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Directors' Liability to Creditors - What are the Alternatives?

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Directors' Liability to Creditors - What are the Alternatives?

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Abstract

It is timely to examine alternatives to imposing liability on directors for creditor losses when a company is unable to pay its debts. Directors' personal liability for corporate fault and corporate social responsibility are currently being investigated by parliamentary committees, but there are dangers of risk aversion and unfair legal complianace burdens on directors if liability is extended too far. This article examines alternatives to director liability, such as mandatory capitalisation or insurance, shareholder liability and government funded schemes, to assess whether they provide appropriate and sufficient compensation for losses in times of corporate failure. It is concluded that imposing liability on directors appears to be a superior way in which to ensure creditor protection because it not only potentially gives creditors access to funds for compensation but also deters the adverse behaviour which may be a cause of loss to creditors.

DIRECTORS' LIABILITY TO CREDITORS – WHAT ARE THE ALTERNATIVES?

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Precis

It is timely to examine alternatives to imposing liability on directors for creditor losses when a company is unable to pay its debts. Directors' personal liability for corporate fault and corporate social responsibility are currently being investigated by parliamentary committees, but there are dangers of risk aversion and unfair legal complainance burdens on directors if liability is extended too far. This article examines alternatives to director liability, such as mandatory capitalisation or insurance, shareholder liability and government funded schemes, to assess whether they provide appropriate and sufficient compensation for losses in times of corporate failure. It is concluded that imposing liability on directors appears to be a superior way in which to ensure creditor protection because it not only potentially gives creditors access to funds for compensation but also deters the adverse behaviour which may be a cause of loss to creditors.

Introduction

The Corporations and Markets Advisory Committee has recently¹ released a discussion paper examining the personal liability of directors for corporate fault.² It is

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¹ May, 2005.

² Corporations and Markets Advisory Committee, Parliament of Australia, *Personal Liability for Corporate Fault* (2005). Senator Campbell's reference spoke of directors being 'subject to a range of both general common law and statutory duties'. He also suggested that CAMAC could consider 'whether this potential liability would result in a disincentive for persons accepting or continuing to hold directorships; and directors engaging in entrepreneurial but responsible risk taking'. This Discussion Paper has, however, concentrated on direct and derivative personal liability for corporate criminal fault. A later reference to CAMAC,

based on a reference to the Committee from Senator Ian Campbell, who was 'concerned that duties being imposed on directors by various pieces of legislation may result in inconsistent compliance burdens and increased costs for business'.³

Many of these duties are imposed for the protection of creditors, and often it appears that the debate on creditor protection in the event of a company's inability to pay concentrates on choosing between letting the loss lie where it falls or imposing liability on directors for that loss.

There are, however, alternative ways of ensuring recovery for creditors, such as imposing liability on shareholders or government subsidised schemes of compensation. Indeed, employees currently enjoy the benefits of such a scheme, outlined below. Nonetheless, imposing liability on directors appears to be a superior way in which to ensure creditor protection because it not only potentially gives creditors access to funds for compensation but also deters the adverse behaviour which may be a cause of loss to creditors.

However, imposing liability on directors is not without cost, and Senator Campbell's concerns are real ones. Inconsistent or excessive compliance burdens may deter qualified people from accepting directorships and may discourage appropriately risky behaviour which is beneficial to shareholder wealth maximisation, the creation of employment and the economy as a whole. It is therefore timely to consider alternative ways of protecting creditors and assess whether they are effective means of achieving equal or better compensation for creditors without the need to impose liability on directors.

The article is divided into parts. Part II will briefly address economic theory to determine whether in fact creditors require compensation or whether the loss should lie where it falls. It will be seen that some creditors are arguably already protected by contract against the risk of loss ex ante, and it is maintained by economic theorists that

dated 23 March, 2005 and entitled 'Reference in Relation to Directors' Duties and Corporate Social Responsibility' has now come from the present Parliamentary Secretary to the Treasurer, the Hon Chris Pearce. One of its questions is '[s]hould the Corporations Act be revised to require directors to take into account the interests of specific classes of stakeholders [other than shareholders] or the broader community when making corporate decisions?' The Parliamentary Joint Committee on Corporations and Financial Services is currently calling for submissions on Corporate Responsibility and Triple Bottom Line Reporting, and will report on 29th November, 2005

³ Reference from Senator the Hon Ian Campbell, Parliamentary Secretary to the Treasurer to the Corporations and Markets Advisory Committee, 9 July 2002. <http://www.camac.gov.au/camac/camac.nsf/print/Directors%27+Duties+and+Personal+Liability+%28July+2002%29?opendocument>.

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these creditors do not require further compensation ex post. Others, however, are more vulnerable. These include small trade creditors and employees who are not fully compensated by contract, and tort creditors who may have no contract with the company.

Part III looks at the means by which the debts of all types of creditors could be protected against the risk of loss. These include companies holding mandatory debt insurance, mandatory minimum capital requirements, and imposing liability on shareholders, especially on holding companies of insolvent subsidiaries.

Part IV examines the methods by which the creditors noted above as vulnerable could be protected. The means of compensation for them include priority in a winding up, mandatory insurance held by the company and the provision of government assistance schemes, funded either by levies on companies or from taxpayer revenue.

Part V weighs the various methods of creditor recovery and protection against the imposition of liability on directors, and considers the relevance of risk aversion and professional indemnity insurance to director liability. It will be concluded that while lifting the corporate veil on holding companies and some means of creditor protection targeted towards vulnerable creditor groups may be desirable, the imposition of liability on directors where they are at fault is a superior means of protecting creditors from loss.

Creditors' Need for Recovery

Not all creditors are vulnerable to the risk of loss in the event of a company's insolvency. Economic theorists argue that creditors can self protect against the risk of non-payment by the company. This can be done in a number of ways. For example, protection can be afforded by the terms of the contracts they negotiate.⁴ Easterbrook noted that '[a]s long as these risks are known, the firm pays for the freedom to engage

⁴ Wishart asserted that '[c]reditors charge interest for the service they render. Built into that fee is compensation for the risk of loss they bear. The greater the risk of loss, the more is charged to compensate for that risk. Creditors cannot complain that insolvency as such has caused them loss because they have contracted to bear that risk, and have built compensation for bearing it into the cost of credit. If creditors do not charge for the probability of certain events happening, they should not be supported in their foolishness. They should not survive to charge less than wiser people.' David Wishart, 'Models and Theories of Directors' Duties to Creditors' (1991) 14 *New Zealand Universities Law Review* 323, 336.

in risky activities. ... The firm must offer a better risk-return combination to attract investment'.⁵

In addition to the capacity to price protect, some creditors can also be protected by devices such as loan covenants, restricting the company's ability to sell or further pledge its assets, security over the corporation's major assets or personal guarantees from the directors.⁶ Other means of protection against loss include the ability of some creditors to diversify their client base so that non payment by one does not lead to their own financial ruin. Additionally, creditors may have short term credit periods, which allow them to carefully assess credit worthiness with current information about the company's financial stability.

This ability to provide self protection would indicate that creditor protection at common law or under statute is unnecessary. However, the self-protection argument is based on the 'efficient markets' hypothesis. This holds that 'all relevant information will be available to the market and that the market will rapidly, if not instantaneously, digest all information as it becomes available'.⁷ But even the proponents of this theoretical outlook are prepared to admit that markets do not always work efficiently,⁸ because it does not take into account situations where there is not full information about the investment or the borrowing company's financial position. Moreover, the size of the company⁹ with which creditors are dealing can have a

⁵ Frank Easterbrook and Daniel Fischel, *The Economic Structure of Corporate Law* (1991) 50. See also Ross Grantham, 'Directors' Duties and Insolvent Companies' (1991) 54 *Modern Law Review* 576, 579. Posner also commented that 'the interest rate on a loan is payment not only for renting capital but also for the risk that the borrower will fail to return it': Richard Posner, 'The Rights of Creditors of Affiliated Corporations' (1976) 43 *University of Chicago Law Review* 499, 501. However, Keay noted research by Cheffins (published in Brian Cheffins, *Company Law: Theory, Structure and Operation* (1997) 501) which establishes that 'there is little evidence that creditors charge a higher interest rate when dealing with a limited liability company, compared to other creditors'. Andrew Keay, 'Directors' Duties to Creditors: Contractarian Concerns Relating to Efficiency and Over-Protection of Creditors' (2003) 66 *Modern Law Review* 665, 689.

⁶ Posner, 'Affiliated Corporations', above n 5, 504.

⁷ Jeffery Gordon and Lewis Kornhauser, 'Efficient Markets, Costly Information and Securities Research' (1985) 60 *New York University Law Review* 761, 770.

⁸ Wishart, 'Models and Theories', above n 4, 336. Also Ross Grantham, 'The Judicial Extension of Directors' Duties to Creditors' [1991] *Journal of Business Law* 1, 2-3.

⁹ The vast majority of companies in Australia are not listed on the Stock Exchange. As at the 30/6/04 there were approximately 1,309,870 companies in Australia, of which approximately 1,291,110 were proprietary companies and 18,670 were public companies. Approximately 1,400 public companies are listed on the Stock Exchange. Email from Debbie Cowley, Product Team, ASIC, to Helen Anderson 6 December, 2004.

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significant impact on their ability to obtain information about solvency, as small closely held companies are more likely to deprive creditors of vital information than larger companies with mandated public disclosure or a board well separated from its shareholders.¹⁰ In addition, directors of a company may choose to take additional risks,¹¹ which creditors have not foreseen and for which no premium has been charged.¹²

Certainly, not all creditors are able to protect themselves¹³ and indeed, the ability of some creditors to protect themselves, for example, with charges over company assets or loan covenants, increases the risk to weaker parties who cannot negotiate such protection.¹⁴ Small trade creditors may lack the knowledge and expertise to make accurate assessments of risk and in any event, would be unable to calculate an appropriate premium to compensate for it. Because the size of their individual debts are comparatively small, the cost of obtaining information about the risk may be prohibitive. They lack information about their fellow trade creditors to enable them as a group to negotiate collectively¹⁵ for fuller particulars of risk.¹⁶ Van der Weide argued

¹⁰ Wishart, 'Models and Theories', above n 4, 336.

¹¹ Eisenberg noted: 'It is almost impossible to deal adequately with this potential for ex post opportunism by ex ante contracting'. Melvin Eisenberg, 'The Structure of Corporation Law' (1989) 89 *Columbia Law Review* 1461, 1465. See also Mark Byrne, 'An Economic Analysis of Directors' Duties in Favour of Creditors' (1994) 4 *Australian Journal of Corporate Law* 275, 277.

¹² Arrow commented that '[i]t is a plausible hypothesis that individuals are unable to recognise that there will be many surprises in the future; in short, as much ... evidence tends to confirm, there is a tendency to underestimate uncertainties'. Kenneth Arrow, 'Risk Perception in Psychology and Economics' (1982) 20 *Economic Inquiry* 1, 5. See also Posner, 'Affiliated Corporations', above n 5, 504-5.

¹³ Lipson labelled these creditors 'low VCE creditors', who 'lack volition, cognition and exit'. This describes creditors who lack voluntariness in their dealings with the company (tort creditors, taxing authorities, terminated employees); lack information (cognition) about the true state of company affairs; and lack the ability to exit from these relationships because of the absence of a market to sell their rights against the company. Jonathan Lipson, 'Directors Duties to Creditors: Power Imbalance and the Financially Distressed Corporation' (2003) 50 *UCLA Law Review* 1189, 1193.

¹⁴ Keay, above n 5, 688. Judith Freedman, 'Limited Liability: Large Company Theory and Small Firms' (2000) 63 *Modern Law Review* 317, 351.

¹⁵ Reinier Kraakman et al, *The Anatomy of Corporate Law* (1st ed, 2004) 72.

¹⁶ The ability to negotiate collectively may explain why employees have been given protection under the law. Part 5.8A of the *Corporations Act 2001* (Cth), hereinafter referred to as the *Corporations Act*, was introduced by the *Corporations Law Amendment (Employee Entitlements) Act 2000* (Cth). It aims 'to protect the entitlements of a company's employees

that short term creditors 'can quickly respond to bad firm behaviour by taking their business elsewhere'¹⁷ but Keay described this as 'typical of the gross overstatements that pervade some works that have contributed to the law and economics literature'.¹⁸

Employees are in a particularly vulnerable position, despite being labelled 'voluntary' creditors in the economic literature. In times of high unemployment, employees may be faced with a difficult decision between unemployment and a financially unstable employer. Unlike trade creditors, employees lack the ability to diversify their risk.¹⁹ In some circumstances, employees may be compensated for their lack of ability to diversify by having superior access to information about their employer's financial position²⁰ and senior employees may be able to seek added remuneration in exchange for running the risks associated with possible financial instability. However, not all employees are in this favourable position, and the ones who are most likely to need the protection of the law are also the ones least likely to be privy to the company's private financial troubles.²¹

The tort claimant,²² such as a person injured by the negligence of the defendant company, is the most vulnerable of all, when the company is insolvent, uninsured²³ and unable to provide compensation an injured plaintiff. These people have no ability to diversify their risk and no ex ante information about the financial position of the company.

from agreements and transactions that are entered into with the intention of defeating the recovery of those entitlements.'

