LIABILITY FOR CORPORATE WRONGS

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I INTRODUCTION

One of the major attractions of the corporate form is limited liability, which permits those who invest in an incorporated business to limit potential losses. Limited liability allows for 'risk sharing' between the owners of the company and the outside parties with whom the company interacts. If the company fails, the effect of the doctrine is that losses are partly externalised – they fall upon external creditors. Although this is generally seen as acceptable in the ordinary course of commerce, where incorporated businesses benefit from reciprocal risk transfers, it proves to be far less palatable where the costs of business failure fall upon tort claimants. Tort claimants are unlikely to have opportunities to deal with the company that injures them. They require special protection by the law. However, the problem facing tort claimants has been the preference of the law to uphold limited liability at the expense of both ordinary tort doctrines and the principle of full compensation for wrongs.

Recent scholarship has sought to re-examine current rules of risk-sharing between the owners of incorporated businesses and outside parties, including the rule of shareholder limited liability. There are a number of aspects to this. Thus, scholars have noted the changed role of shareholders within the corporation. Contrary to the Berle and Means hypothesis, shareholders can no longer always be assumed to be passive investors. Indeed, they might prove pivotal in business decision-making. This has led to a number of proposals to base shareholder liability on the exercise of shareholder control over the company that injures. Scholars have noted, further, the injustice that accompanies the judgment-proofing of companies when this means denying full compensation to tort claimants injured by corporate wrongdoing.

This paper attempts to draw together certain strands of these debates. It argues that it is appropriate to make all shareholders personally liable, pro-rata, for personal injuries inflicted by companies in which they hold shares. This conclusion is reached on a number of bases that do not include reliance upon the control that shareholders have over the companies in which they invest. It is argued that reliance upon a notion of control is unnecessary in the decision to impose liability on shareholders for personal injuries. Liability can be justified, instead, on the grounds that shareholders are company insiders who perform a distinct function – in arming companies with capital – and that the claims of personal injury claimants are of a higher order than any financial losses to be borne by shareholders. Personal injury

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claimants have the right to identify shareholders with their companies. And they have the better claim in a comparative contest over responsibility for loss.

The paper proceeds as follows. First, it examines the nature of the limited liability doctrine and the justifications offered for it. Second, the paper discusses a consequence of the doctrine, which is the practice of corporate group parents arranging relations between companies so as to judgment-proof the major assets of the group. This is illustrated by reference to the recent James Hardie group re-structure. The problems to which this practice gives rise for tort claimants are then explained. Third, the paper surveys the legislative and common law protections that currently exist for tort claimants. Brief reference is also made to a recent report by CAMAC on *Long-tail liabilities*. It is concluded that the law offers insufficient protection for tort claimants seeking redress from companies for the personal injuries that they have caused. Fourth, the paper offers a re-examination of the justifications for the limited liability doctrine. It is suggested that the doctrine is not as crucial as might be assumed for the operation of the business world. Fifth, the paper moves on to examine proposals that have been proffered by a number of writers for reform to the limited liability doctrine. From the remains of these proposals a new proposal for modified limited liability is constructed and defended. The paper concludes with an assessment of the likely operation of a rule of modified limited liability.

II LIMITED LIABILITY DOCTRINE

In Australia, the limited liability doctrine is enshrined in the Corporations Act 2001 (Cth) section 516, which provides that 'if the company is a company limited by shares, a member need not contribute more than the amount (if any) unpaid on the shares in respect of which the member is liable as a present or past member'.[1] Beyond this residual liability, shareholders are protected – a court cannot reach into their personal assets and satisfy the debts of the company from those assets. This has been described as 'defensive asset partitioning'[2] and it is said to be 'the primary business advantage' of the corporate form.[3]

Limited liability is said to be justifiable on a wider basis than concern for the personal assets of investors. These justifications point to the more fundamental

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1 See also Paul Davies, *Introduction to Company Law* (2002) 12.

2 Reiner Kraakman and ors, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (2004) 9; Henry Hansmann and Reiner Kraakman, 'The Essential Role of Organizational Law' (2000) 110 *Yale Law Journal* 387, 395-6. A recent article looks at the other side of the 'partition', focussing upon the ways in which corporate law structures the sharing of corporate assets amongst co-owners: John Armour and Michael Whincop, 'The Proprietary Foundations of Corporate Law' (2007) 27 *Oxford Journal of Legal Studies* 429. The corporate structure allows for 'sequential sharing between shareholders and creditors, and delegation from shareholders to managers' as well as 'joint sharing between shareholders of … residual returns': ibid 441. They assert that 'the law has a distinct function to play by giving effect to the sharing agreements not as simple contracts but as the contours of shared ownership': ibid 442.

3 AA Berle Jr, 'The Theory of Enterprise Entity' (1947) 47 *Columbia Law Review* 343, 343. Another way of putting matters is to say that, in order to obtain the benefits of limited liability it is necessary for a business to incorporate: Larry E Ribstein, 'Limited Liability and Theories of the Corporation' (1991) 50 *Maryland Law Review* 80, 89-1.

economic significance of limited liability as an inducement to capital-raising.[4] Thus, limited liability is said to facilitate the separation of ownership and control by reducing the need for shareholders to monitor the performance of the company.[5] It negates the need for shareholders to monitor each other because the personal liability of each shareholder does not vary with the wealth of other shareholders.[6] This, in turn, ensures that shares are homogenous commodities and allows for their easy transfer.[7] Limited liability is also said to shift some of the costs of monitoring the company from shareholders to credit providers. Creditors 'are more likely than they otherwise would be to scrutinize closely – both before and after extending credit – the likely fortunes of the firm and the behaviour of the firm's managers'.[8] Each of the advantages so far mentioned permits shareholders to exist as passive owners of the company.[9] Limited liability also permits shareholders to diversify their holdings of shares because the risk of liability does not increase with holdings in a larger number of companies.[10] Diversification reduces the risks of investing in any particular company, leaving the shareholder vulnerable primarily to swings in the overall economic cycle.[11]

These assumptions about the fundamental economic significance of limited liability have not been the subject of rigorous empirical testing and are open to attempts to refute them.[12] As will be explained below, their validity has been questioned. But clearly, limited liability has been seen as a key element in the growth of the industrial economy.[13] For this reason, courts have been reluctant to appear to undermine it.[14]

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4 See, in general, Frank Easterbrook and Daniel Fischel, 'Limited Liability and the Corporation' (1985) 52 *University of Chicago Law Review* 89. Four of the arguments ordinarily highlighted in the literature will be discussed in this paper.

5 Ibid 94-5.

6 Ibid 95.

7 This and related points are well explained in Timo Kaisanlahti, 'Extended Liability of Shareholders?' (2006) 6 *Journal of Corporate Legal Studies* 139, 143.

8 Hansmann and Kraakman, above n 2, 425. Note that shareholders might be perfectly content with this because the alternative is that they also would have to monitor the wealth of individual shareholders under a regime of personal liability: Stephen M Bainbridge, 'Abolishing Veil Piercing' (2001) 26 *Journal of Corporate Law* 479, 492-3. But the counter-argument is that limited liability reduces the potential targets for redress from X number of shareholders to one corporate shareholder.

9 Ribstein, above n 3, 102.

10 Easterbrook and Fischel, above n 4, 95; Harry M Markowitz, 'Portfolio Selection' (1952) 7 *Journal of Finance* 77.

11 Kaisanlahti, above n 7 147.

12 Henry Hansmann and Reiner Kraakman, 'Toward Unlimited Shareholder Liability for Corporate Torts' (1991) 100 *Yale Law Journal* 1879, 1880; Phillip I Blumberg, 'Limited Liability and Corporate Groups' (1986) 11 *Journal of Corporate Law* 573, 611.

13 LCB Gower, Paul Davies, *Gower's Principles of Company Law* (4th ed, 1979) 49; Richard Posner, *Economic Analysis of Law* (4th ed, 1990) 393-98; Paul Halpern, Michael Trebilcock and Stuart Turnbull, 'An Economic Analysis of Limited Liability in Corporation Law' (1980) 30 *University of Toronto Law Journal* 117, 117-20; Stephen Presser, 'Thwarting the Killing of the Corporation: Limited Liability, Democracy, and Economics' (1992) 87 *Northwestern University Law Review* 148, 155-6.

14 William Douglas and Carroll Shanks, 'Insulation from Liability Through Subsidiary Corporations' (1929) 39 *Yale Law Journal* 193, 193 the authors noting that limited liability is 'ingrained in our economic and legal systems'. Reluctance to impinge upon the doctrine has puzzled some corporate lawyers. Thus, it has been observed that '[a] major object of the law of torts is to shift the financial burden of the loss from the victim

III STRUCTURING COMPANY RELATIONS

The doctrine of limited liability facilitates the structuring of relations within groups of companies so as to protect the group's main assets. This practice has become a feature of the Australian corporate landscape. The James Hardie case provides a recent and controversial illustration.

Two James Hardie subsidiaries were involved in the manufacture of asbestos-based products.[15] Although they stopped manufacturing these in 1987, asbestos-related injuries have a 'long-tail' and develop over decades.[16] For this reason, the companies' estimated liabilities grew dramatically during the late 1990s. The retention of its asbestos 'legacy' came to be seen as a threat to the commercial viability of the James Hardie group.[17]

James Hardie's response was to re-structure the group with the intention of minimising the impact upon its assets of liability for asbestos-related harms. This was done by divesting the subsidiaries of their operational activities and setting up the Medical Research and Compensation Fund, which was a company limited by guarantee that held the shares in the 'legacy' companies. The MRCF was severed from the group. Agreements were entered into with the former parent company James Hardie Industries Ltd to ensure that it was not the subject of asbestos-related suits.[18] The fund was nearing exhaustion when the New South Wales Government stepped in to negotiate its renewal. Were it not for government intervention, it is possible that thousands of tort claimants would have gone without compensation.[19]

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to the person whose activity caused the damage. There is no reason why a company … should not be held liable to pay compensation for harm flowing from civil wrongs in the course of its activities if a natural person in similar circumstances would have been liable': RP Austin and IM Ramsay, *Ford's Principles of Corporations Law* (12th ed, 2005) 807.

15 This summary is derived from David Jackson QC, *Report of the Special Commission of Inquiry into the Medical Research and Compensation Fund* (2004) hereinafter referred to as the *Jackson Report*. For a broader background to the events, see Gideon Haigh, *Asbestos House* (2006).

16 Asbestos products have caused numerous cases of mesothelioma, asbestosis, lung cancer and pleural diseases: Jackson, above n 15, Annexure 'J'.

17 Another purported aim of the restructure was to reduce the withholding tax liability on dividends paid from the United States to Australia. However, this aim was undermined by a subsequent amendment to Australian tax laws: *Jackson Report* [2.46] and [25.25].

18 This company was later severed from the group, again by the setting up of a foundation which acquired its shares. For a summary of events, see Edwina Dunn, 'James Hardie: No Soul to be Dammed and No Body to Be Kicked' (2005) 27 *Sydney Law Review* 339.

