia, UK).
(11) Inadequate capitalization of an entity, so that it does not have an adequate capital basis for carrying out its operations (USA). This may apply at the time of establishment, or be the result of capital depletion by way of refunds to shareholders or by shareholders drawing more than distributable profits.
(12) Making the enterprise group structure as a mere sham or façade, by using the corporate form as a device to circumvent statutory or contractual obligations (UK, France).

33. *Idem*, at. 4–5.

DOI: 10.1002/iir

(13) Misfeasance, where any person, including another group member, can be required to compensate for any loss or damage to an entity arising from fraud, breach of duty or other misfeasance, such as actions causing significant injury or environmental damage (USA, UK).
(14) Conducting the affairs of the group or of a subsidiary in such a way that some classes of creditors might be prejudiced (for example, incurring liabilities to the detriment of employees of one group member) (Poland).

Generally, the mere incidence of control or domination of a subsidiary by a parent, or other form of close economic integration within an enterprise group, is not regarded as sufficient reason to justify disregarding the separate legal personality of each group member and piercing the corporate veil.

One difficult issue highlighted in this session of the UNCITRAL Working Group is the personal liability of the directors of the controlling entity for the debts of the insolvent subsidiary, considered as *de facto* or shadow directors of the latter. While directors of an entity may generally owe certain duties to that entity, directors of a group member may be faced with balancing those duties against the overall commercial and financial interests of the group. Achieving the general interests of the group, for example, may require that the interests of individual members are sacrificed in certain circumstances. Some of the factors that might be relevant to determining whether directors of a controlling entity will be personally liable for the debts or actions of a controlled entity subject to insolvency proceedings include: grievous negligence or fraud in the management of the insolvent entity; breach of duties of care and diligence; abuse of managerial power; and direct relationship between the management of the controlled entity and its insolvency.[34]

Certain laws provide for parent entities to accept liability for debts of subsidiaries by contract, especially where the creditors involved are banks (Belgium, Netherlands), or by entering intro voluntary cross-guarantees (Australia). Under other laws, the principal entity can be jointly and severally liable to the creditors of the integrated entities, for liabilities arising both before and after the formalization of the integration of the enterprise group.[35]

B. Contribution orders

This is another possible remedy in corporate groups insolvency. A contribution order is an order by which a court or a statute can require a solvent group member to contribute specific funds to cover all or some of the debts of other group members subject to insolvency proceedings. Although contribution orders are not widely available under insolvency laws, a few jurisdictions have adopted or are considering adopting these measures and they are generally available only in liquidation proceedings.[36]

34. *Id.*, at 5.
35. *Ibid.*
36. *Ibid.*

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As this UNCITRAL document recognizes, New Zealand introduced contribution orders in its 1980 Corporations Act, in Sections 271–272. The provisions specify that the companies should be "related" companies as defined in Section 2 (3).[37] Under that definition, the related company does not need to be the ultimate holding company of the group member in liquidation. The New Zealand provisions permit a liquidator, creditor, or shareholder of a company in liquidation to make an application for a contribution order, although payment must be made to the liquidator, not to the applicant.

The New Zealand legislation provides that, in making a contribution order the court must take into account certain specified circumstances. These include: the extent to which a related group member took part in the management of the group member in liquidation; the conduct of the related group member towards the creditors of the member in liquidation, although creditor reliance on the existence of a relationship between the group members is not sufficient grounds for making an order; the extent to which the circumstances giving rise to liquidation are attributable to the actions of the related group member; the conduct of a solvent group member after commencement of liquidation proceedings with respect to another group member, particularly if that conduct indirectly or directly affects the creditors of the group member subject to insolvency proceedings, with respect to failure to perform a contract. Such an order might also be possible, for example, in cases where the subsidiary had incurred significant liability for personal injury or the parent had permitted the subsidiary to continue trading whilst insolvent.[38]

Because of the problem of reconciling the interests of the two sets of unsecured creditors that have dealt with the two separate companies, the power to make a contribution order is not commonly exercised. Furthermore, the courts have taken the view that a full contribution order may be inappropriate if the effect is to threaten the solvency of the related company not already in liquidation. However, conduct of the solvent company after commencement of the liquidation of its related company might be relevant if it indirectly or directly affects the creditors of the related company, with respect to failure to perform a contract.[39]

A number of the issues noted here may not require specific provisions to be included in the insolvency law, as remedies may already exist under other laws, such as those addressing liability and wrongful trading.

V. Conclusion

Liability of a parent for obligations of an insolvent subsidiary strikes not only at limited liability but also at the abuse of the power of control as well. Entity law, as may be

37. This provision defines the necessary relationship by reference to a holding/subsidiary relationship; direct or indirect ownership of more than half of the shares of the company, either by the other company, members of the other company or companies related to the other company; the businesses of the companies have been conducted in such a way that they cannot be separated; or both the insolvent company and the related company have one of these specified relationships with a third company. See *supra* note 27, at 10.
38. See *id. supra* note 29, at 10.
39. See *id. supra* note 29, at 11.

DOI: 10.1002/iir

expected, remains the rule. Although a number of cases show signs of change, entity law continues to be strong. This is the last area in which enterprise law will prevail, even if accepted elsewhere. Equitable subordination provides a much more acceptable avenue for the application of enterprise law than the direct imposition of liability. Although, in form, equitable subordination of the parent's claim is not an imposition of liability, the result in the overwhelming number of cases will be the same. The subsidiary's assets will typically be inadequate to pay all claims. As a result of subordination, assets otherwise going to the parent will be paid to the public creditors.[40]

Piercing the corporate veil jurisprudence is the traditional safety valve in entity law under which, in exceptional cases, liability may be imposed on a parent (or controlling shareholder) for the debts of its subsidiary.

With limited liability at stake, the courts appear firmly wedded to the traditional concepts of entity law when faced with possible imposition of liability for the debts of a bankrupt subsidiary (or controlled corporation) upon its parent (or controlling shareholder). The jurisprudence of piercing the corporate veil, not the special concerns of bankruptcy, provides the basis for exception in "exceptional" cases.

It is noteworthy that the Argentine Companies Act, as amended in 1983, in its section 54.3, is the first one that places the overriding jurisprudence of piercing the corporate veil, involving corporate groups by analogy, especially in bankruptcy cases, in a statute text in one country of the European Civil Law System.

Finally, it is to be expected that "enterprise law"—that is to say the legal consequences of the economic integration, far beyond the "piercing the veil approach" doctrine—will be a source of inspiration for future new avenues on the law of corporate groups in insolvency and especially on liability issues.

40. See Blumberg and Fowler (2000 Supplement), *supra* note 1, at 596.

DOI: 10.1002/iir