¹⁷ Mark Van der Weide, 'Against Fiduciary Duties to Corporate Stakeholders' (1996) 21 *Delaware Journal of Corporate Law* 27, 49.

¹⁸ Keay, above n 5, 697.

¹⁹ Paul Halpern, Michael Trebilcock and Stuart Turnbull, 'An Economic Analysis of Limited Liability in Corporation Law' (1980) 30 *University of Toronto Law Journal* 117, 149.

²⁰ *Ibid* 143.

²¹ See above n 16.

²² Victims of corporate torts are often referred to as 'tort creditors'. However, more correctly, they are tort claimants or even simply victims of tort, as they may not have initiated action and proved their case against the defendant company due to its insolvency.

²³ Easterbrook and Fischel argued that economic theories take into account the protection of tort creditors. They contend that if the compensation of tort creditors could affect the financial viability of the company, the directors will ensure that adequate insurance is maintained. Easterbrook and Fischel, 'Economic Structure', above n 5, 52-4.

Protection for the Benefit of All Creditors

The foregoing indicates that vulnerable cohorts of creditors are undercompensated or uncompensated in their dealings with companies *ex ante* and therefore are arguably entitled to some form of recovery *ex post*. Even so called 'strong' creditors who have adopted some means of protection against the risk of loss may not be entirely compensated for the risks to which they are exposed. The following discussion will therefore examine methods of protecting creditors in the event of a company's insolvency which are for the benefit of all creditors. These include mandatory minimum capitalisation, imposing liability on shareholders and mandatory debt insurance. It will be seen that while they are, or could be, of some benefit to creditors, none are a satisfactory means of ensuring that creditor protection, particularly of vulnerable creditor groups.

Mandatory Minimum Capital Requirements

Undercapitalisation of a company is a significant problem in insolvency. Sometimes all assets of a company are already charged to secured creditors and there is nothing left for unsecured creditors. Sometimes a company is set up deliberately undercapitalised, perhaps because it is a vehicle by which a holding company conducts risky ventures. Sometimes it is set up simply because its promoter wants the benefit of limited liability.

These different reasons for undercapitalisation will be examined separately. This section will deal with the general question of undercapitalisation, and the next two will deal with the holding company situation and the issue of whether, or in what circumstances, the privilege of limited liability should be removed from shareholders.

The *Corporations Act* already has substantial capital maintenance provisions. The rule in *Trevor v Whitworth*²⁴ has been incorporated into Part 2J of that Act and regulates share capital reductions and share buy backs, self-acquisition and control of shares, and the provision of financial assistance for the acquisition of shares. The aim of the provisions is to maintain companies' capital because its reduction could prejudice the rights of shareholders and creditors.²⁵

²⁴ (1887) 12 App Cas 409.

²⁵ *Corporations Act* s 256A says '... The rules [in pt 2J.1] are designed to protect the interests of shareholders and creditors by

- (a) addressing the risk of these transactions leading to the company's insolvency ...'

However, the law does not prescribe initial minimum capital requirements.²⁶ Therefore it is possible for a company to be seriously undercapitalised without ever breaching any of the statutory or common law rules relating to the maintenance of share capital.

Easterbrook and Fischel point out that ‘the lower a firm’s capitalization, the higher the probability that it will engage in excessively risky activities’.²⁷ Often the risk associated with a debt increases after the debt is incurred.²⁸ Even if the capitalisation of the company had been checked and was deemed adequate, later borrowing which prejudices creditors’ ability to recover may take place where creditors are unable to obtain negative pledges to prevent it.

The report entitled ‘Corporate Insolvency Laws: A Stocktake’,²⁹ released in 2004 by the Parliamentary Joint Committee on Corporations and Financial Services, included recommendations about ‘assetless’ companies. It said:

The Committee is of the firm belief that the problem of assetless companies must be addressed. It recommends that the Government establish an assetless company registration fund to finance preliminary investigations of breaches of directors’ duties and fraudulent conduct using the skills of registered insolvency practitioners.³⁰

Further recommendations were that an empirical study of assetless companies be commissioned³¹ and that statistics be collated and published.³² While these measures will help to determine the extent of the problem, clearly more is needed to overcome its detrimental effects.

Nonetheless, it must be recognised that any attempt to impose minimum capital requirements involves costs to the company. These may be in the form of administrative costs, as well as the cost of having capital sit idle or being subject to

²⁶ Even listed companies do not have minimum capitalisation requirements to qualify for listing on the Australian Stock Exchange. While one ASX Listing Rule looks at assets (Listing Rule 1.3), an alternative to qualify for listing is the company’s annual profit history (Listing Rule 1.2). However, it should be noted that periodic disclosure requirements apply to these companies under Listing Rule 4.1.

²⁷ Easterbrook and Fischel, above n 5, 60.

²⁸ Grantham, ‘Judicial Extension’ above n 8, 3.

²⁹ Parliamentary Joint Committee on Corporations and Financial Services, Parliament of Australia, *Corporate Insolvency Laws: A Stocktake* 2004.

³⁰ Ibid [7.50].

³¹ Ibid [7.56].

³² Ibid [7.57].

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statutory limits on its use.³³ Such requirements may also interfere with the company's ability to be flexible in its financing, if, for example, maximum debt/equity ratios are mandated. The question of how much capital is adequate is also difficult to ascertain and presumably would alter with the company's growth. Even if sufficient capital were required to be set aside to cover present trade debts and employee entitlements, these sums may not be sufficient to compensate a plaintiff badly injured by the company's negligence.

Holding Company Liability for Debts of an Undercapitalised Subsidiary

The recent James Hardie asbestos claims illustrate the possible extent of tort liability that can arise in the context of the unpaid liabilities of a subsidiary of a solvent holding company.³⁴ The Report of the Special Commission of Inquiry into the Medical Research and Compensation Foundation³⁵ stated:

One of the main public policy objectives of tort law is to discourage activity that is needlessly harmful to people, by imposing the cost of compensation on the wrongdoer. That policy is undermined where wrongdoers can externalise their risk. In reality, it is substantially undermined if a company about to undertake an activity that poses serious health risks for mere bystanders or ultimate consumers can ensure it will never have to satisfy any claims for compensation by the simple technique of carrying out the operations through a company with no capital, funded by loans from the parent secured by a debenture over its assets. Indeed, the limited liability principle as it presently operates actually *encourages* managers so to act, because it is in the 'shareholders' interests' to do so.³⁶

³³ For example, banks are subject to minimum capital requirements, and these are monitored by the Australian Prudential Regulation Authority, which has the responsibility, under Division 2 of the *Banking Act 1959* (Cth), of ensuring the protection of depositors.

³⁴ Spender notes that 'Australian asbestos manufacturers arranged their corporate groups after the dangers of asbestos had already been recognised overseas. Therefore, from its inception, the mining and manufacture of asbestos in Australia tended to be conducted by the undercapitalised subsidiaries of firms'. Peta Spender, 'Blue Asbestos and Golden Eggs: Evaluating Bankruptcy and Class Actions as Just Responses to Mass Tort Liability' (2003) 25 *Sydney Law Review* 223, 234.

³⁵ David Jackson, The Report of the Special Commission of Inquiry into the Medical Research and Compensation Foundation, 2004, *Annexure T The Concept of Limited Liability – Existing Law and Rationale*, <<http://www.cabinet.nsw.gov.au/hardie/Volume1.pdf>>.

³⁶ *Ibid* 419-20.

Easterbrook and Fischel described the problem of 'moral hazard' which can exist with groups of companies as follows:

If limited liability is absolute, a parent can form a subsidiary with minimum capitalisation for the purposes of engaging in risky activities. If things go well, the parent captures the benefits. If things go poorly, the subsidiary declares bankruptcy [to the detriment of its outstanding unsecured creditors] and the parent creates another with the same managers to engage in the same activities. The asymmetry between benefits and cost, if limited liability is absolute, would create incentives to engage in a socially excessive amount of risk activities.³⁷

Nolan also commented:

There may be powerful commercial or fiscal incentives for a parent company to allow one or more group members to operate at a loss, or to deny them economic opportunities or to undercapitalise them, or to adopt integrated financing techniques characterised by the shuffling of assets (particularly funds) and liabilities between them as the need arises. Thus, interest-free or otherwise uncompetitive inter-company loans may be made, or one group member may guarantee another's borrowings without specific regard to the guarantor company's liquidity. Resources may be shifted between companies under the label of 'interest', 'dividends' or 'management fees'. Indeed, as one of the American academics has explained:

the managers of the enterprise would be acting irrationally if they failed to use the resources of one company to salvage another if such assistance would ultimately enhance the profitability of the corporate enterprise.³⁸

³⁷ Frank Easterbrook and Daniel Fischel, 'Limited Liability and the Corporation' (1985) 52 *University of Chicago Law Review* 89, 111. See further Halpern, Trebilcock and Turnbull, above n 19, 124. They suggest that a more appropriate way to avoid moral hazard in groups of companies is to impose liability of the directors, rather than the shareholders of the holding company, at 149. Directors themselves are aware of this conflict. Tomasic and Bottomley report that '[t]he vast majority of Australian directors recognise that the group context of corporate life can and does create significant legal problems for directors'. Roman Tomasic and Steve Bottomley, 'Corporate Governance and the Impact of Legal Obligations on Decision Making in Corporate Australia' (1991) 1 *Australian Journal of Corporate Law* 55, 63.

³⁸ Anthea Nolan, 'The Position of Unsecured Creditors of Corporate Groups: Towards a Group Responsibility Solution Which Gives Fairness and Equity a Role' (1993) 11 *Company and Securities Law Journal* 461, 485, quoting Jonathan Landers, 'A Unified Approach to Parent, Subsidiary and Affiliate Questions in Bankruptcy' (1975) 42 *University of Chicago Law Review* 589, 648-9.

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To overcome this situation, the Harmer Report recommended that the New Zealand model of liability be adopted.³⁹ This allows for the making of contribution orders⁴⁰ and pooling orders⁴¹ against the holding company. Instead, Australia followed the British wrongful trading model,⁴² with the addition of a provision for holding company liability, s 588V of the *Corporations Act*.⁴³ As with the liability for insolvent trading of directors under s 588G of the *Corporations Act*, s 588V of that Act only provides for liability by a holding company with respect to the incurring of contract debts. Tort liabilities are ignored.

The lifting of the corporate veil⁴⁴ to impose liability on the holding company which is, after all, a shareholder in the subsidiary, is doubtless justified by the frequent reality of control of the subsidiary by the holding company. In doing so, the legislature has recognised that companies can avoid liability for debts by incorporating undercapitalised subsidiaries which can trade into insolvency without damaging the

³⁹ Australian Law Reform Commission, *General Insolvency Inquiry*, Report No 45 (1988) (The Harmer Report) [336] and [857] (Vol 1), D13 and PR9 (Vol 2). See further John Farrar, *Corporate Governance in Australia and New Zealand* (2001) 240.

⁴⁰ A contribution order requires a solvent company in a group to contribute to the debts of an insolvent company within the group.

⁴¹ A pooling order requires the assets of the group to be pooled for the benefit of the creditors of companies within the group.

⁴² *Insolvency Act 1986* (UK) s 214.

⁴³ Nolan commented that 'The pooling order recommendation appears to have been forgotten entirely even though the Harmer Committee "received no submissions opposing this proposal" [Harmer Report, above n 39, [857]]. The contribution order recommendation has been recast as an insolvent trading provision ... In the Explanatory Memorandum to the Corporate Law Reform Bill ... it is claimed that this provision implements "the Harmer Report's recommendations in relation to available assets" even though ... the Harmer Report's recommendations are quite different to those enacted under the Reform Act. At most, the Government has simply accepted the *philosophy* underlying the Harmer Reports' contribution order proposal'. Nolan, above n 38, 464-5 (emphasis in original).

