PIERCING THE VEIL ON CORPORATE GROUPS IN AUSTRALIA: THE CASE FOR REFORM

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[Many large-scale businesses are conducted through the form of corporate groups, each company being a separate legal entity enjoying limited liability. This can create problems for those dealing with corporate group companies. This article makes two points: first, with reference to the theoretical literature on limited liability and veil-piercing, that the corporate veil should be pierced to impose liability on parent companies for conduct involving a lack of care and diligence or a lack of good faith in the dealings of their subsidiaries; and secondly, that the piercing should be done via statute, in effect codifying the liability of a parent company as a shadow director. It is argued that this would overcome the vagueness of the present veil-piercing doctrine in Australia and send a message to parent companies that they cannot shield themselves behind the veil of incorporation to deny recovery to those affected by their decisions and their conduct.]

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I INTRODUCTION

Limited liability and separate legal personality are arguably the most important characteristics of incorporation. The company is an artificial legal entity separate from its shareholders, whose liability for the company's debts is limited to their contributions to the company's capital. Given the fundamental nature of these characteristics, it is not surprising that piercing[1] the veil of incorporation to make shareholders liable for the debts of the company is a contentious issue amongst

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1 The terms 'veil-lifting' and 'veil-piercing' are often used synonymously. The author has chosen 'veil-piercing' in this article, adopting the reasoning of Ramsay and Noakes: Ian M Ramsay and David B Noakes, 'Piercing the Corporate Veil in Australia' (2001) 19 *Company and Securities Law Journal* 250. Learned minds differ, however: see, eg, Jennifer Payne, 'Lifting the Corporate Veil: A Reassessment of the Fraud Exception' (1997) 56 *Cambridge Law Journal* 284, 284 fn 2.

scholars[2] and litigants.[3] This is so even where the shareholder is another corporation.[4]

This article considers the liability of parent corporations within corporate groups and makes recommendations for its reform in Australia. It is noteworthy that corporate groups were not in existence at the time of the *Limited Liability Act 1855*, 18 & 19 Vict, c 133, and were only just beginning to be recognised in the United States of America at the time of *Salomon v Salomon & Co Ltd* ('*Salomon*').[5] Phillip Blumberg notes legislation in New Jersey in 1890 that, for the first time, allowed companies to acquire shares in other companies.[6] Difficulties with corporate groups emerged shortly thereafter. By 1912, the term 'piercing the veil' had been coined in the US.[7] Soon, plaintiffs were arguing that subsidiaries were 'mere instrumentalities' or 'alter egos' of their parent companies, in order to overcome the latter's separate legal entity status.[8]

[2] See, eg, Harvey Gelb, 'Piercing the Corporate Veil — The Undercapitalization Factor' (1982) 59 *Chicago Kent Law Review* 1; S Ottolenghi, 'From Peeping behind the Corporate Veil, to Ignoring It Completely' (1990) 53 *Modern Law Review* 338; Henry Hansmann and Reinier Kraakman, 'Toward Unlimited Shareholder Liability for Corporate Torts' (1991) 100 *Yale Law Journal* 1879; Robert B Thompson, 'Piercing the Corporate Veil: An Empirical Study' (1991) 76 *Cornell Law Review* 1036; Robert B Thompson, 'Unpacking Limited Liability: Direct and Vicarious Liability of Corporate Participants for Torts of the Enterprise' (1994) 47 *Vanderbilt Law Review* 1; Franklin A Gevurtz, 'Piercing Piercing: An Attempt to Lift the Veil of Confusion Surrounding the Doctrine of Piercing the Corporate Veil' (1997) 76 *Oregon Law Review* 853; Payne, 'Lifting the Corporate Veil', above n 1; Robert B Thompson, 'Piercing the Veil within Corporate Groups: Corporate Shareholders as Mere Investors' (1999) 13 *Connecticut Journal of International Law* 379; David L Cohen, 'Theories of the Corporation and the Limited Liability Company: How Should Courts and Legislatures Articulate Rules for Piercing the Veil, Fiduciary Responsibility and Securities Regulation for the Limited Liability Company?' (1998) 51 *Oklahoma Law Review* 427; Stephen M Bainbridge, 'Abolishing Veil Piercing' (2001) 26 *Journal of Corporation Law* 479; Jason W Neyers, 'Canadian Corporate Law, Veil-Piercing, and the Private Law Model Corporation' (2000) 50 *University of Toronto Law Journal* 173; Kurt A Strasser, 'Piercing the Veil in Corporate Groups' (2005) 37 *Connecticut Law Review* 637; Robert B Thompson, 'Piercing the Veil: Is the Common Law the Problem?' (2005) 37 *Connecticut Law Review* 619.

[3] In the United States at least, piercing the corporate veil is the most litigated issue in corporate law: Thompson, 'An Empirical Study', above n 2, 1036; Robert B Thompson, 'Agency Law and Asset Partitioning' (2003) 71 *University of Cincinnati Law Review* 1321, 1325. There is less veil-piercing in Australia, although what litigation there is has proven unsatisfactory and unpredictable: see Ramsay and Noakes, above n 1, 261.

[4] See Bainbridge, above n 2, 482.

[5] [1897] AC 22. Corporate groups were recognised by courts in the United Kingdom by the 1860s. Blumberg notes that in England 'the corporate power to acquire and own the shares of another corporation could arise from provisions inserted in the memorandum [of association] … notwithstanding the omission of such power in the incorporation statute': Phillip I Blumberg, 'Limited Liability and Corporate Groups' (1986) 11 *Journal of Corporation Law* 573, 608.

[6] Phillip I Blumberg, 'The Transformation of Modern Corporate Law: The Law of Corporate Groups' (2005) 37 *Connecticut Law Review* 605, 607. See also Blumberg, 'Limited Liability and Corporate Groups', above n 5, 607, where he notes that limited liability was an automatic consequence of the ability of companies to own shares in other companies. Further, at 576, Blumberg states: 'This development appear[s] to have followed without any recognition that the principle was receiving a dramatic extension.'

[7] I Maurice Wormser, 'Piercing the Veil of Corporate Entity' (1912) 12 *Columbia Law Review* 496.

[8] In the US, that parent corporations should be held accountable for their actions in managing their subsidiaries was recognised in *Taylor v Standard Gas & Electric Co*, 306 US 307 (1939). This broad principle of subordination became known as the Deep Rock doctrine: see Myron N Krotinger, 'The "Deep Rock" Doctrine: A Realistic Approach to Parent–Subsidiary Law' (1942) 42 *Columbia Law Review* 1124.

Part II of this article looks at the theory behind limited liability and the maintenance of the veil of incorporation, which can be used as a shield by controllers and shareholders as well as a sword against these parties.[9] The meaning of 'veil-piercing' will be addressed to distinguish liability imposed because a legal person occupies a certain position — director or shareholder — from that imposed because of some action on the part of that person. It will be observed that only a small number of writers suggest that liability ought to be imposed on shareholders simply because they are the beneficiaries of the corporate enterprise. Rather, most veil-piercing permitted by courts and supported by commentary is based on the behaviour of a person while he or she occupies a position as a corporate insider. The latter is arguably not veil-piercing but rather liability imposed as a result of the application of distinct legal doctrines; nonetheless, the convention of describing it as veil-piercing, common amongst courts and commentators, will be maintained in this article.

