IMPLEMENTATION OF VICARIOUS LIABILITY TO PARENT COMPANY FOR ITS SUBSIDIARY IN INDONESIA

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ABSTRACT

Indonesian company law sees a legal entity corporation as a separate entity to its shareholder. So as the relationship between a parent company and its subsidiary, both are considered as two different entities, with limited liability on each side. However, in regard to vicarious liability, an entity may be held liable for acts conducted by other entity. This paper will explain the implementation of vicarious liability to parent company in its relationship with the subsidiary. First, by elucidating the basic concept of limited liability. Second, by elucidating the basic concept of vicarious liability, and distinguishing between the direct liability of the parent company to its subsidiary and the condition where the parent company is held vicariously liable. Third, by showing how Indonesia implements the principle of vicarious liability in several court's decision. Fourth, by giving a representation of the dishonest use of subsidiary by the parent company, which has been the background of this paper. And finally, explaining how the rule of vicarious liability can be implemented to the parent company, and why that is important to enforce in Indonesian company law.

***Keywords**: parent company, subsidiary, limited liability, vicarious liability, special purpose vehicle*

I. BASIC LIMITED LIABILITY COMPANY CONCEPT

Limited liability is a main characteristic of a legal entity, or specifically a legal entity corporation. The liability of "the corporation" is limited by the fact that the corporation is not real. It is no more than a name from contracts made among managers, workers, and contributors of capital or shareholders. It has no existence independent of these relations. By the rule of limited liability, investors in the corporation are not liable for more than the amount they invest.[3] That is a common principle to describe limited liability appropriately. For example, investors who pay $50 for stock risk that $50, but no more. Its liability (exactly a shareholder's liability) is limited to its investment in a corporation. The principle of limited liability means that claims against the company may only be executed against the company's assets, not the assets of the shareholders.[4]

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[3] Frank H. Easterbrook and Daniel R. Fischel, *"Limited Liability and the Corporation",* The University of Chicago Law Review, Vol. 52, No. 1 (1985), pg. 89-90.

[4] P. Davies, *"Introduction to Company Law",* Oxford University Press, Clarendon, 2002, pg. 10-11.

Historically, limited liability for corporate shareholders arose separately from and apparently later than the other characteristic corporate features, such as the capacity to take legally binding action.[5] Limited liability allowed companies to externalize costs for which they would be forced to pay tort damages. Early on, some American states, such as Massachusetts and Rhode Island, granted corporate provision that shareholders would be fully liable. This comes from theory that unlimited liability would best ensure economic growth because it increases creditor's trust that the loan is guaranteed to be returned. Many states had enacted provisions that holding shareholders are liable for amounts in excess of the value of their shares.[6] In other American states such as Georgia and Hawaii, specifically on Section 6.22 of the Model Business Corporation Act, it specifies that the shareholder's obligation to the corporation is solely to "pay the consideration for which the shares were authorized to be issued.[7] A shareholder is "not personally liable for the acts or debts of the corporation except that he may become personally liable by reason of his own acts or conduct."

Commentary on limited liability for corporate torts divided into two major regimes which are: (i) Limited liability regime; and (ii) Pro rata liability regime. Limited liability regime defend limited liability rules against all comers[8], in the other side, pro rata liability regime proposes to abandon it altogether in the case of tort and statutory violations and substitute a scheme of unlimited shareholder liability divided among shareholders pro rata.[9] Both groups focus on the corporation as the unit. However, neither regime seems to account the differences among shareholders. Shareholders may have varying access to information and ability to make decisions. Controlling shareholders may have special opportunities to take benefit from corporation. A limited liability regime might indeed save significant cost for a shareholder with only a tiny

[5] See e.g., James Williard Hurst, The Legitimacy of the Business Corporation in the Law of the United States, 1780-1970, at 19 (1970) (noting development of other features beginning in late eighteenth century); see id. at 26 ("On balance, and from the outset, the corporation was an instrument to provide firm central direction for the enterprising use of pooled assets."); see id. at 27 (noting development of judge-made law of limited liability beginning in early nineteenth century); on Nina A. Mendelson, *"Control-Based Approach to shareholder Liability for Corporate Torts",* Columbia Law Review, Vo. 102, No. 5 (Jun., 2002), pg. 1209.

[6] Philip Blumberg, (1986), *"Limited Liability and Corporate Groups",* 11 J. CORP.

[7] Model Business Corporation Act, 6.22(a) (1985) (sser, Piercing, supra note 16, ?? 2.01-.52 (reviewing state laws on corporate veil piercing). Section 6.22(b) of the Model Business Corporation Act has been adopted in Arkansas, Colorado, Connecticut, Georgia, Hawaii, Idaho, Indiana, Kentucky, Michigan, Mississippi, Montana, Nebraska, New Hampshire, North Carolina, Oregon, South Carolina, Tennessee, Vermont, and Wyoming. ited liability."). Two exceptions are the New York and Wisconsin statutes, which impose liability on shareholders for employee wage claims if the corporation fails to satisfy those claims. New York's default articles of incorporation impose liability on the ten largest shareholders of a corporation. N.Y. Bus. Corp. Law, Sec. 103 (McKinney 1986) (applies to all corporation).

