ANNEXURE T

The Concept of Limited Liability - Existing Law and Rationale

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The separate entity principle and corporate groups

1. It is a fundamental principle of Australian corporate law that a company is a legal entity separate from the legal persons who became associated for its formation or who are now its members (see *Ford's Principles of Corporations Law* at [4.140]). For the most part, there is a 'corporate veil' shielding the members from the company's liabilities. This separate entity principle, first enunciated by the House of Lords in *Salomon v Salomon & Co Ltd* [1897] AC 22, was explained by Lord Sumner in *Gas Lighting Improvement Co Ltd v IRC* [1923] AC 723 at 740-1 as follows:

> *Between the investor, who participates as a shareholder, and the undertaking carried on, the law interposes another person, real though artificial, the company itself, and business carried on is the business of the company, and the capital employed is its capital and not in either case the business or the capital of the shareholders. Assuming, of course, that the company is duly formed and is not a sham … the idea that it is mere machinery for effecting the purposes of the shareholders is a layman's fallacy. It is a figure of speech, which cannot alter the legal aspects of the facts.*

2. The separate legal entity principle does not of itself 'impose' limited liability. However, the formation of the company as a separate entity capable of acquiring obligations separate from those of its members makes it possible for the members to derive the privilege of limited liability; limited in the sense that recourse by the company's creditors is only to the company's assets rather than the totality of the members' personal assets.

3. Applied to corporate groups, the principle means that they can determine the size and choose the limits of their legal responsibilities by the relatively simple mechanism of making one company (the 'parent' or 'holding' company) a member of another company or companies (the 'subsidiary'/'subsidiaries') in the group. That is: they are able to determine the limits of their 'capital boundary' (see H Collins, 'Ascription of Legal Responsibility to Groups in Complex Patterns of Economic Integration' (1990) 53 *Mod Law Rev* 731 at 736–737). In economic terms, companies may by this technique externalise the risk of their operations by exposing third parties to the risk of uncompensated losses where the subsidiary's assets are insufficient to satisfy its liabilities.

Justifications for limited liability

4. Limited liability is justified by its economic benefits, which include:

   (a) the decreased cost to shareholders of monitoring the actions of managers;

   (b) the increased incentive to managers to act efficiently and in the interests of shareholders by promoting the free transfer of shares;

   (c) the increased efficiency of securities markets since share trading does not depend on an evaluation of the wealth of individual shareholders, only the company itself;

   (d) its encouragement to shareholders to hold diverse share portfolios, thereby permitting companies to raise capital at lower costs because of the shareholders' reduced risks; and

   (e) the facilitation of optimal investment decisions by managers by pursuing projects with positive net present values rather than being concerned with the risk to shareholders that such projects may bring.

   (See Easterbrook and Fischel *The Economic Structure of Corporate Law*, Harvard University Press, 1991, pp. 41–4, summarised in *Ford's Principles of Corporations Law* at [4.160]). In short, limited liability encourages entrepreneurial risk-taking, which encourages economic growth.

5. These benefits come at a price, a price that is felt keenly by creditors in respect of whom risks are successfully 'externalised'. The question of present concern is a narrower one however – namely, the proper role of limited liability *within a corporate group* in relation to claims in respect of persons killed or physically injured as a result of wrongs committed by a company in the group. In answering that question it is necessary first to outline briefly the established limits of the limited liability principle in this context.

The boundaries of limited liability

6. It must be noted that some common law and statutory exceptions exist, which allow the lifting of the corporate veil in certain limited circumstances. The common law already imposes some limits on the doctrine of limited liability in relation to torts committed by a group company (even if wholly owned). The main ones are:

(a) cases of agency, partnership or trust between the subsidiary and parent company (e.g. *Spreag v Paeson Pty Ltd* (1990) 94 ALR 674; cf *Adams v Cape Ind PLC* [1990] Ch 433 at 545–49; *Briggs v James Hardie & Co Ltd* (1989) 7 ACLR 841 at 845–846);

(b) attribution of direct liability by reason of the parent company and subsidiary both owing a duty of care to the tort claimant according to the limiting tests of reasonable foreseeability and proximity, chiefly demonstrable by a level of actual control over day-to-day operations of the subsidiary (e.g. *CSR Ltd v Wren* (1998) Aust Tort Rep 81-461; *CSR Ltd v Young* (1998) Aust Tort Rep 81-468) akin to the subsidiary being a mere façade (see *James Hardie & Co Ltd v Hall* (1998) 43 NSWLR 554 at 579–84).

