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# The Future of Corporate Limited Liability in Australia

## **Abstract**

The purpose of this paper is to analyse the historical and economic rationale of corporate limited liability and to contribute to the debate about its future. Part one of this paper proposes to give a background to the concept of limited liability by looking at its roots in Roman entity law which shows that its original purpose was to protect public property from the creditors of individuals who comprised the public body. The subsequent evolution of the two principles mentioned above is considered together with the exceptions which have evolved through the legislature and the courts.

The most compelling arguments for limited liability are the economic ones. Part two of the paper will consider the economic arguments for and against the three possible liability regimes of corporate limited liability: limited, unlimited and pro rata. This paper concludes that corporate limited liability will continue to exist in its present form because of the economic incentives it accommodates, provided it does not protect those individuals and larger companies who are truly culpable for the losses of others. A section of society will always suffer loss but the overall gain of society outweighs these losses.

## **Keywords**

corporate law, limited liability

## THE FUTURE OF CORPORATE LIMITED LIABILITY IN AUSTRALIA



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### Introduction

The concept of corporate limited liability is traditional to the modern Australian corporation. It is an element of the corporation and is recognised as an advantage of conducting business using the corporate form. The original objective of corporate limited liability has permutated far beyond insulating the investor from the debts of the enterprise. In the wake of the corporate collapses of the nineteen eighties, the recent environmental disasters of global proportions such as the Exxon Valdez, Dupont's Bhopal and worldwide recession, an examination of limited liability and its future in Australia raises a number of legal, economic and social issues. Many commentators have addressed the economic structure of corporate limited liability. However history may help us to identify the original objectives of corporate limited liability so the role it will take into the twenty-first century can be better distinguished. Like any other legal rule, corporate limited liability has underlying policies necessary to achieve certain objectives. As time progresses and circumstances change, the original objectives of a legal principle can be clouded. If the application of limited liability to modern circumstances does not meet the original objectives, then the continued application of corporate limited liability must be critically examined with a view to reform.

In introducing a discussion on this topic it is important to note that the words 'corporate limited liability' encompass two distinct principles. First, liability and the contractual principle that parties may agree to limit their exposure to the liabilities of an enterprise of which they are a part. Freedom of contract allows any permutation of this notion, be it unlimited, limited or pro rata liability. At common law every person is liable upon his or her contracts up to the whole amount of their estate<sup>1</sup>. These contracts often contain limits, a simple example is an acknowledgment of debt which is limited to the amount of the debt. Individuals find sanctuary from unlimited liability in the law relating to bankruptcy and are able to be excused from debts above and beyond their personal estate. Therefore an individual's liability is limited by his or her own bankruptcy. Individuals can interpose a

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<sup>1</sup> Oppe AS, *Wharton's Law Lexicon*, (14 ed) London 1938.

fictitious legal entity ('the entity') between them and the person with whom they contract ('the third party'). The contract between the entity and the third party can have the same antecedents as a contract between an individual and the third party. The third party is not a party to the contract between the individual and the entity. The contract between the entity and the individual may allow any of the permutations mentioned above. The nature of this contract is of prime importance to the third party because this contract determines whether the third party is limited to recourse against the entity or the third party's recourse either includes the individual or permits the entity to oblige the individual to meet part or all of the entity's obligations. The modern contract between the entity and the individual protects the individual who invests in the entity, which is engaging in enterprise with third parties, from the liabilities of the enterprise above and beyond the loss of the individual's capital investment<sup>2</sup>.

Secondly, a fictitious legal entity is separate from an individual and using the common law principle cited above should have unlimited liability to the full extent of its estate. The third party contracts with the entity and therefore can only expect to have recourse against the entity. It is the separate legal personality that protects individuals from the claims of the third party as the individual is not privy to the contract between the entity and the third party.

The purpose of this paper is to analyse the historical and economic rationale of corporate limited liability and to contribute to the debate about its future. Part one of this paper proposes to give a background to the concept of limited liability by looking at its roots in Roman entity law which shows that its original purpose was to protect public property from the creditors of individuals who comprised the public body. The subsequent evolution of the two principles mentioned above is considered together with the exceptions which have evolved through the legislature and the courts.

The most compelling arguments for limited liability are the economic ones. Part two of the paper will consider the economic arguments for and against the three possible liability regimes of corporate limited liability: limited, unlimited and pro rata. This paper concludes that corporate limited liability will continue to exist in its present form because of the economic incentives it accommodates, provided it does not protect those individuals and larger companies who are truly culpable for the losses of others. A section of society will always suffer loss but the overall gain of society outweighs these losses.

### **A brief historical analysis of corporate limited liability**

The history of corporate limited liability in Australia is based largely on the law of England and its sources. In 1788 on the arrival of the First Fleet there

<sup>2</sup> Phillip I Blumberg, *The Law of Corporate Groups*, Boston 1987. (Hereinafter cited as 'Blumberg')

was little use of the corporation as penal law prevailed. In the words of Blackstone: 'colonists carry with them only so much of the English law as is applicable to their own situation and condition of an infant colony'<sup>3</sup>. By virtue of the Act of 1828<sup>4</sup> Blackstone's principle was formally received as law in Australia and with these propositions in mind an examination of the sources of English limited liability concepts before their introduction in Australia is necessary and that begins in Roman entity law.

### *Roman entity law*

Roman entity law is the origin of the notion of separate legal personality and the circumstances surrounding its development are instructive.

Every system of law in western Europe adopted and turned to its own use an idea of non-human persons, ideal subjects of rights and duties, which were gradually discovered in the Roman law books. From the nature of the case it is not often that jurisprudence can make discoveries comparable to the discoveries made by other sciences or arts, for it has to await rather than to forestall the slow changes of common opinion. But here there is something that we may fairly call a discovery, though it was made by no man and no one again order that the relationships between men may be adequately and succinctly stated, we must in thought institute a new order of persons who are not men<sup>5</sup>.

The first 'proto-corporations', according to Blackstone<sup>6</sup>, had their beginnings in the days of King Numa Pompilius<sup>7</sup>. The city of Rome had been divided by two rival factions of the population, the Sabines and the Romans. King Numa believed it would be prudent politics to divide these two groups into many smaller groups by creating separate societies for each trade and profession. Rome's system of government - a government of states, municipalities, colonies, villages and districts<sup>8</sup> - is given greater credit for the origin of the corporation. This system called for a practical doctrine of ownership of property by the public. Before this, Roman jurists had not applied the concept of ownership to public property and new theory was

<sup>3</sup> Murray J, *Commentaries on the Laws of England*, Kerr(ed) Vol 1,(1857) 90-1; Vermeesch RB, Lingren KE, *Business Law of Australia*, 5 ed, Sydney, (1987).