19 Agreement on a compensation plan was achieved after six years of concerted effort by unions, victims' groups and the New South Wales Government: 'James Hardie compensation battle finally over', *The Age* (Melbourne)(online edition), 8 February 2007. See also James Hardie Industries NV and New South Wales Government, *Amended and Restated Final Funding Agreement* (21 November 2006) <http://www.ir.jameshardie. com.au/jh/asbestos_compensation.jsp> (at 22 July 2008). The agreement excludes claims for property damage and economic loss: ibid 91-2; and the State of NSW is not to alter by legislation the common law applicable to the determination of dust disease compensation cases: ibid 114. Actions were commenced by ASIC against former directors of James Hardie: *ASIC v Macdonald*, Second Further Amended Statement of Claim (19 November 2007), available at: <http://www.asic.gov.au/asic/asic.nsf/ byheadline/James+Hardie> (at 10 December 2008). Judgment was delivered in *ASIC v Macdonald* [2009] NSWSC 287 (23 April 2009, Gzell J).

The structuring of relations in this way is unlikely to occur between companies dealing with each other at arm's length. In arm's length transactions between entities, 'each company will seek independent gain… [N]o company will give up value without demanding equivalent value in return'.[20] But large business enterprises are typified by the group structure, based upon parent-subsidiary relationships. A Co holds the important assets while B Co and C Co, without substantial assets, undertake the risky activities that lead to injury.[21] The relationship between the companies is 'symbiotic' and the gains are allocated as the parent desires.[22] According to LoPucki, the parent incorporates multiple sub-entities *in order to defeat* liability[23] – a practice known in pejorative terms as 'judgment-proofing'.[24] Although it is undoubtedly commercially sound to structure relations so as to protect group assets, the problem to which it gives rise is especially evident in cases like James Hardie – involving the externalisation of the costs of corporate activity upon outside parties such as tort victims.[25]

According to *Adams v Cape Industries plc*,[26] the structuring of relations within corporate groups is lawful, given the separate personality of individual companies and the limited liability of shareholders. Group companies are to be treated as separate entities with their own legal obligations. It is impermissible for a court to 'lift the corporate veil as against a defendant company which is the member of a corporate group merely because the corporate structure has been used so as to ensure that the legal liability (if any) in respect of particular future activities of the group … will fall on another member of the group rather than the defendant company'.[27]

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20 Steven Schwarcz, 'The Inherent Irrationality of Judgment Proofing' (1999) 52 *Stanford Law Review* 1, 3. Some of the specific adverse effects that may impact upon the company purchasing assets and leasing them back to the originator are dealt with ibid 23-4. See also James White, 'Corporate Judgment Proofing: A Response to Lynn LoPucki's *The Death of Liability*' (1998) 107 *Yale Law Journal* 1363, 1394.

21 LoPucki, ibid 28. For another Australian example where asset ownership and employment were separated, relating to stevedoring operations see: D Noakes, 'Dogs on the wharves: Corporate groups and the Waterfront dispute' (1999) 11 *Australian Journal of Corporate Law* 1.

22 L LoPucki, 'The Essential Structure of Judgment Proofing' (1998) 51 Stan LR 147, 149. Another way of describing this is to say that 'because the firm determines its own size, it also chooses the limits of its legal responsibilities': Hugh Collins, 'Ascription of Legal Responsibility to Groups in Complex Patterns of Economic Integration' (1990) 53 *Modern Law Review* 731, 737. See also, David Skeel Jr, 'Corporate Anatomy Lessons' (2004) 113 *Yale Law Journal* 1519, 1564-9; Michael Gillooly, 'Outside Shareholders in Corporate Groups' in Michael Gillooly (ed), *The Law Relating to Corporate Groups* (1993) ch 7.

23 LoPucki, above n 20, 21.

24 For a general overview of the means by which companies might seek to escape from, or ameliorate the size of, successful tort claims, see Mark Roe, 'Corporate Strategic Reaction to Mass Tort' (1986) *Virginia Law Review* 1. This paper focuses upon a particular set of responses, to be explained below, called 'judgment-proofing'.

25 This is also the effect in cases of companies that are under-capitalised – a feature of asbestos-related activity in Australia: Peta Spender, 'Blue Asbestos and Golden Eggs: Evaluating Bankruptcy and Class Actions as Just Response to Mass Tort Liability' (2003) 25 *Sydney Law Review* 223, 234. It is also the effect where activities are under-insured. Much of the asbestos liability in the James Hardie case was not the subject of insurance – hence the attempt to divest the group of responsibility: *Jackson Report* [15.95]. Moreover, businesses often choose a 'strategy' of under-insuring: Hansmann and Kraakman, above n 12, 1889.

26 [1990] Ch 433.

27 [1990] Ch 433, 544 (Slade, Mustill and Ralph Gibson LJJ).

Of course, the significant point about the James Hardie re-structure was that it took place *after* the scale of the asbestos liability began to be realised.[28] This is one of the main reasons for which the case attracted special attention from the New South Wales Government (and the union movement).

IV THE POSITION OF TORT VICTIMS

Limited liability and judgment-proofing impact differently upon contract and tort creditors. In theory, at least, contract creditors deal voluntarily with companies to which they extend credit.[29] They are able to examine the credit-worthiness of customers, take security on goods sold[30] and obtain guarantees.[31] Experience tells us that contract creditors with bargaining power often do insist upon the taking of guarantees – personal guarantees from directors and others.[32]

Tort claimants might include insiders such as employees or outsiders such as independent contractors, consumers and other third parties (including innocent bystanders injured when a product fails). For reasons of exposition, the focus of this paper is upon the position of outsiders making personal injury claims against the company. However, many of the principles developed will be equally applicable to innocent employees making personal injury claims against the company.[33]

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28 This was the subject of comment by the New South Wales Attorney-General: Chris Merritt and Fiona Buffini, 'States Push for Tougher Liability Laws', *Australian Financial Review* (30 July 2004) 1 and 8.

29 Brian Cheffins, *Company Law: Theory, Structure, and Operation* (1997) 501. Theory does not always correspond to reality: Helen Anderson, 'Creditors' Rights of Recovery: Economic Theory, Corporate Jurisprudence and the Role of Fairness' (2006) 30 *Melbourne University Law Review* 1, 8-9; Michael Whincop, 'Overcoming Corporate Law: Instrumentalism, Pragmatism and the Separate Legal Entity Concept' (1997) 15 *Company and Securities Law Journal* 411, 430. Indeed, there are arguments that involuntary creditors include 'many trade creditors, consumers, and workers': Blumberg, above n 12, 576.

30 For a summary of actions that a creditor might take involving secured finance, see Davies, above n 1, 70-1. For some of the problems that arise, see Vanessa Finch, 'Security, Insolvency and Risk: Who Pays the Price?' (1999) 62 *Modern Law Review* 633 (discussing, e.g., the problems faced by unsecured, non-adjusting creditors).

31 These are not the only strategies that can be taken. See ibid 634-5 (sale arrangements that serve as de facto means of taking security), and 642 (imposition of contractual restrictions upon corporate activity).

32 Kraakman and ors, above n 2, 99; Davies, above n 1, 69; Andrews Rogers, 'Reforming the Law Relating to Limited Liability' (1993) 3 *Australian Journal of Corporate Law* 136, 138; Halpern, Trebilcock and Turnbull, above n 13, 135. Where groups are concerned, 'it is common for creditors to require security on a group basis': Companies and Securities Advisory Committee, *Corporate Groups Final Report* (2000) 17. This means the entering into of cross-guarantees between group members: ibid 47.

33 With respect to the potential vulnerability of employees, see Blumberg, above n 12, 619. Note, however, that employee claims are unlikely to be as compelling as the claims of true outsiders. As has been noted about employees, 'doing their job': 'To do one's job is to be responsive to norms and directives internal to an organization; it is to accept the relevance of the collective, institutional norms to one's actions…': Christopher Kutz, *Complicity – Ethics and Law for a Collective Age* (2000) 162. He concludes that 'the claims of victims to compensation has lexical priority over the claims of organizational members to fairness': ibid 201.

Employees might be classed as 'involuntary creditors'[34] where they do not have the opportunity to bargain with the company for which they work.[35]

Tort claimants are recognised as a vulnerable group.[36] Their vulnerability is exacerbated by judgment-proofing within groups.[37] On account of this practice, LoPucki has opined that the tort liability system has begun to fail.[38] Deserving claimants are not being compensated as they should be. This is seen as both an inevitable and an accelerating process – accelerating because those enterprises that fail to judgment-proof themselves will be at a competitive disadvantage.[39] This ability to externalise costs reduces companies' incentives to take care in the conduct of their activities. More persons are injured than would otherwise be the case. It is thus clear that significant legal protection of tort claimants is required against the company – and, so it will be argued, its owners.

V LEGISLATIVE PROTECTIONS

To determine the accuracy of LoPucki's claim about the alleged failure of the law to provide for tort claimants, it is necessary to turn to the various ways in which it attempts to protect them. The next sections of this paper discuss legislative and common law protections and consider recent CAMAC proposals to strengthen the position of those making 'long-tail' claims in tort law.

Corporate laws around the world protect creditors against the dissipation of company funds in a number of fundamental ways. These include rules about paying dividends only out of the profits of the company[40] and prioritising repayments to creditors on a winding up of the company.[41] In Australia, the Commonwealth has taken a number of further specific steps to alleviate some of the problems of judgment-proofing.[42] These steps include the passage of various provisions in the Corporations Act 2001, which shall be surveyed briefly.

The Corporations Act 2001 (Cth) Chapter 2J deals with transactions affecting share capital. These provisions reinforce the priorities rule by restricting the circumstances in which the assets of the company can be diminished by transfers *to shareholders*. Creditors 'should not be expected to rank behind shareholders with respect to payments voluntarily made by the company'.[43] Such transactions will not be permissible where they prejudice the interests of the company's current

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34 Closely related are the 'reluctant' creditors – government agencies and tax authorities: Finch, above n 30, 655.

35 See observations in *Briggs v James Hardie & Co Pty Ltd* (1989) 7 ACLC 841, 863-4 (Rogers AJA).

36 See, e.g., Hon. A Rogers, 'Reforming the Law relating to Limited Liability' (Speech to the Business Section of the Law Council of Australia, October 1992)(copy on file with the author).

37 LoPucki, above n 20, 20-3.

38 Ibid 4.

39 Ibid 4. This claim has been disputed: James White, above n 20.

40 Corporations Act 2001 (Cth), s 254T.

41 Corporations Act 2001 (Cth), s 556.

42 Argument persists that amendments to the law have been ad hoc in nature, without consideration of fundamental principle and that they leave us no wiser as to the 'legitimate ends of incorporation': John Farrer, *Corporate Governance: Theories, Principles and Practice* (2nd ed, 2005) 27 and 35.

43 Elizabeth Boros and John Duns, *Corporate Law* (2007) 315.

creditors.[44] Taking the reduction of capital as an example,[45] section 256B(1) requires that such transactions be fair and reasonable to the company's shareholders as a whole, that they not materially prejudice the company's ability to pay its creditors and that they be approved by the shareholders. Breach of the provision leaves those involved exposed to the civil penalty regime under which compensation orders can be made.[46] Significantly, there is no need for the company, when determining whether or not to reduce capital, to consider the interests of possible future creditors of the company, such as victims of long-tail liabilities.