7. The most notable statutory exception is under s 588V to s 588X of the Corporations Law, which provides that where a holding company ought to have suspected its subsidiary's insolvency, it may be liable for debts the subsidiary incurred whilst insolvent.

8. It will be observed that the exceptions are quite narrow in compass. Moreover, they depend on the resolution of factual issues that are costly and risky to litigate. It is rare for assaults on the corporate veil to succeed.

9. It follows that the existing exceptions to limited liability do not provide adequate protection for victims of torts committed by insolvent subsidiaries of wealthy holding companies. That raises the question of the strength of the objections to qualifying the principle in such cases, and of the justifications for doing so.

Consideration of Reform

10. There are four primary grounds for justifying restricting the application of the limited liability principle as regards liability for damages for personal injury or death caused by a company that is part of a corporate group and confining the benefit of limited liability to the members of the ultimate holding company. *First*, unlike other creditors, involuntary tort claimants dealing with a corporate group entity do not voluntarily assume the risk of the subsidiary's insolvency. *Secondly*, leaving the involuntary tort claimant to bear the risk of uncompensated loss is economically inefficient. *Thirdly*, limiting the liability of the tortfeasor company results in ineffective deterrence of harm-causing behaviour in a corporate group context.

Finally, there is an ethical question – should companies be able to profit from business operations without bearing the costs if wrongful death or injury ensue from them?

Tortfeasor's involuntary assumption of risk and inefficient allocation of risk

11. The first and second points are related. In the context of tort claims there is a consideration of economic efficiency which weighs in favour of piercing the corporate veil. This is based on the proposition that liability is most efficiently assigned to the one who is able to avoid risk at the least cost (see K Hoftstetter, 'Multinational Enterprises Parent Liability: Effective Legal Regimes in a World Market Environment' (1990) 15 *Nth Carolina J Int L & Comm Reg* 299 at 307).

12. Tort claimants generally are the least likely of all persons dealing with a company to be able to protect themselves against the risk of harm by it because:

    (a) with no contractual nexus, they have no mechanism to ensure compensation for assuming a risk of injury, such as by obtaining intra-group securities or cross guarantees that may be secured by voluntary creditors;

    (b) they are in a poor position to assess creditworthiness prior to commission of the tort, since they have limited access to such information, and are unlikely to use or be aware of information otherwise made available through enhanced financial disclosure requirements on companies; and

    (c) they are not effective monitors of managers of a company in ways that other creditors (such as financiers and banks) or the controlling shareholder can be.

13. The difficulty faced by the involuntary tort claimant dealing with a corporate group entity was accepted by Rogers A JA in *Briggs v James Hardie & Co Ltd* (1989) 7 ACLR 841 at 863–864:

> *Generally speaking, a person suffering injury as a result of the tortious act of a corporation has no choice in the selection of the tortfeasor. The victim of the negligent act has no choice as to the corporation which will do him harm. In contrast, a contracting party may readily choose not to enter into a contract with a subsidiary of a wealthy parent. The contracting entity may inquire as to the amount of paid up capital and, generally speaking, as to the capacity of the other party to pay the proposed contract debt and may guard against the possibility that the subsidiary may be unable to pay.*

14. By contrast, a holding company is in a better position relative to an involuntary creditor – and, arguably, in the best position overall – to 'avoid the risk at least cost'. This is clearly so in the present context. For example, JHIL could, and did, obtain insurance for forecast liabilities in order to offload the risk. There can be no doubt that at all times it was within the power of JHIL to cease the use of asbestos by its subsidiaries, or to set standards for the conduct of their businesses, or to require them to issue appropriate warnings to consumers and end users. It was JHIL's economic interests that were likely to determine the extent to which any of these things happened.

15. There is much to be said for the proposition that development of the principle of limited liability enunciated in *Salomon v Salomon & Co Ltd* [1897] AC 22 failed to give due weight to whether all claimants can be said to have voluntarily accepted the risk of limited liability.