⁴⁴ The Companies and Securities Advisory Committee, Parliament of Australia, *Corporate Groups Final Report* (CASAC Report) (2000) in Chapter Six: Liquidation of Group Companies examines a number of ways in which holding companies can be held liable. These include as shadow directors, at [6.15], liability for misfeasance, including liability for knowingly assisting another company to breach its fiduciary duty under the doctrine of *Barnes v Addy* (1874) LR 9 Ch App 244, at [6.16], agency, at [6.17], letters of comfort, at [6.18] and a variety of situations where transactions may be set aside, at [6.19] to [6.25].

parent company and that sometimes the subsidiary is incorporated for the very purpose of hiding the true and parlous financial state of the holding company.⁴⁵

Rogers CJ in *Qintex Australia Finance Ltd v Schroders Australia Ltd* ⁴⁶said:

It may be desirable for Parliament to consider whether this distinction between the law and commercial practice should be maintained. ... there is a great deal to be said for the suggestion ... that assets and liabilities of the parent and the subsidiaries should be aggregated. It may be argued that there is justification for preserving the same attitude in relation to the demised companies as was displayed during their active commercial life.⁴⁷

Ramsay⁴⁸ also considered that holding company liability for the subsidiary's debts may be appropriate. He adopted a 'law and economics' perspective on the section, asking first, whether it 'creates incentives for individuals and firms to behave efficiently'⁴⁹ and secondly, whether the holding company is the best party to bear the risk of the subsidiary's insolvency.⁵⁰ He found these economic criteria substantially satisfied.⁵¹

Nonetheless, the imposition of liability on a shareholder poses a major theoretical dilemma for corporate law. Section 588G of the *Corporations Act*, which provides for liability of a director for the insolvent trading of a company, does not consider the shareholding of the director. A human shareholder with a large shareholding will frequently but not necessarily be represented on the board of directors, but it is the directorship rather than the shareholding that is the basis of insolvent trading liability. Under s 588V of that Act, on the other hand, it is the holding company rather than its directors which is liable for the insolvent trading.

⁴⁵ Ian Ramsay, 'Holding Company Liability for the Debts of an Insolvent Subsidiary: A Law and Economics Perspective' (1994) 17 *University of New South Wales Law Journal* 520, 525-6. Ramsay noted that there are also legitimate business reasons to incorporate subsidiaries, at 533-4.

⁴⁶ [1991] 3 ACSR 267, 269.

⁴⁷ See also Robert Baxt, 'The Duties of Directors of Public Companies – the Realities of Commercial Life, the Contradictions of the Law and the Need for Reform' (1976) 4 *Australian Business Law Review* 289; Robert Baxt, 'Duties to a Corporate Group – One Step Forward or Two Steps Backwards?' (1994) 22 *Australian Business Law Review* 138.

⁴⁸ Ramsay, above n 45.

⁴⁹ *Ibid* 521.

⁵⁰ *Ibid*.

⁵¹ *Ibid*.

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In no other area of the law does a shareholder bear liability for the acts of a company unless that person is also a director of the company. Removing limited liability for any group of shareholders would appear to undermine the rationale of incorporation, as outlined by theorists such as Easterbrook and Fischel,⁵² and Halpern, Trebilcock and Turnbull.⁵³ Limited liability enables shareholders to avoid excessive monitoring costs, both of the company and their fellow shareholders, and thus encourages a wide diversification of investment to both new and existing businesses. Limited liability allows the free transfer of shares which also promotes wide diversification of shareholding. All of these are vital to the continuation and expansion of a capitalist economy.⁵⁴ Parliament's lifting of the corporate veil is inconsistent with the reification of the company as a legal entity separate from the directors of that company, and is also highly inconsistent with the approach shown by courts in the common law actions.

Farrar expressed reservations about the consequences of placing liability on a holding company:

These provisions represent a limited piercing of the corporate veil but will give rise to concern where the holding company is not the principal operating entity. The risk of liability of the holding company will be a cause for concern amongst the boards of large corporation, who will be required to monitor the affairs of subsidiaries more closely. Where the ultimate holding company is in an overseas jurisdiction there may be practical difficulties with doing this.

The practical implications for directors are twofold. The first is to pursue a strategy of 'ignorance is bliss' regarding the affairs of the subsidiary. Do not share directors or employees or information, if this is at all practicable. The second is to avail itself of one of the defences (eg reasonable grounds to expect solvency and reliance on information from a competent and reliable person.)⁵⁵

A more elaborate reform of enterprise liability based on some concept of group legal personality or *automatic* group responsibility would probably create as many problems as it would solve. Since we are currently seeking to escape from the straightjacket of separate legal personality, it seems a mistake to seek refuge

⁵² Easterbrook and Fischel, 'Limited Liability' above n 37; also Easterbrook and Fischel, '*Economic Structure*' above n 5.

⁵³ Halpern, Trebilcock, and Turnbull, above n 19.

⁵⁴ Easterbrook and Fischel, '*Economic Structure*', above n 5, 41-4.

⁵⁵ John Farrar, 'Legal Issues Involving Corporate Groups' (1998) 16 *Company and Securities Law Journal* 184, 192.

in a larger concept of group legal personality or responsibility, enticing though this may be because of its apparent reflection of commercial reality.⁵⁶

In 2000, the Corporate Groups Final Report (CASAC Report) looked at the issues arising from corporate groups closely. Unlike the Harmer Report, the CASAC Report did not endorse the introduction of contribution orders⁵⁷ but did recommend that liquidators be permitted 'to pool the unsecured assets, and the liabilities, of two or more group companies in liquidation with the prior approval of all unsecured creditors of those companies.'⁵⁸ It also recommended that the law should give courts the power to make pooling orders in the liquidation of two or more companies.⁵⁹

However, the Report had noted that imposing liability on the parent company has disadvantages:

... the value of recovery rights of unsecured creditors of a parent company could be diminished through that company's exposure to the financial risks of all the group's activities. At the same time, creditors of controlled group companies could gain a windfall from the parent company providing, in effect, a form of liability insurance against any defaults by its group companies.⁶⁰

⁵⁶ Ibid 201. Farrar also notes a number of British cases which adopt the two different approaches, *ibid* 185-6. The more flexible approach was taken by *DHN Food Distributors Ltd v Tower Hamlets LBC* [1976] 1 WLR 852; *Aiglon Ltd and L'Aiglon SA v Gau Shan Co Ltd* [1993] BCLC 1,321; *TSB Private Bank International SA v Chabra* [1992] 1 WLR 231. The traditional separate legal entity approach was taken by *Adams v Cape Industries plc* [1990] Ch 433; *Woolfsen v Strathclyde Regional Council* (1978) 38 P & CR 521. See also Farrar, 'Corporate Governance' above n 39, 229. Baxt and Lane also note the English High Court decision in *Re Polly Peck International plc* [1996] 2 All ER 433 which upheld the strict legal position rather than recognising the economic reality of the companies in a group. Robert Baxt and Timothy Lane, 'Developments in Relation to Corporate Groups and the Responsibilities of Directors – Some Insights and New Directions' (1998) 16 *Company and Securities Law Journal* 628, 633. See also John Farrar, 'Frankenstein Incorporated or Fools' Parliament? Revisiting the Concept of the Corporation in Corporate Governance' (1998) 10 *Bond Law Review* 142, 158-160.

⁵⁷ CASAC Report, above n 44, Recommendation 21, [6.59].

⁵⁸ Ibid [6.85]. Note the confirmation of the ability of liquidators to pool assets in the recent decision in *Tayeh & De Vries; re The Black Stump Enterprises Pty Ltd* [2005] NSWSC 475. Barrett J held that liquidators under a creditors' voluntary winding up who wished to pool the assets of companies in a group for the purpose of distribution to the creditors of all of the companies must obtain the unanimous consent of all creditors prior to the court permitting the pooling of those assets under s 511(1)(a).

⁵⁹ Ibid [6.97].

⁶⁰ Ibid [1.64].

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Therefore, the Report suggested that the judicial power to make pooling orders must 'make clear that pooling orders do not affect the rights of external secured creditors' and to 'permit individual external creditors to apply to have a pooling order adjusted to take their particular circumstances into account.'⁶¹

Fridman also believed that group liability would cause more problems than it would solve.⁶² He suggested that the oppressive conduct remedy⁶³ is a more appropriate way to deal with abuses of the separate legal entity rule by companies in a group. In discussing the judgment in *Qintex Australia Finance Ltd v Schroders Australia Ltd*⁶⁴ he said that '[c]learly the problem of identifying which member of a corporate group should be responsible for a given obligation should not be resolved by destroying the notion of corporate personality that has been enshrined in the law since *Salomon v Salomon ...*'.⁶⁵

Nonetheless, creditors taking action against companies in a group face considerable difficulties. One is information asymmetry. Creditors frequently are not sure of the particular entity with which they are contracting, and rely on the credit worthiness and reputation of the group as a whole. Transactions within the group can increase the risk without the knowledge of creditors. The Harmer Report considered '[t]here is little sense in promoting a law that is at odds with commercial reality'.⁶⁶ It found that often it is 'difficult or impossible to reconstruct the financial position of a company at or about a particular time'⁶⁷ because a liquidator has to 'cope with either inadequate or meaningless company accounting records or no accounting records at all'.⁶⁸

The foregoing discussion largely focuses on the arguments for and against holding company liability for the unpaid *contract* liabilities of its subsidiaries. Ramsay highlighted the frequently overlooked inadequacy of the current law by saying '[t]he section is seriously deficient in that it provides no protection for tort claimants of

⁶¹ Ibid [6.97]. The CASAC Report also considered whether courts should be permitted to subordinate intra-group claims in the insolvency of a group company, but rejected the idea, at [6.112]. This was also considered by John Farrar, 'Corporate Group Insolvencies, Reform and the United States Experience' (2000) 8 *Insolvency Law Journal* 148, 153.

⁶² Saul Fridman, 'Removal of the Corporate Veil: Suggestions for Law Reform in *Qintex Australia Finance Ltd v Schroders Australia Ltd*' [1991] *Australian Business Law Review* 211.

⁶³ Currently found in *Corporations Act* s 232.

⁶⁴ [1991] 3 ACSR 267.

⁶⁵ Fridman, above n 62, 213.

⁶⁶ Harmer, above n 39, [33].

⁶⁷ Ibid [297].

⁶⁸ Ibid [290].

insolvent subsidiaries'.⁶⁹ These creditors are particularly vulnerable given that the holding company may deliberately incorporate an undercapitalised subsidiary to conduct dangerous activities which may lead to tort claims.⁷⁰

In some cases, the holding company may be held liable in tort because of its own breach of duty to the plaintiff. This occurs where the holding company has such a degree of control over the activities of the subsidiary that it is in effect conducting those activities itself.⁷¹ Where there is no evidence that the subsidiary is a mere façade, however, courts have held that the fact that a parent company exercises control and influence over its subsidiary does not of itself justify lifting the corporate veil.⁷²

Yet despite the fact that most holding companies will not attract liability for their subsidiary's tortious actions, and that creditors of their undercapitalised subsidiaries will remain uncompensated, CASAC's *Corporate Groups Final Report*⁷³ concluded that:

The introduction of a general tort liability for parent companies in corporate groups is undesirable, as:

this liability would undermine the separate legal entity principle and could have negative consequences for the economy

this area should be dealt with by specific legislation where the extension of liability beyond the tortfeasor company is desirable in the public interest.⁷⁴

Shareholder Liability

Any discussion of the removal of the privilege of limited liability from shareholders necessarily involves a consideration of economic theory. As noted above, the concept of limited liability for shareholders is central to the purpose of incorporation. However, as the foregoing section has shown, the holding company as a shareholder

⁶⁹ Ibid. A noteworthy example of this is *Briggs v James Hardie & Co Pty Ltd* (1989) 7 ACLC 841.

⁷⁰ Ramsay, above n 45, 542.

⁷¹ *CSR Ltd v Young* (1998) Aust Torts Reports [81-468], 64,952; *CSR Ltd v Wren* (1998) Aust Torts Reports [81-461].

⁷² *James Hardie & Co Pty Ltd v Hall* (1998) 43 NSWLR 554, 579-84. Rogers AJA in *Briggs v James Hardie & Co Pty Ltd* remarked: 'Rare indeed is the subsidiary that is allowed to run its own race.' (1989) 7 ACLC 841, 858.

⁷³ Above n 44.

⁷⁴ Ibid [4.20].

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can be stripped of the benefit of limited liability where parliament considers it to be warranted.

The question here is whether the privilege of limited liability should be withdrawn from the shareholders of small, undercapitalised companies,⁷⁵ where the temptation to use the corporate form to defeat the claims of creditors is most prevalent. The shareholders of these companies are the beneficiaries of the risky behaviour of the director if it yields the desired results, and the directors of such companies are frequently the principal shareholders. Therefore their risky behaviour is not curbed by the fear of losing their positions or the threat of actions for breach of fiduciary duty. They may undercapitalise the company so that their losses as shareholders are minimised, while financing the business by means of debt, sometimes in the form of secured loans from themselves and others.

This situation leaves creditors of these companies particularly exposed if the company becomes insolvent. Of course, if a sole trader becomes bankrupt, the same situation may occur, especially if they transfers their main assets to another person or entity for safekeeping. Nonetheless, but it is easier for a company to exist with shareholder equity of \$2 than it is for a sole trader.