<sup>4</sup> 9 Geo IV, c 83 'all laws and statutes in force within the realm of England at the time of passing of this Act (25 July 1828) ... shall be applied in the administration of justice in the courts of New South Wales ... so far as the same can be applied within the said colonies; and as often as any doubt shall arise as to the application of any such laws or statutes in the said colonies respectively, it shall be lawful for the Governors of the said colonies respectively, ...by ordinances ... to declare whether such laws or statutes shall be deemed to extend to such colonies and to be in force with the same, or to make and establish such limitations and modifications of any such laws and statutes within the said colonies respectively as may be deemed expedient in that behalf....'

<sup>5</sup> Pollack and Maitland *Hist Eng Law I*, 468 as quoted in Burdick WL 'The Principles of Roman Law and their relation to modern law' London 1938 (1989 reprint) (hereinafter cited as 'Burdick').

<sup>6</sup> Ibid at 278.

<sup>7</sup> C 715 673 BC.

<sup>8</sup> Burdick at 280.

needed to extend the concept of private ownership. The concept that an individual could exercise ownership over property was developed to allow a municipality, something apart from the individuals who comprised it, to be the legal owner of property<sup>9</sup>. At this time corporations could only be created by the sovereign power of the state. A corporation could not be brought into being by the mere agreement of the persons who desired to create it<sup>10</sup>.

The most significant development in Roman law was the recognition of the corporation as a distinct entity. This acknowledgment by jurists conceived that the entity no longer had merely collective rights and liabilities of all the members but rather its own separate rights and liabilities. Whilst there are a number of commentators who question whether Roman law included principles of limited liability, because of the paucity of material and the uncertainty surrounding the general character of Roman corporations<sup>11</sup> the following maxim extracted from the digest of Justinian is used as authority:

Si quid universitate debetur singuli non debetur; nec quod debet universitas singuli debent. Where anything is owing to a corporation, it is not due to the individual members of the same, nor do the latter owe what the entire association does<sup>12</sup>.

The use of the public corporation for the purpose of protecting public property and its transition to the private company was not easy. There were a number of conceptual and social prejudices that impeded the acceptance of a separate legal personality. The reasons for this will be considered in the following section.

### English law

The scope of a corporation's powers and capacities under the English law is similar to the Roman civil law and to some commentators the principles applicable to English corporations are borrowed from the Roman municipal corporations established during their colonisation of Britain<sup>13</sup>. However, this is not evidence of the fact that limited liability was received into early English law because the existence of both direct and indirect shareholder liability in very early English law suggests that corporate limited liability was not an element of the medieval version of Roman law accepted into English law<sup>14</sup>. Clearly the general principles of Roman entity law were received into

<sup>9</sup> Ibid at 283.

<sup>10</sup> Ibid at 286.

<sup>11</sup> Perrott, 'Changes in Attitude to Limited Liability and the Corporation the European Experience', in *Limited Liability and the Corporation*, (Orhnial T ed) 1982, 85-7; Savigny, 'System des heutigen romischen rechts', in W Rattigan, *Jural Relations; or The Roman Law of Persons as Subjects of Jural Relations: being a Translation of the Second Book of Savigny's System of Modern Roman Law* 1884 (1978 reprint); Williston, 'History of the Law of Business Corporations Before 1800' (pt 2), (1888) 2 *Harv L Rev* 149, 160-1 quoted in Blumberg.

<sup>12</sup> Burdick at 291; Berle A *Studies in the Law of Corporation Finance* 1928; Conard A, *Corporations in Perspective* 1976, 487 quoted in Blumberg.

<sup>13</sup> Birdick at 279.

<sup>14</sup> Handlin O and Handlin M, 'Origins of the American Business Corporations', 5 *J Econ Hist* 1, 10n 52 (1945) quoted in Blumberg.

English medieval law<sup>15</sup> but the concept of limited liability was not grasped until the late seventeenth century<sup>16</sup>. Holdsworth<sup>17</sup> recognises the principle that an individual of a non trading company was not liable for the company's debts as early as the fifteenth century. The seminal cases of *Edmunds v Brown and Tillard*<sup>18</sup>, *Case of the City of London*<sup>19</sup> and *Salmon v The Hamborough Co*<sup>20</sup> are authority, although somewhat reserved, for the application of limited liability. Dafydd Jenkins<sup>21</sup> considers that the cases of *Edmunds* and *Salmon* are generally not authority for the proposition that the members of a seventeenth-century company were personally liable for the company's debts. The cases do, however, show that the courts would look at the exercise of powers by the governing body to decide whether to lift the corporate veil and make the members personally liable. As in Roman entity law the power to incorporate was given to the sovereign but there was no direct relationship between incorporation<sup>22</sup> and limited liability. Limited liability was a common incident of the corporation created by royal charter. However, if limited liability was not specified in the charter, the members were expected to meet all debts from their own funds. At common law associations did not possess limited liability and were treated as partnerships with unlimited liability.

In early English corporations or joint stock companies the members had unlimited liability and, where liable, they had to pay levitations or calls that the company was entitled to make if it did not have money to pay its debts. It is important to note that the liability regime was pro rata and not joint and several. If the company did not make the calls then the creditors could pursue the debts directly<sup>23</sup>. There was considerable delay in obtaining a charter as an act of parliament was needed. Incorporated bodies were invariably statutory authorities such as canal and waterworks companies. The *Bubble Act* 1720 actively discouraged persons from acting as corporate bodies, raising funds by transferable shares or stock without legal sanction and using antiquated charters. The joint stock company was a form of partnership that developed from an unincorporated association having a trustee and a deed of settlement. The trustee held stock for the benefit of members. The members held transferable shares. The deeds of settlement were either silent or specific about the members' liability concerning calls. The trust deed generally provided that every person who owned shares would promise to hold their shares on the terms set out in the trust deed. The joint stock company made the public aware of members' limited liability regarding calls by placing the word 'limited' after its name.

<sup>15</sup> Buckland W, *Roman Law and Common Law*, F Lawson ed 2d ed 1965 quoted in Blumberg.

<sup>16</sup> Gower L, *Principles of Modern Company Law*, (London, 1954) at 25 (hereinafter cited as 'Gower').

<sup>17</sup> Holdsworth W, *A History of English Law*, (5 ed 1973) at 482-9.

<sup>18</sup> (1668) 1 Lev 237, 83 ER 385.

<sup>19</sup> (1680) 1 Vent 351, 86 ER 226.

<sup>20</sup> (1671) 1 Ch Cas 204, 22 ER 763 (HL).

<sup>21</sup> Dafydd Jenkins, 'Skinning the Pantomime Horse: Two early cases on limited liability' [1975] 34 *CLJ* 308.

<sup>22</sup> Blumberg at 13.

<sup>23</sup> *Salmon v The Hamborough Co* (1671) 1 Ch Cas 204, 22 ER 763 (HL).