The Corporations Act 2001 (Cth) Chapter 2E deals with related party transactions. The provisions were a specific response to the shifting of assets and siphoning of funds that characterised a number of corporate collapses in the 1980s.[47] According to Austin and Ramsay, 'some corporate controllers had abused their positions of trust by arranging for the shifting of assets around and away from companies and corporate groups, and into their own hands… [T]his was achieved by various means, including remuneration payments, asset transfers and loan arrangements'.[48] The aim of Chapter 2E is 'to protect the interests of a public company's members as a whole, by requiring member approval for giving financial benefits to related parties that could endanger those interests'.[49] The provisions apply to such transactions as intra-group loans and guarantees and contracts with director-controlled entities. Although they do not purport to protect the interests of external creditors, the provisions may have this effect. Contravention of the provisions leaves those involved exposed to the civil penalty regime under which compensation orders can be made.[50] There is the potential for contraventions to result in breaches of directors' duties,[51] in which case compensation may again be payable by those directors to the company.[52] It is apparent that the protections offered in Chapter 2E might not be particularly helpful to external creditors – least of all to victims of mass torts. This is because the members of the company have an opportunity to approve any transfer of assets to related parties by the mechanism provided in sections 217 to 227.

The Corporations Act 2001 (Cth) Part 5.7B Division 2 deals with uncommercial transactions and unfair preferences. Focussing upon the former, the provisions have been enacted on the basis that 'once a company becomes insolvent it is no longer free to make transactions that prejudice its creditors'.[53] 'Uncommercial transactions' are defined as those in to which the reasonable company would not reasonably have

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[44] For doubts about the efficacy of this test, see, Noakes, above n 21, 15.

[45] The legislation also deals with share buy-backs, companies acquiring interests in their own shares and offering financial assistance for the acquisition of shares in the company.

[46] Corporations Act 2001 (Cth), ss 256D(3), 1317E and 1317H. Such an order will augment the assets of the company and permit of payment of creditors.

[47] Austin and Ramsay, above n 14, 497. One of the key exemptions from liability for such transactions is that they occur 'on arm's length terms': Corporations Act 2001 (Cth), s 210. However, Austin and Ramsay are of the opinion that 'most intra-group loans and guarantees cannot be regarded as on arm's length terms': *Ford's* ibid 503.

[48] Austin and Ramsay, above n 14, 497.

[49] Corporations Act 2001 (Cth), s 207.

[50] Corporations Act 2001 (Cth), ss 209(2), 1317E and 1317H.

[51] Corporations Act 2001 (Cth), s 230.

[52] See, Boros and Duns, above n 43, 231.

[53] Austin and Ramsay, above n 14, 1417.

been expected to enter.[54] This matter is determined according to various criteria including 'the detriment to the company of entering into the transaction'.[55] The division takes hold where the transaction was an 'insolvent transaction'[56] and when either it or an effectuating act occurred within the 'relation back period'.[57] The liquidator of the company can seek relief if the other party to the transaction cannot demonstrate good faith and lack of reasonable grounds for suspicion of insolvency.[58] Courts have the ability to make a wide range of orders, including the re-transfer of property or compensation. However, creditors of the company have no direct rights of action against the responsible directors of the company.[59]

Finally, the Corporations Act 2001 (Cth) Part 5.7B Divisions 3 and 5 deal with trading while insolvent. These provisions were enacted on the basis of concern about 'holding companies walking away from insolvent subsidiaries leaving creditors of the subsidiaries unpaid'.[60] Holding companies 'astutely … deflected liability by using established principles of law to the frustration of creditors'.[61] The provisions permit a statutory form of piercing the corporate veil.[62] The pivotal provision, for the purposes of this paper, is s 588V, which makes a holding company liable for the debts of a subsidiary[63] in circumstances where 'there are reasonable grounds for suspecting that the [subsidiary] company is insolvent' or would become insolvent by incurring further debt and that the holding company or one of its directors should have been aware of those grounds for suspicion.[64] The liquidator of the subsidiary company is empowered to bring proceedings for recovery of the losses of the subsidiary and unsecured creditors.[65] The principal provision in Part 5.7B is accompanied by s 588G, which imposes a duty upon directors to prevent insolvent trading by their companies. A parent or other company within a group might be treated as a director for these purposes where the board of the subsidiary is accustomed to acting on the directions of that other company[66]Section 588G creates rights to bring proceedings for compensation against directors for losses caused to the company and to unsecured creditors.[67] Where the requirements of s 588V are fulfilled, the legislation provides a welcome avenue of redress. However, the provision has a limited ambit. It does not offer protection against company funds

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54 Corporations Act 2001 (Cth), s 588FB(1).

55 Corporations Act 2001 (Cth), s 588FB(1)(b).

56 Corporations Act 2001 (Cth), s 588FC.

57 Corporations Act 2001 (Cth), s 588FE.

58 Corporations Act 2001 (Cth), s 588FG(2).

59 Corporations Act 2001 (Cth), s 588M(3). See Helen Anderson, *Corporate Directors' Liability to Creditors* (2006) 161.

60 Ian Ramsay and David Noakes, 'Piercing the Corporate Veil in Australia' (2001) 19 *Company and Securities Law Journal* 250, 259.

61 Niall Coburn, *Coburn's Insolvent Trading: Global Investment Fraud and Corporate Investigations* (2nd ed, 2003) 125.

62 Anderson, above n 59, 143; ibid 35.

63 See Corporations Act 2001 (Cth), s 46 for a definition of 'subsidiary'.

64 Insolvency arises where a person is not solvent. 'A person is solvent if, and only if, the person is able to pay all the person's debts, as and when they become due and payable': Corporations Act 2001 (Cth), s 95A. See also s 588E(3).

65 Corporations Act 2001 (Cth) s 588W(1).

66 Corporations Act 2001 (Cth), s 9. See *Standard Chartered Bank of Australia v Antico* (1995) 38 NSWLR 290, 328 (Hodgson J determining that a court will look for a 'willingness and ability to exercise control and an actuality of control over the management and financial affairs' of the subsidiary).

67 Corporations Act 2001 (Cth) ss 588J and 588K. Compensation is payable, in the first instance, to the company.

being run down without breaching the definition of insolvency.[68] Section 588G has a similar limitation. Taken alone, these provisions would likely prove inadequate to ensure compensation in the case of mass tort exposures. Counsel Assisting the James Hardie Inquiry was of the view that they create a very narrow form of liability. 'Moreover, they depend on the resolution of factual issues that are costly and risky to litigate'.[69]

In conclusion, the provisions of the Corporations Act 2001 (Cth) surveyed in this section of the paper reduce the opportunities for companies to siphon off assets or to otherwise misallocate them. However, they will not always be effective to prevent misallocations – especially where managers are amenable to risk-taking. This is to say that managers may be prepared to flout the provisions, in the hope that their transgressions are not discovered. The provisions will have little impact, moreover, where a company declines for legitimate business reasons – leaving creditors high and dry. This is an especial risk in cases of companies whose products give rise to long tail liabilities.

VI CAMAC REFORM RECOMMENDATIONS

Some of the issues to which reference has been made are the subject of a recent CAMAC *Report* on *Long-tail liabilities: the treatment of unascertained future personal injury claims*.[70] The *Report* examines a proposal by the former Federal Government that would require companies to make various provisions for 'unascertained future personal injury claimants' or 'UFCs'. These are persons who are anticipated to have a future claim but do not yet have one because, for example, their injuries have not yet become manifest. [71] CAMAC recommended that the position of UFCs should be guarded by a range of specific protections where companies are engaged in transactions that affect their share capital. It would require amendment to the Corporations Act 2001 (Cth) share capital, buy-back and financial assistance provisions 'to add a requirement that a proposed transaction not materially prejudice the interests of UFCs'.[72]

CAMAC also recommended the implementation of a special procedure to deal with claims by UFCs against solvent companies which anticipate being unable to meet all claims in full. The procedure would involve a court-sanctioned plan setting up a trust fund. Newly-issued voting shares with dividend rights and other company assets would be transferred to the trust to satisfy the claims of UFCs. Under the procedure, damages would be payable to UFCs at a uniform rate. The rights of UFCs to claim for damages would be confined to trust funds.[73] Such a procedure would give the company an opportunity to avoid being forced into liquidation by long-tail liabilities.[74] CAMAC also recommended, in the case of companies in the process of being wound up, that 'asset distributions to creditors known at the time of external administration [sh]ould take place as normal except a proportion of the assets

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68 Coburn, above n 61, 8.

69 Jackson, above n 15, Annexure 'T', 417.

70 Corporations and Markets Advisory Committee, *Long-tail liabilities: The treatment of unascertained future personal injury claims: Report* (May, 2008), hereinafter referred to as the *CAMAC Report*.

71 Ibid 5-6.

72 Ibid 46.

73 Ibid 90 or 91.

74 Ibid 53.

[sh]ould be set aside for future creditors'.[75] These assets would, again, be paid into a trust fund administered for the benefit of UFCs; the claims of UFCs would cease to be claims in the liquidation and the company would be extinguished.[76] Finally, CAMAC recommended that the Corporations Act 2001 (Cth), s 263A be amended so as to 'prohibit payment of debts to shareholders if UFCs are only to get a proportional return under the terms of the trust'.[77]

Although these recommendations would assist in compensating tort claimants, they would not prevent all such claimants from slipping through the cracks. There would always be cases in which injuries are not reasonably foreseeable until risky activity is well in progress.[78] There would be other cases in which the provision made for UFCs would turn out to be inadequate. Thus, the CAMAC *Report* recommendations do not provide the whole answer to the problem of long-tail liabilities.

The answer would not be found in more private insurance either. Recent events in insurance markets prove that gaps can arise in the availability of cover.[79] Insurance companies are especially unlikely to insure activities that are risky and which give rise to the potential for very large claims[80] – even if made only many years into the future. Where insurance is offered, this will be for a limited sum.[81] Companies exposed to large asbestos claims, such as Johns-Manville and Dow Corning, were under-insured.[82] Finally, a requirement that companies insure risks would be very difficult to police.[83] In the words of LoPucki, the overall picture that emerges is that '[l]iability insurance is a valuable adjunct to the working of an otherwise sound liability system, but it can neither save nor replace an unsound one'.[84]

For these reasons, it is necessary to go further and to determine the extent to which tort claimants should have redress against the parent company and natural person shareholders. While the focus of the CAMAC *Report* was on ex ante provision, the focus of this paper is upon ex post determinations of where liability should arise.

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75 Ibid 82.

76 Ibid 90.

77 Ibid 94. See also Corporations and Markets Advisory Committee, *Shareholder Claims Against Insolvent Companies: Implications of the Sons of Gwalia Decision* Discussion Paper (September 2007).

78 See, e.g., *Cambridge Water Co v Eastern Counties Leather* [1994] 2 AC 264. By contrast, it seems quite clear that the proposals would apply in cases of product defects, mining-related injuries, cancer and environmental pollution: Patrick Durkin, 'Provisioning far ahead', *The Australian Financial Review*, 31 August 2007 (citing the Chief Executive of the Insolvency Practitioners Association of Australia, Mike Lotzof).

79 See Panel of Eminent Persons, *Review of the Law of Negligence: Final Report* (2002) 31; Peter Cane, 'Reforming Tort Law in Australia: A Personal Perspective' (2003) 27 *Melbourne University Law Review* 649, esp. 658ff. See also K Arrow, *Essays in the Theory of Risk-Bearing* (1971) 140.