Part III considers three specific circumstances where scholars contend that veil-piercing, as broadly defined, ought to occur. These are where the directors of the company have breached a duty owed to that company; where the company is closely held and has behaved in a way deemed unacceptable; and where the company has committed a tort. The scholars argue that in these situations there is a lack of theoretical justification for keeping the veil, either because there is effective control of the operations of the company by its directors (or shareholders), or because creditors are unable to self-protect, *ex ante*, against the risk of loss. The arguments put forth with respect to these three situations will be applied to the question of liability on the part of parent companies.

The approach to veil-piercing in the US is far more broad-ranging and litigated than in Commonwealth countries, leading, in the US, to a 'laundry list' attitude to the identification of relevant factors which justify shareholder liability.[10] The American theoretical literature is considered not for the purpose of suggesting that Australia adopts such an approach but rather to glean from it relevant notions to inform the development of the law in Australia.

Part IV then examines the justifications for piercing the corporate veil on corporate groups through reviewing some of the extensive literature on the subject as well as by analogy to the circumstances considered in Part III. One of

[9] Shareholders and their personal creditors have no access to company assets. This is called 'liquidation protection' and 'serves to protect the going concern value of the firm against destruction either by individual shareholders or their creditors': Henry Hansmann and Reinier Kraakman, 'What is Corporate Law?' in Reinier Kraakman et al (eds), *The Anatomy of Corporate Law: A Comparative and Functional Approach* (2004) 7. It is also known as 'asset partitioning': Henry Hansmann and Reinier Kraakman, 'The Essential Role of Organizational Law' (2000) 110 *Yale Law Journal* 387, 393–4. 'Affirmative asset partitioning' provides a pool of assets owned by the company as security for its contracts. 'Defensive asset partitioning' protects the owner's assets from the company's creditors and is the concept now known as 'limited liability'.

[10] See, eg, Thompson, 'An Empirical Study', above n 2, 1063; Bainbridge, above n 2, 510, citing *Associated Vendors Inc v Oakland Meat Co Inc*, 26 Cal Rptr 806, 813–15 (Molinari J) (Cal Dist Ct App, 1962); David Millon, 'Piercing the Corporate Veil, Financial Responsibility, and the Limits of Limited Liability' (Working Paper No 2006-08, School of Law, Washington and Lee University, 2006) 17–20 <http://ssrn.com/abstract=932959>. See also Ottolenghi, above n 2, 353; Gevurtz, above n 2, 861–70.

the principal reasons for maintaining the corporate veil is that a regime of unlimited liability would make shareholders unwilling to invest, and to diversify their investments, because of the need to monitor the company and fellow investors. The point will be made that holding a parent company liable for the debts of its subsidiary does not impose unlimited personal liability on any individual shareholder, thus removing one of the most persuasive grounds for maintaining the corporate veil.

Nevertheless, there need to be appropriate grounds on which the veil-piercing is based. The mere fact that a subsidiary has incurred a debt that it cannot pay is not, and should not be, enough to pierce the corporate veil. Otherwise, the doctrine of limited liability would have no application within corporate groups. Nor should the fact of control or domination of the subsidiary be the basis of the veil-piercing. In almost all circumstances, such control of the subsidiary by the parent company exists. Using control as the sole test for veil-piercing would be tantamount to removing the veil altogether. Given that control alone should not be sufficient to justify veil-piercing, Part IV also considers what those grounds should be.

It is recommended that, in addition to control, a necessary element required to pierce the veil on corporate groups should be an act of wrongdoing on the part of the parent company, either through its own actions or through the actions of the board of the controlled subsidiary. What should be recognised in a statutory veil-piercing scheme are the substantive grounds on which the veil should be pierced, rather than the means, such as agency, by which it is done. It is suggested that directors' duties to act with care and diligence and in good faith be the model of liability for parent companies facing veil-piercing. This would build on and codify the present liability of parent companies as shadow directors.[11]

Part V then makes the case that veil-piercing on corporate groups be regulated through statute, rather than leaving it to the common law. There are three bases for this. First, it would remove the uncertainty and unpredictability that currently bedevil common law veil-piercing, consequently reducing the cost of litigation. Secondly, legislation would send clear signals to the controllers of parent companies regarding proper uses of the corporate group form and provide compensation to parties suffering loss when those signals are ignored. Finally, legislation would overcome the judicial reluctance to pierce the veil on corporate groups evinced by Australian courts. The aim of this article is not to discuss the policy and controversy surrounding the misuse of separate legal entity and

[11] This article is not about *Briggs v James Hardie & Co Pty Ltd* (1989) 16 NSWLR 549 ('*James Hardie*') and the cases that followed. Many fine authors have already given the problems that arose there a thorough examination. Nonetheless, it is noteworthy that behaviour such as that shown by James Hardie Industries could be addressed, if not redressed in that particular instance, by the reform suggested here. See, eg, Peta Spender, 'Blue Asbestos and Golden Eggs: Evaluating Bankruptcy and Class Actions as Just Responses to Mass Tort Liability' (2003) 25 *Sydney Law Review* 223; Peta Spender, 'Second Michael Whincop Memorial Lecture: Weapons of Mass Dispassion — James Hardie and Corporate Law' (2005) 14 *Griffith Law Review* 280; Edwina Dunn, '*James Hardie*: No Soul to Be Damned and No Body to Be Kicked' (2005) 27 *Sydney Law Review* 339; Susan Engel and Brian Martin, 'Union Carbide and James Hardie: Lessons in Politics and Power' (2006) 20 *Global Society* 475; Lee Moerman and Sandra van der Laan, 'Pursuing Shareholder Value: The Rhetoric of James Hardie' (2007) 31 *Accounting Forum* 354.

limited liability by those in control; rather, it attempts to design an efficient, economically justified legislative veil-piercing regime that precludes such conduct.

II THEORETICAL JUSTIFICATIONS FOR LIMITED LIABILITY AND THE CORPORATE VEIL

Many commentators have expounded the theoretical justifications for limited liability and the retention of the veil between the company, as a separate legal entity, and its shareholders.[12] Put simply, in the contractarian analysis of the corporation, limited liability is one of the default rules making up the standard form contract which is corporate law.[13] The aim of a set of default or 'off-the-rack' rules is to lower the cost of transacting.[14] Default rules save firms the cost of negotiating and inserting terms into each of the contracts they form.[15] Corporate law rules and norms deal with disputes between corporate stakeholders — managers, shareholders, employees, suppliers, customers and the broader community — and aim to achieve a balance between the objective of shareholder wealth maximisation and the protection of those who may be adversely affected by the activities of the corporation.[16] Being default rules, they can be overcome by express contract terms to the contrary.[17]

As Stephen Bainbridge notes, '[t]here is nothing intrinsically fraudulent about deciding to incorporate or about dividing a single enterprise into multiple corporations, even when done solely to get the benefit of limited liability.'[18] It is perhaps surprising that creditors would agree to contract with an entity whose shareholders have limited liability; after all, limited liability encourages shareholders to invest in projects with higher risk, externalising some of the risk

[12] See above n 2.