Private citizens were given the right to incorporate under the *Joint Stock Companies Registration Act* 1844. The *Bubble Act* was repealed as it had been largely ignored by the authorities. The joint stock company had been responsible for economic growth during these times despite unlimited liability. The courts also recognised this development by not applying *The Bubble Act* to a company in 1811 because the objects of the joint stock company in question were not prejudicial to the public interest<sup>24</sup>. Firstly, the *Joint Stock Companies Registration Act* provided for a clear distinction between private partnerships and joint stock companies. Secondly, it provided for incorporation by registration. Thirdly, provision was made for full disclosure, considered the best safeguard against fraud. Limited liability was excluded and personal liability was retained. This was an innovation because the crown had not separated the right to incorporate from limited liability in the past<sup>25</sup>. Once the two were separated charters were granted more freely. The trade off was that liability for the firm's obligations ceased three years after a member's shares had been transferred<sup>26</sup>. As the Act provided for general incorporation but did not provide for limited liability, members had to satisfy corporate judgements. Limited liability was prohibited in charter provisions although the contracts with third parties could contain provisions limiting the liability of members. It appears that the fact of unlimited liability did not stifle enterprise as there was a healthy public market in England trading in the shares of unlimited joint stock companies at least two hundred years before limited liability was formally adopted<sup>27</sup>. The difficulty with unincorporated bodies conducting business is that a creditor must sue each of the members of the body to satisfy their claim. The Act of 1844, however, gave associations the right of a separate legal entity to remove this difficulty.

It was not until 1855 when the *Limited Liability Act* enabled companies to be incorporated utilising the concept of members' limited liability. This occurred after considerable debate that criticised limited liability as speculative and fraudulent<sup>28</sup> whereas others urged it as necessary for the new and growing industrial order<sup>29</sup>. Gower notes that the *Limited*

<sup>24</sup> *R v Webb* (1811) 14 East 406, 104 ER 658.

<sup>25</sup> Cooke, *Corporation Trust and Company*, 1951 (hereinafter cited as 'Cooke') at 110.

<sup>26</sup> *Ibid* at 124.

<sup>27</sup> Hunt B, *The Development of the Business Corporation in England 1800 - 1867*, 1936 (hereinafter cited as 'Hunt') at 105-12.

<sup>28</sup> 'Nothing can be so unjust as for a few persons abounding in wealth to offer a portion of their excess for the information of a company, to play with that excess - to lend the importance of their whole name and credit to the society, and then should funds prove insufficient to answer all demands, to retire into the security of their unhazarded fortune and leave the bait to be devoured by the poor deceived fish.' *The Times*, Editorial, 25 May 1824 quoted in Halpern P, Trebilcock M, and Turnbull S, 'An Economic Analysis of Limited Liability in Corporation Law', (1980) 30 *University of Toronto Law Journal* 117 (hereinafter cited as 'Halpern, Trebilcock and Turnbull').

<sup>29</sup> 'The economic historian of the future may assign to the nameless inventor of the principle of limited liability, as applied to trading corporations, a place of honour with Watt and Stephenson, and other pioneers of the Industrial Revolution. The genius of these men produced the means by which man's command of natural resources was multiplied many times over; the limited liability company was the means by which huge aggregations of capital required to give effect to their discoveries were collected, organised and efficiently administered' *The Economist*, 18 December 1926 quoted in B Hunt, *The Development of the Business Corporation in England 1800 - 1867* at 116 (1936).



*Liability Act* of 1855 allowed limited liability of members upon complete registration. First, there had to be at least twenty-five members holding £10 shares paid up to twenty per cent. Secondly, three-quarters of the nominal capital must have been subscribed. Thirdly, the word 'limited' was placed at the end of the company's name and, fourthly, the Board of Trade had given its approval of the auditors. Under the Act, directors were liable for insolvent trading and loaning funds to members. The legislation was short lived as it was repealed and incorporated into the *Joint Stock Companies Act* 1856. This legislation was influenced by *laissez-faire* as none of the safeguards previously mentioned were incorporated. There was no minimum requirements of subscription nor nominal value nor paid-up capital. It was considered that those who dealt with companies would be aware of the consequences if the company's venture failed. During the period between 1844 and 1862 liberalism affected the amount of regulation placed on parties wishing to incorporate<sup>30</sup> and when liberalism waned the abuses of limited liability were recognised<sup>31</sup>. In the years between 1855 and 1862, 2479 companies registered under the *Limited Liability Acts*. This can be contrasted with the period between 1844 and 1855 during which 956 companies were registered under the Act of 1844<sup>32</sup>. This data is cited as authority for limited liability having a significant and desirable effect on commercial activity<sup>33</sup>.

The House of Lords independently developed certain fundamental principles toward the end of the nineteenth century. *Saloman v Saloman and Co Ltd*<sup>34</sup> established the legality of the one-man company and showed that incorporation was readily available to the small private partnership and sole trader. A person could limit their liability to the extent of their investment in the enterprise. *Trevor v Whitworth*<sup>35</sup> and *Ooregum Gold Mining Co v Roper*<sup>36</sup> sought to protect against abuses of limited liability by espousing the principle of capital maintenance.

#### *Australian law*

The use of the corporation in Australia had a somewhat retarded beginning as there was the practical difficulty of communication with England, and little thought was given to the development of the colony's own independence. As will be seen from the following, the initial uses of the corporation in Australia were akin to the pioneering spirit of the colonists. The first governor of New South Wales to authorise the formation of a corporation was Governor Lachlan Macquarie. The colony had been starved of currency and Macquarie

<sup>30</sup> Yorston RK, *Limited Liability Companies in Australia*, Sydney (1956).

<sup>31</sup> Amsler, Bartlett and Bolton, 'Thoughts of Some British Economists on Early Limited Liability and Corporate Legislation', (1981) 13 Hist Pol Econ 774; 789.

<sup>32</sup> Todd, Some Aspects of Joint Stock Companies 1844-1900, (1932) 4 Econ Hist Rev 46, 62-4.

<sup>33</sup> Blumberg at 21.

<sup>34</sup> [1897] AC 22, (HL).

<sup>35</sup> (1887) 12 App Cas 409, (HL).

<sup>36</sup> [1892] AC 125, (HL).

sought to establish a bank. His brief denied him the authority to found a government bank but he had no instructions to prevent private citizens from doing so. On 20 November 1816 a group of leading merchants met to discuss the formation of a bank to be called 'the Wales'. On 7 February 1817 rules were adopted and shortly thereafter a memorial requesting a charter of incorporation as a joint stock company was presented to and granted by Macquarie on 22 March 1817. The Wales (now Westpac) is now one of the largest banks in Oceania. Macquarie had no power to issue a charter for the bank, and sought to support his actions by obtaining a legal opinion from the Judge Advocate and the Judge of the Supreme Court. He also sought a charter from England. Macquarie wanted to stimulate the economy of the colony. In the shaky economy none of the leading merchants would have been prepared to expose themselves to the liability of a partnership and risk creditors attacking their personal assets. The terms of the original Macquarie charter were very vague but stressed one point in particular: that the original founders of the Wales were limited in their liability beyond the full value of their shares. The lack of authority by Macquarie to create the bank was largely ignored and had the bank failed at an early stage it is unclear what remedies the members would have had because of their inducement to invest on the incorrect premise that the bank was duly incorporated. Macquarie was clearly fraudulent in his actions. The fraud was obviously weighed up against the economic greater good of the colony by relieving it of the monetary chaos that had previously existed. Even with the gloss of a charter and the purported benefit of limited liability the Wales had difficulty raising capital. It is not clear whether this lack of enthusiasm was due to the shortage of currency or the uncertainty surrounding the formation of the company<sup>37</sup>.