Freedman⁷⁶ suggested three tests for evaluating the efficacy of limited liability and therefore the desirability of retaining it in a given situation:

First, does limited liability allocate risk to those most capable of bearing it? Secondly, does it result in optimal levels of risk taking, ensuring that ventures with a net positive value to society, but not others, are undertaken? Thirdly, does it reduce transaction and monitoring costs? In [economic analysis] literature, these measures of 'efficiency' operate within an overall framework of profit maximisation.⁷⁷

Under Freedman's first test, it is not possible to generalise that creditors are more capable than shareholders of bearing the risk of loss. For example, limited liability is not justified for shareholders where the claims being denied are those of the uncompensated and undercompensated creditors identified by this article as deserving recovery. Employees, tort claimants and small trade creditors suffering from contractual powerlessness or information asymmetry are no more capable of bearing the risk of loss than shareholders are.

⁷⁵ Reinier Kraakman, 'Corporate Liability Strategies and the Costs of Legal Controls' (1984) 93 *Yale Law Journal* 857, 873. Also Robert Clark, 'The Duties of the Corporate Debtor to Its Creditors' (1977) 90 *Harvard Law Review* 505, 547-50.

⁷⁶ Freedman, 'Limited Liability', above n 14.

⁷⁷ *Ibid* 319.

Under the second test, limited liability may encourage shareholders acting in their capacity as directors to take excessive risks which bring a net positive benefit to themselves if no adverse consequences result but not to society if the risks do eventuate.⁷⁸

Under the third test, while limited liability may reduce transaction and monitoring costs for shareholders, it increases them for creditors, who have far less power to demand information than members of the company do. Limited liability is even less justified under this test for closely held companies. Since the shareholders are likely also to hold the company's directorships, monitoring costs for shareholders are minimal. Limited liability increases those costs for creditors, particularly of small closely held companies, where information is unlikely to be publicly available.

However, if limited liability were to be removed⁷⁹ because it is considered to be unjustified in certain circumstances, such as in the case of undercompensated trade creditors and employees, it would require legislation to do so. It cannot be done by individual contract as it is only the strong creditor who will have the economic power to negotiate a reversal of the limited liability default, such as by the obtaining of personal guarantees from directors. It is beneficial for the company to make this type of arrangement with large creditors as it reduces the risk, and therefore cost, of their transaction. Large creditors are kept happy at the expense of small ones.

Most small trade creditors and employees have little or no bargaining power to insist on such terms, if they wish to continue to do business with the company. Obviously tort creditors⁸⁰ are also unable to negotiate ex ante a state of unlimited liability. In

⁷⁸ Leebron commented that 'an investment may be undertaken even though from society's point of view it is not worthwhile. In addition, the full risk of the enterprise will not be reflected in the required rate of return. The tort victim, or society at large, may be quite averse to the prospect of the catastrophic loss. The purely rational investor, however, will continue to regard the enterprise as being only moderately risky since the worst possible outcome is the loss of the investment'. David Leebron, 'Limited Liability, Tort Victims and Creditors' (1991) 91 *Columbia Law Review* 1565, 1585.

⁷⁹ The justification for the removal by the state of limited liability lies in the 'fictive entity' theory, also known as the 'concession' theory. This sees the corporation as a concession of the government, and thus subject to government regulation. 'What the state gives ... the state can take away'. David Cohen, 'Theories of the Corporation and the Limited Liability Company: How Should Courts and Legislatures Articulate rules for Piercing the Veil. Fiduciary Responsibility and Securities Regulation for the Limited Liability Company' (1998) 51 *Oklahoma Law Review* 427, 435.

⁸⁰ Macey suggested that the position of tort victims can be protected by 'common law judicial craftsmanship', that is, by lifting the corporate veil. Jonathan R Macey, 'The Limited Liability Company: Lessons for Corporate Law' (1995) 73 *Washington University Law*

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addition, such individual contracts involve costs, which the small trade creditors are least able to afford. Freedman noted:

Limited liability with partial reversal through contract does not seem to ensure allocation of risk to those most capable of bearing it. ... Nor does the risk shift onto superior risk bearers. Small creditors least able to monitor and assess risk and to contract out of limited liability may in fact pick up any remaining losses. It is mainly the sophisticated creditor with bargaining power who seems to gain.⁸¹

She concluded:

Other values must also be weighed in the balance. ... These underlying considerations, reflecting society's values, need to be exposed and discussed in order to ensure that legal policy does properly reflect moral and political criteria. ... There may come a point at which we are prepared to choose certain principles, such as fairness, over and above profit maximisation.⁸²

Therefore, contracting around limited liability does not appear to be a feasible way of ensuring creditor protection. Another way to achieve this would be to remove limited liability for all small companies. However, this presents its own difficulties. Defining companies as small is problematic.⁸³ Such entities are unlikely to grow if unlimited personal liability makes shareholders reluctant to delegate management to a board of directors because it would involve them incurring substantial monitoring costs.⁸⁴ New enterprises may struggle to attract capital for innovative, possibly worthwhile ventures.

In 1989, the *Close Corporations Act 1989* (Cth) was passed.⁸⁵ Its purpose was to reduce financial and reporting costs by simplifying the corporate law rules for small businesses. The maximum membership was ten natural persons.⁸⁶

Quarterly 433, 449. In reply to this notion, Freedman commented that lifting the corporate veil 'is both uncertain and cumbersome, and operates only in extreme cases.' Freedman, 'Limited Liability', above n 14, 350.

⁸¹ Freedman, 'Limited Liability', above n 14, 332.

⁸² *Ibid* 319-20.

⁸³ Judith Freedman, 'Small Businesses and the Corporate Form: Burden or Privilege' (1994) 57 *Modern Law Review* 555, 566-71.

⁸⁴ Easterbrook and Fischel, 'Economic Structure', above n 5, 60.

⁸⁵ It was based on the recommendations of the Companies and Securities Law Review Committee, Parliament of Australia, *Report to the Ministerial Council on Forms of Legal Organisation for Small Business Enterprises*, 1985.

⁸⁶ *Close Corporations Act 1989* (Cth) s 60.

Under this Act, the members were exempt from liability for company debts except for certain specified situations.⁸⁷ One of these was where the company unreasonably delays initiating winding up proceedings.⁸⁸ Another was where the company acquires its own shares when there were not reasonable grounds for the required declaration of solvency.⁸⁹ However, the Act was never proclaimed. Since then the Corporations Law Simplification Program Task Force has released a report entitled 'Small Business Proposal to Simplify Proprietary Companies'⁹⁰ but it did not take up the ideas of the *Close Corporations Act 1989* (Cth).

Mandatory Debt Insurance

Another possible way to protect creditors in general is by forcing companies to obtain insurance for their creditors against losses.⁹¹ While some companies might chose to insure without compulsion, there is little incentive⁹² to do so on the part of the company's owners. They would see the company's undercapitalisation and their own limited liability as a cheaper and more effective means of 'insurance' against claims.

Mandatory professional indemnity insurance has recently been adopted as a condition of allowing auditors to incorporate. The *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004* (Cth) introduced provisions into the *Corporations Act*⁹³ permitting auditors to incorporate and be registered as authorised audit companies, subject to a number of conditions. One of these is the obtaining of 'adequate and appropriate professional indemnity insurance for claims that may be made against the company in relation to the audit of companies'.⁹⁴

⁸⁷ *Close Corporations Act 1989* (Cth) s 106.

⁸⁸ *Close Corporations Act 1989* (Cth) s 110.

⁸⁹ *Close Corporations Act 1989* (Cth) s 111.

⁹⁰ Corporations Law Simplification Program Task Force, Parliament of Australia, *Small Business Proposal to Simplify Proprietary Companies*, 1994.

⁹¹ Keay, above n 5, 696.

⁹² The greater the perceived risk, the greater the premium charged by 'powerful' creditors with the ability to do so, such as banks. Insurance would reduce both the risk and therefore the cost of credit provided by these creditors. However, as noted above, not all creditors have the ability to charge such a premium, so insurance against losses by *all* creditors is an inefficient way to reduce the cost of credit provided by 'powerful' creditors. A cheaper and more efficient way is to provide security to those creditors by way of charges over company property or personal guarantees by directors.

⁹³ *Corporations Act* pt 9.2.

⁹⁴ *Corporations Act* s 1299B.

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What amounts to 'adequate and appropriate insurance' was outlined in the ASIC Policy Proposal which preceded the *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004* (Cth).⁹⁵ It was suggested that where the maximum engagement fee is less than \$50,000, the insured amount be \$500,000; where the maximum is over \$50,000, the insurance must be at least ten times the estimated maximum engagement fee, up to a maximum of \$20 million.⁹⁶

However there are a numbers of reasons why mandatory insurance against creditor losses by companies in general may be hard to implement. Setting an appropriate amount of insurance is not as easy for other types of business as it is for professional services businesses. In addition, auditors are willing to undertake adequate insurance as the price of their right to incorporate; other businesses take the right to incorporate for granted.

The cost of the insurance is also clearly significant. It will be seen in the discussion of mandatory insurance for employee entitlements below that industry objected vigorously to the cost of the proposal. The cost for general creditor insurance would be considerably higher than insurance purely for employee entitlements. This cost would have to be socialised, that is, passed on to the public by way of increased costs for goods and services.⁹⁷ As a result, some small traders could be forced out of the market.⁹⁸ If the cost of the insurance impacted upon dividends to shareholders, it could lead to a withdrawal of capital from the market, which would be highly detrimental for economic activity.

In addition, debt insurance might encourage unnecessarily risky behaviour.⁹⁹ This could result in higher claims, leading to either higher insurance premiums where the insurer was aware of the additional risk, or else exposing the insurer to losses, where

⁹⁵ ASIC Policy Proposal CLERP 9 Bill *Authorised Audit Companies: Insurance Arrangements*, June 2004. This was replaced by ASIC on 21 December, 2004 with PS 180 *Auditor Registration*. PS180.32 deals with the adequacy and quantum of professional indemnity insurance, which is a condition of registration for authorised audit companies.

⁹⁶ *Ibid* PS180.33.

⁹⁷ Many auditors would currently hold professional indemnity insurance, so the cost of their insurance is already passed on to their clients and socialised in the cost of their client's goods and services.

⁹⁸ Easterbrook and Fischel, *Economic Structure*, above n 5, 60.

⁹⁹ See further Keay, above n 5, 685. It will be noted below that insurance held by directors does not encourage risky behaviour because directors have reputational disincentives against improper behaviour leading to claims against them. Debt insurance, held by the company, does not carry such disincentives because improper behaviour by the director is not the trigger for the insurance claim to be paid.

it was unaware.¹⁰⁰ Small businesses, especially in risky areas such as new technologies, may have difficulty obtaining insurance.¹⁰¹ This could stifle innovation and entrepreneurship. Fixing the appropriate level of insurance and ensuring that it is obtained are also problematic. The issue of insurance of directors against their liability will be discussed below.

Other Methods of Protection of Creditors

A brief note should be made of other schemes to protect creditors. There have been many initiatives to improve and simplify corporate law in Australia and to make it safer for shareholders and creditors. The current CLERP program was preceded by the Corporations Law Simplification Program.¹⁰² ASIC's National Insolvency Co-ordination Unit (NICU) initiated a National Insolvent Trading Program in July 2003 to review companies suspected of trading while insolvent.¹⁰³ ASIC staff conduct surveillance visits, which can result in the appointment of voluntary administrator or liquidator.

Federal government financial assistance in the form of social security is also available for those who are unemployed or ill.¹⁰⁴ While these socialise to some extent the cost of loss of employment and injury, they do not ensure adequate compensation for those who lose their employment entitlements or suffer injury due to the insolvency or negligence of companies. In addition, they do not provide any payments whatsoever for trade creditors whose debts are not paid by insolvent companies or for tort creditors who suffer no personal injury.

¹⁰⁰ Halpern et al pointed out that information for monitoring is costly and that 'the insurance payment is typically independent of the actions of the insured'. Halpern, Trebilcock and Turnbull, above n 19, 140.

¹⁰¹ Freedman also noted that small businesses with no track record may have difficulties obtaining insurance at an affordable price. These are the businesses which are most likely to fail, yet the economy relies on the incorporation of new, small businesses. Freedman 'Limited Liability' above n 14, 340.

¹⁰² Parliament of Australia, Attorney-General's Department, *Corporations Law Simplification Program*, Simplification Task Force, 1994 – 1996.

¹⁰³ ASIC, 'Court Decision a First for ASIC's Insolvent Trading Program' (Press Release, 3 February 2004).

¹⁰⁴ *Unemployment and Sickness Benefits Act 1944* (Cth).

Protection for the Benefit of Specific Groups of Creditors

The forms of protection described above are ones which were or could be available for the benefit of creditors generally. What follows is a discussion of those types of measures which could be targeted for the benefit of creditors identified as vulnerable. They include Government initiatives and actions available to certain groups of creditors under the Act. In addition, the issue of priority distributions by the liquidator will be examined. The aim of this discussion is to evaluate the adequacy of the methods by which vulnerable creditors can be protected in the wake of a company's insolvency.