[13] Bainbridge, above n 2, 486.

[14] Frank H Easterbrook and Daniel R Fischel, 'The Corporate Contract' (1989) 89 *Columbia Law Review* 1416, 1444.

[15] Michael J Whincop, 'Painting the Corporate Cathedral: The Protection of Entitlements in Corporate Law' (1999) 19 *Oxford Journal of Legal Studies* 19, 28.

[16] Note here the comments of Cohen, above n 2, 430, with respect to achieving a balance between efficient wealth maximisation and protection of those who miss out:

> at no time in American history was a successful balance between these two goals reached. Indeed, every theory of the firm propounded contains, to some extent, the tensions inherent in the broader debate over what firms are for. This fact has made the thinking about the firm and its regulation quite schizophrenic, and the history of corporate law see-saws between a paternalistic and free market approach.

He also comments, at 446 (citations omitted), that:

> On the one hand society wants to promote free ordering in the belief that in so doing they are increasing the general welfare; on the other hand, society wants to restrict private ordering for paternalistic reasons and out of concern for the less fortunate or those less able to look after their own interests. Society has never come to a satisfactory conclusion about the proper balance between these two interests.

[17] Bainbridge, above n 2, 486.

[18] Ibid 483.

of loss to the creditors themselves. The shareholders do not jeopardise their personal assets, yet reap the rewards of the investment should it succeed.[19]

The aim of a default rule is to minimise the cost of transactions in general, rather than for each individual party. This occurs when the default rule is the one to which most people would agree. Known as the 'majoritarian default',[20] the use of default rules saves the majority the cost of having to expressly negotiate these contract terms. For the minority who want to bargain out of the rule, their transaction costs will be higher because they choose to negotiate a term to the contrary. This is done, for example, when creditors obtain a personal guarantee executed by a shareholder or director of a company, effectively piercing the corporate veil.

Theorists have examined the reasons why limited liability, rather than unlimited liability, is the default rule chosen by the majority.[21] In essence, it is because the difficulties for shareholders with an unlimited liability regime exceed the difficulties for creditors with a limited liability regime. With unlimited liability, shareholders would be concerned about the risk of losing their personal assets in the event of nonpayment of a debt by the company. The risk could be disproportionate to the return; a small investment could render the shareholder liable for a large corporate debt, yet the return, should the company be successful, would remain small.[22] Shareholders would therefore need to monitor the company's behaviour. To reduce their exposure to loss of personal assets through many companies, and because monitoring is time-consuming and costly, shareholders would limit their investments to a small number of companies. This would effectively limit investors' ability to reduce their risk through the diversification of their portfolio of investments, which would in turn drive up their required rate of return.[23]

[19] Ibid 489.

[20] Ian Ayres, 'Preliminary Thoughts on Optimal Tailoring of Contractual Rules' (1993) 3 *Southern California Interdisciplinary Law Journal* 1, 5. See also Russell Korobkin, 'The Status Quo Bias and Contract Default Rules' (1998) 83 *Cornell Law Review* 608, 614; Robert E Scott, 'A Relational Theory of Default Rules for Commercial Contracts' (1990) 19 *Journal of Legal Studies* 597, 606–8; Bainbridge, above n 2, 486.

[21] The consideration of the appropriateness of limited liability and of the economic consequences that would flow from its absence is not new. See, eg, Paul Halpern, Michael Trebilcock and Stuart Turnbull, 'An Economic Analysis of Limited Liability in Corporation Law' (1980) 30 *University of Toronto Law Journal* 117, 118–19, who note debates taking place on the matter around the time of the passing of the *Limited Liability Act 1855*, 18 & 19 Vict, c 133.

[22] Unless the liability were imposed pro rata, as suggested by Hansmann and Kraakman, 'Toward Unlimited Shareholder Liability for Corporate Torts', above n 2, 1892–4.

[23] This is a summary and simplification of the work of a large number of prominent law and economics scholars. A few of the leading publications in this area are: Richard A Posner, 'The Rights of Creditors of Affiliated Corporations' (1976) 43 *University of Chicago Law Review* 499; Michael C Jensen and William H Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure' (1976) 3 *Journal of Financial Economics* 305; Jonathan M Landers, 'A Unified Approach to Parent, Subsidiary, and Affiliate Questions in Bankruptcy' (1975) 42 *University of Chicago Law Review* 589; Henry G Manne, 'Our Two Corporation Systems: Law and Economics' (1967) 53 *Virginia Law Review* 259; Halpern, Trebilcock and Turnbull, above n 21; Frank H Easterbrook and Daniel R Fischel, *The Economic Structure of Corporate Law* (1991) 41–50. The arguments are nicely summarised by Blumberg, 'Limited Liability and Corporate Groups', above n 5, 611–23.

Monitoring alone does not reduce risk. Shareholders facing unlimited personal liability would want access to current financial information and would seek to intervene in corporate decision-making to ensure that risky behaviour is avoided. This would be costly and cause significant problems, particularly where the company is large and management is separate from its shareholders. In addition, shareholders would need to monitor their fellow investors to ensure that they were not left bearing the debt alone. This again would cause considerable problems for large corporations with extensive and changing membership. Consequently, the economy would suffer from a lack of investment, particularly in industries with an inherently high degree of risk. Share trading would also suffer as incoming investors make sure they are investing in an entity with an acceptable risk profile, adequate capitalisation and well-resourced fellow shareholders. With limited liability, on the other hand, the potential amount of each shareholder's loss is finite and known, giving the shares a stable price and aiding their transferability.[24]

Creditors do face problems with a limited liability regime but are considered to be the 'cheapest cost avoider' because of their capacity, at least in theory, to protect *ex ante* against the risk of loss.[25] Creditors' apparent ability to self-protect against the risk of loss, combined with the above concerns attributed to shareholders, explains why the default rule is not in creditors' favour. For example, creditors are expected to reduce the risk of nonpayment by the company by charging more for their services.[26] Frank Easterbrook and Daniel Fischel assert that, '[a]s long as these risks are known, the firm pays for the freedom to engage in risky activities. … The firm must offer a better risk–return combination to attract investment.'[27]

[24] These arguments are well considered in Halpern, Trebilcock and Turnbull, above n 21.

[25] Bainbridge, above n 2, 508. Bainbridge also notes, at 501–2 (citations omitted), that:

> contract creditors can protect themselves by bargaining with the controlling shareholder and obtaining a modification of the default rule. To the extent contract creditors fail to do so, and accordingly fail to adequately protect their own interests, there seems little reason for the law to protect them. … Thus, in many situations, it makes sense to impose liability on the cheapest cost avoider (ie, the party who could have most cheaply taken precautions against the loss). Doing so gives that party an incentive to take precautions, while minimizing the cost of those precautions.