The English *Limited Liability Act of 1862* was adopted by the Australian colonies in the mid 1860s. This legislation came to the colonies with little or no infrastructure to support it<sup>38</sup>. The legislation was designed to serve British interests and little thought was given to promoting purely Australian business interests. The principle of limited liability has been enshrined in Australian law since the adoption of the English *Limited Liability Act of 1862*, although it has remained a legal battleground<sup>39</sup>.

### *The Corporations Law*

The legislative predecessors of the *Corporations Law* since the adoption of the English *Limited Liability Act of 1862* have contained the privilege of limited liability for shareholders. Presently a member's limited liability is found in sections 117, 180(2) and Part 5.6 Division 2 of the *Corporations Law*. The company has no right of action against individual members except

<sup>37</sup> Sykes T, *Two Centuries of Panic: A history of corporate collapses in Australia*, (Sydney, 1988) at 7; Historical Records of Australia, Series I, Volume vii.

<sup>38</sup> McQueen R 'Limited Liability Company Legislation - The Australian Experience' *Australian Journal of Corporate Law* (hereinafter cited as 'McQueen'), (1991) 1 AJCL 22.

<sup>39</sup> Australian Corporation Law Principles and Practice para [2.1.0055].

to the extent of the members' shares or guarantees. The *Corporations Law* provides for legislative exceptions to limited liability. First, section 186 provides that where the number of members of a company is reduced in the case of a proprietary company below two, or in the case of any other company below five, and the company carries on business for more than six months, and the company continues to trade, a person who is a member at any time after those six months have elapsed is severally liable for the payment of any debt incurred by the company after that time. It is important to note that this section imposes pro rata liability.

Secondly, section 219, in particular subsection 6, provides that where an officer of a company signs, issues or authorises to be signed or issued on behalf of the company a negotiable instrument etc and the name of the company does not appear on the document then the person is liable to the holder of the instrument for the amount due unless the debt is paid by the company. Thirdly, section 588G<sup>40</sup> provides that where a director has reasonable grounds to expect that the company will not be able to pay all its debts as and when they become due, or if the company incurs a debt that it will not be able to repay, then a person who was a director or took part in the management of the company at the time the debt was incurred, is jointly and severally liable for the payment of the debt. The *Corporations Law* makes provision for five different liability regimes under which individuals may incorporate<sup>41</sup>, a company limited by shares<sup>42</sup>, by guarantee<sup>43</sup>, by shares and guarantee<sup>44</sup>, an unlimited company<sup>45</sup> and a no liability company.

This paper does not seek to consider the other statutory exceptions to limited liability such as section 53 of the *Environmentally Hazardous Chemical Act* 1985 (NSW) and Part IVA and 80A (for example) of the *Income Tax Assessment Act* 1936.

### Lifting the corporate veil

A member's limited liability is eroded when he or she plays a part in the management of a company. The fact of a corporation's legal personality does not give it mobility or thought and it must act through individuals. The involvement of shareholders in the management of companies and the liabilities imposed on them as against third parties is the result of a need to protect the community against the possible abuses of limited liability. The rule of the separate legal personality is intact except where the shareholder participates in some aspect of management for which the shareholder is culpable for a third party's loss. The doctrine of the separate legal entity

<sup>40</sup> Section 592 applies prior to the introduction of Part 5.7B.

<sup>41</sup> Section 115 *Corporations Law*.

<sup>42</sup> Section 117(5).

<sup>43</sup> Section 117(1)(d).

<sup>44</sup> Section 117(1)(d).

<sup>45</sup> Section 117(1)(e) and 523.

protects members from the creditors of the corporation. The judicial circumstances where the corporate veil is removed, exposing shareholders to unlimited liabilities are described as chaotic in their application and this paper only seeks to consider the general policy. Firstly, whether the conduct of the shareholder warrants the grant of a remedy to a third party disregards the distinction between the shareholders'38 capacity as shareholders and their capacity as individuals. Secondly, the ease with which a third party may guard against conduct of that kind the more reprehensible the conduct, the less the third party should have to guard against it<sup>46</sup>. The general principle that can be extracted from current policy is that there are circumstances where individuals should bear liability irrespective of the corporate facade provided that some 'antisocial act' is committed requiring action to be taken by the community to correct that conduct. The nature of the 'antisocial act' will depend on whether the ordinary person with decent feelings would realise that he is committing a wrong or alternatively the person is negligent<sup>47</sup>.

In *United States v Milwaukee Refrigerator Co*<sup>48</sup> the court said:

If any general rule can be laid down...it is that a corporation will be looked upon as a legal entity as a general rule, and until sufficient reason to the contrary appears; but, where the notion of legal entity is used to defeat public convenience, justify a wrong, protect fraud, or defend a crime the law will regard the person as an association of persons.

Gower believes the English cases show no consistent principle other than a refusal to apply the logic laid down in *Saloman's Case*<sup>49</sup> where it is used to avoid justice, convenience and revenue interest<sup>50</sup>. Farrar agrees that there is no common unifying principle<sup>51</sup>. Ford states that the circumstances where the corporate veil has been lifted in Australia are extremely limited<sup>52</sup>. Whilst this is unsatisfactory from the jurist's point of view it allows the courts flexibility to deal with new situations.

Whilst the Australian limited liability legislation had been introduced, the small number of businesses that registered is believed to be because of the small scale of colonial business and the belief that incorporation was the province of large undertakings and such circumstances perpetuated the use of partnerships<sup>53</sup>.

<sup>46</sup> Davies GL, *The Law of Corporations* (1989)24 no 2 Taxation in Australia 102.

<sup>47</sup> Company Directors Duties Report by Senate Standing Committee on Legal and Constitutional Affairs, November 1989 177-8.

<sup>48</sup> (1905) 142 Fed Rep 247, 255.

<sup>49</sup> [1897] AC 22, HL.

<sup>50</sup> Gower at 112.

<sup>51</sup> Farrar JH et al, *Farrar's Company Law* 5ed, Butterworths.

<sup>52</sup> *Hobart Bridge Co Ltd v FCT* (1951) 82 CLR 372; *Sienberg v FCT* (1975) 134 CLR 640 at 682 per Barwick CJ; *Walker v Wimbourne* (1976) 137 CLR 1; *Pioneer Concrete Services Ltd v Yelnah Pty Ltd* (1987) 11 ACLR 108; *Quintex Australian Finance Ltd v Schroders Aust Ltd* (1990) 3 ACSR 267.

<sup>53</sup> McQueen R 'Limited Liability Company Legislation - The Australian Experience' *Australian Journal of Corporate Law*, (1991) 1 AJCL 22.