[8] See, e.g., Frank H. Easterbrook & Daniel R. Fischel, "*The Economic Structure of Corporate Law",* pg. 41-44 (1991); Frank H. Easterbrook & Daniel R. Fischel, *"Limited Liability and the Corporation"*, pg. 52 U. Chi. L. Rev. 89, 104 (1985) ("Modifying limited liability has its costs and . . . moral hazard would exist without limited liability."); infra text accompanying notes 51-63 (discussing efficiency justification for limited liability).

[9] See, e.g., Hansmann & Kraakman, *"Unlimited Liability"*, supra note 2, at 1880 ("There may be no persuasive reasons to prefer limited liability over a regime of unlimited pro rata shareholder liability for corporate torts."); Leebron, supra note 2, at 1569 ("If unlimited liability were adopted, it should be pro rata."). Christopher Stone also proposes pro rata liability. See Christopher D. Stone, *"The Place of Enterprise Liability in the Control of Corporate Conduct"*, 90 Yale. LJ. 1, 74 (1980) ("Each would be liable only in proportion to his or her equity interest.")

proportion of a corporation's shares and limited access to information. By contrast, for shareholders whose role is a parent corporation or a shareholder that otherwise can control corporate activities, information costs savings may be less significant.[10]

The moral hazard created by corporation with limited liability depends on shareholder characteristic. For example, a controlling shareholder will be more able to influence corporation to take excessive risk because such shareholders are authorized to. Further, a controlling shareholder likely will prompt a corporation to externalize more cost than if the corporation's held by a many vary small shareholders. By that, one more regime can be found, it called control-based liability regime.[11] In control-based regime liabilities are shifted to the shareholder with the capacity to control the corporation. However, no literature has ever given an adequate definition of controlling shareholder.

Indonesia adopts the principle of limited liability in a legal entity corporation. A corporation is only liable for its own self, and the liability is limited, whether to its shareholder or other company. Indonesian Company Law does not impose juridical recognition to group company structure. Nonetheless, Article 84 Law number 40 year of 2007 regarding Limited Liability Company (hereinafter referred to as Law 40/2007) legitimates a corporation to own shares in other company.[12] For example is the relationship between parent company and subsidiary company. Generally, a subsidiary is wholly or mostly or even partially owned by its parent company, however, both are a separate entity, with a limited liability between the two.

The relationship between parent and its subsidiary arises if both are not assimilated. These four standards will keep the business units from being treated as assimilated:[13] (1) A separate financial unit should be set up and maintained; (2) The day to day business of the two units should be kept seperate. And in addition the financial and the business records of the two units should be separately kept; (3) The formal barriers between the two management structures should be maintained. The ritual of separate meeting should be religiously observed. The activities of the individuals serving on the two boards can be tagged so that the individuals *qua* directors of the subsidiary can always be distinguished from the same individuals *qua* directors of the parent. Separate meetings of the boards are sufficient; and (4) The two units should not be represented as being one unit. Those with whom they come in contact should be kept sufficiently informed of their separate identities.

Many commentators argue that limited liability in the parent-subsidiary context is inappropriate because the principal justification for limited liability does not apply to parent-

[10] Nina A. Mendelson, *"Control-Based Approach to shareholder Liability for Corporate Torts",* pg. 1206.

[11] See Nina A. Mendelson, *"Control-Based Approach to shareholder Liability for Corporate Torts",* pg. 1206 (It defined that there are two major regimes which are limited liability regime and pro rata regime, but also stated control-based liability regime which shifted liabilities to controlling shareholders).

[12] See also Sulistiowati, *Legal Aspect and Business Reality of Group Company in Indonesia,* Jakarta: Erlangga, 2010, pg. 23-24.

[13] William O. Douglas and Carrol M. Shanks, *Insulation from Liability Through Subsidiary Corporations,* The Yale Law Journal, Vol. 39, No. 2 (Dec., 1929), pg.196-197.

subsidiary context.[14] However, in such condition, congress or state legislation could implement the common law doctrine called "piercing the corporate veil".

Indonesian company law subjects to the Law 40/2007. The provisions within that regulation mostly come from what is practiced in countries that adhere to the Anglo Saxon legal system (e.g England and the USA).[15] Piercing the corporate veil, as one of the provisions adopted from the Anglo Saxon, is regulated in Article 3 number 2, Article 104, and Article 115 Law 40/2007.

Some research stated factors for piercing the subsidiary's corporate veil, which are:[16] fraud/misrepresentation,[17] commingling of funds,[18] undercapitalization,[19] overlap,[20] directors/officers or corporate records non-existent,[21] directors/officers non-functioning,[22] unfairness/injustice,[23] assumption of risk,[24] and parent control/dominance.[25] Underlying cause of piercing the subsidiary's veil shows that courts pierce more often in contract cases (28,8%) than in tort cases (9,45%), and criminal cases (50%) more than bankruptcy cases (30,77%) and statute cases (7,41%).[26]

II. BASIC THEORY OF VICARIOUS LIABILITY IN REGARD TO PARENT AND SUBSIDIARY COMPANY

A person is generally liable for the consequences of his own acts. For example, a person under a duty of care will be held liable for negligence if his conduct constituted a breach of his

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[14] Phillip Blumberg, *Limited Liability and Corporate Groups,* 11 J. CORP. L. 573, 574-75, 1986 (criticizing corporations' frivolous creation of subsidiaries to insulate themselves from liability).