[26] David A Wishart, 'Models and Theories of Directors' Duties to Creditors' (1991) 14 *New Zealand Universities Law Review* 323, 335 (citations omitted), maintains that:

> Creditors charge interest for the service they render. Built into that fee is compensation for the risk of loss they bear. The greater the risk of loss, the more is charged to compensate for that risk. Creditors cannot complain that insolvency as such has caused them loss because they have contracted to bear that risk, and have built compensation for bearing it into the cost of credit. If creditors do not charge for the probability of certain events happening, they should not be supported in their foolishness. They should not survive to charge less than wiser people.

[27] Easterbrook and Fischel, *Economic Structure*, above n 23, 51. See also Ross Grantham, 'Directors' Duties and Insolvent Companies' (1991) 54 *Modern Law Review* 576, 579–80. Posner, above n 23, 501, also commented that 'the interest rate on a loan is payment not only for renting capital but also for the risk that the borrower will fail to return it.' However, Keay, noting research by Cheffins, suggests that 'there is little evidence that creditors charge a higher interest rate when dealing with a limited liability company, compared with other creditors': Andrew Keay, 'Directors' Duties to Creditors: Contractarian Concerns Relating to Efficiency and Over-Protection of Creditors' (2003) 66 *Modern Law Review* 665, 689, citing Brian R Cheffins, *Company Law: Theory, Structure, and Operation* (1997) 501.

In addition to the capacity to price-protect, creditors with superior bargaining power can also be protected by devices such as loan covenants (restricting the company's ability to sell or further pledge its assets), security over the corporation's major assets, retention of title clauses or personal guarantees from the directors.[28] Trade creditors in particular may have short-term credit periods, which allow them to carefully assess creditworthiness with current information about the company's financial stability. Creditors are also expected to diversify away their risk of loss by dealing with many companies.[29]

In reality, there are many obstacles to the ability of creditors to self-protect under a limited liability regime. The contention that creditors can self-protect is based on the theoretical 'efficient markets' hypothesis, which assumes that all relevant information is available and immediately digested by the market, leading to accurate assessment and pricing of risk.[30] This does not always happen in practice.[31] Frequently, there is a lack of full or timely information about the risk attaching to an investment or to a debtor company's financial position. Small closely held companies are more likely to deprive creditors of vital information about solvency than are larger companies with mandated public disclosure or a board well separated from its shareholders.[32]

Moreover, the premium charged to compensate for risk may be insufficient if the controllers of a company choose to take additional risks[33] which creditors may not have foreseen. Creditors may undertake to bear a particular level of risk and charge for it based upon factors such as industry norms, financial ratios relating equity to loan capital, the history of the enterprise, industrial relations with employees and other similar factors. Creditors also vary in their ability to protect themselves, as some creditors cannot make their own bargains.[34] Indeed, the ability of some creditors to protect themselves with charges over company assets or loan covenants increases the risk to weaker parties who cannot

[28] See Posner, above n 23, 504.

[29] Diversification for creditors mimics its operation for shareholders under a limited liability regime. The risk of a large loss from investment in a single company is reduced by being exposed to a small loss from many companies on the basis that it is unlikely that all or most of the entities will default on their obligations.

[30] See Jeffrey N Gordon and Lewis A Kornhauser, 'Efficient Markets, Costly Information, and Securities Research' (1985) 60 *New York University Law Review* 761, 770–1.

[31] See Wishart, 'Models and Theories', above n 26, 335–6. See also Ross Grantham, 'The Judicial Extension of Directors' Duties to Creditors' [1991] *Journal of Business Law* 1, 2–3.

[32] Wishart, 'Models and Theories', above n 26, 336.

[33] Eisenberg notes that '[i]t is almost impossible to deal adequately with this potential for ex post opportunism by ex ante contracting': Melvin Aron Eisenberg, 'The Structure of Corporation Law' (1989) 89 *Columbia Law Review* 1461, 1465. See also Mark Byrne, 'An Economic Analysis of Directors' Duties in Favour of Creditors' (1994) 4 *Australian Journal of Corporate Law* 275, 277.

[34] Lipson labelled these creditors 'low VCE creditors', many of whom 'have little or no volition, cognition, and exit'. This describes creditors who lack voluntariness in their dealings with the company (tort creditors, taxing authorities, terminated employees), lack information (cognition) about the true state of company affairs, and lack the ability to exit from these relationships because of the absence of a market to sell their rights against the company: Jonathan C Lipson, 'Directors' Duties to Creditors: Power Imbalance and the Financially Distressed Corporation' (2003) 50 *University of California Los Angeles Law Review* 1189, 1193.

negotiate such protection.[35] Some trade creditors may lack the knowledge and expertise to make accurate assessments of risk and would be unable to calculate an appropriate premium to compensate for this. With small debts, the cost of obtaining information about the risk may be prohibitive. Creditors may lack information about their fellow creditors to enable them as a group to negotiate collectively for fuller particulars of risk.[36]

Suppliers of specialised products are frequently unable to diversify their client bases. While their long-term relationship with the client may bring knowledge that partly compensates for the lack of diversification, nonetheless, these suppliers may lack the ability to seek customers elsewhere because of existing contractual obligations to a possibly financially unstable customer. In addition, suppliers may be unable to charge a premium to compensate for the risk of loss due to the reality of economic conditions and competition in the market.[37]

Despite these grounds for recognising that many creditors can suffer loss under a limited liability regime — just as shareholders would be adversely affected by an unlimited liability regime — most commentators support the default rule favouring shareholders.[38] However, a number of special circumstances have been claimed to justify piercing the veil. These will now be considered.

III ARGUMENTS FOR PIERCING THE VEIL

Judicial veil-piercing, broadly understood, is present in many parts of the world. While courts and commentators have examined the issue in Australia and elsewhere, the majority of the scholarship on the issue comes from the US. This Part considers circumstances in which commentators contend that the corporate veil ought to be pierced. Despite Easterbrook and Fischel's famous comment that '"[p]iercing" seems to happen freakishly. Like lightning, it is rare, severe, and unprincipled',[39] there is a unifying theme underlying the arguments in favour of veil-piercing. It is that some or all of the elements which are used to justify limited liability and the veil of incorporation are not present,[40] either because there is effective control of the operations of the company by the directors or the shareholders (leading to some action on the part of the company which is deemed unacceptable) or because there is an inability by the creditors to self-

[35] Keay, above n 27, 688. See also Judith Freedman, 'Limited Liability: Large Company Theory and Small Firms' (2000) 63 *Modern Law Review* 317, 351.

[36] Gerard Hertig and Hideki Kanda, 'Creditor Protection' in Reinier Kraakman et al (eds), *The Anatomy of Corporate Law: A Comparative and Functional Approach* (2004) 72.

[37] Van Der Weide argues that short-term creditors 'can quickly respond to bad firm behavior by taking their business elsewhere' (Mark E Van Der Weide, 'Against Fiduciary Duties to Corporate Stakeholders' (1996) 21 *Delaware Journal of Corporate Law* 27, 49), while Keay describes this as 'typical of the gross overstatements that pervade some works that have contributed to the law and economics literature' (Keay, above n 27, 697).