80 Finch, above n 30, 654 (describing the moral hazard problems as 'severe'); Halpern, Trebilcock and Turnbull, above n 13, 138.

81 Scott Harrington and Patricia Danzon, 'The Economics of Liability Insurance' in G Dionne (ed), *Handbook of Insurance* (2000) 287-8; Finch, ibid 654-5.

82 LoPucki, above n 20, 46.

83 Judith Freedman, 'Limited Liability: Large Company Theory and Small Firms' (2000) 63 *Modern Law Review* 317, 341.

84 LoPucki, above n 20, 72. '[T]he insurance market does not offer non-limited cover when that is not imposed [upon it] by law': Kaisanlahti, above n 7, 153. Even where cover is offered, the premiums would be so high as to be infeasible: ibid 154.

VII Veil Piercing Doctrine

Outside the scope of the legislative provisions, the courts have been reluctant to act in cases of judgment-proofing.[85] Although courts have the ability to look behind corporate structures where abuse is taking place,[86] 'piercing the corporate veil', this seldom occurs.[87] Courts are loath to disregard the legal separation of companies in favour of viewing them as parts of a greater enterprise.[88] They retain a very rigid view of the separate personality doctrine and are prepared to pierce the veil only in cases that are characterised by dominance over the company *and* fraud or some other kind of 'sharp practice' in its management.[89] Studies have indicated, moreover, that courts are more hesitant to pierce the veil in tort cases than in contract cases.[90] And that they are more hesitant to impose liability upon corporate parents than upon natural person shareholders.[91] This means that veil-piercing is unlikely to be relevant to the case of a large company responsible for mass torts.[92]

Even in those cases where they might be sympathetic to veil-piercing, Australian courts have struggled to articulate well-defined grounds for doing so – resulting in an unsatisfactory decisional history. Rogers AJA admitted in *Briggs v James Hardie & Co Pty Ltd* that 'there is no common, unifying principle, which underlies the

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85 See S Watson, 'Who Hides Behind the Corporate Veil? Finding a Way out of "The Legal Quagmire"' (2002) 20 *Company and Securities Law Journal* 198, 200-1.

86 The general purpose of veil-piercing is to enable the courts to consider the reality of the relationship between various parties and to allow for the imposition of legal obligations on those who should be made responsible for the commission of wrongs in circumstances where the corporate form has been misused: R Thompson, 'Piercing the Veil Within Corporate Groups: Corporate Shareholders as Mere Investors' (1999) 13 *Conneticut Journal of Internation Law* 379, 380.

87 Kraakman, above n 2, 93-4; LoPucki, above n 22, 153.

88 The attitude of the courts has been determined in large part by a brief consideration of the issue in *Walker v Wimborne* (1976) 137 CLR 1, 6-7 (Mason J). See, e.g., *James Hardie & Co Pty Ltd v Putt* [1998] 43 NSWLR 554, 584 (Sheller JA, Beazley and Stein JJA agreeing). Statutory and other exceptions to this approach will be examined below. One development (that is not examined in this paper) is the passage of the Corporations Act 2001, s 187. This provision has been described as introducing 'enterprise' principles into Australian company law: J Cilliers, 'Directors' duties in corporate groups – Does the green light for the enterprise approach signal the end of the road for *Walker v Wimborne*?' (2001) 13 *Australian Journal of Corporate Law* 109.

89 See the classic statement in *Dennis Willcox Pty Ltd v Federal Commissioner of Taxation* (1988) 79 ALR 267, 274 (Jenkinson J). It should be noted that one factor impeding the development of this doctrine is that many of the parties seeking to invoke it are those who were involved in setting up the corporate structures that they subsequently wished to ignore. This has been described in the cases as attempting to 'have one's cake and eat it too': see, e.g., Transcript of Proceedings, *O'Brien v Boral Roof Tiles Ltd*, (High Court of Australia, Dawson J, 14 August 1995). Reluctant to investigate these matters too deeply, the courts have been content to invoke the need for certainty in the development of the law: e.g., *Hadoplane Pty Ltd v Edward Rushton Pty Ltd* [1996] 1 Qd R 156, 164-5 (Thomas J).

90 Ramsay and Noakes, above n 60, 264; Thompson, above n 86, 384. The explanation of this may be that claims are litigated in contract cases only when there is some certainty that a remedy will be in the offing: Bainbridge, above n 8, 505.

91 Kraakman, above n 2, 94. See also Ramsay and Noakes, ibid, 263; Thompson, above n 86, 389.

92 Bainbridge, above n 8, 523 (noting that piercing is more likely to occur in the case of a single-car taxi company owner than in the case of Union Carbide).

occasional decision of courts to pierce the corporate veil'.[93] His Honour has further observed that '[p]arties in dispute do not know until the final judicial determination whether or not, in any given circumstance, the corporate veil will be set aside'.[94]

Thus, one might agree with LoPucki that the law has yet to respond adequately to the challenges of judgment-proofing. Cases like James Hardie reveal that it has 'failed to develop principles of group responsibility applicable to integrated economic organisations which lack a single identity because they comprise different capital units'.[95] The goals of tort law are being subverted by the operation of corporate law doctrines.[96] This is despite the fact that the kinds of problem arising in the James Hardie case can only be expected to increase over time with global movements of natural resources, goods and components, mass production and distribution, and ever-increasing reliance upon artificial materials, chemicals and other substances.

VIII Re-examining the Limited Liability Doctrine

Blumberg is of the opinion that there is no conceptual reason to equate the corporate form with limited liability.[97] The wider literature reveals that the assumptions about the need for limited liability have been questioned. Each of the assumptions will now be examined in turn.

The first assumption relates to the separation of ownership and control. This argument is weak with respect to corporate parents, which have a financial incentive to monitor their subsidiaries.[98] Studies have indicated that parent companies often exercise a great degree of control over their subsidiaries' strategies and activities.[99] The argument is also a weak one with respect to companies at the other end of the spectrum – small closely-held firms in which the shareholders are the day-to-day managers.[100] Where shareholders are removed from day-to-day corporate activities,

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93 (1989) 16 NSWLR 549, 567.

94 Rogers, above n 36, 10 (on file with the author). For these reasons, argument has been made in the US that the doctrine should be abolished: Bainbridge, above n 8.

95 Collins, above n 22, 732. This failure of company law to respond is reflected, e.g., in the pre-James Hardie publication Companies and Securities Advisory Committee, above n 32. The Advisory Committee decided not to recommend any changes to the law with respect to either tort liability within corporate groups or the priority of intra-group claims in the insolvency of a group company. However, it was recommended that courts be permitted to make pooling orders to 'enable courts to more closely monitor how particular corporate groups have conducted their affairs': ibid 145. Note that Collins outlines some of the ad hoc responses of the law – such as the imposition of non-delegable duties between companies and 'independent' contractors: (1990) 53 *Modern Law Review* 731, 734-6. See also David Parker, 'Piercing the veil of incorporation: company law for a modern era' (2006) 19 *Australian Journal of Corporate Law* 35, 49.

96 Paul Spender, 'Weapons of Mass Dispassion: James Hardie and Corporate Law' (2005) 14 *Griffith Law Review* 280, 285-6. See also, Roe, above n 24, 40-2; Robert Thompson, 'Unpacking Limited Liability: Direct and Vicarious Liability of Corporate Participants for Torts of the Enterprise' (1994) 47 *Vanderbilt Law Review* 1, 1.

97 Blumberg, above n 12, 604.

98 Ian Ramsay, 'Allocating Liability in Corporate Groups: An Australian Perspective' (1999) 13 *Conneticut Journal of International Law* 329, 343.

99 See, Jose Antunes, *The Liability of Corporate Groups* (1994) 67-8. See also comment in *Briggs v James Hardie & Co Pty Ltd* (1989) 16 NSWLR 549, 572 (Rogers AJA commenting that '[r]are indeed is the subsidiary that is allowed to run its own race').

100 Freedman, above n 83, 331.

a modified rule of limited liability would not necessarily compel them to more actively monitor companies in which they invest. This is because a number of stakeholders already monitor management performance – including regulators, credit-rating agencies, institutions and creditors.[101]

The second assumption relates to shareholders monitoring each other. Shareholders might have an incentive to monitor each other under a rule of joint unlimited liability. However, this is not what is proposed in this paper.[102] This paper argues in favour of pro-rata unlimited liability in cases of death and personal injury. Liability under such a rule does not depend upon the level of each shareholder's wealth.

The third assumption relates to the shifting of costs of monitoring. This paper argues in favour of a modified rule of limited liability and an alteration in the Corporations Act 2001 (Cth) with regard to priority of payment on a winding up. Tort claimants will be better compensated for the personal injuries that they suffer if they are given priority over both secured creditors and (assuming that they are different persons) employees of the company.[103] This is justified by the fact that employees often can be seen as company 'insiders', while contract creditors have only financial interests at stake.[104] If the Act were amended in the way suggested, one might expect contract creditors to monitor company behaviour more prodigiously.[105] Costs would be reflected in the contracts that are entered into with the company. [106] To the extent that it makes a difference, this would assist in reducing the amount of injury-producing activity that occurs.[107]

The fourth assumption relates to the need for investors to diversify their holdings of securities. This argument has been seen as the most crucial for risk-averse investors. The problem with unlimited liability is that it would seem to increase the risks of personal bankruptcy for those investing in more than one company.[108] However, the argument is less important with respect to parent companies than to

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[101] Richard Booth, 'Limited Liability and the Efficient Allocation of Resources' (1994) 89 *Northwestern University Law Review* 140, 147; Presser, above n 13, 159. It should be noted that only large and sophisticated creditors, such as banks, are likely to be willing and effective monitors of companies to which they extend credit: Freedman, ibid 330.

[102] Even if monitoring became necessary, some commentators deride its importance in the context of tort claims: Booth, ibid 147. Note, also, that the efficacy of credit rating agencies has been questioned in recent times: Securities Industry and Financial Markets Association, *Recommendations of the Securities Industry and Financial Markets Association Credit Rating Agency Taskforce* (July, 2008), <http://www.sifma.org/capital_markets/docs/SIFMA-CRA-Recommendations.pdf> at 21 December 2008; International Organisation of Securities Commissions, *The Role of Credit Rating Agencies in Structured Finance Markets: Final Report* (May, 2008), <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD270.pdf> at 21 December 2008. The Australian Government has announced plans for the regulation of credit rating agencies in order to restore confidence to securities markets: D Crowe, 'PM toughens rules for ratings agencies', *The Australian Financial Review*, 14 November 2008, 1.

[103] As to the latter, see Corporations Act 2001, s 556 (governing order of payment amongst unsecured creditors).

[104] Cf Halpern, Trebilcock and Turnbull, above n 13, 139 and 141 (discussing the information likely to be available to employees about the company and its obligations).

[105] Ramsay, above n 98, 374.

[106] David Leebron, 'Limited Liability, Tort Victims, and Creditors' (1991) 91 *Columbia Law Review* 1565, 1601-2.

[107] Note, however, that doubts exist about this kind of proposal: Finch, above n 30, 654.