## Comments

Thus from the principles of private ownership applying to the property over which public bodies exercised rights, the modern notion of limited liability originates. The principle was developed more to protect the public property of the municipalities from the creditors of individuals rather than protecting the individual from the claims of third parties. Such a concept has social merit as it enables collective ownership for the benefit of all citizens. The concept is idealistic and may have been influenced by the Platonic principles of equality, social justice, civic cooperation, progress and individual freedom. The transposition of the municipal entity from a body designed for the greater good of the people may not have the same benefits when placed in the hands of self interested economic individuals. The need for protection of individuals from the principle of limited liability becomes evident.

Limited liability is a concept that had been treated with caution, and if it had not, it would have been accepted by the legislatures much earlier than 1855. There is little evidence of a limit being placed on the rights of tort victims to recover their losses. The application of the principles of limited liability and the corporation are influenced by economic considerations, however the restraint with which they were adopted is for a number of reasons.

First, philosophical reasons of 'natural liberty' and 'freedom of contract'<sup>54</sup>. Liability is viewed as an attribute of enterprise from which an individual is not able to separate himself or herself. Liability is a right or responsibility associated with private property rights, and private property rights in turn associated with natural rights of liberty. It is a democratic premise that recognition of such a right is for the common good. The separation by an individual from their 'right to liability' is then inconsistent with natural justice. The philosophy of the Stoics and Thomas Aquinas would assert that the alienation of liability from the individual is immoral being against natural justice and any attempt to vary this rule is not true law. The 'right to liability' is a right that is secondary to liberties such as freedom and private property rights as it only arises because of the interaction with other individuals and the infringement of their rights. The other question that could be asked from a 'humanist' perspective is: why is an individual so concerned about the consequences of liability that it is necessary to have limited liability to stimulate investment?<sup>55</sup>

Secondly, it took time for democratic principles to be accepted and applied - 'the imposition of limited liability was perceived as a means of

<sup>54</sup> Veblen T, *Theory of Business Enterprise*, (1904) quoted in Blumberg.

<sup>55</sup> Gabaldon TA 'The Lemonade Stand: Feminist and other Reflections on the Limited Liability of Corporate Shareholders', (1992) 45 *Van L Rev* 1387; 1394 (herein after cited as 'Gabaldon').

encouraging the small scale entrepreneur and of keeping entry into business markets competitive and democratic'<sup>56</sup>.

Thirdly, McQueen identifies that the diffusion of the corporate form was slow in England, and even as late as the early twentieth century it was believed that trading companies were an improper form of economic organisation that managed to succeed in spite of, rather than because of, laws of economics<sup>57</sup>. The rate of acceptance of limited liability in Britain can be explained by cultural prejudice. Businessmen saw the company and the concept of limited liability as improper because it allowed businessmen to avoid their gentlemanly and moral responsibilities.

Fourthly, Adam Smith's *Wealth of Nations* had a strong influence on the use of the joint stock company as he had said that the only successful area in which joint stock companies could conduct business was where 'all the operations were capable of being reduced to what is called routine or to such uniformity of methods as admits little or no variation'<sup>58</sup>. Other types of enterprise, in Smith's view, were inefficient and contrary to public interest. He later stated that the joint stock company was only really beneficial to banking, insurance, canal development and waterworks<sup>59</sup>.

Fifthly, the amount of economic activity was small during these times and most business could be transacted by sole traders or partnerships. McQueen says that despite the many factors discouraging spread of the corporate form it is undeniable that it became a more acceptable device by the late nineteenth century.

Sixthly, people came to realise that there were significant benefits in being able to attract outside capital without losing control of the venture and keeping privacy. The prime object of the corporate form was to permit fundraising to 'enable capitalists to carry on speculation in numbers beyond what ordinary machinery of the law could deal with'<sup>60</sup>. However the early limited liability legislation in Australia showed that the desire toward limiting liability was greater than the motive of raising capital. The primary reason for incorporation today is to quarantine an individual's accumulated wealth by placing the conduct of an enterprise into the limited liability company<sup>61</sup>. In theory the interposed entity shifts the risk of personal bankruptcy to a separate entity which bears all the risk.

<sup>56</sup> Presser Stephen B 'Thwarting the Killing of the Corporation, Limited Liability, Democracy and Economics' (1992) 87 *Northwestern Law Review* 148 at 155 (hereinafter cited as 'Presser') quoting Seavoy Ronald E, *The Origins of the American Business Corporation, 1784-1855*, 70 (1982); 'This system of general incorporation laws should allow men of small means to come in and unite in carrying on business. The principle was democratic; but when these privileges were limited to the few through individual grants by the legislature....it was opposed to every principle of democracy': Seavoy at 185.

<sup>57</sup> McQueen R, as above, note 53 quoting Hadden T, *Company Law and Capitalism* 2 ed, Wiedenfield and Nicholson, London, (1977) 28.

<sup>58</sup> Adam Smith, *The Wealth of Nations*, Norman S Berg, Dunwoody, Georgia 713.

<sup>59</sup> *Ibid* 713-6.

<sup>60</sup> *Oakes v Turquand* (1867) LR 2 HL 335 at 365 per Lord Cranworth.

<sup>61</sup> Frieberg A, 'Abuse of the Corporate Form - Reflections from the Bottom of the Harbour' (1987) 10 *UNSWLJ* 67 at 69.

The *Corporations Law* makes available a full complement of liability regimes to private citizens and of these regimes the company limited by shares is the most popular. Despite this there is no historical justification for the limited liability of a member for corporate debts and it has developed because of the influence of private enterprise on the legislature. Some commentators have hailed limited liability as having profound commercial implications: 'the limited liability corporation is the greatest single invention of modern times...' <sup>62</sup> and 'limited liability is by far the most effective legal invention for business purposes made in the nineteenth century' <sup>63</sup>. Others argue that limited liability does not affect business <sup>64</sup> whereas others believe it was responsible for industrialisation <sup>65</sup>.

### The economic analysis of corporate limited liability

The legal relationship between a shareholder and a company is a statutory contract that limits the shareholder's liability to the paid-up value of their shares. The shareholder's assets that are above and beyond the paid-up value of the shares are quarantined and usually safe from the company's creditors. The economic analysis of this relationship has been the subject of much comment that comes primarily from the United States and a brief consideration of the assumptions used is of assistance.

All the economic arguments are assessed on the question whether they are 'efficient'. A result is 'efficient' if those who benefit gain more than those who suffer a loss <sup>66</sup>. 'Benefit' is assessed on the willingness to pay by using a model of pre-act bargaining <sup>67</sup>. Such an analysis is not dependent upon whether compensation moves from the benefited to the detriment and societal wealth maximisation is the goal, not individual wealth <sup>68</sup>. The economic arguments are bounded by the theory of perfect capital markets. This theory can only endeavour to achieve a rationale for legal constructs <sup>69</sup>. This section proposes to consider the arguments for and against limited liability by comparing the different regimes available - unlimited, pro rata and limited.