[38] See, eg, Strasser, above n 2; Bainbridge, above n 2.

[39] Frank H Easterbrook and Daniel R Fischel, 'Limited Liability and the Corporation' (1985) 52 *University of Chicago Law Review* 89, 89.

[40] Easterbrook and Fischel make the point that piercing 'cases may be understood, at least roughly, as attempts to balance the benefits of limited liability against its costs': Easterbrook and Fischel, *Economic Structure*, above n 23, 55.

protect *ex ante* against the risk of loss. In these circumstances, the balance between the objective of shareholder wealth maximisation and the protection of those adversely affected by a corporation's activities arguably tips back in favour of creditors.[41]

Strictly speaking, the concepts of limited liability and the veil of incorporation are relevant only to the shareholders of a corporation and not to its officers. Veil-piercing is therefore, properly, a doctrine to overcome limited liability rather than the separate legal entity of the company, but the widespread use of the term requires its meaning to be clarified. 'Pure' veil-piercing occurs where liability is imposed simply because a legal person occupies the position of shareholder. It will be seen below that this is sometimes suggested as a source of compensation where the company has committed a tort and there are unmet liabilities to tort claimants. It is this narrower, truer type of veil-piercing which is so often successfully countered by the arguments in favour of limited liability.

The more common use of the term 'veil-piercing' involves the imposition of liability on one or more legal persons — usually shareholders or directors — where those persons have caused the company to act in a certain way and liability is sought to be attributed to them by virtue of their control of the company and their actions as a result of that control. While most scholars[42] quite correctly ignore the liability of directors in their discussion of veil-piercing, many, as do the judiciary, conflate 'pure' veil-piercing of shareholders with the broader sense of imposing liability on them as a result of their control over, and actions under, the company. The 'laundry list' of factors employed by courts and commentators in the US is an attempt to clarify what actions and what control will be sufficient to justify both 'piercing the corporate veil' of this kind and the imposition of personal liability.[43] The motives for this wider type of veil-piercing are compensation and deterrence, and form the basis of the argument in this article that liability ought, in specified circumstances, to be imposed on parent companies. The broader use of the term 'veil-piercing' will be maintained in this article to conform to its widespread application. Three circumstances where commentators maintain that the corporate veil ought to be pierced will now be

[41] See above n 16 and accompanying text.

[42] Courts, on the other hand, frequently use the terminology of limited liability, separate legal entity and veil-piercing (or veil-lifting) to refuse to impose liability on directors. This is commonly observed in the cases dealing with the personal liability of directors for torts: see, eg, *Trevor Ivory Ltd v Anderson* [1992] 2 NZLR 517, 525–6 (Hardie Boys J). In *Mentmore Manufacturing Co Ltd v National Merchandising Manufacturing Co Inc* (1978) 89 DLR (3d) 195, 202, Le Dain J (for Urie, Ryan and Le Dain JJ) struggled with 'a very difficult question of policy', namely:

> the principle that an incorporated company is separate and distinct in law from its shareholders, directors and officers, and it is in the interests of the commercial purposes served by the incorporated enterprise that they should as a general rule enjoy the benefit of the limited liability afforded by incorporation.

Cf Andrew Willekes and Susan Watson, 'Economic Loss and Directors' Negligence' [2001] *Journal of Business Law* 217; Helen Anderson, 'The Theory of the Corporation and Its Relevance to Directors' Tortious Liability to Creditors' (2004) 16 *Australian Journal of Corporate Law* 73.

[43] See above n 10 and accompanying text.

considered: where the veil is pierced to impose liability on the directors of the company; where the company is closely held; and where the company has committed a tort.

A *Directors*

Both common law and statute frequently impose personal liability on directors in specified circumstances for a number of reasons. It is instructive to examine these reasons before moving on to consider veil-piercing in more ambivalent circumstances.

One reason for imposing personal liability on directors is to correctly attribute liability to the party responsible for wrongdoing. The separate legal entity principle enshrined in *Salomon*[44] and the organic theory from *Lennard's Carrying Co Ltd v Asiatic Petroleum Co Ltd*[45] ensure directors have a unique place in the law. On one hand, the director is separate from the company, so that contracts made by the director in the company's name bind only the company and not the director personally. The company is the proper plaintiff and defendant. On the other hand, under the organic theory, the directors act as the company, so that their actions and intentions are the actions and intentions of the company, which cannot act or think for itself.[46]

However, the organic theory was never intended to act as a device to relieve directors of personal liability for their own wrongdoing. Rather, its purpose is to attribute mental states to the company in order to determine the company's liability.[47] This was confirmed by Lord Hoffmann's judgment in *Meridian Global Funds Management Asia Ltd v Securities Commission*.[48] The proper determinant of whether the individual's own personal liability will arise when he

[44] [1897] AC 22.

[45] [1915] AC 705, 713–14. Viscount Haldane LC spoke of the directors of the company not as its agents but as the company itself, a process known as 'anthropomorphism': see David A Wishart, 'Anthropomorphism Rampant: Rounding Up Executive Directors' Liability' [1993] *New Zealand Law Journal* 175. See also John H Farrar, 'Frankenstein Incorporated or Fools' Parliament? Revisiting the Concept of the Corporation in Corporate Governance' (1998) 10 *Bond Law Review* 142, 155.

[46] In *Tesco Supermarkets Ltd v Nattrass* [1972] AC 153, 170, Lord Reid stated that:

> A living person has a mind which can have knowledge or intention or be negligent and he has hands to carry out his intentions. A corporation has none of these: it must act through living persons, though not always one or the same person. Then the person who acts is not speaking or acting for the company. He is acting as the company and his mind which directs his acts is the mind of the company. There is no question of the company being vicariously liable. He is not acting as a servant, representative, agent or delegate. He is an embodiment of the company or, one could say, he hears and speaks through the persona of the company, within his appropriate sphere, and his mind is the mind of the company.

[47] *H L Bolton (Engineering) Co Ltd v T J Graham & Sons Ltd* [1957] 1 QB 159, 172, where Denning LJ explained that the managers of a company who control what it does can be its directing mind and will, so that their intentions can be attributed to the company to make it liable — this is known as the identification doctrine. See also Neil Campbell and John Armour, 'Demystifying the Civil Liability of Corporate Agents' (2003) 62 *Cambridge Law Journal* 290, 292–6.