[108] Leebron, above n 106, 1597.

natural person shareholders because the former are likely to be risk-neutral rather than risk-averse.[109] But more crucially, it is important to recognise that a modified rule of limited liability will only partly reduce the opportunities to diversify risks. Most shareholders will be able to limit their investments in companies engaged in injury-producing activities (at least where the risks are foreseeable) and focus on alternative investments. In fact, shareholders will maintain the ability to invest across a broad range of asset classes, including debt instruments, real estate, commodities and cash.[110] Such diversification reduces the chance of losses from particular investments in risky companies and also reduces the chance of losses stemming from downturns in the economic cycle.[111]

The exception to these propositions concerns shareholders in smaller companies, who are more likely to invest all of their time and a large proportion of their wealth in their business ventures.[112] These shareholders may be unable to diversify their risks, until such time as their businesses begin to prosper and provide significant financial returns.[113] Even then, their ability to diversify will remain restricted by the call of their businesses upon their human capital.[114] But the significance to them of the distinction between modified limited liability and limited liability vanishes almost completely when it is acknowledged that these are just the sorts of shareholders who are likely to be required to extend personal guarantees over the debts of their companies.[115]

Argument has been made in the literature for unlimited liability in the case of small, closely-held companies.[116] The proposal in this paper does not extend that far. The exposure of shareholders in small companies (as with shareholders in all other companies) to company-specific risks will arise only in cases of personal injury – not in the more prevalent cases of financial loss. The arguments that exist in favour of limited liability are strongest with respect to contract debts and financial losses. In such cases, limited liability permits of risk-sharing and is relatively uncontroversial.[117]

IX RE-EXAMINING THE ROLE OF THE SHAREHOLDER

The assumptions upon which the rule of limited liability has been enacted are even more tenuous than the arguments already made would indicate. Referring back to the argument about the way in which limited liability facilitates the separation of ownership and control, it should be recognised that shareholders cannot simply be assumed to either want to be, or to be, passive investors in the company. Recent scholarship has observed the increasingly activist nature of shareholders and the growing number of conflicts to which they are exposed. This has led to a number of proposals to reform the law governing shareholders.

[109] Hansmann and Kraakman, above n 12.
[110] Leebron, above n 106, 1596. See also Hansmann and Kraakman, above n 12, 1904.
[111] This is not to say that diversification across asset classes eliminates system-wide risks: see Ribstein, above n 3, 103.
[112] Freedman, above n 83, 332; ibid 103-6.
[113] Note that an argument has been made that limited liability should not, in any case, be granted to shareholders of small companies: Freedman, ibid.
[114] This point applies even under a limited liability regime: Freedman, above n 83, 332.
[115] Ibid 332.
[116] Halpern, Trebilcock and Turnbull, above n 13, 148.
[117] This is not to say that there is no controversy at all: see, e.g., John Farrar, *Corporate Governance: Theories, Principles, and Practice* (2nd ed, Melbourne, 2006) 26.

In a major contribution to the debate, Anabtawi and Stout have declared that:

> The American corporate landscape has changed substantially since Berle and Means' time.[118] Changes in markets, business practice and business institutions, and in corporate and securities law, have seriously eroded the realism of the standard assumptions that shareholders are passive and powerless'.[119]

The authors argue that shareholders have become more powerful. This is seen in the rise of institutional investors, such as mutual funds and superannuation funds.[120] Although these investors' holdings in particular companies may be only a small proportion of their total investments, the institutions' collective force is potentially great because they can co-ordinate action through shareholder advisory services, such as RiskMetrics (formerly ISS).[121] In more recent times, these institutions have been joined by activist hedge funds. The hedge funds are less likely to have diversified holdings, more likely to target particular companies and also more likely to demand accommodations to their demands.[122]

Shareholders have been provided with greater incentives to become active through financial innovation. Financial innovation permits of opportunities for 'investors who purchase one type of security to push for corporate actions that harm the value of another type of security issued by the same company'.[123] It also has 'lowered the cost of activist strategies by allowing the separation of voting rights and economic interests. Thus, a hedge fund can buy a block of [shares] and vote the shares while simultaneously entering a derivatives contract that hedges away its economic interests in' them.[124]

The authors point out that shareholder conflicts may arise not only through obvious means such as the award of contracts and advisory agreements, but also through the taking of '"adverse positions" in derivatives or in securities issued by other companies'.[125] The authors note that '[t]he underlying disease is shareholder opportunism'.[126] They seek new responses to the changed position of the

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[118] The reference here is to Adolf Berle and Gardiner Means, *The Modern Corporation and Private Property* (1932) esp. 7, 66, 78 and 82 (a seminal work which observed the growing trend in US corporations to be too large for detailed oversight by individual investors, power thus moving to boards of directors).

[119] Iman Anabtawi and Lynn Stout, 'Fiduciary Duties for Activist Shareholders' (2008) 60 *Stanford Law Review* 1255, 1275. What has been said about the US corporate scene applies mutatis mutandis to the Australian scene.

[120] Ibid 1275-6.

[121] Ibid 1277.

[122] Ibid 1279.

[123] Ibid 1280.

[124] Ibid 1280. It has been observed: 'The theoretical possibility of decoupling votes from economic ownership is not new. What is new is investor ability to do so on a large scale, declining transaction costs due to financial innovation, and a trillion-dollar-plus pool of sophisticated, lightly regulated, hedge funds, free from conflicts of interest and concerns with adverse publicity that may deter other institutional investors from using decoupling strategies': Henry Hu and Bernard Black, 'The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership' (2006) 79 *Southern California Law Review* 811, 819. The latter authors survey the means of decoupling at pp 823-49. See also the more recent piece Henry Hu and Bernard Black, 'Equity and Debt Decoupling II: Importance and Extensions' (2008) 156 *University of Pennsylvania Law Review* 625 and Takeovers Panel, *Equity derivatives* (Discussion paper, Sept 2007).

[125] Anabtawi and Stout, above n 119, 1286.

[126] Ibid 1294.

shareholder. They would have the courts recognise a duty of loyalty owed by the shareholder in any situation where they seek 'to promote a corporate strategy or transaction in which that particular shareholder has a material, personal pecuniary interest'.[127]

While the particular problems that Anabtawi and Stout speak of are not of direct concern to this paper, the basic facts which give rise to them are nevertheless of considerable interest. In Australia, it is clear that an increasing proportion of shares in major companies are now beneficially owned by, not individuals but, institutional investors.[128] These shares are not, however, registered in the names of the institutions – often they are registered in the names of custodians. Moreover, the institutions may not actually vote their shares – but may leave policy-making and voting in the hands of advisers such as RiskMetrics.[129] This means that it is *increasingly incoherent* to insist upon control as a criterion for shareholder liability.

X Limited Liability and Corporate Groups

It is now pertinent to examine the proposals that appear in the literature in favour of a rule of unlimited liability. In the case of groups, the issue is whether or not the parent should be made liable for the wrongs of subsidiary companies. Reasons for proceeding against the parent include the greater array of assets from which judgments might be satisfied. In cases of multinational companies, there might be procedural benefits in suing the parent company when located within certain jurisdictions, including access to class actions.[130]

The commentators are largely agreed that limited liability is out of place in corporate groups and that parent companies should be liable for the debts of their subsidiaries. A justification often given for increased shareholder responsibility is the exercise of control by the shareholder.[131] Although control is a significant element in the determination of corporate liability, the argument will be made that this is not a necessary element.[132] Good reasons exist for making even passive shareholders liable for the personal injuries that their companies inflict. The arguments of the major proponents of change are now surveyed.

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[127] Ibid 1295-6.

[128] See Parliamentary Joint Committee on Corporations and Financial Services, *Better shareholders – Better company: Shareholder engagement and participation in Australia* (Commonwealth of Australia, 2007) 6.

[129] Ibid ch 3-4.

[130] Sarah Joseph, *Corporations and Transnational Human Rights Litigation* (2004) 129.

[131] See, Kraakman, above n 2, 92; Davies, above n 1, 61. Davies writes: 'With regard to a passive shareholder, … there is little reason to be worried about such a person's exemption from responsibility for the company's liabilities, at least while we are prepared to accept that lenders of money to the company are not responsible for the company's liabilities': ibid 61.

[132] Indeed, control is said not to be a sufficient element in the piercing the veil cases: *Heytesbury Holdings Pty Ltd v City of Subiaco* (1998) 19 WAR 440, 451 (Steytler J); Ramsay and Noakes, above n 60, 258. Cf S Watson, above n 85, 208ff (asserting the importance of control as a factor on the basis that courts are more likely to pierce the *smaller the number of shareholders*).

A *Jose Antunes*[133]

In his survey of corporate groups in Europe and the United States, Antunes finds that parent companies undoubtedly exercise control over their subsidiaries through inter-locking directorships. This is on the basis of parental desire optimally to allocate resources within the group.[134] Control over subsidiaries is exercised not simply ad hoc, but on a structured basis.[135] It is most likely to be exercised with respect to key personnel and finance decisions.[136] Antunes argues that with power must come responsibility. '[T]he parent corporation should be liable for those [subsidiary] liabilities stemming from management decisions which had been taken under its control'.[137] Parents should be able to take advantage of the limited liability rule only in those cases where they have abstained from interfering with subsidiary companies. 'It would then be up to the parent corporation itself to prevent its own exposure to a liability burden by taking careful consideration of the degree and the way in which it exerts control over the various group affiliates'.[138]

B *Counsel Assisting the James Hardie Inquiry*

Counsel Assisting the James Hardie Inquiry, John Sheahan SC, offered a slightly different regime of corporate parent liability. Liability would be based on the parental right to control, but he would amend the limited liability rule with respect to death and personal injury only. This is on the basis that limiting the liability of the parent company results in ineffective deterrence of harm-causing behaviour.[139] Moreover, there is an ethical dimension to the compensation issue – whether a business should be able to profit from harm-producing activity without bearing the full costs of that activity.[140] Counsel Assisting opined that: 'Ultimately, economic objections may be outweighed by the combination of ethical and efficiency concerns raised by the prospect of permitting companies to transfer the cost of wrongful death and injury from the company to the injured themselves – and indirectly to the taxpayer – by utilisation of an interposed entity'.[141] Under this proposal, limited liability would be retained only by the natural person shareholders of the parent company.[142] Unfortunately, Counsel Assisting did not address an important question

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133 Antunes, above n 99.

134 Ibid 67-8. See also: Companies and Securities Advisory Committee, above n 32, 22-3; T Hadden, 'The Regulation of Corporate Groups in Australia' (1992) 15 UNSWLJ 61, 64-5; G Teubner, 'Unitas Multiplex: Corporate Governance in Group Enterprises' in D Sugarman and G Teubner (eds), *Regulating Corporate Groups in Europe* (Nomos, 1990), 83; Blumberg, above n 12, 620. This finding should come as no surprise. It has long been acknowledged that a corporate group is 'an enterprise bounded by economics' rather than by 'a charter, minute books, and books of account': AA Berle Jr, above n 3, 345. However, as will be appreciated from the argument so far, the courts have treated the distinction between legal and economic treatment as 'fundamental': *Bank of Tokyo Ltd v Karoon* (Note) [1987] AC 45, 64 (Robert Goff LJ).

135 Antunes, above n 99*,* 152.

136 Ibid 178-9.

137 Ibid 132.

138 Ibid 389. See also AA Berle Jr, above n 3, 357 (noting the availability of a choice to the parent company).

139 *Jackson Report*, Annexure 'T', 417.

