

## Limited Liability

What is limited liability?

- Upon registration, a company comes into existence as a body corporate per s 119
- S 124(1) provides that a company has the legal capacity and powers of an individual and the powers of a body corporate
- At law, a company is a separate entity from its members: Salomon. Its rights, privileges, duties and liabilities are not those of its members or directors: Gas Lighting per Lord Sumner. Thus its property and choses in action are separate to those of its members: Macaura. Where a company is limited, its members are not liable except to the extent provided by legislation: Salomon; see also ss 514–29. Section 516 provides that if a company is 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

What are its benefits?

- Shielding oneself from liability by interposing the company between the owners/managers and third parties who deal with the company
- De jure benefits of legal personality: compared with partnership
  - Partnership property is owned by partners personally; members of a company do not own the property of the company
  - Creditors of the partnership are creditors of the partners personally and a creditor who obtains a judgment debt against a partnership can enforce it personally against the partner
    - Clearly, you do not want to expose yourself to many partnership
    - Partners are jointly and severally liable for torts committed by partners or employees of the partnership. Members of companies are not personally liable for torts committed by the company or its employees
- Reduces the need to monitor managers, thus reducing costs
- Reduces costs of monitoring other shareholders' capacity to contribute proportionately to company failure
- By promoting the free transfer of shares, it gives managers incentive to act efficiently
- It also makes diversification and passivity a more rational strategy, and facilitates optimal investment decisions

On one view, limited liability is a privilege that the parliament has conferred on businesspeople - should that privilege be balanced by the need to protect external parties? Economic theorists would argue that this would discourage investment

## Limited Liability and the Corporate Veil

The corporate veil can be pierced which provides some protection to third parties - but only in very limited circumstances

### Why is the corporate veil controversial?

- Shields company's owners from their moral, and arguably legal, obligations
- Shielding personal assets from business risks is a privilege and an attractive aspect of incorporation - economic theory would suggest this encourages investment
- Theories:
  - Economic theory is in favour of corporate veil - encourages investment
  - Communitarian - should look beyond the narrow economic interests and look at third parties who are harmed by corporations e.g. tort victims and employees
- *James Hardie* and the Corporate Veil:
  - Asbestos liabilities were a threat to the profits of the company
  - Assets were moved to the Netherlands and then to Ireland
  - Company acted legally, even though directors did not

### Piercing the corporate veil:

H Anderson, 'Piercing the Veil on Corporate Groups in Australia':

#### *Theoretical justifications for limited liability and the corporate veil:*

- There is nothing intrinsically wrong with incorporation with the sole purpose to attain a limited liability status
- Limited liability is allowed because it would be too difficult having an unlimited liability system where shareholders must contract-in or -out of each investment. This would discourage investment, defeating one of the aims of incorporation
- It would also mean that shareholders must constantly monitor the company's behaviour
- There would also be a larger amount of information to be disclosed, many investors would not even understand this information
- On the other hand, creditors have greater knowledge and may easily choose whether or not to invest
- The harm to shareholders would outweigh the harm to investors if there was an unlimited liability scheme

#### *Arguments for piercing the veil (Directors):*

- One reason for piercing the veil on directors is to correctly attribute liability to the party responsible for the wrongdoing
- The proper determinant of whether the individual's own personal liability will arise when he or she acts for a company is the principle of agency, not organic theory.
- There is disagreement between academics whether directors should be personally liable for their actions
- A second reason to impose liability is to deter actions that are detrimental to the company and other corporate stakeholders as creditors.
- BUT there are civil and criminal provisions which may apply to directors
- While directors may lose personal assets, they may control the decisions of the company. Perhaps imposing liability is not unfair?

#### *Arguments for piercing the veil (Companies closely held):*

- Because the incentive that arises from limited liability is absent for companies that are closely held, commentators believe that the corporate veil should be pierced in these

scenarios.

- BUT it is difficult to draw a line based on firm size for when the veil should and should not be pierced.

Arguments for piercing the veil (Where the company has committed a tort):

- Where a company is insolvent, uninsured or unable to compensate a victim, it is natural that the victim will seek compensation from the person behind the tort.
- Courts are more likely to pierce the veil in contract than in tort cases. This is surprising.
- This may be because the overall social cost of the tortious activity may exceed the gain to the shareholders.
- It is argued that unlimited liability would force companies to obtain adequate insurance.
- It is also difficult to impose liability because the pool of shareholders is always changing (who should you recover from? The present or past shareholders?)
- A government funded comprehensive injury compensation scheme may be a better approach. However, this scheme would fail to deter controllers of parent companies from running underfunded and underinsured subsidiaries that engage in high risk activities. (see NZ's approach)

Piercing the corporate veil on corporate groups:

- Again, unlimited liability would make shareholders unwilling to invest and to diversify their investments
  - However, at least in respect of wholly-owned subsidiaries, there appears to be no issue, for individual shareholders will ultimately be protected by the holding company's limited liability
- There needs to be concrete grounds for when the veil should be pierced
- The mere fact that a subsidiary has incurred a debt it cannot pay is not enough
- Control or domination of the subsidiary is also not enough because this would occur in almost all circumstances
- In Australia courts will only pierce the veil if the corporation has been used for fraud, to shield the parent company from an existing legal obligation or for corporate groups where the level of control is so complete that the parent company is deemed to be directly liable for activities of the subsidiary
- What may be needed in addition to control is an act of wrongdoing on the part of the parent company either its own or through the subsidiary it controls

Are there any grounds for an introduction of a statutory rather than common-law approach to veil piercing?

- Tort law may be one area
- Where the parent company has sufficient control over a subsidiary so that they may prevent excessive risk taking this may be a justification for veil piercing
- Corporate groups were not in contemplation when the legal entity and limited liability rules were introduced. As they were 'accidental beneficiaries' there may be need for a statutory inclusion
- Undercapitalisation is another area of fault where the parent company could be liable. Section 588V (for insolvent trading including on behalf of the subsidiaries) does not solve this issue because it does not take into account actions that occurred while the company was solvent. BUT there may be difficulties in defining when there is undercapitalisation
- The subsidiary's lack of insurance may be another cause to pierce the corporate veil

- Also fraud and misrepresentation
- A statutory response would provide clarity and may be the best solution

*The case for statutory veil-piercing for corporate groups:*

- Legislation for veil piercing would (i) overcome the objection that veil-piercing is uncertain, discretionary and therefore costly and unreliable; (ii) it would provide clarity, deterrence, reliable compensation and minimal litigation costs; and (iii) provide a clear signal from the legislature that veils should be pierced.