[48] [1995] 2 AC 500, 506–7. See also *Smorgon v Australia & New Zealand Banking Group Ltd* (1976) 134 CLR 475, 483 (Stephen J).

or she acts for a company is the principle of agency, not organic theory.[49] With a separate legal identity comes the possibility of separate individual liability. Agents are not personally liable for contracts between the company (as principal) and a third party, if made within the scope of actual authority. However, they retain liability for their own wrongful acts,[50] whether they are directors, employees[51] or parties outside the company. While some commentators have maintained that directors should not bear personal liability for their actions,[52] others disagree. For example, Neil Campbell and John Armour have argued that:

> The function of the company law regime is to ensure that the company *but not shareholders* bears liability. So in relation to shareholders company law rules do have primacy over tort and other liability rules. But the regime has never functioned to ensure that the company *but not corporate agents* bears liability. In relation to corporate agents, neither civil liability law nor company law has 'primacy' — there is no inconsistency between the two.[53]

A second reason for imposing personal liability on directors is to deter actions that are detrimental to the company and other corporate stakeholders such as creditors. As controllers of the company, directors are in a position to prevent the company from engaging in insolvent trading,[54] transactions that prevent employees from recovering their entitlements[55] and a multitude of actions specified as civil penalty provisions under part 9.4B of the *Corporations Act*

[49] See Jennifer Payne, 'The Attribution of Tortious Liability between Director and Company' [1998] *Journal of Business Law* 153, 159 (citations omitted), where it is noted that agency theory 'is more generally accepted in English law and even Gower describes the law of agency as being "at the root of company law". According to agency theory a company's representatives act for it, not as it. They retain their separate identity.'

[50] Not all courts agree. In *Standard Chartered Bank v Pakistan National Shipping Co [Nos 2 and 4]* [2003] 1 AC 959, 968, Lord Hoffmann held: 'And just as an agent can contract on behalf of another without incurring personal liability, so an agent can assume responsibility on behalf of another for the purposes of the *Hedley Byrne* rule without assuming personal responsibility.' Lord Hoffmann was referring to *Hedley Byrne & Co Ltd v Heller & Partners Ltd* [1964] AC 465, 530 (Lord Devlin).

[51] There is no doubt that an employee is principally liable for his torts and that the employer, whether a company or otherwise, is vicariously liable under the doctrine of *respondeat superior*. But see *Meridian Global Funds Management Asia Ltd v Securities Commission* [1995] 2 AC 500, 506–7 (Lord Hoffmann). The reason that employees are infrequently sued is because employers are usually in a superior financial position to meet any damages claims.

[52] See, eg, Ross Grantham and Charles Rickett, 'Directors' "Tortious" Liability: Contract, Tort or Company Law?' (1999) 62 *Modern Law Review* 133, 139, where it was stated that:

> the company law regime modifies the normal consequences of the director's actions, precisely to ensure that responsibility for, and the legal consequences of, the tortious conduct or contractual undertaking are not sheeted home to the individual. Where the company law regime applies, its essential function is to identify a different entity as the tortfeasor or contractor.

See also Andrew Borrowdale, 'Liability of Directors in Tort — Developments in New Zealand' [1998] *Journal of Business Law* 96, 97–9; Ross Grantham, 'The Limited Liability of Company Directors' (Research Paper No 07-03, TC Beirne School of Law, The University of Queensland, 2007) <http://ssrn.com/abstract=991248>.

[53] Campbell and Armour, above n 47, 296 (emphasis in original) (citations omitted). See also Willekes and Watson, above n 42, 218–19.

[54] *Corporations Act 2001* (Cth) s 588G(1) ('*Corporations Act*').

[55] *Corporations Act* pt 5.8A; see especially s 596AB(1).

2001 (Cth) ('*Corporations Act*').[56] Directors also face personal civil and/or criminal liability for their actions under a huge raft of other legislation,[57] including taxation legislation,[58] trade practices law,[59] environmental protection law,[60] and occupational health and safety law.[61] Frequently, liability under these provisions extends to others who are responsible for decision-making in the company.[62] This highlights the legislature's intention to target those in control whose actions and omissions cause the company to breach the law.[63]

Thus it can be seen that the reasons identified above in Part II for maintaining limited liability and the corporate veil are not present when considering the liability of directors. While directors risk losing their own assets if personal liability is imposed, they have control over the company in a way that shareholders generally do not. They are able to monitor the actions of their fellow directors to assess that only appropriate risks are taken. Liability is only imposed under the provisions outlined above where there is some wrongdoing on the director's part and is not simply imposed whenever there is a loss by a creditor. Diversification as a means of reducing risk is therefore not required. The issue of transferability of shares is not relevant. Given these facts, it is

[56] There are other provisions imposing liability on directors under the *Corporations Act*. For example, s 197 imposes personal liability on the directors of a trustee company for trustee company debts that the company cannot discharge where there has been a breach of trust. There are also a number of criminal offences for directors' improper actions in relation to capital raising (ch 6D), continuous disclosure obligations (ch 6CA) and capital reduction rules (ch 2J).

[57] See Corporations and Markets Advisory Committee, *Personal Liability for Corporate Fault: Report* (2006) ('*CAMAC Report*') <http://www.camac.gov.au/camac/camac.nsf/byHeadline/PDFFinal+Reports+2006/$file/Personal_Liability_for_Corporate_Fault.pdf>.

[58] *Income Tax Assessment Act 1936* (Cth) pt 6 div 9. In addition, *Taxation Administration Act 1953* (Cth) s 8Y(1) provides that a person who is 'concerned in, or takes part in, the management of the corporation' shall be deemed liable for the company's taxation offences.

[59] Under *Trade Practices Act 1974* (Cth) s 75B(1), an individual may be liable if he or she is involved in the company's contravention of certain parts of the Act. Directors would generally be covered by this section, as a person 'directly or indirectly, knowingly concerned in, or party to, the contravention' (s 75B(1)(c)), if not more directly implicated by aiding, abetting, counselling or procuring, or inducing the contravention (ss 75B(1)(a)–(b)).

[60] *Environment Protection and Biodiversity Conservation Act 1999* (Cth) pt 17 div 18; *Hazardous Waste (Regulation of Exports and Imports) Act 1989* (Cth) s 40B. The principal state and territory provisions for individual liability are: *Environment Protection Act 1997* (ACT) ss 147(1), (4); *Protection of the Environment Operations Act 1997* (NSW) s 169(1); *Waste Management and Pollution Control Act 1998* (NT) s 91(1); *Environmental Protection Act 1994* (Qld) s 183(2); *Environment Protection Act 1993* (SA) ss 129(1)(a), (3); *Environmental Management and Pollution Control Act 1994* (Tas) ss 60(1)(a), (3); *Environment Protection Act 1970* (Vic) s 66B(1); *Environmental Protection Act 1986* (WA) s 118(1).

[61] *Occupational Health and Safety Act 2000* (NSW) s 26(1); *Workplace Health and Safety Act 1995* (Qld) s 167(2); *Occupational Health, Safety and Welfare Act 1986* (SA) s 61; *Workplace Health and Safety Act 1995* (Tas) s 53(1); *Occupational Health and Safety Act 2004* (Vic) s 144(1); *Occupational Safety and Health Act 1984* (WA) ss 55(1), (1a).

[62] See, eg, *Environmental Protection Act 1997* (ACT) s 153(2)(b), which imposes liability not just upon directors but also any 'other person responsible for the management of the activity in relation to which the environmental harm happened'.