140 *Jackson Report*, Annexure 'T', 418.

141 *Jackson Report*, Annexure 'T', 423.

142 *Jackson Report*, Annexure 'T', 424.

– the point in time when liability should attach to a parent company. It is possible for liability to attach on three different bases: claims made, date of awareness of claims arising and the date of company dissolution.[143] However, this issue is addressed by proponents of the next proposal to be considered.

XI Limited Liability and Natural Person Shareholders

Parent company responsibility for the personal injuries caused by the torts of their subsidiaries would create an important source of compensation. In most cases, this would be enough to satisfy the claims of tort claimants. However, the odd case will arise in which this will not be true. And so the question arises whether the law should go further in modifying the rule of shareholder limited liability. There are good arguments for dealing with all shareholders in the same way – in order to avoid differential pricing and distortion. A number of proposals call for a re-consideration of the doctrine with respect to *natural person shareholders*.[144] These shall now be considered.

A *Henry Hansmann and Reinier Kraakman*[145]

In a well-known paper, Hansmann and Kraakman express a desire to give effect to the primacy of tort law doctrines over those of company law. They argue in favour of pro-rata unlimited liability for the torts of the company to be attached at the time of knowledge that claims will be made. The reason for extended shareholder liability for the torts of the company is to ensure that 'share prices reflect tort costs'.[146] Lower share prices mean greater pressures on managers. Such pressures will induce managers to properly consider risks and communicate fully about projects in which they believe the company should invest.[147] Overall, the result should be the undertaking of a lower level of risky activity than presently occurs.

Hansmann and Kraakman argue in favour of pro-rata rather than joint liability because the latter could potentially result in a single shareholder assuming the liabilities of an entire corporation – depending on the financial status of the other shareholders. Theory suggests that it would then become imperative for shareholders to monitor each other – and for decisions to invest to be made on the basis of shareholder wealth. The potential also arises for shares to be valued differently according to the wealth of each owner.

Hansmann and Kraakman argue also for liability to attach on the basis of knowledge of pending claims in order to avoid a number of problems with the alternatives, including obvious attempts to evade responsibility. 'This information based rule would fix liability before shareholders could evade responsibility for tort damages, without creating the uncertainties and complexities that would attend an occurrence rule'.[148] They would retain limited liability for contractual debts.

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[143] Hansmann and Kraakman, above n 12.

[144] According to one commentator, in 'traditional piercing cases the judicial focus has not been on passive shareholders, but rather on active investors': Thompson, above n 96, 29.

[145] Hansmann and Kraakman, above n 12.

[146] Ibid 1903.

[147] Ibid 1907.

[148] Ibid 1897.

Hansmann and Kraakman acknowledge that their proposal would operate in ways which might seem harsh – in particular when passive shareholders are held liable for vast losses. They argue that this harshness could be alleviated by the exercise of court discretion in the award of damages.[149] However, this paper argues against such an approach on the basis that it is not for judges to play fast and loose with the full compensation principle;[150] any attempt to do so would undermine the idea that tort law is to prevail over company law doctrines. It is submitted that the better approach is to limit the exposure of shareholders by restricting claims to those for death and personal injury.

Hansmann and Kraakman's proposal has been the subject of intense scrutiny in the literature and substantial criticism. A first criticism is that the rule that they propose would be easy to evade – by way of off-shore purchases of shares, rendering judgments against shareholders unenforceable.[151] But this strategy would entail other, off-setting risks – most notably the problem of adverse movements in exchange rates and the risk of foreign transaction losses. It would also create certain problems which have been discussed, including difficulties for shareholders trying to monitor management and in enforcing any claims that the shareholder might have against the company. A second criticism is that a pro-rata rule would bring with it extremely high enforcement costs.[152] Indeed, this is a problem for the United States litigation system, where all parties carry their own costs regardless of the outcome of actions.[153] Such a rule does not apply in Australia, which adopts instead a rule that 'costs follow the event'.[154]

A third criticism is that a rule of unlimited liability might lead to the dis-aggregation of enterprises and co-ordination of activities by way of 'independent contracts'. This is different (so it seems) from mere judgment-proofing because it means not only isolating risky corporate activities, but splitting up groups and larger companies within groups. Larger companies would be divided up and run as smaller companies linked by contracts. This is on the rationale that smaller companies are more likely to present challenges of enforcement and to be judgment-proof.[155] In this way:

> A large oil company, rather than continuing to ship its oil in tankers that it owns and operates through subsidiary corporations, might sell each of its tankers to a separate individual who would then contract with the company to ship its oil. Similarly, small firms with only one or a few high-rolling shareholders might replace large drug companies in the development and initial marketing of pharmaceuticals; these small firms would then sell a product line to a large company for mass production and marketing only when it proved safe.[156]

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[149] Ibid 1917.

[150] Amendments to the law have been effected by legislatures in each State, imposing certain thresholds and caps on damages. However, these do not generally apply in cases of dust diseases: e.g., Civil Liability Act 2002 (NSW), ss 3B.

[151] Joseph Grundfest, 'The Limited Future of Unlimited Liability: A Capital Markets Perspective' (1992) 102 *Yale Law Journal* 387, 393, 395 and 399.

[152] Ibid 397-7.

[153] This is acknowledged in Henry Hansmann and Reinier Kraakman, 'Do the Capital Markets Compel Limited Liability? A response to Professor Grundfest' (1992) 102 *Yale Law Journal* 427, 432. See also LoPucki, above n 20, 57.

[154] See Corporations and Markets Advisory Committee, above n 77, 30.

[155] LoPucki, above n 20, 64-6.

[156] Hansmann and Kraakman, above n 12 1913-4.

However, it is submitted that this kind of dis-aggregation would be unlikely to follow any move to a rule of unlimited (or modified limited) liability. A number of problems would present themselves. First, it would be difficult for any presently-existing company to find willing buyers for its more risky business activities. Any purchaser of such assets will seek 'independent gain'.[157] Second, it is well-understood that enterprises gain all sorts of efficiencies (for example with respect to raising debt finance) when they operate either as a single company or as a closely-integrated group.[158] 'An incentive for disaggregation in any given case would not arise under unlimited liability unless the resulting inefficiencies, including lost economies of scale or quality of management, were smaller than the private gains from avoiding potential tort liability'.[159] Third, coordination costs would arise, as would risks of opportunism. '[T]here will always be some residual loss from strategic behaviour that slips through the net' of coordination efforts. Disaggregation is a high-risk strategy to adopt ex ante. Provisions in the Corporations Act 2001 (Cth), already referred to, limit the extent to which enterprises can restructure by disaggregating *after exposure* to liabilities.

B *Nina Mendelson*[160]

Mendelson believes that all shareholders with the capacity to exercise control should be liable in an unlimited amount. This is on the basis that those who control the company have better access to information than do ordinary shareholders, the ability to influence management decisions and 'special opportunities to benefit from corporate activity' (including the ability to find synergies between businesses with which they are associated, to control the payment of dividends and to write off the losses of one subsidiary against another).[161] And Mendelson recognises an important point about companies that injure – that key shareholders have a greater capacity to avoid the causation of harm than do tort claimants. 'Compared with an individual tort victim, controlling and institutional shareholders both can better monitor the extent of the firm's research into product risks and act on that information to influence the corporation to address the risks…'.[162]

Unlike Hansmann and Kraakman, Mendelson would base liability on the capacity to control rather than on the mere ownership of shares.[163] She would also allow for joint liability amongst the controllers of the company with a right to contribution – thus doing away with costly enforcement. But the problem is that this re-introduces the need for costly monitoring by shareholders of management and of each other. Mendelson also acknowledges that her proposal has a significant hole in it – it offers no compensation for tort victims in cases where there are no controlling

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157 Schwarcz, above n 20, 3.

158 Alfred Chandler, *Scale and Scope: The Dynamics of Industrial Capitalism* (1990) 14-8 (noting the general advantages of scale in the manufacturing industry); Hansmann and Kraakman, above n 12, 1914 (noting that 'an individually-owned firm with substantial firm-specific assets will have difficulty obtaining debt financing').

159 Hansmann and Kraakman, above n 12, 1914.

160 Nina Mendelson, 'A Control-Based Approach to Shareholder Liability for Corporate Torts' (2002) 102 *Columbia Law Review* 1203.

161 Ibid 1206. It has also been said that 'controlling shareholders [are] among the principal beneficiaries of opportunism vis-à-vis creditors': Kraakman, above n 2, 96.

162 Ibid 1222.

163 The relevance of the mere capacity to control has been recognised elsewhere in the literature: e.g., CASAC, above n 32, 8.

shareholders.[164] For this reason alone her proposal cannot be seen as an answer to the problems of limited liability and judgment-proofing. Argument will be presented in what follows rejecting the need for an element of control to ground the liability of shareholders for the debts of the companies in which they invest.

C *Christopher Kutz*[165]

Kutz presents the most radical of the proposals for reform of the rule of limited liability. He would impose liability upon all shareholders on the basis of his rejection of some of the ordinary assumptions about responsibility. He rejects the 'individual difference' principle. This is the idea that responsibility should flow only in those circumstances where the individual has made a difference in a causal sense to the outcome of an event.[166] He also rejects the 'control principle'. This is the idea that the agent is only accountable for the acts and outcomes over which he or she has control.[167] This is a clear departure from the proposals of both Antunes and Mendelson.

Kutz notes that the ordinary assumptions about responsibility 'define an individualistic conception of moral agency'.[168] He prefers a collective conception of moral agency. A key element is that collective responsibility flows from the participatory intention of the agent.[169] This is on the basis that 'intentional participation generally shapes agents' normative relations to the consequences of collective action, as well as their relations to other members of the group'.[170] He says that participation on these terms means that agents can be accountable for the outcomes attributable to the group as a whole as well as for those attributable to other members where 'done for the sake of the institution's goals, in conformity with restrictions on those members' participatory powers'.[171] This is to point to the fact that there is an intention on the part of agents by which they 'conceive of their [own] actions as standing on a certain instrumental relation to the group act'.[172]

In important passages, Kutz writes:

> A set of individuals jointly G [take part in a group activity] when the members of that set intentionally contribute to G's occurrence by doing their particular parts, and their conceptions sufficiently and actually overlap…[173]
>
> [M]arginally effective participants in a collective harm are accountable for the victims' suffering, not because of the individual differences they make, but because their intentional participation in a collective endeavour directly links them to the consequences of that endeavour. The notion of participation rather than causation is at the heart of both complicity and collective action.[174]

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164 Mendelson, above n 160, 1280-1.
165 Kutz, above n 33.
166 Ibid 3.
167 Ibid 3.
168 Ibid 4.
169 Ibid 67.
170 Ibid 69.
171 Ibid 69 and 107.
172 Ibid78.
173 Ibid 103.
174 Ibid 138.