[15] Munir Fuady, *Hukum Perusahaan dalam Paradigma Hukum Bisnis,* (Bandung: Citra Aditya Bakti, 2002), pg. 1-3.

[16] John H. Matheson, *"The Modern Law of Corporate Groups: An Empirical Study of Piercing the Corporate Veil in the Parent-Subsidiary Context".* North Carolina Law Review, Vol. 87, pg. 1113.

[17] "Misrepresentation" included misrepresentation as to the corporation's assets and financial condition, and as to the party responsible for payment. Professor Thompson notes that, while is activity is often referred to by the court as "fraud", many courts will find that the evidence supports a finding of misrepresentation where a common law claim of fraud could not be established.

[18] Commingling of parent and subsidiary funds, siphoning of funds by the parent, or treatment by the parent shareholder of subsidiary funds as owned by the parent.

[19] "Undercapitalization" includes both those cases where uncapitalization was present at the subsidiary's inception and those where the subsidiary became undercapitalized later.

[20] "Overlap" identifies common activities, persons, or places between the parent and the subsidiary, such as common offices, common business activity, and common employees, including directors and officers.

[21] "Directors/officers or corporate records non-existent" identifies cases in which a corporation never appointed some or all of its directors, officers, or other functionaties. This factor was also noted where no corporate records, financial or otherwise, were created at all.

[22] "Directors/officers non-functioning" identifies cases in which a corporation appointed directors and officers, but the directors or officers held meeting or otherwise took formal action rarely, if ever. In other words, even though corporate functionaries existed, the business was run informally without recognition of titles or roles.

[23] Cases that involved "unfairness/injustice" were most often marked by a statement, albeit a conclusory one, by the court.

[24] "Assumption of risk" identifies cases where the court determined that there was an assumption of risk by the plaintiff such that the veil should not be pierced. Generally, such cases included an explicit statement by the court.

[25] "Parent control/dominance" identifies situations in which the parent/shareholder is to be held liable and the veil is pierced because the parent exerted direct control over or dominated the subsidiary company.

[26] John H. Matheson, *"The Modern Law of Corporate Groups: An Empirical Study of Piercing the Corporate Veil in the Parent-Subsidiary Context",* pg. 1122.

duty and damage resulted from the breach, that person will be held liable for fraud where he himself made a false representation of fact to another party, knowing it to be false and intending to be acted upon, and the fact acted to his detriment.[27] However, the law lays down condition when a person incurs liability as a result not of his own acts, but of the acts of other persons, whose liability is imputed to him by law. This is what is known as vicarious liability.[28]

Vicarious liability is a system of strict liability through which one entity A is made strictly liable for the torts of another, B, even though A is not at fault.[29] Historically, the principle of vicarious liability was intended for employment. A master is liable for the tort of his servant although it is not the master's acts which gave rise to the liability. In order to hold the master liable it sufficient and necessary that the servant has committed the tortious act in the course of his employment.[30]

Traditionally, vicarious liability requires that the tort was committed in the course of an employment.[31] The technicalities of employment law are increasingly of little importance in the law of vicarious liability, particularly since the introduction of the category of vicarious liability of 'akin to employment', that currently been used for religious ministers and prisoners, but such a category may also be used for companies, even if they are not technically 'employed' due to being legal, but not natural, persons. The contract between the companies, or the functional control exercised by one company over another, may be analogous to employment, i.e. akin to employment.[32]

Some Swiss scholars have argued that the parent-subsidiary relationship is comparable to a master-servant relationship where parents dominate subsidiaries hierarchically, and they suggest accordingly that the vicarious liability provisions of Swiss tort law[33] be applied to tort obligations of a parent-managed subsidiary.[34] The suggested application of vicarious liability to parent companies in Swiss tort law would establish parent liability upon proof of the subsidiary's subordination under parent direction.[35]

Merely being a subsidiary of a parent company is not enough to fulfil this akin to employment criteria. For instance, acquiring a subsidiary with legacy liabilities would not make the new parent vicariously liable. The question is instead whether or not vicarious liability was

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[27] Aharon Barak, *"Mixed and Vicarious Liability-A Suggested Distinction*, Vo. 29, No. 2 (Mar., 1966), pg. 160.

[28] Staveley Iron and Chemical Co. Ltd. v. Jones [1956] A.C. 627; Imperial Chemical Industries Ltd. v. Shatwell [1964] 2 All E.R. 999.

[29] Phillip Morgan (a), "*Recasting Vicarious Liability",* The Cambridge Law Journal, Vol. 71, No. 3 (Nov. 2012), pg. 617.

[30] See Broom v. Morgan [1953] 1 Q.B. 597 ("It may be, however, that an action cannot be brought against the servant for procedural reasons, even though he is liable under the substantive law").

[31] Janet O'Sullivan, *"The Sins of The Father - Vicarious Liability Extended",* The Cambridge Law Journal, Vol. 71, No. 3 (Nov. 2012), pg. 485.