[63] Additionally, there is debate over whether directors have a common law duty to consider the interests of creditors when the company is near insolvency: see, eg, Andrew Keay and Hao Zhang, 'Incomplete Contracts, Contingent Fiduciaries and a Director's Duty to Creditors' (2008) 32 *Melbourne University Law Review* 141.

proper that the veil of incorporation be pierced to impose liability on corporate agents such as directors in circumstances specified by the law.

B *Closely Held Companies*

For one- or two-person companies, the issue of imposing liability on shareholders may appear moot — if the shareholders are also the directors, as noted above, there are a number of established pathways to pierce the corporate veil and make corporate wrongdoers liable in their capacities as directors. However, where some of the shareholders of closely held companies are not directors nor in control of the company, the issue of veil-piercing for those shareholders becomes relevant.

Commentators have identified a number of reasons why the veil should be pierced on closely held companies.[64] In essence, it is because the justification that shareholders need limited liability in order to encourage them to invest is absent.[65] Often these companies are run as though they were partnerships but with the added benefit of incorporation. Their shareholders can therefore monitor the management of the company, whether or not they personally participate in it. There is not the same desire or need for diversification to reduce the risk of loss as there is with public companies, where effective monitoring is not readily achievable. The wealth of fellow shareholders is also more easily observed, which is beneficial in the event that personal liability is imposed on them as a group.

Furthermore, the constitutions of small companies frequently limit the transferability of shares, making irrelevant the argument that limited liability is required to facilitate share trading. Even where shares can be transferred, they are not traded to 'strangers' through a stock exchange but rather sold to parties who have some closer knowledge of the company and who would be able to demand further information to assess risk if that was required. In any event, where small companies borrow, they lack the market strength to transfer the risk of loss. Lenders such as banks are likely to require personal guarantees from directors or other shareholders, and trade creditors might insist on security from the company or else demand prepayment or retention of title clauses in their contracts for the supply of goods.[66]

Easterbrook and Fischel observe that limited liability for closely held companies increases the probability of excessively risky behaviour.[67] Bainbridge also

[64] In the US, these include where the company is an instrumentality, alter ego or dummy of the shareholders, cases involving misrepresentation, agency, undercapitalisation, and failure to observe corporate formalities: Thompson, 'An Empirical Study', above n 2, 1064.

[65] See, eg, Freedman, above n 35, 331–3; see generally at 319–20, 327–35; Easterbrook and Fischel, *Economic Structure*, above n 23, 55–6; Bainbridge, above n 2, 500–1; Millon, 'Piercing the Corporate Veil', above n 10, 6–8.

[66] See Bainbridge, above n 2, 500–3.

[67] Easterbrook and Fischel, *Economic Structure*, above n 23, 55.

notes that with closely held companies

> it becomes significantly more likely that shareholders will cause the corporation to act in ways that in fact externalize risk onto creditors. In the public corporation context, the separation of ownership and control means that shareholders cannot cause the corporation to do anything. Decisions about risk bearing are made by managers who likely are substantially more risk averse than diversified shareholders. In contrast, in the close corporation, shareholders and managers frequently are one and the same. Consequently, such shareholder-managers can cause the corporation to externalize risk and, moreover, have strong incentives to do so.[68]

In the US, courts are more willing to pierce the veil when there are few shareholders. Robert Thompson reports that:

> Among close corporations, those with only one shareholder were pierced in almost 50% of the cases; for two or three shareholder corporations, the percentage dropped to just over 46%, and for close corporations with more than three shareholders, the percentage dropped to about 35%.[69]

As these statistics demonstrate, one of the difficulties of having a regime of unlimited liability for small companies is the requirement to 'draw the line'. This is especially so where the rule is a statutory one, enacted to provide certainty to both plaintiffs and defendants. Noting that moral hazard is more prevalent in small, closely held companies,[70] Paul Halpern, Michael Trebilcock and Stuart Turnbull have advocated an unlimited liability regime for these companies as a means of reducing the incentive to transfer the risk of insolvency to creditors.[71] However, they conceded that there would be difficulties

> associated with attempting to distinguish by law small from large corporations for the purpose of applying different liability regimes, and that the distinction may induce some perverse and wasteful incentive effects as firms seek to manipulate internal structures to ensure compliance with the requirements of the preferred regime.[72]

Bainbridge has likewise concluded that 'it would be very difficult for the law to try to draw a general line based on firm size. … The limited liability rule thus creates an efficient general presumption about the allocation of risks between shareholders and creditors.'[73]

[68] Bainbridge, above n 2, 501 (citations omitted).

[69] Thompson, 'An Empirical Study', above n 2, 1054–5. See also Thompson, 'Unpacking Limited Liability', above n 2, 9–10. This is confirmed in Australia by the study by Ramsay and Noakes, above n 1, 263; see also at 268.

[70] Halpern, Trebilcock and Turnbull, above n 21, 148.

[71] Ibid 148–9.

[72] Ibid 148.

[73] Bainbridge, above n 2, 501.

C *Where the Company Has Committed a Tort*

Unlike contract creditors, the involuntary tort creditor, injured by corporate negligence, has a need for compensation but no ability to self-protect *ex ante* against the risk of nonpayment.[74] Where the company is insolvent, uninsured and unable to compensate an injured plaintiff, it is natural for the claimant to look to those behind the company for recompense. In the first instance, it is likely that the claim will be made against the directors if there is some element of personal culpability on their part. However, the law regarding the liability of directors for torts committed qua director is highly unsettled and unsatisfactory.[75] As noted above in the discussion of directors' personal liability, this confusion in the law stems from a misconception of the meaning of limited liability and veil-piercing in relation to corporate agents.[76]

In relation to shareholders, on the other hand, the issues are quite different. Control still plays a role where the corporation is closely held[77] or where the defendant corporation is a subsidiary of a parent company. As will be seen below, it is sometimes considered that the controllers of the offending company ought to be responsible for compensating the plaintiff, both to punish personal fault and to avoid shielding those persons from financial responsibility by the veil of incorporation. For this reason, the discussion of tort liability for shareholders often becomes mixed with that of directors, closely held companies and corporate groups.

However, some leading academics have suggested that regardless of issues of control or personal fault the corporate veil ought to be pierced. This is an example of 'pure' veil-piercing, as discussed above. It is noteworthy, however, that courts in both Australia and the US are more likely to pierce the corporate veil in contract rather than tort cases.[78] This is surprising given that, when

[74] They cannot diversify away the risk of nonpayment by multiple tortfeasors, and they lack *ex ante* information about the financial position of the company to ensure that they are injured by a prosperous tortfeasor.

[75] See Anderson, above n 42 (and cases and commentators cited therein); Payne, 'The Attribution of Tortious Liability between Director and Company', above n 49; Willekes and Watson, above n 42.

[76] Neyers, above n 2. Neyers argues that, although agency has the same effect as veil-piercing (in that directors can be held liable for the debts of a corporation), it is in fact an affirmation of the principle of separate legal entity. Agency allows the director to be an agent of another legal person — the company — just as he might be the agent of a natural legal person: at 181. He comments that the finding of a director as an agent of the company 'actually "define[s] the corporate veil rather than pierce[s] it"': at 182, quoting Robert Flannigan, 'Corporations Controlled by Shareholders: Principals, Agents or Servants?' (1986) 51 *Saskatchewan Law Review* 23, 26.