<sup>62</sup> Butler N, *Why Should We Change Our Form of Government*, 1912 as quoted in Blumberg at 8.

<sup>63</sup> Cook, 'Watered Stock Commissions Blue Sky Laws Stock Without Par Value' (1921) 19 *Mich L Rev* 593 n 4.

<sup>64</sup> Meiners, Mofsky and Tollison, 'Piercing the Veil of Limited Liability' (1979) 4 *Del J Corp L* 351; 362-363.

<sup>65</sup> Forbes K F, 'Limited Liability and the Development of the Business Corporation' (1986) 2 *J L Econ and Org* 163; 164.

<sup>66</sup> Landes W and Posner RA, *The Economic Structure of Tort Law* Harvard (1987) at 16 (hereinafter cited as 'Landes and Posner').

<sup>67</sup> Posner RA, *Economic Analysis at Law*, 3d ed, Boston (1986) (hereinafter cited as 'Posner').

<sup>68</sup> Landes and Posner at 16; Oabaldon

<sup>69</sup> A brief description of the perfect capital market is as follows: (1.) No transaction costs; this includes the case where there are no costs incurred by the equity holders or debtors to monitor and constrain the actions of the management of the firm; (2.) all transactions are small relative to the size of the market; that is, all participants are price takers; (3.) information is costlessly available to all participants; (4.) there is no personal taxation; (5.) there are no costs to bankruptcy; and (6.) all financial claims to the firm's earning stream are treated identically for corporate tax purposes: Halpern, Trebilcock and Turnbull at 127.

The general economic argument against limited liability is that an uncompensated transfer of the risk of business failure from the members to the creditors of the company occurs. Gabaldon<sup>70</sup> argues that there are two ways of viewing the risk shifting that occurs under limited liability. Firstly, it is condemned as a conscious injury to third parties for profit. Secondly, individuals should not be passive when involvement is possible and the exploitation of third parties is a failure to care. Such arguments call for the abolition of limited liability but are difficult to sustain because of the entrenchment of passivity in market ideology. It is postulated that if the risk transfer was not available to limited liability corporations economic activity would be minimised<sup>71</sup>. The counter argument is that the use of limited liability facilitates investment by middle and working classes who would otherwise be discouraged from investing in the large variety of possible investment outcomes. This allows individuals to use small fractions of their savings without risking a large loss if the corporation becomes insolvent<sup>72</sup>.

Easterbrook and Fischel<sup>73</sup> emphasise the contractual nature of corporate law and argue that limited liability is found in all kinds of business and financial contracts. They say that but for the legal restrictions firms would also contract to limit liability although, the costs of conducting businesses would increase. They argue that the corporate form allows large amounts of capital to combine with people who have specialist skills and limited liability reduces the cost of such transactions.

*Shareholders monitoring management and other shareholders - Increased agency costs.*

The Berle-Means model of the corporation<sup>74</sup> provides that there is a separation of control from investment. Easterbrook and Fischel assert that limited liability encourages the division of responsibility for enterprise. Management skill is separated from the risk bearing capital providing shareholders. As either function is performed by self interested individual both the management and the shareholders must monitor each other's performance. The more risk a shareholder bears, the greater the need to monitor their investment because they are separated from the management function. The greater involvement management has in the investment the greater the chance of their being 'emotional' about their decisions. These decisions are gauged by the price the shareholder is prepared to pay for shares and the chance that a shareholder will purchase sufficient shares to remove

<sup>70</sup> Gabaldon at 1430.

<sup>71</sup> Halpern, Trebilcock and Turnbull at 118.

<sup>72</sup> Manne HG, 'Our Two Corporation System: Law and Economics' (1967) 53 *Va L R* 259 (hereinafter cited as 'Manne') at 262, 263.

<sup>73</sup> Easterbrook FH and Fischel DR, *The Economic Structure of Corporate Law* Harvard, (1991). (hereinafter cited as 'Easterbrook and Fischel').

<sup>74</sup> Beale AA and Means GC, *The Modern Corporation and Private Property*, 1936.



the corporation's management and put in their own. Limited liability reduces the cost of separation of management from investment and of the division of labour and expertise from capitalists.

Presser argues that this is not necessarily correct because shareholders would meet the costs of monitoring by using the same method as they do now even if it was under a scheme of unlimited liability<sup>75</sup>. The reality is that even under a scheme of limited liability small investors do not have the resources to monitor their investments other than the information the company is obliged to provide. In an unlimited regime the shareholders would still examine management's track record and if the return on the investment was high enough then they would still invest. The larger number of investors in an enterprise that had unlimited liability would indicate that the investment is sound and subsequently the risk is smaller. Presser's argument would appear to be fundamentally flawed as under an unlimited regime each party is jointly and severally liable for the enterprise's debts and shareholders would be more vigorous in monitoring share portfolios since the associated costs of employing professional monitors would be inefficient. As a person invests with a purpose of gain then the same could be said in both regimes. It is the quality of the investment opportunity and the likelihood of return that is considered and not the question of limited liability. Presser's arguments are based on sound investments. His propositions do not contemplate high risk ventures.

Gabaldon considers that the monitoring of management is a social good rather than a duplicative cost. Such monitoring need not be directed toward profit motives and this should not be the primary motive of management. The societal good must be considered and consultation between the investor and management can only improve these principles<sup>76</sup>.

Easterbrook and Fischel assert that limited liability reduces the monitoring of other shareholders because the greater the wealth of the other shareholders, the lower the probability that any one shareholder's assets will be needed to pay a judgement<sup>77</sup>. Presser considers that this proposition fails to consider the pro rata treatment given to shareholders in the nineteenth century. Under pro rata liability a member bears their proportion of the liability and the wealth of individual shareholders is irrelevant<sup>78</sup>. The commentators do not deal with the specifics of a pro rata regime, such as the distribution of liability. For example, if there is a shareholder's insolvency is the liability of the insolvent distributed between the remaining shareholders or is the liability extinguished? If the liability is extinguished then there is a de facto limited liability in the shareholder's own bankruptcy although,

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<sup>75</sup> Presser at 159.

<sup>76</sup> Gabaldon at 1430.

<sup>77</sup> Easterbrook and Fischel at 42.

<sup>78</sup> Presser at 161; Manne at 262

generally, shareholders may not be sufficiently risk-adverse to go to such an extent. If the liability of the insolvent is distributed proportionally then it cannot be said that shareholder monitoring of other less wealthy shareholders would not occur. The cost of such monitoring would be less than under the unlimited regime. Halpern, Trebilcock and Turnbull argue that under a pro rata regime because the risk is greater the returns will be greater and the price of shares lower<sup>79</sup>. The shareholder need not be as interested in the wealth of each other shareholder but they would have greater interest in examining the business of the company to ensure that increases in the risks do not affect earnings. As the risk increases the cost of insurance will increase and the efficiencies of the pro rata regime lessen<sup>80</sup>.