[32] Phillip Morgan (b), *"Vicarious Liability for Group Companies: the Final Frontier of Vicarious Liability?",* Professional Negligence, Vol. 31, No. 4 (2015), pg. 296.

[33] Swiss Code of Obligations, Art. 55.

[34] Karl Hofstetter, "*Parent Responsibility for Subsidiary Corporations: Evaluating European Trends*", The International and Comparative Law Quarterly, pg. 591.

[35] See *supra note* 34, pg. 595.

present at the time of the tort. Mere ownership at the time of the tort (for instance by being the majority or absolute shareholder) is likewise insufficient, passive investment is not enough. Instead the key issues are those of control and integration.[36]

The main elements of vicarious liability which should be emphasized are the next ones:[37] (i) a wrongful act or omission by another. Subsidiary commits a wrong independently, for example, breaches environmental law, competition law or a duty towards its employees; (ii) some relationship between the actual tortfeasor (subsidiary) and the defendant (parent company) on whom liability is imposed; and (iii) some connection between the wrongful act or omission and that relationship. The subsidiary has to commit tort within the authority delegated to it by the parent. Both the company itself and its directors should not act *ultra vires*, i.e. beyond the power granted by the articles of association and/or other internal documents of the company.

Theory of vicarious liability is quite complicated and deals with non-fault liability and as a combination of strict and fault liability. *First concept*, vicarious liability is a form of strict liability. Strict liability is a concept of liability without fault. Vicarious liability is considered as a form of strict liability because the liability is attributed to the employer for the tort committed by the employee when it was committed in the course of his employment (very often vicarious liability is considered only as employer liability for its employee). The "innocent" employer is held liable for the fault of his employee.[38] Vicarious liability is described as strict because it requires no proof of personal wrongdoing by the person subject to it.[39] The same concept is applicable to the parent company's vicarious liability to its subsidiary.[40] However, this concept does not reflect the legal nature of vicarious liability, because vicarious liability has more complicated structure than mere strict liability because it includes two level relationship:[41] (i) Relation a tortfeasor vis-a-vis third party who is a victim; and (ii) Relationship between actual tortfeasor and a person who bears liability; and a fault element on the part of the tortfeasor.

Second concept, vicarious liability is a form of non-fault liability. Under strict liability, the defendant must engage in prohibited conduct, but its culpable mens rea is excluded. In contrast, vicarious liability does not require the defendant to directly engage in the prohibited conduct, which means that the vicarious liability is based on more difficult concept which involves, on the one hand, tortfeasor's prohibited conduct and, on the other hand, connection between tortfeasor and defendant.[42] According to that, it seems that non-fault liability is divided into two types of liability, i.e strict and vicarious liability.

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[36] Phillip Morgan (b), *"Vicarious Liability for Group Companies: the Final Frontier of Vicarious Liability?"*, pg. 296.

[37] Tetiana Kravtsova & Ganna Kalinichenko, *"The Vicarious Liability of Parent Company Liability for Its Subsidiary",* Corporate Ownership & Control, Vol. 14, No. 1 (2016), pg. 686.

[38] Osborne P.H. (2003), The Law of Torts 2nd ed., Toronto, Carswell 59 Waddams S.M. (2003), Dimensions of Private Law, Cambridge University Press, United States of America, New York.

[39] See *supra note* 38.

[40] See *supra note* 38 ("However, the same concept is applicable to the parent company's vicarious liability).

[41] Tetiana Kravtsova and Ganna Kalinichenko, *"The Vicarious Liability of Parent Company Liability for its Subsidiary",* pg. 688.

[42] See *supra note* 40.

Third concept, vicarious liability as a combination of fault and strict liability. Cees van Dam states that vicarious liability as strict liability with an extra (strictly liable) debtor.[43] He argues that strict liability is basically a liability without negligence, but the element of negligence may still play a role in the implementation of strict liability. For example, the employer can be imposed liability for its employee's negligence conduct, seems that the negligence should exist.[44]

A parent company may be held liable in parallel with its subsidiary on the basis on its own negligent conduct and on the basis of vicarious liability.[45] It is evidenced by the fact that some authors do not distinguish between tortious liability of the parent company itself (for breach of the duty of care) and vicarious liability of the parent company for its subsidiary (which is primary based on the relationship between the parent company and its subsidiary).[46] Direct liability is liability for breach of one's own duty of care, while vicarious liability is liability for breach of another's duty of care.[47] Direct liability is when a subsidiary company abuses human rights, its parent company may be held liable if the conduct of the parent company itself was also negligent or intentional (i.e. parent company was "at fault").[48] The ground for holding the parent company liable is when the doctrine of separate legal personality is being abused to perpetrate fraud or avoid existing legal obligations, the courts may be prepared to "lift the corporate veil", look behind the corporate structure, impute subsidiary's conduct to the parent, and hold the parent company liable on the basis of vicarious liability for acts of its subsidiary.[49]

Agency is the most common legal theory by which the U.S. Department of Justice may establish vicarious liability,[50] that a subsidiary does not become the agent of its parent merely because the parent company has control over the subsidiary through equity ownership.[51] In the rule of agency, "agent" is a party who is hired by a business equity to perform a task connected with the business, and a "principal" is a party who employs an agent. In parent-subsidiary company context, to establish an agency relationship between a parent and its subsidiary in a given transaction, the particular circumstances at issue must demonstrate that the subsidiary in fact acted at the direction or authorization of the parent, which these three elements must be met to establish agency: (i) the manifestation by the principal that the agent shall act for him; (ii) the agent's acceptance of the undertaking; and (iii) the parties' understanding that the principal is to be in

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[43] Coleman J.L., *"Risk and Wrongs",* Cambridge University Press, United States of America, New York, (1992, reprinted 2013).