16. It should be stressed that, for practical purposes, the present context largely involves the risk of injury to complete strangers to the corporate group. Employees of the group company are given some protection against its insolvency by various statutory regimes. Leaving them aside, the typical personal injury plaintiff will be an ultimate consumer of a good or service provided by the company. Often the relationship will be completely involuntary, as it was in the case of many victims of James Hardie's asbestos products – e.g. employees of other businesses which chose to use or deliver the products; members of the family of such persons; visitors to worksites where asbestos was being used; home renovators who come across asbestos sheeting inside a wall or door, or as lagging on old pipes, etc; workers in environments where asbestos had previously been deployed. In such cases the information and control asymmetry as between holding company and tort victim is extreme. Accordingly, considerations of the efficiency of risk allocation – that is, of '*who is able to avoid the risk at least cost?*' – operate in a particularly strong way in this context.

Ineffective deterrence of harm-causing behaviour

17. One of the main public policy objectives of tort law is to discourage activity that is needlessly harmful to people, by imposing the cost of compensation on the wrongdoer. That policy objective is undermined where wrongdoers can externalise their risk. In reality, it is substantially undermined if a company about to undertake

an activity that poses serious health risks for mere bystanders or ultimate consumers, can ensure it will never have to satisfy any claims for compensation by the simple technique of carrying on the operations through a company with no capital, funded by loans from the parent secured by a debenture over its assets. Indeed, the limited liability principle as it presently operates actually *encourages* managers so to act, because it is in the 'shareholders' interests' to do so.

Ethical problem of group companies deriving benefit without bearing the burden

18. Clearly, the problem of lack of deterrence of wrongful behaviour is closely related to the issue of group companies gaining benefit while avoiding burden. In *Re Southard & Co Ltd* (1979) 1 WLR 1198 at 1208, Templeman J described how the doctrine of separate legal personality in corporate groups could give rise to this problem:

> A parent company may spawn a number of subsidiary companies, all controlled directly or indirectly by the shareholders of the parent company. If one of the subsidiary companies, to change the metaphor, turns out to be the runt of the litter and declines into insolvency to the dismay of its creditors, the parent company and the other subsidiary companies may prosper to the joy of the shareholders without any liability for the debts of the insolvent subsidiary.

19. It has been argued that in its application to corporate groups the limited liability principle is better understood as an 'historical accident' (Blumberg, 'Limited Liability in Corporate Groups' (1986) *J Corp Law* 573 at 605) which confuses separate legal personality and limited liability so that within corporate groups there is the possibility of limited liability within limited liability (see JH Farrar, 'Legal Issues Involving Corporate Groups' (1998) 16 *Aust Co & Sec L J* 184 at 189).

Possible Objections To Reform

20. The May 2000 Companies and Securities Advisory Committee's *Final Report on Corporate Groups* (see *Final Report* at paras [4.16, 4.20]) rejected wholesale reform to the principle of limited liability within corporate groups. It did, however, countenance specific 'see through' liability legislation lifting the corporate veil and imposing direct liability on holding or other group companies for the negligence of subsidiaries where to do so was 'desirable in the public interest' (see *Final Report* at paras 4.16, 4.20.

21. A number of reasons, based on submissions to the Committee, were given for opposing a more wide-ranging reform. As some may be regarded as relevant to the present proposal, they must be considered here.

- It would put Australia out of step with overseas jurisdictions.

(a) This proposition requires very careful analysis. In the United States for example, the corporate veil doctrine has, in broad outline, very similar operation to the doctrine here. However, its effect is mitigated in many cases by doctrines unknown to Australian law (e.g. the 'successor liability' doctrine) and doctrines which operate somewhat differently there (e.g. fraudulent transfer rules – see USC s 548(a), UFTA s 7(a)(1)).

- The separate entity doctrine is not only a fundamental legal principle but a commercial expectation entrenched within commercial investment practice. Coupled with limited liability it stimulates investment. The revenue from such investment allows further research and development. Within a corporate group, the separate entity doctrine can promote the provision of diverse goods and services. This aids competition in all industries and promotes growth and development.

(b) This second proposition overlooks the extent to which statute already intrudes on the doctrine, the economic inefficiency of poor risk allocation for torts, and the special concerns raised by the case of claimants who have suffered personal injury through involuntary dealings with the company. It is unlikely the Committee was intending to suggest that stimulation of commercial investment, diversity, growth and research and development could legitimately be founded upon the opportunity to injure and kill by negligence, with impunity.