The justification for studying targeted solutions is twofold. First, as this article has maintained, certain creditor groups, in particular tort creditors, are not given sufficient compensation *ex ante* for the risk of non-payment by an insolvent company. Therefore, it is possible that the best way to protect them is to devise remedies expressly for them.¹⁰⁵ Secondly, creditor rights of recovery are not costless – they are at the expense of other parties.¹⁰⁶ Where this other party is the director of the company, the burden of potential liability may arguably have adverse economic effects on the entrepreneurial function of the director. This will be examined further in Part V. Therefore, a targeted solution may be beneficial if it ensures acceptable levels of recovery for vulnerable creditors, while minimising levels of liability on other parties.

Small Trade Creditors

It was noted above that small trade creditors may be undercompensated by the terms of their contracts with companies, and therefore are arguably deserving of recovery in the event of the company's inability to pay. However, it is difficult to categorise *ex ante* those creditors who are undercompensated, and therefore to devise rules which ensure their compensation *ex post*. This is so, even if the trade creditors are particularly disadvantaged in terms of price protection, information asymmetry and inability to diversify. To determine the extent of their disadvantage would be both a complex question and a costly one. Therefore they are treated *pari passu* as unsecured creditors and recover from the liquidator after the distribution of preferential

¹⁰⁵ Clearly, some specific remedies already exist. Employees are given special protection under *Corporations Act* pt 5.8A, outlined below.

¹⁰⁶ Lipson, above n 13, 1251. See also Rizwaan Mokal, 'Priority as Pathology: The *Pari Passu* Myth' (2001) 60 *Cambridge Law Journal* 581, 609.

payments pursuant to s 556(1) of the *Corporations Act*.¹⁰⁷ As a result, they do not enjoy any priority in winding up or other special privileges.

Employees

Employees are the most well treated of the undercompensated groups of creditors. Possibly this is because they have powerful political representation by trade unions, and because business closures and job losses are frequently newsworthy.

Few employees, with the exception of senior management, have the ability to price protect against the risk that their entitlements will not be paid, or to diversify away the risk of non-payment by holding multiple jobs. However, currently, employees enjoy a degree of priority in the distribution of the assets of a company when it is wound up. Section 556(1)(e) of the *Corporations Act* provides priority for wages and superannuation contributions of employees, with limits applicable to directors and their spouses.¹⁰⁸ Leave entitlements and retrenchment payments are covered by s 556(1)(g) and (h) of the Act respectively.

The Harmer Report noted that employee priority 'was first introduced into insolvency legislation for social welfare reasons to ease the financial hardship caused to a relatively poor and defenceless section of the community by the insolvency of their employer'¹⁰⁹ but that 'the principal rationale for the employee priority has been significantly diminished by the development of a sophisticated social welfare system.'¹¹⁰

However, it is likely that the lowest priorities relate to 'non-distribution' as there is rarely enough funds to satisfy the highest categories of priority payment, each of

¹⁰⁷ Mokal commented that *pari passu* 'is best seen as a fall-back provision. It is the rule which takes over when it would be pointless to provide any other. ... Recall that most insolvency proceedings (75% of them or more) yield nothing for general unsecured creditors. And when they do bring some returns, the yields are fairly small (about 7 pence in the pound on average). So there simply is no point in deciding how *these* claims should rank vis a vis each other. For such claims to be governed by the *pari passu* rule makes very good sense, since the cost in terms of time, effort and resources required to determine *their* appropriate (fair and efficient) rankings would far exceed any benefits'. Mokal, above n 106, 613 (emphasis in original). These statistics are from the United Kingdom.

¹⁰⁸ *Corporations Act* s 556(1A) refers to excludes employees, which is defined in s 556(2) of that Act.

¹⁰⁹ Harmer, above n 39, [721].

¹¹⁰ *Ibid* [722].

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which must be paid in full before later categories receive anything.¹¹¹ Overcompensation of employees as a result of priority in a winding up is therefore unlikely to be a problem.

Another issue, raised by the Harmer Report, is whether giving preference to employees deprives other worthy creditors.

Further, the effect of the priority is to deprive other unsecured creditors of their claim to a share of the available assets. Included in that class of unsecured creditors may be small traders who were substantially dependent upon the insolvent for their business and persons who were in an employee-like relationship with the insolvent but who are classified (in a strict legal sense) as independent contractors. These creditors may be as vulnerable as employees in the event of bankruptcy or liquidation but enjoy no protection.¹¹²

In particular, those with claims against the company for compensation for injury rank behind employees.¹¹³ This issue will be discussed further in the next section.

Another point to note is that the priority of employees in a winding up does not extend to other forms of insolvency administration. Taylor¹¹⁴ noted that

[i]n liquidation, the legislative priority is fairly exhaustive, but in controllership it is less so, and in the two remaining administrations under Part 5.3A of the *Corporations Law* [voluntary administration and deeds of company arrangement] it is or may be almost non-existent.¹¹⁵

Under Part 5.2 of the *Corporations Act*, when the company is in receivership or subject to other controllership, employees have a degree of priority under s 433(3)(c) of that Act.¹¹⁶ One of the recommendations of the recent report entitled *Corporate Insolvency Laws: A Stocktake 2004* was 'that the law be amended to make it mandatory for a deed of company arrangement to preserve the priority available to creditors in a winding up under s 556(1) unless affected creditors agree to waive their priority.'¹¹⁷

¹¹¹ Rizwaan Mokal, 'On Fairness and Efficiency' (2003) 66 *Modern Law Review* 452, 459.

¹¹² Harmer, above n 39, [722].

¹¹³ *Corporations Act* s 556(1)(f).

¹¹⁴ Terry Taylor, 'Employee Entitlements in Corporate Insolvency Administrations' (2000) 8 *Insolvency Law Journal* 32.

¹¹⁵ *Ibid* 34.

¹¹⁶ This section only applies where the receiver is appointed to act on behalf of holders of debentures that are secured by a floating charge, not a fixed charge: *Corporations Act* s 433(2).

¹¹⁷ Stocktake, above n 29, [11.20].

In 2001, the Federal Government proposed¹¹⁸ that employee entitlements be a maximum priority and that they rank ahead of secured creditors. The fact that this proposal was made appears to provide evidence that employee entitlements are not fully paid out under the current level of winding up priority, and that the joint initiatives of 2000 were not sufficient.¹¹⁹ Despite strong support from the trade union movement and others, criticisms of the proposal were expressed to the Parliamentary Joint Committee.¹²⁰ Reasons included the uncertainty the proposal would have on the cost and administration of secured lending, the complexity it would cause during administrations and the incentives for avoidance by secured creditors.

As a result of these criticisms, the Stocktake Report concluded:

The Committee recommends that the maximum priority proposal not be adopted. The emphasis in any reform proposals in relation to employee entitlements should be on preventative measures to minimise the risk of loss of employee entitlements and modifying current behaviour to ensure directors and managers of companies take greater responsibility in meeting the cost of employee entitlements in the event of business failure.¹²¹

The scope of this proposed action is unclear; nonetheless, it is plain that the Report considered that the present situation is unsatisfactory and that some action is warranted. The Report said that

[t]he committee considers that the protection of employee entitlements in the circumstances of employer insolvency is an important public policy and it is appropriate for governments to explore options for better protecting employee entitlements.¹²²

Therefore it is clear that priority in winding up is insufficient to ensure the adequate protection of employee entitlements.

A national insurance scheme to protect employee entitlements on the event of liquidation was mooted in 1999.¹²³ In a survey by insolvency firm Benfield Greig,

¹¹⁸ It was announced by the Prime Minister at a press conference on 14 September, 2001, and reiterated in the Government's November 2001 election policy statement entitled 'Choice and Reward in a Changing Workplace': Stocktake, above n 29, [10.29].

¹¹⁹ These are *Corporations Act* pt 5.8A and the Employee Entitlements Support Scheme, discussed below.

¹²⁰ Stocktake, above n 29, [10.33] – [10.51].

¹²¹ Ibid [10.55].

¹²² Ibid [10.53].

¹²³ Commonwealth of Australia, *The Protection of Employee Entitlements in the Event of Employer Insolvency*, Ministerial Discussion Paper (1999). The Harmer Report, above n 39, also

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commissioned by the New South Wales Government,¹²⁴ the authors observed that annual losses of entitlements could be up to \$464 million.¹²⁵ It was suggested that the scheme be funded from a levy on businesses calculated in accordance with their wages bill, similar to workers' compensation, except where businesses could prove that they had provided protection for employee entitlements. However, the proposal was opposed by industry groups and was abandoned in favour of the Employee Entitlements Support Scheme (EES), discussed below.

An insurance scheme funded by employers has certain advantages. The cost to the taxpayer is minimised. It also provides an incentive to business to reduce the risk of loss of employee entitlements. Many countries have adopted such a scheme.¹²⁶ However, the scheme as proposed in Australia was not without its problems. To ease the cost burden to small businesses (defined as those with less than 20 employees), they would be exempt from the proposal, with a separate government-funded safety net provided for their employees. Hammond¹²⁷ noted research by the ACTU which placed the average number of employees per company in 1998 as 8.75, meaning that a great many businesses would be exempt under the scheme.¹²⁸ In addition, the differential treatment of small and other businesses would add a further layer of administration and complexity for both businesses and employees affected by the scheme, especially for those businesses close to the employee limit. The scheme assumed that the insurance industry would have the capacity to absorb whatever losses occurred from business failures. In times of recession, this may not be realistic.

Trust funds established by specific industries funded by levies on employers are another alternative frequently contemplated when compulsory insurance is analysed. The Stocktake report concluded that:

suggested a wage earner protection fund, at [727]. See further Celia Hammond, 'Insolvent Companies and Employees: The Government's Year 2000 Solutions' (2000) 8 *Insolvency Law Journal* 86, 88.

¹²⁴ 'National Insurance Scheme to Protect Employee Entitlements: Preliminary Feasibility Study', noted in Steve O'Neill and Bronwen Shepherd, *Corporate Insolvencies and Workers' Entitlements* (2002) Parliament of Australia Parliamentary Library <<http://www.aph.gov.au/library/intguide/econ/insolvencies.htm>>, (date of retrieval) 6.

¹²⁵ More recent estimates of potential losses put the figure much higher. Institute of Actuaries of Australia, *Protection of Employee Entitlements in the Event of Employer Insolvency*, 2003, 18.

¹²⁶ Argentina, Austria, Belgium, Canada, Denmark, Finland, Greece, Germany, Ireland, Italy, Israel, Japan, Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, United Kingdom and Oregon in the USA.

¹²⁷ Hammond, above n 123, 90.

¹²⁸ As noted above n 9, nearly 99 per cent of companies in Australia are proprietary limited companies.

the proposals for the establishment of insurance schemes or trust funds are a major departure from the current system and would require a thorough examination and extensive consultation with industry before even preliminary models could be produced. The Committee believes that the proposals are worthy of further attention but suggests that much ground work would need to be done before any serious consideration could be given to the proposals.¹²⁹

The Employee Entitlements Support Scheme (EESS)¹³⁰ was introduced by the Federal Government on 8 February, 2000. It adopted the recommendations of the Ministerial Discussion Paper entitled 'The Protection of Employee Entitlements in the Event of Employer Insolvency'.¹³¹ Its purpose was to provide a safety net for employees who lose their jobs due to the insolvency of their employers. As noted above, the alternative proposal for an insurance scheme contained in that Discussion Paper was rejected.

The EESS scheme involved a 50% contribution from the states collectively, but initially support was not forthcoming.¹³² Unions also expressed considerable concern about the scheme.¹³³ It was replaced by the General Employee Entitlements Redundancy Scheme (GEERS) on 11 September, 2001, which does not rely on contributions from the states. In addition, a scheme purely for Ansett employees called the Special Employee Entitlements Support Scheme (SEES) was introduced, funded by a levy on airline tickets.¹³⁴

GEERS provides for the payment of all unpaid wages, all accrued annual leave, all accrued long service leave, all accrued pay in lieu of notice and up to 8 weeks of redundancy entitlements. The restrictive cap on total payments under the EESS¹³⁵ was removed, and a much more generous one derived from the *Workplace Relations Act 1996* (Cth)¹³⁶ put in its place.

The protection of employee entitlements by a government scheme has a number of disadvantages. Those who are not classified as employees, such as independent

¹²⁹ Stocktake, above n 29, [10.86].

¹³⁰ See further Hammond, above n 123; also, Christopher Hughes, 'Towards Pinstriped Unionism: Protecting Employee Entitlements Through Securitisation' (2000) 12 *Bond Law Review* 7.

¹³¹ Ministerial Discussion Paper, above n 123.

¹³² For a full discussion of the history of the scheme, see O'Neill and Shepherd, above n 124.

¹³³ *Ibid.*

¹³⁴ *Air Passenger Ticket Levy (Collection) Act 2001* (Cth) and the *Air Passenger Ticket Levy (Imposition) Act 2001* (Cth).

¹³⁵ \$20,000.

¹³⁶ \$75,200 for 2001-2002, \$81,500 for 2002-2003 and \$85,400 for 2003-2004.