[44] See *supra note* 43.

[45] Tetiana Kravtsova & Ganna Kalinichenko, *"The Vicarious Liability of Parent Company Liability for Its Subsidiary",* pg. 690.

[46] See *supra note* 43, pg. 685.

[47] Phillips v. Kaiser Aluminium & Chem. Corp., 875 P.2d 1228, 1234 (Wash. App. 1994) in Burns J. J., *"Respondeat Superior as an Affirmative Defense: How Employees Immunize Themselves from Direct Negligence Claims",* Michigan Law Review, Vol. 109, No. 4, pg. 668.

[48] ICJ, *Corporate Complicity and Legal Accountability: Facing the Facts and Charting a Legal Path - Report of the International Commission of Jurists Expert Legal Panel on Corporate Complicity in International Crimes*, Report, Civil Remedies, Vol. 3 (2008), pg. 47.

[49] See *supra note* 48.

[50] Michael R. Geroa, *"Complying with U.S. Antibribery Laws",* The International lawyer, Vol. 31, No. 4 (Winter 1997), pg. 1043.

[51] Restatement (Second) Agency 14M (1957).

control of the undertaking.[52] Where these elements are established, a parent company and its officers may be held criminally liable for the actions of a subsidiary company.[53]

Absent a factual showing that these three elements are met, courts normally will not find a parent corporation liable for the acts of its corporate subsidiary. Unless courts find a justification to pierce the subsidiary's corporate veil and hold the parent corporation accountable, limited corporate liability will protect an incorporated parent company from the unauthorized actions of its subsidiary.[54]

In State *Department of Environmental Protection v. Ventron Corp.,* the parent company, Velsicol, was not vicariously responsible for the contamination caused by a mercury processing plant owned by Velsicol's wholly-owned subsidiary, Wood Ridge. Wood Ridge was formed specifically for the purpose of operating the mercury processing plant. The plant had dumped mercury process waste into a tidal estuary of the Hackensack River in New Jersey, resulting in extraordinary contamination: "For a stretch of several thousand feet, the concentration of mercury...is the highest found in fresh water sediments in the world." The parent company's involvement with the subsidiary's day-to-day operations was "constant," the subsidiary's board of directors were all officers of the parent, and the subsidiary's board reviewed not only finances and public relations, but also the details of daily operations such as personnel practices and production. Nonetheless, the parent company did not voluntarily undertake responsibility for its subsidiary's liability and was not held vicariously liable because the subsidiary had not been created to "perpetrate a fraud or injustice."

In *Choc v Hudbay Minerals Inc.,*[55] a first instance strike out decision of the Ontario Superior Court of Justice, 'passing reference' was made in the case to vicarious liability of the parent company. This case is brought against Canadian mining company HudBay Minerals and its subsidiaries by Maya-Q'eqchi' villagers from eastern Guatemala alleging gross human rights abuses by the company in Guatemala. The Maya-Q'eqchi' opposed the mining project, and claimed that security personnel employed by HudBay's local subsidiary shot and killed school teacher and anti-mining activist and several other people in Guatemala. HudBay brought motions to dismiss the claims, on the basis that a parent company can never owe a duty of care to those who may be murdered, harmed, or raped by security personnel employed by the company's subsidiary in a foreign country. The Ontario Superior Court of Justice dismissed HudBay's

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[52] Restatement (Second) Agency 1 (1957).

[53] *See also* 18 U.S.C. 2 (1996); Nye & Nissen v. United States, 336 U.S. 613, 618-19 (1949) (one commanding, inducing, or procuring the commission of an act is responsible for the act as if he or she committed it directly); Morgan v. United States, 149 F.2d 185, 187 (5th Cir. 1945) (in determining criminal liability, the act of an agent with the knowledge and consent of his or her principal is treated as the act of the principal). See also Michael R. Geroa, *"Complying with U.S. Antibribery Laws",* pg. 1043.

[54] Under the alter ego theory of liability, founded in equity, a court will pierce the corporate veil "when the court must prevent fraud, illegality or injustice, or when recognition of the corporate entity would defeat public policy or shield someone from liability from a crime." Frank v. U.S. West, 3 F.3d 1357, 1362 n.2 (10th Cir. 1993). *See also* Zubik v. Zubik, 384 F.2d 267, 272 (3d Cir. 1967). See also Michael R. Geroa, *"Complying with U.S. Antibribery Laws",* pg. 1044.