Turning more specifically to the company, Kutz is of the opinion that the corporation is a 'co-operative structure'. In such a structure, each individual cooperates by contributing either financial or human capital.[175] 'The corporation and its goals exist only in virtue of this participatory structure. Restricting liability to corporate assets only makes sense on the assumption that there is something, the corporation, and no one else' that stands behind it.[176] He opines that the participatory intentions of shareholders mean that they can be held accountable for the wrongs of the company even if they are not blameworthy.[177]

There are some important elements in this reasoning, which deserve comment. First, Kutz does not depart completely from the free-will paradigm of responsibility that he ostensibly rejects. He takes comfort (so it would seem) in finding that relevant 'intentions' exist at the time that a member of a company takes up his or her shareholding – rather than at the time of the injurious interaction. The question is whether this is necessary to a holding of liability. This paper argues for a conception of shareholder liability that does not depend upon any ex ante intention or ex post proof of fault in the person to be made liable. Liability should depend upon a comparison of the position of the physical loss that tort claimants have suffered as against the potential financial losses that shareholders would suffer if made liable.

Second, Kutz identifies the fact that shareholders are insiders. They play a particular *function within* companies that injure.[178] A function indicates the role played by the particular part in the operation of a whole system.[179] A part which plays a vital function in the operation of the system can be said to be necessary or intrinsic to that whole. A part which is not necessary in this way might nevertheless contribute to the overall efficacy of the system.[180] The idea of a function is important in certain legal contexts in determining the relationships between legal persons.[181] Kutz is right to believe that the idea is important in relating the company to the shareholder.[182] The very point and purpose of shareholders is that they arm companies with the funds that companies require to undertake activities that lead to injury.[183] This is a function that is legally significant and provides a potential basis for liability – a matter which is fully recognised by the legislature in its decision to

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[175] Ibid 253.

[176] Ibid 253. It has long been recognised that the reality is that 'a corporation is at bottom but an association of individuals united for a common purpose and permitted by law to use a common name': AA Berle Jr, above n 3, 352.

[177] Kutz ibid 246.

[178] This point has been noted by writers of a very different stripe from Kutz. See Easterbrook and Fischel, above n 4, 94.

[179] Andrei Marmor, *Positive Law and Objective Values* (2001), 158. See also, to like effect, J Levin, 'Functionalism' in *Stanford Encyclopedia of Philosophy* (2004).

[180] Cf Jules Coleman, *The Practice of Principle: In Defence of a Pragmatist Approach to Legal Theory* (2001) 25-31 (discussing functionalism in its causal and 'hermeneutic' senses).

[181] A well-known example from the law concerns the place of a person within an organisation in attributions of vicarious liability: see *Stevenson, Jordan and Harrison Ltd v MacDonald and Evans* [1952] 1 TLR 101, 111 (Lord Denning MR).

[182] See also Peter Cane, *Responsibility in Law and Morality* (2002) 42.

[183] Note, in another context, that the financing of terrorist activities is an unlawful function under various instruments: e.g., 18 USC § 2339B, discussed in T Stacy, 'The "Material Support" Offense: The Use of Strict Liability in the War Against Terror' (2005) 14 *Kansas Journal of Law and Public Policy* 461. For an indication of further measures taken by the United States Government, see D Shetterly, 'Starving the Terrorists of Funding: How the United States Treasury is Fighting the War on Terror' (2006) 18 *Regent Law Review* 327.

grant shareholders the privilege of limited liability. The legislature has at once recognised the potential for liability to fall upon the shareholders and at the same time determined that they should be protected from this result. It is the extent of that legislative protection which, it is submitted, now requires re-assessment.

Third, when shareholders make their choice to extend funds, they identify themselves with the companies in which they invest. This identification manifests itself in the shareholder who attends 'her company' meeting or who reads the newspaper to see how 'his company's' share price is doing. These practices reflect the facts that the company is accountable to shareholders and that shareholders have a right to share in the spoils of the company in proportion to its profitability. There is a strong argument, then, that outsiders should be able to identify shareholders with those companies in which they invest. This argument is in no way diminished by the commonness of share ownership – by the fact that 'mums and dads' comprise a great proportion of the class of shareholders. Indeed, the commonness of share-holdings simply indicates that risk, ideally, should be socialised in a way that it has been in New Zealand – through statutory accident compensation funded through the taxation system.[184] However, the argument in this paper does not require the legislature to go that far.

Liability should be imposed upon shareholders without the need to establish that they have either control over the company or the capacity to control. The reasons for this include: the difficulty of settling upon an adequate definition of control;[185] the potential for evasion of controller liability by splitting up holdings in particular companies; and the disincentive that this would provide to active engagement by shareholders in their companies.

There are further reasons for rejecting the need for control as a basis of liability. The nature of company ownership is changing. As already discussed, an increasing proportion of shares in major companies are now beneficially owned by institutional investors rather than by natural persons.[186] Their shares are often registered in the names of custodians and voting rights are exercised by advisers such as RiskMetrics.[187] This means that it is increasingly incoherent to insist upon control as a criterion for shareholder liability. It also means, with respect to major companies, that the first liability 'hit' usually will fall upon institutions rather than natural person shareholders. It will be a rare event indeed for the investors in major companies to become liable for the personal injuries caused by their companies. These comments do not apply, of course, with respect to smaller (and perhaps many medium size) companies.

XII A PROPOSAL: MODIFIED LIMITED LIABILITY

The doctrine of limited liability limits the risks of business failure and insolvency for shareholders. However, this is not to say that limited liability limits the overall risks of business decline and insolvency.[188] If anything, it *increases the total amount*

184 See, Injury Prevention, Rehabilitation and Compensation Act 2001 (NZ).

185 Mendelson, above n 160, 1290.

186 See, Parliamentary Joint Committee on Corporations and Financial Services, above n 128, 6.

187 Ibid ch 3-4.

188 Kaisanlahti, above n 7, 147 (commenting that the 'advantage of diversification is simply in eliminating the most extreme outcomes' of risk manifestation); Halpern, Trebilcock and Turnbull, above n 13, 129.

of risk of harm by *creating a moral hazard* with respect to declining companies. The doctrine of limited liability externalises risks and the most vulnerable to such risks are tort claimants. This article proposes an alteration to the law of limited liability, so as to ameliorate the risks for tort claimants.

A *Strict liability*

The effect of a modified rule of limited liability for personal injuries would be to create a form of strict liability for shareholders with respect to the wrongs of the companies in which they invest. This is to say that shareholders could be held liable for their companies' causation of personal injuries regardless of fault.[189] For some, this might be a troubling thought. However, the free will paradigm,[190] which insists upon fault in the doing of a wrong, does not provide the only basis on which tort liability might be imposed.[191] The focus within that paradigm is upon one person – the doer of a wrong. However, there are substantial arguments for viewing the commission of a tort through a wider lens. Thus, Cane has argued that '[r]esponsibility in civil law is two-sided, concerned not only with agent conduct, but equally with the impact of that conduct on others… Responsibility in civil law is always *to* someone as well as *for* something'.[192] An important line of thought suggests that 'the basic measure of civil law remedies is the impact of the proscribed conduct on the victim, not the nature of the agent's conduct or the quality of the agent's will'.[193]

A strict liability standard coheres better with the idea of collective responsibility for harms than does a negligence or other fault-based standard.[194] 'Only strict liability will force each [responsible entity or person] to consider the full social cost of its actions in determining' the level of activity to undertake.[195] Strict liability provides strong incentives for those responsible to either cease the conduct of a particular activity[196] or to put in place policies and procedures that actually work in preventing wrongs occurring. Duty-based regimes are less effective because they require merely that *reasonable action* be taken.

In recent decades, United States' tort rules have been formulated so as to impose greater levels of collective responsibility on organisations. The best known examples of this are strict products liability and attributions of causal contribution to injury based on market share for drugs and other substances.[197] This focus upon the organisation and shared responsibility in attributions of liability reflects the fact that

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189 Cane, above n 182, 82.

190 For the origins of the theory, see, James Gordley, *Foundations of Private Law: Property, Tort, Contracts, Unjust Enrichment* (2006) 14-31. Note that the 'free will' paradigm translates ordinarily as the 'principle of personal responsibility': see, e.g., Collins, above n 22, 731.

191 '[V]olition is one ground of responsibility, but not the only ground': Meir Dan-Cohen, 'Responsibility and the Boundaries of the Self' (1992) 105 *Harvard Law Review* 959, 961.

192 Cane, above n 182, 50 (italics in original).

193 Ibid 189.

194 Kenneth Abraham, 'Individual Action and Collective Responsibility: The Dilemma of Mass Tort Reform' (1987) 73 *Virginia Law Review* 845, 854-5.

195 Jennifer Arlen and Reiner Kraakman, 'Controlling Corporate Misconduct: An Analysis of Corporate Liability Regimes' (1997) 72 *New York University Law Review* 687, 692.

196 Cane, above n 182, 84.

197 See Abraham, above n 194, 859ff; Ariel Porat and Alex Stein, *Tort Liability Under Uncertainty* (2001).

organisations are comprised of multiple persons and are 'actively engaged in the manufacture of risk'.[198] 'The complexity of an organization means that mistakes or misconduct in one part of it may have serious repercussions elsewhere; anomalies may be systemic and relate to poor coordination and communication between different parts of a company'.[199] Various incentives must be created to ensure that risks are properly assessed in the different components of the whole and that management properly regulates the creation of risk by the organisation.[200]

The efficacy of strict liability might also be seen in the operation in Australian law of the non-delegable duty. The non-delegable duty is a doctrine of strict liability that seeks to ensure that organisations adopt proper systems, processes and procedures for averting risks of personal injury with respect to particularly vulnerable groups such as school children and hospital patients.[201] In the case of the proposal advocated by this paper, incentives would be provided to individual shareholders. Modified limited liability for personal injuries would provide an incentive for shareholders to ensure that the managers of their companies take action by putting in place effective policies and procedures.

There are other fundamental points to note about the tort system of compensation which are often neglected in the debate about the liability of companies and their individual constituents. In cases like James Hardie, claimants are seeking redress for their personal injuries and defendants are seeking to protect their financial interests. Tort law is characterised by a *comparative contest* over liability.[202] When a claimant sues a defendant, judgment will be for *either* the claimant *or* the defendant – there are no other possibilities. Tort theory suggests that the claimants' interests are worthy of greater protection than shareholders' financial interests.[203] Tort protects to a very high degree interests in the body and property.[204] Although damage to property can generally be made good by a monetary payment, debilitating injuries have an impact upon lives that can never really be made good in the same way.

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198 Ulrich Beck, *Risk Society: towards a new modernity* (1992), quoted in Bridgett Hutter and Michael Powers (eds), *Organizational Encounters with Risk* (2005), 3.

199 Bridgett Hutter and Michael Power, 'Organizational encounters with risk: an introduction' in Hutter and Power, above n 198, 14. These matters are encapsulated in the idea of 'system interconnectedness': ibid 17.

200 Ibid 9.

201 See *Leichhardt Municipal Council v Montgomery* (2007) 233 ALR 200 (HCA) and discussion in Christian Witting, '*Leichhardt Municipal Council v Montgomery*: Non-Delegable Duties and Roads Authorities' (2008) 32 *Melbourne University Law Review* 332. Another writer to note the importance of the non-delegable duty in the context of complex economic organisations is Collins, above n 22.