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contractors, miss out on the scheme's benefits. It may also encourage a degree of carelessness on the part of directors, since they know that their workforce's entitlements will be protected. However, the recent Stocktake report was of the view that 'GEERS is an important aspect of the overall arrangements for the protection of employee entitlements in Australia and should continue to be a feature of those arrangements.'¹³⁷

Tort Claimants

Tort claimants are in a unique position amongst creditors in that they have no capacity to price protect or to diversify in order to spread the risk that their claims will be unpaid. Even where there is also a contract between a creditor and the company, and where the tort committed is, for example, negligent misstatement with respect to the contract, it is unlikely that the contract price will include a premium to protect against tortious, as opposed to contractual, breach. Diversification is also clearly not possible.

Tort claimants, due to their involuntary nature, are also disadvantaged in terms of information. They are unlikely to have any prior knowledge of the company's financial position or the fact that the company's insolvency may intervene to prevent full payment of their claims.

There is a limited degree of priority in a winding up for some tort creditors. Under s 556(1)(f) of the *Corporations Act*, amounts due in respect of injury compensation rank as a category of preference in a winding up. However, as noted above, the entitlements of employees rank ahead of injury compensation payments, and may not be fully compensated by liquidator distributions in a winding up. If they were, government initiatives such as GEERS and the maximum priority proposal would not have been considered. Therefore, given that the higher ranking categories of priority are to be paid in full before lower categories receive any distribution, it is unlikely that tort creditors will obtain adequate recovery as a result of this priority.

In addition, the priority only extends to injury compensation. There are many types of torts that do not involve injury, and therefore that are left with no priority for payment. This lack of priority might be considered appropriate, given that tort claims which do not concern personal injury are treated more strictly by courts,¹³⁸ than those which do. However, it should be remembered that the claims of trade creditors and

¹³⁷ Stocktake, above n 29, [10.79].

¹³⁸ For example by the 'salient features' requirement of a duty of care, as shown by *Graham Barclay Oysters Pty Ltd v Ryan* (2002) 194 ALR 337.

employees also entail economic loss rather than physical injury, and in both of those situations, there is at least some consent to deal with the company and to a greater or lesser extent, the ability to price protect or diversify. Tort claimants, whether suffering personal injuries or some form of economic loss, lack all of these. Therefore, it can be seen that the small amount of priority which tort claimants do enjoy under s 556(1) of the *Corporations Act* is clearly inadequate as well as inconsistent with the treatment of employees.

Currently there is no specific government scheme targeted at the compensation of those claiming in tort against insolvent companies. Schwarcz considered it a viable alternative to imposing liability on directors. He said:

Where contracting parties fail to internalize externalities, government can mitigate distributional inequities through taxation and transfers. For example, government could give tort claimants, the most common type of non-adjusting creditor, priority over other unsecured creditors; or it could create a fund for paying unpaid tort claims; or it could give tax breaks to unpaid tort claimants.¹³⁹

The advantages of such a scheme would be that compensation should be available more quickly and easily, without protracted and costly litigation. Complex questions of fault would also be irrelevant. However, as was noted above with respect to the GEERS scheme, a government 'safety net' may undermine the deterrence aspect of the imposition of liability on directors and also socialises the cost to those not at fault.

In addition, since there is no general no-fault tort compensation in Australia, it is arguably unfair to allow directors acting tortiously to escape the consequences of their actions simply because of their status as directors where other individuals do not. Moreover, those schemes which do exist, such as those for transport or workplace injury compensation,¹⁴⁰ generally focus on personal injury losses and ignore economic loss. Claimants under these schemes do not usually receive compensation for all their losses.

One possible way of ensuring tort claimant recovery could be by lifting the corporate veil to make shareholders liable for unpaid corporate torts. Hansmann and

¹³⁹ Steven Schwarcz, 'Collapsing Corporate Structures: Resolving the Tension Between Form and Substance' (Paper presented at the Corporate Law Teachers Association Conference, Canberra, 10 February, 2004) 17.

¹⁴⁰ See <http://www.workcover.vic.gov.au/dir090/vwa/home.nsf/pages/about> and <http://www.tac.vic.gov.au/>.

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Kraakman¹⁴¹ saw no economic justification for shareholder limited liability for corporate torts, regardless of the size of the company, and they identified a number of reasons why limited liability may cause sub-optimal decision making. Limited liability externalises the true costs of engaging in hazardous activities for companies without sufficient funds to meet judgments. Therefore it reduces the incentives for companies to take appropriate precautions and for shareholders to vote for a board prepared to pay for safety measures. Following this reasoning, it also encourages shareholders to invest in risky undercapitalised enterprises where their dividends may be large, because neither the company nor the shareholders will bear the liability if the risk eventuates. These enterprises may have a positive value for shareholders but not for society as a whole.¹⁴²

The authors, however, acknowledged that in the case of publicly traded companies, lifting the corporate veil to impose shareholder liability may undermine the free trading of the shares which is so fundamental to the market in securities. In addition, the timing of the attribution of liability is problematic for a number of reasons. If liability attaches to the shareholders at the time of the tort, this time may be difficult to ascertain if the damage accrues, as in the asbestos cases, over a long period of time. If it is attributed to those at the time of the first claim being made, there is a great incentive in mass tort cases for shareholders to sell their shares to avoid liability for further claims. The same reasoning applies to liability attaching to those who are shareholders at the time of judgment.¹⁴³

Moreover, the imposition of liability creates an incentive for shareholders to minimise their own assets, in the same way that companies may deliberately undercapitalise.¹⁴⁴ Leebron commented that '[i]n fact, there is no such thing as truly unlimited liability'.¹⁴⁵

Comparison of Methods of Creditor Protection and Compensation

The aim of this article was to explore the array of options for ensuring that creditors are compensated for their losses in the event of the insolvency of their debtor companies, without imposing liability on directors. These range from imposing

¹⁴¹ Henry Hansmann and Reinier Kraakman, 'Towards Unlimited Shareholder Liability for Corporate Torts' (1990) 100 *Yale Law Journal* 1879.

¹⁴² *Ibid* 1882-3.

¹⁴³ *Ibid* 1896-7.

¹⁴⁴ *Ibid* 1910.

¹⁴⁵ Leebron, above n 142, 1575.

personal liability on various parties such as shareholders, to socialising the cost of compensation through debt insurance and government assistance.

However, each of the options for general creditor protection examined in Part III were either insufficient for vulnerable creditors or were problematic. Mandatory insurance of debts may be excessively costly and may encourage risky behaviour. In addition, setting appropriate levels of debt insurance is difficult, and insurance may not be available to all companies. Setting mandatory levels of capitalisation is also complex. Apart from the external costs of regulating and enforcing any requirements, companies face costs in both administration and in the restrictions on their ability to raise and use finance. Again, setting appropriate levels is difficult.

Making holding companies liable for the debts of their undercapitalised subsidiaries is sometimes suggested as an alternative to overcome the problems associated with mandatory capitalisation levels. It would discourage the practice of holding companies incorporating undercapitalised subsidiaries for the purpose of engaging in excessive risk taking, and would surmount the present obstacle facing creditors of knowing which company in a complex group should be sued.

Section 588V of the *Corporations Act* is arguably a partial solution to the problem but it is too narrow for general creditor protection, as it merely targets those debts incurred while the subsidiary company was insolvent. Some would argue that the section is too wide because it lifts the corporate veil to impose liability on shareholders. In addition, the imposition of liability under the current provision may encourage the holding company to turn a blind eye to subsidiary practices and may also have a detrimental effect on recovery by holding company creditors. Nonetheless, some measure of holding company liability or liability of holding company directors may be a part of a solution to the need for creditor protection.

The imposition of liability on shareholders generally is highly contentious. The limited liability of shareholders is seen as the bedrock of incorporation and thus the economy. Lifting the veil by statute on non-corporate shareholders, even in a partial way, is unlikely to be acceptable as a way of protecting creditors. For example, removing the privilege of limited liability from shareholders of small, undercapitalised companies would possibly stifle the incorporation and growth of new enterprises, essential for economic and social progress and development. Removing limited liability with respect to certain types of action may appear to be a possible answer but is arguably unworkable. For example, the removal of limited liability for tort claims would be hard to implement due to problems associated with the identification of liable shareholders.

Solutions for the benefit of all creditors, therefore, are inadequate in ensuring recovery for deserving creditors. Likewise, the solutions targeted specifically to

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undercompensated and uncompensated creditors, outlined in Part IV of this article, were also seen to be unable to offer the protection which those vulnerable creditors require.

For example, providing priority in a winding up for undercompensated trade creditors would be troublesome. It is difficult to generalise about trade creditors in their ability to price protect against the risk of loss and to diversify their risk. Some will be particularly vulnerable to loss and others not at all, with many degrees of undercompensation in between. Since the fact and degree of their undercompensation is not uniform, to distinguish the infinite variety of situations may well consume resources which are much better distributed to creditors in general.

It is easier to make generalisations about the inability of employees and tort creditors to self-protect and therefore about their worthiness for a targeted remedy. As noted above, employees frequently lack information about the financial viability of their employer. They are unable to diversify away their risk of loss, and they may lack the contractual power to negotiate a premium to compensate for this risk. Tort claimants are the most vulnerable of all, lacking all means of ex ante self-protection.¹⁴⁶

Therefore this article maintains that tort creditors and employees are deserving of special rights to recover their entitlements, even if the claims of these plaintiffs takes funds away from other classes of creditor. The means of providing these rights, however, is not straight forward, as all the methods of recovery outlined above have some shortcomings. Giving employees and tort creditors priority in a liquidation, for example, does not guarantee sufficient funds for recovery. This is clear from the further measures to cover employee entitlements which have been implemented or suggested since the late 1990s.

For employees, a taxpayer-funded or even employer-funded compensation scheme administered by the government, such as GEERS, appears to be a simple way of ensuring that they receive the full amount of their entitlements, but the existence of the scheme has the potential to undermine the deterrence of improper behaviour of the imposition of liability on directors which Part 5.8A of the *Corporations Act*¹⁴⁷ might otherwise achieve.

¹⁴⁶ Clearly, tort victims could insure themselves against losses, particularly for those resulting from personal injuries. It would be more difficult, and possibly very costly, to insure against losses from negligent misstatements, breaches of copyright or other tortious conduct.

¹⁴⁷ Pursuant to s 596AC(1) of the *Corporations Act*, a person who has breached s596AB(1) by entering into a transaction with the intention of preventing or significantly reducing the amount of the recovery of employee entitlements is liable to pay compensation. There are

In contrast, tort claimants against insolvent companies are presently ignored by government protection schemes, possibly because tort creditors of bankrupt individuals are not protected. The New Zealand experience shows that accident compensation schemes are not always economically effective,¹⁴⁸ despite the cost savings from avoiding litigation that such schemes bring. Even if government protection of tort claimants were to be considered, it is highly unlikely that tax payer funded assistance would be provided for the payment of tort claims for economic loss unrelated to personal injury or property damage.

The reason for the absence of tort compensation recovery mechanisms under the *Corporations Act* has never been articulated. Economic theorists have consistently acknowledged that tort claimants are neglected by contractarian analysis of corporations,¹⁴⁹ so their lack of ability to be compensated by the market for the risk of non-payment comes as no surprise. Perhaps the reason for the neglect is that tort creditors are involuntary and their claims will occur regardless of the fairness of the regime that deals with them. Contract creditors, on the other hand, are optional – the more their interests are protected, the more they will be willing to engage in commercial activities to the benefit of all society.

Another possible reason for the present disregard of tort claimant's rights is that their numbers are much smaller than those of trade creditors or even employees. Unlike employees who are represented by trade unions, tort creditors have isolated and individual claims, and thus are rarely able to mobilise in sufficient numbers to force action by the government or the company for the protection of their interests.¹⁵⁰

difficulties with actions against directors under this section, one of which is the need to prove a subjective intention on the part of the director.

¹⁴⁸ New Zealand has had a no-fault accident compensation scheme since 1972. Its *Accident Compensation Act 1972* (NZ) established the Accident Compensation Corporation (ACC). The *Injury Prevention, Rehabilitation, and Compensation Act 2001* (NZ) is now the principal Act under which ACC operates. However, the scheme has been criticised as being uneconomical and subject to widespread fraud. See Stephen Todd, 'Negligence Liability for Personal Injury: A Perspective from New Zealand' (2002) 25 *University of New South Wales Law Journal* 895, 900, who noted that in 1997, the unfunded liabilities from the scheme was estimated at NZ\$8.2 billion.

¹⁴⁹ Leebron remarked: 'Tort claimants differ from contract creditors in important ways. Indeed almost every commentator has paused to note that limited liability cannot be satisfactorily justified for tort victims ("involuntary creditors") and then moved on as though there is nothing to do about this unfortunate wrinkle in the economic perfection of the law'. Leebron, above n 142, 1601 (footnote omitted).