[55] OJ No. 3375, 2013 ONSC 1414. See also Phillip Morgan (b), *"Vicarious Liability for Group Companies: the Final Frontier of Vicarious Liability?",* pg. 289.

motions, finding that the parent Canadian company owed a duty of care to the Maya-Q'eqchi' villagers affected by the actions of the security personnel of its subsidiary companies.[56] Carole Brown J., in allowing a claim against the parent company to proceed, considered vicarious liability to be 'in essence, the same as the attempt to pierce the corporate veil'.[57]

III. IMPLEMENTATION OF VICARIOUS LIABILITY IN INDONESIA

Vicarious liability is a common doctrine on civil law. In Indonesia's civil law, vicarious liability is considered in Article 1367 Indonesian Civil Code that mentioned:[58]

> *"Everyone is not only responsible for the loss caused by his own actions but also for losses which is caused by the actions of those who become dependents, or caused by items that are on under his supervision"*

There are two examples of court's decision implementing vicarious liability in Indonesia Civil Law. First is the Supreme Court decision No. 2081 K/Pdt/2006.[59] In this case, the plaintiff is the husband of the victim killed in an accident between the car carrying the wife of the plaintiff and a train. Formerly, this case has been decided through criminal decision No. 707/Pid.B/2003/PN.Smg by declaring the train signpost guard (Defendant III) was guilty for not being careful about guarding the signpost and causing the death of the victim. In the civil law domain, the Plaintiff requested compensation from Indonesian Railway Company Bandung Head Office on behalf of Indonesian Railway Company Area IV (Defendant II) as the Indonesian Railway Company to pay for compensation, and Defendant II refused on the grounds that the responsibility for the accident was the Semarang City Government on behalf of Semarang City Transportation Agency (Defendant I). The Central Java High Court Judge referred his decision to the vicarious liability principle as stipulated in Article 1367 of Indonesian Civil Code. According to the High Court Judge, Defendant II had no employment relationship with Defendant III so that Defendant II could not be held liable for Defendant III's acts. The Appeal Court decision only bases the vicarious liability principle on the master and servant relationship. The Supreme Court agreed with the High Court decision. Based on this case, the rule of vicarious liability only considered in the course of an employment.

The plaintiff on case above mentioned refers his argumentation to the Supreme Court decision No. 649 K/Pdt/1993, which stated that vicarious liability can be implemented on functional relationship when the tort acted among the defendants.[60] Based on that, the rule of vicarious liability can be applied widely, not only for the course of an employment but for the functional relationship.

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[56] *Angelica Choc v. HudBay Minerals*, https://www.amnesty.ca/legal-brief/angelica-choc-v-hudbay-minerals, accessed on September 28th, 2018.

[57] OJ No. 3375, 2013 ONSC 141 at 43. See also Phillip Morgan (b), *"Vicarious Liability for Group Companies: the Final Frontier of Vicarious Liability?"*, pg. 289.

[58] Author's free translation.

[59] See Indonesian Supreme Court Decision No. 2081 K/Pdt/2006.

[60] See *supra note* 59, pg. 15.

In Indonesia's criminal law, corporation is a subject of law that can bear liability. Corporate liability was based on respondeant superior doctrine, which stated that corporation can not conduct fault. The corporation's agent were the ones that act for and on behalf the corporation. Thus, the corporation's agent were the ones conducting fault. The respondeant superior doctrine generates three models of corporate liability: (i) direct corporate criminal liability; (ii) strict liability; and (iii) vicarious liability. However, until now, Indonesia, through Indonesian Criminal Code has not yet adopted the rule of vicarious liability.

The implementation of vicarious liability in Indonesia can be found through the court's decision. When giving arguments regarding vicarious liability, some court's decisions referred to the Indonesian Supreme Court Decision No. 572 K/Pid/2003.[61] In this case, the defendants are: (i) Former Secretary of Republic of Indonesia (Defendant I); (ii) Head of Raudatul Jannah Foundation (Defendant II); and (iii) Director of Bintang Laut Timur Baru Company (Defendant III). In this case, the Defendant I was accused of corruption against the Indonesian Beureau of Logistics, with the amount of Rp.40 billion. He was found guilty by the court's decision, with three years of prison. The court's decision stated that he committed abuse of power in his authority as a Secretary of Republic of Indonesia. In the end, the Supreme Court annulled the previous decisions and stated that only the Defendant I was not guilty, and, however, other defendants were. The judge stated that:

> *"The Defendant I as a Secretary of Republic of Indonesia just accepts and carries out job given by his superiors, the President of Republic of Indonesia, in a public employment relationship. In this case, the principle of vicarious liability is applied."*

Based on that argument, vicarious liability is applied on a public employment relationship, and in a condition when someone carries out jobs given by his superior, the superior (master) is liable for its servant.

According to Indonesian law, vicarious liability can be applied on an employment relationship, or even wider, for example, a functional relationship. There are no regulation or court's jurisdiction implementing the rule of vicarious liability in a relationship of parent company and its subsidiary. It shows the difference over the implementation of vicarious liability between Indonesian Law and other country, as what mentioned above, in other countries, vicarious liability can be imposed to parent company for its subsidiary's act.

IV. DISHONEST USE OF SUBSIDIARY BY THE PARENT COMPANY

Currently, with development of globalized processes and businesses all over the world we can see in increasing frequency establishment of local and multinational corporations, that they create complicated structures and subsidiaries within the territory of one country or in the territories of different countries to pursue different goals: optimization of business processes and taxation (tax-reduction), cost-cutting, and increase of business efficiency.[62]

[61] See Indonesian Supreme Court Decision No. 2130/K/Pid. Sus/2011, pg. 30; and Indonesian Supreme Court Decision No. 104/Pid. Sus-TPK/2014/PN. Bdg, pg. 138.