Hansmann and Kraakman<sup>81</sup> submit that the 'perverse incentives and transaction costs' that differentiate between unlimited and limited liability are similar to the differences between joint and several liability and a pro rata regime. They assert that joint and several liability ensures that judgement proof shareholders do not externalise tort costs. A wealthy shareholder must police the firm's insurance coverage or alternatively monitor the assets of other shareholders and the risk of the enterprise. Alternatively personal liability could be imposed on managers for not maintaining an adequate level of insurance and risk<sup>82</sup>. Meiners, Mofsky and Tollison contend that shareholders would not monitor each other because there is no incentive to do so as the stock market and the price provide all the information that is necessary to make the decision to invest or not to invest<sup>83</sup>.

#### *Share Valuation and Transferability.*

Easterbrook and Fischel<sup>84</sup> assert that the value of shares is determined by the income stream from the company's assets under limited liability. In public companies the principal explanation for limited liability is the efficient capital market where share prices adjust to new information about traded firms and thus provide the best available unbiased estimate of future return<sup>85</sup>. Under unlimited liability, the value of shares must take the wealth of other shareholders into account together with the income stream from the firm's assets<sup>86</sup>. Consequently, the price of each person's shares would depend on

<sup>79</sup> Halpern, Trebilcock and Turnbull at 137.

<sup>80</sup> Ibid at 138.

<sup>81</sup> Hansmann H and Kraakman R, 'Toward Unlimited Liability for Corporate Torts' (1991) 100 *Yale L J* 1879 (hereinafter cited as 'Hansmann and Kraakman') at 1872-3.

<sup>82</sup> Kraakman R, 'Corporate Liability Strategies and the Costs of Legal Controls' (1984) 93 *Yale L J* 857 at 871.

<sup>83</sup> Meiners, Mofsky and Tollison, 'Piercing the Veil of Limited Liability' (1979) 4 *Del J Corp L* 351; 362-3.

<sup>84</sup> Easterbrook and Fischel at 42.

<sup>85</sup> Ribstein LE, 'Limited Liability and Theories of the Corporation' (1991) 50 *Md L Rev* 80 at 90 (hereinafter cited as 'Ribstein').

<sup>86</sup> Hunt at 121-2, Easterbrook and Fischel, 'Limited Liability and the Corporation' (1985) 52 *U Chi L Rev* 89 at 96, Halpern, Trebilcock and Turnbull at 130.

the wealth of the owner and it would be very difficult to calculate the value of the firm's shares due to the information costs. The wealthy shareholder may be selling their past liability in the form of an indemnity from the purchaser for past wrongs, together with the income stream. The risk component of the price for the purchaser in the transaction would depend on its own wealth. If a purchaser was wealthier than the share owner then the price paid would have a factored risk component, reducing the cost of the share. If the purchaser was impecunious or of low wealth, the price may be higher as the risk of loss by the purchaser is lessened. The monitoring of market transactions of this nature would be inefficient and practically unworkable. Investors would expend a great deal of money deciding whether the price is right. The transferability of shares would be restricted and efficiency in the market reduced because the shares in an unlimited company would not be traded as often. As the shares are not traded frequently, investor demand for information is reduced and the cost of obtaining information increases as it becomes more scarce<sup>87</sup>. Risk insurance could stabilise the cost of shares however the cost of insurance equivalent to the 'insurance' provided by limited liability would be inefficient when compared with fungibility of shares under a limited liability regime<sup>88</sup>. Presser argues that Easterbrook and Fischel's argument fails under a pro rata regime because the only factor that needs to be considered other than income from the firm's assets is the risk of the enterprise's failure and there is no need to consider the wealth of each shareholder<sup>89</sup>.

### *Portfolio Diversification*

Easterbrook and Fischel emphasise that the diversification of the share portfolio minimises costs because risk can be spread over a number of investments. If the risk is spread over a large number of shares the risk of a loss, as an independent event, will limit the possible loss. The shifting of risk from shareholders to creditors reduces the total cost of risk that the shareholder and the creditor must bear<sup>90</sup>. Posner suggests that the limited liability contract efficiently transfers risk to the party most able to bear that risk<sup>91</sup>. Under unlimited liability if a firm became insolvent the owners would also become insolvent and each additional holding increases the chance of insolvency<sup>92</sup>. Investors would have to ensure that each of their investments was satisfactory by monitoring their investment. Consequently they would be more reluctant to provide capital for other enterprise. Halpern, Trebilcock and Turnbull say that institutional investors and wealthy investors can achieve diversification irrespective of limited liability<sup>93</sup>. There is a difference

<sup>87</sup> Ribstein at 100.

<sup>88</sup> Easterbrook and Fischel at 42.

<sup>89</sup> Presser at 161.

<sup>90</sup> Easterbrook and Fischel at 101.

<sup>91</sup> Posner at 370.

<sup>92</sup> Ribstein at 101.

<sup>93</sup> Halpern, Trebilcock and Turnbull at 298.

between the diversification benefit of the limited liability and pro rata regimes<sup>94</sup> as the costs of enforcing a pro rata recovery action against shareholders would be less efficient<sup>95</sup>.

### *Fearless management*

Limited liability is also said to assist management make optimal investment decisions<sup>96</sup>. Because of a shareholder's diverse portfolio the management can participate in high risk enterprise as the risk of loss to the shareholder is weighed up against the possible gains of other investments. Easterbrook and Fischel argue that society as a whole benefits from the increased investment and the encouragement of risky investments because the potential gain is generally greater than the potential loss.

### *Public v closely held*

In an unlimited liability regime each of the owners of a firm is responsible for the debts and obligations of the firm. Voluntary creditors are able to monitor the wealth of the owners and the wealthier an owner the more attractive they are to a creditor. Usually under such a regime there is no separation of control from investment. The owner's contribution of capital entitles him or her to play a part in the decision making process. The contract between owners inter se is that they have joint and several liabilities amongst each other for liability to third parties. Each owner has a right of contribution from the other if they pay more than their share but such a right is of no value if the other parties are insolvent and as against involuntary creditors, there is unlimited liability. Unlimited liability ensures that owners do not distance themselves from the enterprise and they must monitor management to ensure success because of the responsibility and consequences of the enterprise's failure. There is a significant difference in the economics of a closely held enterprise and a large public enterprise as there is no efficient capital market benefit<sup>97</sup>.

First, the closely held enterprise permits a division of labour that enables each owner to perform a function. The contractual interaction between all owners remains efficient because of the scale of the enterprise. As the enterprise becomes larger the functions that must be performed become more specialised and it is necessary for the labour to be divided among more individuals. The greater the complexity of the enterprise the greater the need for specialist skill to keep it efficient. If each of the specialised labour contracts is not coordinated then the practicality of communication becomes difficult between each of the actors and it is necessary to have central management control. If there is no coordination, the message and the intended result may be corrupted and the result inefficient. Consequently it

<sup>94</sup> Ibid at 137.

<sup>95</sup> Manne at 262, Ribstein at 102.

<sup>96</sup> Easterbrook and Fischel at 45.