¹⁵⁰ Exceptions to this are the class action torts, such as the James Hardie action, outlined in Part IV above. However, it is noteworthy that those tort claimants were former employees

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The shortcomings of alternative ways of protecting creditor focus attention on the director as a source of compensation for creditors. Presently, there are a number of possible actions to recover funds for the benefit of creditors available against directors. Some are enforceable only by the company's liquidator.¹⁵¹ These have the advantage of avoiding a multiplicity of actions and cost, and are therefore of benefit to plaintiffs with small claims for whom the expense and risk of litigation would be prohibitive. Some actions can be taken by creditors directly, although often liquidator consent is needed.¹⁵²

The principal advantage of imposing liability on directors is that it provides two forms of protection for creditors – it deters a director from unacceptably risky conduct which can lead to creditor losses, whilst also providing a measure of compensation for creditors if the director is not deterred. Before concluding, however, that directors' liability is a superior means of creditor protection, two important matters need to be considered. The first is the adverse effect that the possibility of actions against directors might have on appropriate risk taking and the attractiveness of directorships. The second is the availability of insurance.

What amounts to appropriate risk taking alters during the life of a company. Directors may increase the level of their risk taking when the company approaches insolvency. Yeo and Lin remarked that

[t]he argument that the debtor's self-interest will restrain unnecessary risk taking does not stand when the company is in financial distress. As the company may have no future to think about, accordingly it is less likely to be concerned about its credit rating. Self-interest may cause the company to take only a short term perspective of the gain from high-risk activity.¹⁵³

The rationale for director liability is that it ought to curb this behaviour, to the benefit of creditors' ability to recover their debts from the company. Directors will avoid decreasing the few assets left for the creditors or incurring further debts which will compete for payment.

of the defendant company and were assisted by trade unions in their claims against the company.

¹⁵¹ These include the fiduciary duty to consider creditor interests, and statutory actions under *Corporations Act* pt 9.4B, s 598(2) and s 592(3).

¹⁵² For example, s 588R and s 596AC(3) of the *Corporations Act*. An exception is a claim for damages or an injunction pursuant to s 1324 of that Act.

¹⁵³ Victor Yeo and Joyce Lin, 'Insolvent Trading – A Comparative and Economic Approach' (1999) 10 *Australian Journal of Corporate Law* 216, 230.

However, the response of economic theorists and legal commentators, outlined below, is that the effect of liability is not only to deter unduly risky behaviour, but also to discourage appropriately risky behaviour, which behaviour could benefit the company, shareholders and creditors alike. Directors may concentrate on strategies to minimise the risk of possible liability, rather than on the growth and prosperity of the company for the benefit of its shareholders. Byrne reasoned that

the more serious cost is the effect the liability regime will have on the performance of the director. Their inability to efficiently cope with the liability would logically mean further incentive to avoid the riskier ventures which raise the potential losses. It is this cost which may be seen to be of significant social consequence. It is extremely difficult to measure the size of such cost and, therefore, whether or not it will outweigh the benefits to creditors ... ¹⁵⁴

Yeo and Lin¹⁵⁵ agreed:

The economic model on optimal sanctions is this: a person engages in the wrongful conduct because the expected benefits of the wrong to him or her exceed the expected costs. The law cannot vary the level of utility of the wrongful conduct for a director but it can increase the cost to him. ... The logic of imposing personal liability on directors assumes the law has a significant impact on directors' decision making. But a logical rule does not necessarily mean an efficient rule. The important question is what the total social costs involved in imposing liability on directors are.

A significant social cost is the adverse effect potential liability may have on directors' performance. It is essential to bear in mind that ... directors are expected to make risky decisions for the benefit of shareholders of the company. The impact of potential liability ... is likely to be a function of the scope of the provisions, severity of sanctions imposed and avenues through which the directors may shift the risk from themselves to third parties.

Where the scope of the legislative provisions is very wide, the spectre of being subjected to personal liability is all the more real and unpredictable for directors. ... The standard of care required of directors tends to be objective in all the legislative provisions, which means the directors will labour under the possibility that ex post judicial review will find that what they have done or not done is insufficient. The fear of personal liability may create hedging behaviour which will yield a social loss because capital is diverted to more inefficient but less risky uses. Seen in this light, directors' liability can seriously jeopardise allocative efficiency goals.¹⁵⁶

¹⁵⁴ Byrne, above n 11, 283.

¹⁵⁵ Yeo and Lin, above n 153.

¹⁵⁶ Ibid 234.

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Oesterle commented that '[I] legislatures, to catch a few more wrongdoers, have erected bars to legitimate business judgments in recurring and significant situations'.¹⁵⁷ Much has been written about risk aversion in the context of insolvent trading and indeed, 'catching a few more wrongdoers' appears to be the deliberate intention of that law. The insolvent trading provision, s 588G of the *Corporations Act*, was tightened from 'reasonable grounds to expect'¹⁵⁸ to 'reasonable grounds to suspect'.¹⁵⁹ This was a recommendation of the Harmer Report¹⁶⁰ and was designed to encourage directors to be more rigorous in considering the company's financial affairs, and where appropriate, to initiate insolvency administration.¹⁶¹ This test is an objective one, assessed by courts with the benefit of hindsight. It should also be noted that the defences were tightened in 1992. Deterring inappropriate risk taking was therefore the intention of the law.

¹⁵⁷ Dale Oesterle, 'Corporate Directors' Personal Liability for "Insolvent Trading" in Australia, "Reckless Trading" in New Zealand and "Wrongful Trading" in England: A Recipe for Timid Directors, Hamstrung Controlling Shareholders and Skittish Lenders' in Ian Ramsay (ed), *Company Directors' Liability for Insolvent Trading* (2000) 19, 28. This statement overlooks the existence of the court's power to excuse a person from liability. The court has power under s 1318 of the *Corporations Act* to grant relief in connection with any civil proceeding for negligence, default or breach if the person has acted honestly and ought fairly to be excused. Therefore it is arguable that only directors acting improperly will suffer the consequences of their actions. Nonetheless the fact remains that directors may still fear liability – with the attendant effects of risk aversion, the need for additional compensation and the reluctance to act as directors – because they cannot be sure that their behaviour will be excused under this provision.

¹⁵⁸ *Corporations Law* s 592(1)(b).

¹⁵⁹ *Corporations Act* s 588G. In *ASIC v Plymin, Elliott and Harrison* [2003] VSC 123, [427], Mandie J adopted the opinion of Kitto J from *Queensland Bacon Pty Ltd v Rees* (1965) 115 CLR 266, 303: 'A suspicion that something exists is more than a mere idle wondering whether it exists or not; it is a positive feeling of actual apprehension or mistrust.' Mandie J said: 'Section 588G(2)(a) does not require the plaintiff to establish that the particular director had an actual suspicion that Water Wheel was insolvent, nor does it, in my opinion, require the plaintiff to prove that the director had an awareness that the specified facts and matters which were within his knowledge in fact constituted grounds, or reasonable grounds, for suspecting insolvency. Such a requirement would be no different in practice to a requirement that it be proved that the director had an actual suspicion of insolvency. What s588G(2)(a) requires is proof of a subjective awareness by the director of grounds, whether or not the director had a "subjective suspicion" of insolvency, which grounds may be objectively characterised as reasonable grounds for suspecting such insolvency.'

¹⁶⁰ The Harmer Report, above n 39, [287].

¹⁶¹ Niall Coburn, 'Insolvent Trading In Australia: The Legal Principles' in Ian Ramsay (ed), *Company Directors' Liability for Insolvent Trading* (2000) 73, 100.

Not everyone agrees with this approach. Discussing the tightening of insolvent trading liability, Dabner commented, with respect to the word 'suspect':

Its precise scope is unclear and arguably too onerous, especially when viewed in conjunction with the other extensions to the application of the defaulting officer provisions. Arguably, it shifts the balance too far towards protecting creditors by promoting a risk-averse culture in directors performing a risk taking function. Certainly directors ought to be encouraged to contemplate the expected or probable outcomes of their decisions. However, to extend liability to them for failing to appreciate or act on a concern as to a *possible* outcome is, in the context of a risk taking venture, an obtuse responsibility.¹⁶²

Oesterle pointed out:

The legal conundrums have real effects. Whenever a jurisdiction adopts an insolvent trading provision, business people, concerned about the potential breadth of the remedy and about the difficulty courts have in accurately assessing after the fact whether trading falls outside the provisions' prohibition, will take extra precautions to stay out of court.¹⁶³

In addition, the fear of liability may deter people from becoming company directors.¹⁶⁴ Oesterle remarked that

executives on boards will be more likely to resign at the first sign of trouble. Firms may find themselves looking for directors to fill vacancies and to make critical decisions just when good business people will slam the door on inquiries.¹⁶⁵

Expose (non-executive) directors to personal liability and one will see many resign from all but the healthiest of companies. Firms cannot pay them enough to compensate them for the personal risk. Sadly, outside directors are the least needed in the best running companies and are the most needed in companies that are suffering through difficult times.¹⁶⁶

¹⁶² Justin Dabner, 'Trading Whilst Insolvent – A Case for Individual Creditor Rights Against Directors' (1994) 17 *University of New South Wales Law Journal* 546, 562.

¹⁶³ Oesterle, above n 157, 34.

¹⁶⁴ Dabner, above n 162, 561; also, Oesterle, above n 157, 29.

¹⁶⁵ Oesterle, above n 157, 30.

¹⁶⁶ *Ibid* 31. The Age newspaper reported that non-executive directors 'face legal risks (they can be sued) and reputational risks (they are vilified if the company goes bust). ... And while their pay packet might appear to be nominally decent to the average worker, it seems it is not enough to attract and keep non-executive directors.' Gabrielle Costa, 'More Non-Execs Wonder if the Pay is Worth the Pain', *The Age* (Melbourne), 25 September 2004, Business 5.

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Directors who do remain with the company may demand additional compensation for the risks to which they are exposed. Byrne contended that directors

are extremely poor risk bearers. Directors, particularly when bound in service to one company, are unable to diversify their investment and spread their risk. Their personal liability may be unlimited. It would necessarily follow, in the same way that creditors seek compensation for the increased risks [due to] limited liability, that the directors would need proper compensation for their risk. Given the inability of the director to avoid the potential liability or reduce its impact as an inefficient risk bearer, the compensation would have to be quite high.¹⁶⁷

Alternatively, directors, fearing personal liability, may prematurely put a company into liquidation, even where it may be possible for the company to trade out of its difficulties.¹⁶⁸ Yeo and Lin declared:

Making insolvency a prerequisite to the imposition of obligation on directors may unduly constrain the directors' decision making. In order to avoid having personal liability, the directors may feel the pressure to cease business before the company becomes insolvent, which under some circumstances may bring about premature liquidation. ... Highlighting insolvency or the last act that pushed the company into insolvency does not help in establishing the critical link with the extent of the risk that the creditors are prepared to accept.¹⁶⁹

While the above discussion deals with the effect of the insolvent trading provisions on director behaviour, it is also necessary to look at the effect of the availability of the remedy on creditor behaviour and whether it leads to economically efficient behaviour. Oesterle maintained that 'it encourages creditor complacency'.¹⁷⁰ Byrne noted:

If we accept that predominantly creditors accept the higher risks, given that in total it is cheaper for them to bear the associated costs, then to ignore the steps they should take to protect their interest is to leave out half of the answer and to solely place the expectations on only one of the parties involved.¹⁷¹

Despite the dire warnings of these commentators, it is interesting to note that none cited any empirical research to support the contention of risk aversion. In addition, given that the law has gradually been increasing the extent of director liability, there

¹⁶⁷ Byrne, above n 11, 282. (footnotes omitted)

¹⁶⁸ Ian Ramsay, 'An Overview of the Insolvent Trading Debate' in Ian Ramsay (ed), *Company Directors' Liability for Insolvent Trading* (2000) 1, 9.

¹⁶⁹ Yeo and Lin, above n 153, 231-2.

¹⁷⁰ Oesterle, above n 157, 41.

¹⁷¹ Byrne, above n 11, 281-2.

has been no statistical evidence of a detrimental effect of that liability on economic growth or employment growth. Companies, including ones with a high probability of business failure,¹⁷² continued to be incorporated.¹⁷³ It could be argued therefore that the risk aversion effect of the tightening of, for example, the insolvent trading legislation has had a scarcely noticeable effect on society. In respect of the British provision for insolvent trading, Keay noted:

While it might be argued that from a normative perspective section 214 itself is not defensible for the same reasons that contractarians challenge the existence of a duty to creditors, it is interesting to note that there is no evidence that the advent of section 214 has caused a reduction in the amount of risk-taking that occurs in British markets.¹⁷⁴

Another issue relevant to the imposition of liability on directors is insurance and whether its availability undermines the objective of deterrence of excessively risky behaviour that liability may otherwise produce. Directors and officers' insurance against liability whilst acting as a director can be obtained by the director himself or else paid for by the company, subject to limits.¹⁷⁵ It is often suggested as a way to ameliorate the harshness of imposing liability on directors whilst still ensuring that creditors are compensated. Certainly, it may reduce the pecuniary aspects of attributing blame to a director.¹⁷⁶ Finch noted that

insurance proposes a quite different model of justice in which notions of cause and blame are replaced by the idea of a distributive sharing of a collective burden. Insurance makes directorial wrongdoing a collective or social burden to be imposed at the end of the day upon shareholders and /or consumers. If not to the retributivist's taste, it may more easily be justified in the name of efficiency.¹⁷⁷

¹⁷² For example, the 'dotcom' boom of the 1990's.