[62] Tetiana Kravtsova & Ganna Kalinichenko, *"The Vicarious Liability of Parent Company Liability for Its Subsidiary",* pg. 684.

Corporations are offtimes set up to accomplish a fraudulent end or to escape a specific contractual liability of some sort,[63] or to avoid the provisions of a statute.[64] The use of dummy incorporators has received high judicial sanction.[65]

The motive of the parent corporation to secure authority to do business with limited liability is not a dishonest use of the corporate privilege.[66] It is nevertheless true that if the separate corporate capacity is perverted to dishonest uses to evade obligations or to defeat public welfare, the courts will penetrate the device, uncover the abuse of the special privilege, and circumvent fraud.[67]

Consider the existence of Special Purpose Vehicle (SPV). Special Purpose Vehicle is a legal entity (a subsidiary or affiliate corporation)[68] created by a sponsor or originator where the sponsor transfers assets to the entity to carry out some specific purpose or circumscribed activity.[69] SPVs typically are defined as entities created for a limited purpose, with a limited life and limited activities, and designed to benefit a single company.[70] Beside the word "SPV", in various occasions referred as "tramp/pseudo corporations", "conduit/dummy company", or "shell company".[71] Typically, off-balance sheet SPVs have the following characteristics:[72] (i) they are thinly capitalized; (ii) they have no independent management or employees; (iii) their administrative functions are performed by a trustee who follows prespecified rules with regard to

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[63] George v. Rollins, 176 Mich. 144, 142 N. W. 337 (1913); Donovan v. Purtell, 216 I11. 629, 75 N. E. 334 (1905); Rice v. Sanger Bros., 27 Ariz. 15, 229 Pac. 397 (1924). See also William O. Douglas and Carrol M. Shanks, *Insulation from Liability Through Subsidiary Corporations*, pg. 212.

[64] United States v. Lehigh Valley R. R., 220 U. S. 257, 31 Sup. Ct. 287 (1911); United States v. Del. Lack. & West. R. R., 238 U. S. 516, 35 Sup. Ct. 873 (1915); Chicago, M. & St. P. Ry. v. Minn. Civic Ass'n, 247 U. S. 490, 38 Sup. Ct. 553 (1918); United States v. Reading Co., 253 U. S. 26, 40 Sup. Ct. 425 (1919); United States v. United Shoe Machinery Co., 234 Fed. 127 (E. D. Mo. 1916); see So. Pac. Terminal Co. v. Int. Comm. Comm., 219 U. S. 498, 523, 31 Sup. Ct. 279, 286 (1911). See also William O. Douglas and Carrol M. Shanks, *Insulation from Liability Through Subsidiary Corporations*, pg. 212.

[65] William O. Douglas and Carrol M. Shanks, *Insulation from Liability Through Subsidiary Corporations*, pg. 194.

[66] Elenkrieg v. Siebrecht (1924) 238 N. Y. 254, 144 N. E., 519, 34 A. L. R. 592, 297. See also Henry W. Ballantine, "*Separate Entity of Parent and Subsidiary Corporations",* California Law Review, Vol. 14, No. 1 (Nov. 1925), pg. 19.

[67] U. S. v. Reading Co. (1920) 253 U. S. 26, 64 L. Ed. 760, 40 Sup. Ct. Rep. 425; Linn & Lane Timber Co. v. U. S. (1915) 236 U. S. 574, 59 L. Ed. 725; 35 Sup. Ct. Rep. 440; U. S. Lehigh Valley R. R. Co. (1911) 220 U. S. 257, 55 L. Ed. 458, 31 Sup. Ct. Rep. 387; U. S. v. Milwaukee Transit Co. (1905) 142 Fec. 247 (dummy used to obtain rebates); Rice v. Sanger Bros. (1924) Pac. 397; Gardner v. Treasurer (1916) 225 Mass. 355, 367, 114 N. E. 617. See McWilliams, Limitations in the Theory of Corporate Entity in California, 4 California Law Review, 465; Disregarding Corporate Entity in One Man Company, 13 California Law Review, 496; Canfield, Scope of Corporate Entity Theory, 17 Columbia Law Review, 128; Wormser, Piercing Veil Corporate Entity, 12 Columbia Law Review, 496. See also Henry W. Ballantine, "*Separate Entity of Parent and Subsidiary Corporations",* California Law Review, Vol. 14, No. 1 (Nov. 1925), pg. 19.

[68] International Financial Risk Institute.

[69] Tyson E. Taylor, *"Detrimental Legal Implications of Off-Balance Sheet Special Purpose Vehicles in Light of Implicit Guarantees",* Selected Works of Tyson E. Taylor (Jan. 2009), pg. 9.

[70] Al. L. Hartgraves & George J. Benston, *"The Evolving Accounting Standards for Special Purpose Entities and Consolidations",* Accounting Horizons Vol. 16, No. 3 (Sep. 2002), pg. 246.