202 Stephen Perry, 'The Moral Foundations of Tort Law' (1992) 77 *Iowa Law Review* 449.

203 William Lucy, *Philosophy of Private Law* (2007) 216ff.

204 This is reflected in the fact, for example, that the trespass torts are strict liability in nature: see *Williams v Milotin* (1957) 97 CLR 465, 474 (Dixon CJ, McTiernan, Williams, Webb and Kitto JJ). The defendant will escape liability only where able to disprove fault of any kind: *McHale v Watson* (1964) 111 CLR 384, 388 (Windeyer J). For an explanation of why this kind of case can be seen as being of 'strict liability' see Peter Cane, *The Anatomy of Tort Law* (1997) 130. This view of trespass formerly prevailed in England, but has been departed from: *Letang v Cooper* [1965] 1 QB 232, 240 (Lord Denning MR). It should also be noted, in the context of organisations, that strict liability doctrines such as the breach of non-delegable duty apply in cases of bodily injury or the threat thereto: Christian Witting, 'Breach of the non-delegable duty: Defending Limited Strict Liability in Tort' (2006) 29 *University of New South Wales Law Journal* 33.

There are reasons against imposing liability *solely* on the basis of the types of interest at stake in a comparative contest over liability. But such liability might be imposed where the plaintiff has suffered personal injury and the defendant faces the loss of a mere financial interest but has played an important function in the conduct of the injuring activity; where his or her 'actions are modulated to the demands of a collective end'.[205] As we have noted, the shareholder has an important function in the company – in financing its operations.

The argument made herein *specifically rejects* the need for shareholder control over corporate wrongdoing as the basis for their liability. Ordinarily, the law does not refrain from imposing responsibility on persons simply because they lacked sufficient control over an activity.[206] 'If responsibility depended on control over all aspects of our conduct and its consequences, we would never be (fully) responsible for anything'.[207] Vicarious liability, for example, does not depend upon a *substantial causal* relationship between employment and tort. The test for liability is comparatively lax – the tort merely needs to have a *sufficient connection* with the employment.[208] Indeed, vicarious liability has been imposed in circumstances where employers have done all that is reasonable to prevent employee wrongdoing. The similarity between the kind of shareholder liability proposed in this paper and vicarious liability is significant – in both cases there is an expectation that the principal, although not directly engaged in the activities in question, will profit from them.

(Of course, control features heavily in the theories of shareholder responsibility that we have surveyed. For those who insist upon the salience of control, shareholders are more likely to have a certain kind of control over wrongdoing than non-company employee tort claimants. That control subsists in the putting into motion of, or the support for, an enterprise that injures. Depending upon the context in which a harmful interaction arises, this may be more significant than the control exercised by the tort claimant – especially in cases where the claimant is a minor. Again, this points to a similarity between the vicariously liable employer and the shareholder. Just as the employer puts an employment activity into motion, so too do the shareholders put a business activity into motion. However, the point of this paper is that control is not necessary in imposing liability for personal injuries upon shareholders. Any exercise of control by shareholders will merely strengthen the arguments for redress made here.)

B *Priorities rule*

As adumbrated, a move to a pro-rata unlimited liability regime would need to be accompanied by alteration to the rule regarding priority of payments on a winding up of the company.[209] This is to ensure that the law does not favour corporate insiders over outsiders such as tort claimants[210] and that vulnerable tort claimants have the greatest opportunity to obtain redress. Tort claimants should rank first in their

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205 Kutz, above n 33, 162-3.

206 Cane, above n 182, 69. See also John Fischer and Mark Ravizza, *Responsibility and Control: A Theory of Moral Responsibility* (1998).

207 Cane, above n 182, 67.

208 At least this is the test in the United Kingdom: *Lister v Hesley Hall* [2002] 1 AC 215, [28] (Lord Steyn).

209 See comment to similar effect in LoPucki, above n 20, 54-5.

210 As to the present position under the Corporations Act 2001 (Cth), s 556, see Helen Anderson, 'Corporate Social Responsibility – The Case for Unsecured Creditors' (2007) 7 *Oxford University Commonwealth Law Journal* 93, 109.

entitlements (sums set aside for the winding-up of the company apart) – that is, before secured creditors. This is on the basis that compensation for personal injury is more important than are the purely financial interests of secured creditors. Where the injured include *both* outsiders *and* company employees, the former should have the first opportunity to satisfy their claims. This is on the basis that employees can readily be identified with the company and the torts that it commits, given their functional roles within the organisation.

LoPucki has asserted that an alteration to the rules of priority would have readily predictable results: 'without priority, mortgage and other secured lending would be unavailable. Lenders would withdraw from the market…'[211] However, this seems unlikely with the run-of-the-mill loan agreement, where there is no reason to fear tort liabilities. In cases where such fears are legitimate, one of two responses are likely. In the case of moderately risky projects, the creditor will build the expected cost of defaults in to contract prices. In more extreme cases, government-guarantees may be required (as explained in the next section).

C *Consequences*

A question arises as to the likely consequences of a regime of unlimited liability for personal injuries. The predictions range across a spectrum – from a minor re-adjustment to the investment landscape to the collapse of capitalism as we know it. It is suggested that the consequences would not be as dramatic as some might expect.[212] There are several general reasons for this prediction. First, modified limited liability does not entail a completely new form of liability. Leebron is sanguine about the likely consequences of greater shareholder liability, noting that 'exposure to unlimited liability would not be a phenomenon of a completely new order in our lives… we constantly take risks far more drastic than those posed by unlimited liability'.[213]

Second, it is important to appreciate that investors make their decisions looking forward and after assessing the expected returns of investments. They do not make their decisions in hindsight, with the certainty that tort claims will arise. 'One invests in the belief that one will derive a profit, from appreciation of shares, or from dividends. One selects one's investments after having concluded that the investment is one that will *make* money, not *lose* it'.[214]

This leads to a third reason: that very few companies have proven to be worth less than the combined total of their outstanding tort liabilities. The kinds of liabilities of which we speak arise infrequently: 'events of such small probability have relatively little effect on the expected value of an investment'.[215] When they do arise, the company is likely to have the assets (including a future income stream) to meet liabilities.[216] In the rare case where this is not true, certain conditions would

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[211] LoPucki, above n 20, 11.

[212] Experience of a change in liability regime by the State of California in 1931, from pro-rata to limited liability, was neutral with respect to its impact upon share values: Mark Weinstein, 'Share Price Changes and the Arrival of Limited Liability in California' (2003) 32 *Journal of Legal Studies* 1.

[213] Leebron, above n 106, 1574-5.

[214] Presser, above n 13, 159 (emphasis in original).

[215] Leebron, above n 106, 1572.

[216] Roe, above n 24, 1. This has proved to be the case with James Hardie Industries: see James Hardie Industries NV and New South Wales Government, 'Amended and Restated Final Funding Agreement' (21 November 2006), 7 (parties agreeing that 'the

have to form before modified limited liability would arise: the injuring company would need to be under-capitalised and lacking in parental support; the company would have to be under-insured; and claimants would not have recourse against either guarantors or wrongdoing managers.

Given that an increasing proportion of shares in larger companies are held by institutions,[217] it is becoming increasingly unlikely that ordinary investors would ever be called upon personally to satisfy claims. However, that does not mean that this paper has neither a point nor a purpose. Whatever the trends in the ownership and holding of shares, the possibility always remains that the pre-conditions for the liability of natural person shareholders will indeed form. Any civilised system of justice needs to have an adequate response to this possibility.

The proposal advanced in this paper preserves the benefits of risk-sharing by both shareholders and the external creditors of the company.[218] The desire is, simply, to ensure that risks are not shared with tort claimants. However, a system of modified limited liability would not be problem-free for companies, shareholders and the market. The point is that we live in a world of the second best.[219] The current legal order allows for externalisation of risks of company activity upon tort claimants and the suggestion is that this can be improved upon in a way that allows for a more satisfactory (and certainly a more just) compromise.

In general terms, it is anticipated that the consequences of modified limited liability would include some re-pricing of risk. As a result of the re-pricing, there would be some movement by natural persons out of holdings of companies engaged in risky activities and into other companies and asset classes. Shareholdings in companies undertaking risky activities would more likely be acquired by corporate shareholders – because of the extra level of protection that they offer for their natural person shareholders.[220] However, some individuals, perhaps 'high-rollers', would undoubtedly be attracted to the new risk propositions created by a modified rule.[221] Of course, there might be some risky activities – where the *potential* is for catastrophe – that could no longer be adequately insured and for which there would be little investor appetite. An example might be the development, testing and distribution of certain pharmaceutical products.[222] For these activities, government underwriting might be necessary – and might be an acceptable price to pay.[223]

Another point is that experience with modified limited liability *may* (this is not a foregone conclusion) result in the diminished transferability of shares in companies undertaking risky activities. If this occurred because of the need *ex ante* for information about the maximum potential liability to which a share in a company

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JHINV Group's commercial viability and success will provide the basis for the long-term funding of the claims which are to be subject to th[e] funding arrangements'), <http://www.ir.jameshardie.com.au/jh/asbestos_compensation.jsp> at 22 July 2008.

[217] See C Brancato and S Rabimov, *The 2008 Institutional Investment Report* (The Conference Board)(New York, Sept. 2008).

[218] On the importance of risk-sharing, see Easterbrook and Fischel, above n 4, 101; Kraakman, above n 2, 9.

[219] Cf Bainbridge, above n 8, 531.

[220] See Blumberg, above n 12, 575.

[221] Presser, above n 13, 159.

[222] I am thankful to Abe Herzberg for this example.

[223] 'A political decision to subsidize an enterprise that is unable to internalize its expected costs, whether by a special grant of limited liability [not favoured by the author of the present paper], tax benefits or cash subsidies, is preferable to a unilateral decision to engage in possibly overly risky activity under the protective umbrella of limited liability': Leebron, above n 106, 1577-8.

might give rise,[224] some such figure could be legislated for. Thus, the legislature might legislate for a cap on liability equal to (for example) twenty times the value (in real terms) of capital contributed. This would allow markets to price risk and enhance the transferability of equities.[225]

XIII CONCLUSIONS

This paper has argued in favour of a modification to the existing rule of limited liability that protects shareholders. It suggests that it is appropriate to make all shareholders – corporate and natural – personally liable, pro-rata, for personal injuries inflicted by companies in which they hold their shares. The paper departs from previous proposals by finding the appropriate justification not in the exercise by a shareholder of control; but in the facts that the shareholder is a company insider with a distinct function to play – in arming the company with capital – and that the claim of the injured tort victim is of a higher order than any financial loss to be borne by the shareholder. The injured tort victim has the right to identify the shareholder with the company and has the better claim in a comparative contest over responsibility for loss.

It is not supposed that a modified rule of limited liability would present no problems for policy-makers, the courts, litigants and others. The potential consequences of an alteration to the law have been noted. The point is that the present regime of limited liability is deeply flawed and has the potential to operate in ways that offend basic notions of justice. Experience with the James Hardie re-structure suggests that such injustice will not be tolerated. Amendment to the law would assist in reducing the extent to which wrongdoing companies externalise the costs of their activities upon tort claimants. It would ensure that there is a better pricing of risks and it would create incentives to ensure that risky activity is conducted only after all appropriate precautions have been taken.

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[224] See discussion in Kaisanlahti, above n 7, 152-7.

[225] '[T]he available evidence is suggestive that … multiple liability could function even on current stock markets despite the collection costs and other procedural hurdles that tort plaintiffs would have to overcome to hold shareholders accountable': Kaisanlahti, above n 7, 162.