- Making a parent company liable for the torts of a group company would commercially weaken the central economic foundation of all the other group companies. If the tort claims are large or numerous enough, they could ultimately destroy an entire corporate group comprising vastly differing interests, with negative effects on the economy.

(c) It is of course possible that an entire corporate group might be liquidated if its subsidiaries caused widespread injury. However, the negative effects in that case would not arise from the liquidation, but rather from the tortious injuries caused by the subsidiary. This is all the more reason to ensure that the law operates as an effective deterrent.

(d) As to the negative effects on the economy at large, it should be noted that, in the usual course of a liquidation, safe and profitable arms of the business would continue to exist, albeit under new ownership. More importantly, if the corporate citizens who have profited from an activity that causes injuries can lawfully refuse to pay just compensatory damages, it is likely that a substantial portion of the economic burden of those injuries will fall on the public purse (that is, the taxpayers). Where the injuries are of such a magnitude that the compensatory damages could destroy the entire corporate group in question, the drain on public revenue – particularly in the form of increased demands for medical and hospital services – is likely to be very significant.

- The imposition of this tort liability may give rise to increased litigation, particularly against larger corporate groups. Settlement of actions involving these groups will be less probable, given their size and pool of funds.

(e) It must be emphasised that the reform proposed here does not create a new head of tortious liability nor any new class of claimants. All the proposed reform does is allow citizens who have legitimate claims under the law to be justly compensated by enabling them to recover the damages to which they are lawfully entitled from all those companies which, directly or indirectly, have profited from the activity which caused their injuries.

(f) As for settlements being less probable, this seems to be an argument that corporate groups should be able to pressure their victims into unsatisfactory settlements because of a threat of subsidiary insolvency. This seems unconscionable.

- The common law can accommodate the interests of individual justice. The courts can analyse the conduct of companies with common directors and differentiate between the effects of director control and control by ownership of shares by a parent company.

(g) As for the common law, the circumstances of the present case appear to suggest that it does not produce satisfactory outcomes.

- The interests and profiles of different group companies may differ significantly.

(h) This may be so, but it is unclear what significance it has.

22. While the considerations relied on by CAMAC might have weight in the context of the risk of purely economic loss being suffered by third parties, they may not be an adequate answer in the context of deterring torts causing death or injury and compensating victims when they occur. Apprehension that over-deterrence will discourage economic development gives insufficient weight to the other considerations outlined above – particularly, to the special position of tort claimants when compared to shareholders, managers and secured creditors.

23. 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 subsidiary.

24. It should also be observed that subjecting parent companies to liability for the personal injuries caused by the wrongs of their subsidiaries does no more than put them in the same position, so far as exploiting the corporate veil is concerned, as a sole trader. Small business proprietors may shield themselves from liability to the general run of creditors by the use of an interposed company. However, they cannot by that device shield themselves from liability for tortiously inflicting injury – for what they do themselves they remain liable in tort, even though they act as agent for a company.

Statutory Precedents

25. There are statutory precedents for ascribing further limits to the principle of separate legal personality. Noteworthy examples are fiscal measures, such as:

(a) grouping of related companies for the purpose of assessing land tax payable by such companies (see s 29 *Land Tax Management Act* 1956 (NSW) (as amended in 1983) as explained in Office of State Revenue Ruling LTO3, 21 July 1986); and

(b) capacity for members of a group to designate one or more qualified members of the group (whose financial year wages exceed $600,000) to be the designated group employer for the group for the purposes of payment of pay roll tax (see s 16I *Payroll Tax Act* 1971 (NSW); see also Pt 10A *Taxation Administration Act* 1996 (NSW)).

26. It does not seem a large step to treat the interests of those killed or injured by corporate torts as being at least as worthy of special treatment as the revenue.

Recommendation

27. The Commission should recommend reform of the Corporations Act so as to restrict the application of the limited liability principle as regards liability for damages for personal injury or death caused by a company that is part of a corporate group, confining the benefit of limited liability to members of the ultimate holding company.

28. Consideration should be given to making the reform retrospective, so that it extends to corporations that were once but are no longer in the same group as the company in question.