[71] Sudargo Gautama, *International Civil Law*, Jakarta: Kinta, 1989, pg. 282.

[72] Gary Gorton & Nicholas S. Souleles, *"Special Purpose Vehicles and Securitization",* available at http://ssrn.com/abstract=713782, pg. 9.

the receipt and distribution of cash; there are no other decisions; (iv) assets held by the SPV are serviced via a servicing arrangement; and (v) they are structured so that they cannot become bankrupt, as a practical matter. SPVs are just one of those vehicles that companies use to structure financing that avoids recognizing assets and liabilities on their financial statements.[73] SPVs often used to protect financial loss of its parent with the concept of: (i) separation of ownership from the parent; and (ii) limited liability.[74] Therefore, parent's liability of the subsidiary becomes nonexistent.

Accordingly, the above factors encourages the owner of the SPV to let it be used for injustice or unfairness, or let it be used to invest in harmfull undertakings for the environment and the people.[75] Recently, in Indonesia, the enactment of Presidential Regulation Number 13 Year 2018 regarding The Application of the Know-Your-Corporation-Beneficial-Owner Principle in the Context of the Prevention and Eradication of Criminal Acts of Money Laundering and Terrorism Financing (hereinafter referred to as Presidential Regulation 13/2018) supports legal authority to know which parties should be held liable for the violation of law or infringement by SPVs or any subsidiaries made for fraud or injustice.

Specifically, according to Article 3 paragraph 1 Presidential Regulation 13/2018, a corporation must stipulate its beneficial owner. Definition of beneficial owner of limited liability company is available on Article 4 Presidential Regulation 13/2018. If the corporation does not obey the rule, according to Article 24, the corporation will be given sanctions by law. However, those regulations only impose a corporation to disclose its beneficial owner, and there is no further consequences of it. Thus, there will also be no further consequences to the existence of SPV or any subsidiary, that is used for injustice or unfairness, or invested in harmfull undertakings.

It is important to distinguish between parent company's direct liability and parent company's vicarious liability to its subsidiary. As it is mentioned in section I, Indonesia Company Law adopts the principle of limited liability in a legal entity corporation. The relationship between parent company and its subsidiary arises and accommodated in Article 84 Law 40/2007, which stipulated that a corporation can own shares in other company. Nonetheless, the relationship between parent company and its subsidiary is still limited, and both are separate entities. Thus, a parent company can not be directly liable for its subsidiary, but it can be vicariously liable.

V. CONCLUSION

There are several motives of parent company establishing a subsidiary. Whether it is to optimalize its business processes and tax-reduction, cost-cutting, increase its business efficiency, or even to dishonestly use the subsidiary by accomplishing a fraudulent end to escape a specific

[73] Al. L. Hartgraves & George J. Benston, *"The Evolving Accounting Standards for Special Purpose Entities and Consolidations",* pg. 247.

[74] Pramudya Azhar Oktavinanda, "*Establishment of Special Purpose Vehicle (SPV), Holding Company's Liability on SPV's acts, and SPV as Shield of Fraudulent Act, Especially Corruption and Money Laundering",* Climate Change, Corporate Liability Regarding Forestry Sector, 2013, pg. 102.

[75] Pramudya Azhar Oktavinanda, "*Establishment of Special Purpose Vehicle (SPV), Holding Company's Liability on SPV's acts, and SPV as Shield of Fraudulent Act, Especially Corruption and Money Laundering",* pg. 296.

contractual liability of some sort, or avoiding the provisions of a statute. There are no rule prohibiting the existence of an SPV, likewise, an SPV is generally created for a specific purpose, does not mean that the motive is negative. Nevertheless, the fact that an SPV can be used to protect financial loss of the parent company, due to the fact that both has limited liability, oftentimes encourages the owner (parent company) to let SPV be used for injustice or unfairness, as well as to invest in harmfull undertakings. Those dishonest use of a subsidiary led into a misappropriation of a subsidiary.

In such condition, by the rule of limited liability, a parent company could easily avoid liability, whereas, the fraud of the subsidiary is a result of the parent's dishonest conduct. Eventually, the rule of vicarious liability can be imposed. Vicarious liability, however, can not be broadly interpreted, there are also limitations in implementing vicarious liability to the parent company. *First*, there must be an agency relationship between the parent and its subsidiary that is 'akin to employment' which there must be some kind of control by the parent. And *Second*, the subsidiary's veil must be pierced, mostly since parent company dishonestly use its subsidiary.

It can not be determined upon what ground a court will hold the parent, if at all; that depends upon the jurisdiction, and the degree of identity of the corporations, or of the stockholders and directors in both corporations. But, it can be said, with some degree of certainty, that a court will not allow the creditors of the insolvent member of the unit to be defrauded, nor allow the corporation to evade laws which have been dictated by public policy, not to escape existing or future obligations, nor even to escape legal liability for tort, by adhering to the doctrine of "corporate entity". The "legal entity" theory will be upheld as long as is possible, but whenever any of the above elements become present, the court will look through to substance, rather than to form.[76]

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[76] Frank J. Antoine, *"Corporations - Parent and Subsidiary - Corporate Entity",* Marquette Law Review, Vol. 17, No. 5 (Jun. 1933), pg. 283.

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