¹⁷³ As at 31 December, 2002, there were 1,232,150 companies in Australia. That figure had grown to 1,309,870 by 30 June, 2004. This shows an increase of 77,720 companies in 18 months. Emails from Debbie Cowley, Product Team, ASIC, to Helen Anderson, 9 April, 2003 and 6 December, 2004.

¹⁷⁴ Keay, above n 5, 685.

¹⁷⁵ *Corporations Act* s 199B, discussed further below.

¹⁷⁶ Finch noted that 'the risk spreading effect of insurance may dilute the punishment so that it does not fit the crime or the breach.' Vanessa Finch, 'Personal Accountability and Corporate Control: The Role of Directors and Officers' Liability Insurance' (1994) 57 *Modern Law Review* 880, 887. However, any 'crime' for which retribution seems appropriate is unlikely to be covered by insurance. This is discussed further below.

¹⁷⁷ *Ibid* 891.

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However, the payment of the actual damages claim is only one aspect of a finding of liability against a director. When directors act in breach of the law, they may be subject to prosecution.¹⁷⁸ They risk damaging their reputations and their ability to obtain other directorships. They risk increased insurance costs in the future as well as the possibility of insurance being unattainable. Many types of improper behaviour are excluded from coverage of insurance policies.¹⁷⁹ Therefore, insurance of directors is not considered to be contrary to the aim of deterrence that the imposition of liability seeks to achieve.

Insurance is a pragmatic solution to the problem of directors choosing to have no assets. It would be difficult and costly for the law to ensure that directors have sufficient personal assets to satisfy a judgment debt against them. The imposition of liability may encourage directors to shift their assets into the ownership of spouses or other entities.

Insurance also allows the cost of risk to be borne more efficiently. The cost of the insurance is likely to be borne by the company and its shareholders whether the policy is taken out by the director or the company. If directors pay for it themselves, they will pass on the cost to the company in the cost of their services.¹⁸⁰ As mentioned previously, directors are unable to diversify their risk, and so many demand substantial compensation for bearing the risk of liability while acting for the company. However, an insurer has the capacity to diversify away that risk, because it is insuring many different directors from diverse companies. Therefore, the same risk will be borne but by the insurer rather than the director. Thus the premium paid should be less than the amount of compensation demanded by the directors for bearing the same risk. In addition, the insurance payout pursuant to the policy is a certainty, if the claim

¹⁷⁸ However, in this regard the research of Tomasic and Bottomley should be noted. They found that '[t]he paradox of corporations law is that although corporations are creatures of law, the vast body of corporation law seems to have limited impact upon public company directors in general. Reliance upon the vague notion of good corporate citizenship helps to keep the law at bay, although this has little real impact upon the basic motivations of corporate executives and directors. This is not to suggest that most directors are not law abiding, but rather, that they pay relatively little attention to the formal legal rules which govern their positions'. Tomasic and Bottomley, above n 37, 83.

¹⁷⁹ This is discussed further below.

¹⁸⁰ Michael Whincop, 'Reintroducing Releases of Officer Liability into Australian Corporate Law' (2000) 26 *Monash University Law Review* 14, 28.

is within the terms of the policy, whereas the asset level of directors when sued is not.¹⁸¹

There are a number of benefits from insurance being held by the directors rather than debt insurance being held by the company. Kraakman¹⁸² made the following argument as to why directors ought to bear liability in certain circumstances¹⁸³ and be permitted, in some of these circumstances, to insure against it:

[T]he risk shifting opportunities that top managers enjoy in the form of indemnification and insurance ... can force the firm and its shareholders to internalise the expected liability costs that undercapitalisation would otherwise impose ...

From this perspective, the real defect of personal liability as a check on undercapitalisation lies in the danger that agents will *not* pressure the firm into providing adequate coverage of their personal liability risks.¹⁸⁴

... [S]enior managers and directors are ideal targets for incentives aimed at ultimately prodding the firm to cover its potential liability. Their position normally provides them with information about the need for insurance; their power assures that they can act on their knowledge of risk levels; and their personal assets and risk preferences are likely to encourage them to seek adequate insurance coverage. Even when they are not the firm's cheapest harm avoiders, they are likely to be its most reliable insurers. ... When [directors] are not principal shareholders, their demand for insurance may be even greater, since they do not receive the full return of gambling their personal assets unless they are specifically compensated for their risk bearing.¹⁸⁵

Thus the imposition of liability provides directors with a powerful inducement to either be insured against liability themselves,¹⁸⁶ or else make certain that the company is insured or properly capitalised. Kraakman maintained that director liability

¹⁸¹ It should be noted, however, that insuring directors' personal liability does not reduce the cost of litigation. The insurer takes over the handling of the claim from the director and is subrogated to his rights.

¹⁸² Kraakman, above n 75.

¹⁸³ These include asset insufficiency (undercapitalisation), sanction insufficiency and enforcement insufficiency. *Ibid* 867-8. Sanction insufficiency refers to behaviour, such as deliberate crimes, where Kraakman recommended that directors be liable and that insurance not be available, because it would undermine the law's power to deter. Enforcement insufficiency is where neither individual or corporate penalties are sufficient to achieve compliance with the law.

¹⁸⁴ *Ibid* 870.

¹⁸⁵ *Ibid* 871.

¹⁸⁶ Leebron, above n 142, 1636.

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protects against legislative over- and under-provision for tort risks, and it permits [directors] to select the optimal strategy for covering risk from among insurance [of the company], self-insurance and risk reduction through control of the firm's activities.¹⁸⁷

In addition, the protection provided by insurance may encourage non-executive directors to serve on boards. These directors can act as effective monitors and therefore as control mechanisms on the company's behaviour.¹⁸⁸ The temptation on directors to delegate tasks to lesser staff as a device to avoid the possibility of personal liability is removed or reduced when the directors have insurance.

Currently, however, the ability for the company to insure directors against liability is constrained. Section 199B of the *Corporations Act* provides:

(1) A company ... must not pay, or agree to pay, a premium for a contract insuring a person who is or has been an officer... of the company against a liability ... arising out of:

(a) conduct involving a wilful breach of duty in relation to the company; or

(b) a contravention of section 182 or 183.

This provision would therefore prevent a company insuring its directors against liability for a wilful breach of the duty to consider the interests of creditors when the company approaches insolvency, improper use of position or improper use of information. In addition, it was noted in the recent *Directors and Officers Insurance Report* by the Corporations and Markets Advisory Committee (CAMAC Report)¹⁸⁹ that in practice, insurers frequently have a host of other exclusions, whether the insurance is taken out by the company or by directors themselves. These may include prospectus liability, insider trading liability, liability for shareholder claims, dishonesty or fraud, as well as liability for insolvent trading.¹⁹⁰ It appears, therefore, that the exclusions relate to many of the types of actions where it is likely that directors would be sued by creditors.

After taking into account risk factors, insurers may also be reluctant to extend cover to certain applicants. New businesses, technology related enterprises, and speculative mining ventures may find insurance hard to obtain. Directors expressed concerns over

¹⁸⁷ Kraakman, above n 75, 874.

¹⁸⁸ Finch, above n 176, 889.

¹⁸⁹ Corporations and Markets Advisory Committee, Parliament of Australia, *Directors and Officers Insurance*, 2004.

¹⁹⁰ *Ibid* [2.3.4].

the limits on the availability and extent of insurance, in a survey cited in the CAMAC Report. The respondents to the survey pointed out that the lack of insurance for directors of companies in economically risky sectors

affected the ability of these companies to attract experienced persons willing to serve on their boards. Indeed, 41% of respondents considered that their concerns regarding insurance acted as a disincentive for them to take up directorships and engage in risky activity.¹⁹¹

Similarly, those without an established financial track record or whose company is suffering a deteriorating financial position may be unable to find insurance. Public company directors, facing a wider range of possible breaches than their private company counterparts, may be further disadvantaged.¹⁹² The cost of insurance has also increased. The CAMAC Report notes that 'premiums for D&O insurance have increased since 2001 on average between 35-50% on an annual basis. Less attractive risks ... have faced much higher increases'.¹⁹³

Therefore, while insurance is seen by some commentators as meeting the compensation needs of creditors in an economically efficient way, the unavailability of insurance for some directors means that it cannot be relied on for every type of director liability. For example, it is likely that insurance would not cover errant directors found liable to trade creditors with respect to uncommercial transactions, civil penalty breaches, insolvent trading or breaches of fiduciary duty. Therefore such insurance that is available is unlikely to have any adverse impact on the deterrence effect of imposing liability on directors where they behave improperly.

Conclusion

Frequently, it is assumed that if a company is unable to pay its debts, the loss should either lie where it falls or else directors should be liable for it. After all, directors control the company and if the loss to creditors is a result of some wrongdoing on their part, liability serves as a means of both compensation and retribution. The fear of personal liability also acts as a powerful deterrent to improper behaviour.

However, there is a perception that imposing liability on directors will lead to excessive risk aversion, to the detriment of the company's profitability, as well as legal compliance burdens. Experienced business people may refuse directorships, except

¹⁹¹ Ibid [4.2.1].

¹⁹² Ibid [2.4].

¹⁹³ Ibid [2.5].

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for the safest of companies who are arguably least in need of their expertise. For these reasons, it is worth considering alternatives to director liability.

However, it was noted above that both current and proposed alternative means of creditor protection suffer from deficiencies. Mandating capital requirements may result in burdensome rules about the composition and use of capital which unduly restricts companies in their business activities and would involve costly administrative requirements. Legislation already exists to impose liability on holding companies for the debts of their undercapitalised subsidiaries, but this only occurs where there has been acts of insolvent trading by the subsidiary's board and does not necessarily protect the creditors most in need of the law's protection, namely the subsidiary's tort claimants. Other forms of shareholder liability have the potential to undermine the concept of limited liability which is fundamental to incorporation and the market for capital.

Certain groups of creditors were identified as particularly vulnerable in the event of a company's inability to pay its debts. These were the small trade creditors, employees and tort creditors of the company. Various means of protecting them exist, such as some priority in a winding up and GEERS. However, while employees are comparatively well protected, small trade creditors and in particular, tort creditors are not.

This brings the discussion back to the imposition of liability on directors as a means of providing compensation for such creditors. The main disadvantage of actions against directors is the cost of the litigation and the possible detrimental effects that the imposition of liability will have on directors' primary role as risk takers. Risk taking¹⁹⁴ is seen in economic analysis as the key factor in the maximisation of shareholder wealth and its flow on effects for the economy.¹⁹⁵

¹⁹⁴ Len Sealy, 'Directors' "Wider" Responsibilities – Problems Conceptual, Practical and Procedural' (1987) 13 *Monash University Law Review* 164, 181 said that '[a]ny reformulation of directors' duties to take account of the interests of creditors and others has to accommodate the concept of risk, and allow for the fact that directors must be free to take risks and to judge what risks their business should take. We must not lose sight of the fact that it is the principal function of the limited liability company, and of company law, to facilitate this risk-taking'.

¹⁹⁵ The Cooney Committee noted that '[t]he more productive the corporate sector, the more secure the economic well-being of Australia. Directors are crucial to its success. To restrict unnecessarily the operation of their skills, their industry, their enterprise, is to threaten unnecessarily a factor vital to economic growth. Any regulation of directors' activities must be warranted and a sensible balance must be found between measures necessary to promote corporate activity in a way which will be of benefit to all, and measures necessary to protect the bona fide shareholder, worker, consumer, financier, and the public at large.

Yet the risk aversion argument lacks empirical support. In addition, imposing liability on directors only where they are at fault as defined by legislation has the benefit of making apparent what amounts to excessive risk taking. This provides certainty to directors, reduces 'testing' litigation where liability boundaries are not clearly defined and ensures that they are only subject to liability where their own improper conduct has caused the creditors' losses. The notion of retribution appears lost where directors have the ability to be insured against claims, but in reality insurance may not be available for claims involving blameworthy behaviour. It is for the benefit of all present and future creditors, as well as shareholders, of companies if actions against directors for improper conduct deters the behaviour which may cause their losses. This makes director liability superior to other forms of compensation.

Profitability is but one basis for good corporate citizenship'. Senate Standing Committee on Legal and Constitutional Affairs, Parliament of Australia, *Company Directors' Duties: Report on the Social and Fiduciary Duties and Obligations of Company Directors* (1989) [2.39].