<sup>97</sup> Halpern, Trebilcock and Turnbull at 148.

is necessary to separate individuals performing specialised functions from the coordinating body. As tasks get more and more specialised the individuals performing those functions may not be owners but rather employees. An employee's performance can be monitored by management. Employees receive a reward for the investment of their time rather than their capital. The difference between the contract involving an employee and a third party is that the risk component has been removed (except for negligence). Accordingly their returns and possible loss are minimised. The investor bears the risk of the enterprise's failure and those who have wealth can use it even if they do not possess the specialist labour or management skills. Those who possess labour skills can obtain employment and those who possess management skills can obtain capital in the market place<sup>98</sup>.

Secondly, smaller closely held corporations are not subject to the same scrutiny as public corporations and obviously there is a greater incentive to shift risk to others. Limited liability encourages the shareholder-managers of a closely held corporation to minimise their investment in safety precautions<sup>99</sup> for high risk ventures. Over investment in high risk enterprise is encouraged because the losses are externalised and the return may be high to the investor. Such investment is said to have a positive value to shareholders even though the cost to society is negative. The proponents of limited liability would argue that limited liability is still efficient. Further, limited liability encourages under investment in a corporation's equity, so that a firm's exposure to both voluntary and involuntary creditors is minimised<sup>100</sup>. Limited liability permits enterprise on a very large scale. As the scale of enterprise increases the importance of liability also increases. If unlimited liability prevailed in very large enterprises the shareholders would endeavour to control the amount of the risk by keeping the size of the enterprise to a controllable level. In this way unlimited liability deters investment<sup>101</sup>.

There is a distinction between the use of limited liability by public and closely held companies. As will be seen, the real disadvantages of limited liability can be categorised as follows.

#### *Excessive risk taking*

Limited liability encourages companies to undertake enterprise that is excessively risky. If the enterprise is not successful, the company need not meet the full cost of the activity<sup>102</sup>. Exposure to tort liability leads to the reorganisation of the firm so that liability can be externalised. Risky ventures can be placed in a separate company to quarantine the potential losses from

<sup>98</sup> Easterbrook and Fischel at 11.

<sup>99</sup> Hansmann and Kraakman at 1882.

<sup>100</sup> Ibid at 1883.

<sup>101</sup> Manne at 262.

<sup>102</sup> Hansmann and Kraakman at 1879.

other enterprises. Hansmann and Kraakman argue that unlimited liability induces socially efficient behaviour by companies because the shareholders would encourage expenditure on insurance and examine risky enterprise much more closely<sup>103</sup>. Easterbrook and Fischel argue that risky investment is socially efficient under limited liability.

### *Debt v Equity*

A shareholder may fund a corporation by both debt and equity. In either circumstance the shareholder enjoys limited liability<sup>104</sup>. The shareholder who provides debt may place themselves in the position of a secured creditor by, for example, taking a fixed and floating charge over all assets of the company. The tort or trade creditor is not usually privy to such an arrangement. If there is the company's insolvency, the secured shareholder will rank in priority before the unsecured tort and trade creditors. An investor need not hold equity at all in the corporation. The investor could secure a place in the company's management, and secure their debt over the company's assets, thus gaining control of the enterprise and minimising risk. Hansmann and Kraakman cite this as being a way in which the unlimited liability regime could be avoided and risky investment and the subsequent social cost left in its current state of equilibrium. If unlimited shareholder liability existed, then wealthy individuals would fund enterprise by debt. The shareholders would be a group of individuals with few assets who are prepared to undertake the responsibility of high risk equity and not be adverse to personal bankruptcy.

The involuntary creditor has much difficulty in satisfying their claim if the company does not possess insurance and is undercapitalised. Further, if the company is funded primarily by debt, the voluntary creditor is disadvantaged because of the priorities of payments in the *Corporations Law*<sup>105</sup>. Tort creditors rank equally with trade creditors. An employee is given a degree of priority over a floating charge<sup>106</sup> and those employees who are entitled to injury compensation are also entitled to priority provided their accident occurred before the date of winding up.

The tort creditor is unable to contract with a corporation. Hypothetically at least, the tort creditor has bargained in advance with the corporation for price concessions that reflect the possibility that both injury and insolvency would occur<sup>107</sup>. The people who fall into this category are product purchasers, short term trade creditors and unsophisticated employees. These people are not in any position to assess market information and bear the brunt of the social cost of limited liability.

<sup>103</sup> Ibid at 1883.

<sup>104</sup> Easterbrook and Fischel at 90.

<sup>105</sup> Part 5.6 div D *Corporations Law*.

<sup>106</sup> Section 561 *Corporations Law*.

<sup>107</sup> Ribstein at 129-30.

## The Future

There are two considerations cited by Leebron<sup>108</sup> that affect the efficiency of limited liability. First, limited liability must truly externalise costs. If these costs are borne by other parties such as trade creditors or tort victims, then the result may not be efficient. Quite the contrary, limited liability's externalisation of costs may be inefficient. Secondly, the purported externalisation of costs may distort the measure of risk in undertaking an activity that has a high social risk. The measure of social risk should be the standard on which the liability regime used is gauged. Obviously, an investor can lessen risk by limiting liability but a tort victim who has no part in the enterprise does not face less risk. The enterprise is engaging in an excessively risky undertaking from the societal point of view. The issue is whether imposing unlimited liability on shareholders for the wrongs committed by the enterprise has undesirable consequences that outweigh the benefits of having a pro rata or limited liability regime. Clearly unlimited liability would increase the risk of shareholder bankruptcy. Would this consequence cause investors to forgo investment that is socially desirable?<sup>109</sup>

Corporate limited liability achieves a desirable function by creating incentives to invest. Easterbrook and Fischel's arguments in favour of limited liability have significant merit although their arguments are not infallible. It is also clear historically that commercial activity is not dependent upon the existence of limited liability. The real cost of limited liability is borne by involuntary creditors. The solution to this may be to accept that there is a need for further exceptions to the rule. Such exceptions could include compulsory insolvency insurance. The likelihood of such insurance being available is low. The social benefit of limited liability outweighs the costs to involuntary creditors. Hansmann and Kraakman suggest that a pro rata liability regime is the best system in so far as involuntary creditors are concerned because shareholders are encouraged to insure and the cost to tort creditors is minimised.

If the social costs of limited liability become too high then there will be a further change to control further abuses. Presently the possible abuses of limited liability are adequately catered for in the *Corporations Law* and the law relating to lifting the corporate veil. Further regulation can only minimise limited liability's efficiency. A shareholder's limited liability has reached its end of history<sup>110</sup>. Individuals have a choice of five liability regimes under *Corporations Law*. The company limited by shares is the most popular and its wide scale use is evidence of its social value. Corporate limited liability will continue to exist in its present form whilst there is a net social benefit.

<sup>108</sup> Leebron DW, 'Limited Liability, Tort Victims, And Creditors' (1991) 91 *Colum L Rev* 1565.

<sup>109</sup> Leebron at 1574.

<sup>110</sup> Francis Fukuyama, *The End Of History and the Last Man* London, (1992).