[77] Thompson notes that in the US shareholders of publicly held corporations have never been held personally liable for corporate obligations based in contract or in tort: Thompson, 'An Empirical Study', above n 2, 1047. While the absence of contract liability for public company shareholders could be justified by the theory discussed above in Part II (namely, the requirement of the default contract term of limited liability), the particular vulnerability of tort creditors and their inability to self-protect *ex ante* are not considered by courts: at 1068–70, 1072–4.

[78] For Australia, see Ramsay and Noakes, above n 1, 265, 269. For the US, see Thompson, 'An Empirical Study', above n 2, 1068. Thompson later updated the statistics from his landmark study, with the same results — he found that 'there is a lesser percentage of piercing in tort cases than in contract settings and there is a lesser percentage of piercing within corporate groups than

combined with issues of control and personal wrongdoing, there are arguably even more reasons to pierce the veil to allow tort creditors to recover. A number of justifications have been identified by scholars for piercing the corporate veil so as to make shareholders liable for the torts of their companies.

Because relations with tort creditors are neither consensual nor contained in a standard form contract, the 'majoritarian default' term of limited liability has no relevance to tort creditors.[79] Moreover, the moral hazard created by limited liability may encourage excessive risk-taking, causing personal injury to a small or large number of victims (irrespective of company size). Quite apart from the lack of compensation for a particular tort victim, David Millon notes that the overall social cost of the tortious activity may exceed the gain to the shareholders, which is an inefficient resource allocation decision.[80] While entrepreneurial activity has many social benefits, including the creation of employment, investment returns, and goods and services for customers, it is possible that the cost to parties injured by the activity may well be greater than its benefits to the company or to society as a whole.[81]

The concession theory supports the argument that limited liability ought to be seen as a privilege granted by the government, giving rise to an expectation that companies operate in the public interest and justifying government interference when they do not.[82] Ronald Green maintains that:

> Thanks to limited liability, shareholders can fund the activities of large corporations, receive dividends and capital gains on their investments, and yet remain

to individuals who are shareholders': Thompson, 'Corporate Shareholders as Mere Investors', above n 2, 386 (citations omitted). Freedman cites a study of UK courts which came up with a similar finding: Freedman, above n 35, 343 fn 156, citing Charles Mitchell, 'Lifting the Corporate Veil in the English Courts: An Empirical Study' (1999) 3 *Company Financial and Insolvency Law Review* 15.

79 Millon, 'Piercing the Corporate Veil', above n 10, 7.

80 Ibid 7–8.

81 Ibid 8. Millon, at 3, observes that the economic efficiency grounds for limited liability — including, in the case of tort creditors, the ability to diversify away their risk — are not present in all cases:

> The true policy basis for limited liability seems instead to be the reallocation of some of the costs of doing business from business owners to those who transact (voluntarily or involuntarily) with the corporation. By requiring creditors to bear some of these costs, the law in effect requires them to subsidize business activity. This policy does not depend for its legitimacy on a clear demonstration of its efficiency. Instead, there seems to be little more at work than an unquestioned assumption that the benefits of increased business investment will be worth the social costs.

82 Cohen, above n 2, 444, explains that:

> Under this understanding, limited liability entities have a responsibility to operate in the public interest. Under the concession/communitarian view, the 'corporateness' of the artificial entity should be disregarded when the entity is being operated in a manner that runs counter to the spirit of the grant of privilege, ie, when the public weal is damaged, rather than enhanced, by the operation of the corporation.

See also David Millon, 'New Directions in Corporate Law: Communitarians, Contractarians, and the Crisis in Corporate Law' (1993) 50 *Washington and Lee Law Review* 1373.

> immune to some of the costs of misconduct or misjudgment by their corporate agents.[83]

However, he questions maximising shareholder wealth as a company's indisputable priority.[84]

Henry Hansmann and Reinier Kraakman go further and contend that limited liability cannot be justified for either closely held or publicly traded corporations, maintaining that limited liability creates 'perverse incentives' — to spend too little on accident prevention and to invest too much in hazardous industries.[85] They concede that unlimited liability could encourage a number of liability evasion measures: debt rather than equity financing; the premature liquidation of firms which may face 'long-tail' tort liabilities; and the disposal of personal assets to make the shareholder judgment proof.[86] However, they consider that limited liability already provides incentives to conduct business through undercapitalised companies and that unlimited liability would give shareholders the necessary incentive to obtain appropriate levels of insurance.[87] Imposing unlimited liability for corporate torts on shareholders of all sizes of firms would also avoid the line-drawing problem discussed above and remove incentives to artificially configure the firm's structure.[88]

However, Bainbridge rejects Green's communitarianism and concession theory reasoning as being inconsistent with the contractarian model of the firm — the dominant paradigm of corporate law.[89] Bainbridge maintains that the limited liability corporation has contributed so much investment capital to society, from which everyone has benefited,[90] that shareholders owe nothing to society in return. Furthermore, he repudiates Hansmann and Kraakman's arguments for unlimited liability for corporate torts. He contends:

> Under a rule of personal liability … few people would be willing to become shareholders. In such a world, large-scale businesses would be conducted by highly-leveraged firms having a very small amount of equity capital and a very large amount of secured debt. The mass tort plaintiffs Hansmann and Kraakman are so concerned about, in particular, would have a difficult time satisfying

[83] Ronald M Green, 'New Directions in Corporate Law: Shareholders as Stakeholders — Changing Metaphors of Corporate Governance' (1993) 50 *Washington and Lee Law Review* 1409, 1415. Green considers a number of mass tort claims where companies disregarded the risk of injury on the basis that the cost of preventing the losses would have been difficult for managers concerned with making profits for shareholders to justify: at 1419–21.

[84] See ibid 1416–17.

[85] Hansmann and Kraakman, 'Toward Unlimited Shareholder Liability', above n 2, 1882–4.

[86] Ibid 1884–6, 1909–16.

[87] Ibid 1888 (emphasis in original), where the authors conceded that:

> Undoubtedly, some small corporations that are viable under limited liability would cease to be so under unlimited liability, since they could not buy adequate insurance and their shareholders would be unwilling to expose personal assets to the risks of a tort judgment. But there is no reason to assume that such small firms *should* exist … In fact, an important advantage of unlimited liability is precisely that it would force such firms — which are effectively being subsidized by their tort victims — out of business.

[88] See ibid 1895.

[89] Bainbridge, above n 2, 495.

[90] Ibid.

> their claims against such a firm. By encouraging equity investment, the limited liability doctrine actually makes it easier for all creditors to be compensated.[91]

With respect to large corporations, Bainbridge answers Hansmann and Kraakman by pointing to the high costs of recovering judgment debts from individual shareholders and the significant procedural hurdles that would be encountered.[92] Where the pool of shareholders is always changing, the question of who to sue becomes live, and a shareholder exodus problem arises.[93]

Bainbridge nonetheless concedes that it is hard to justify invoking the corporate veil to protect the tort creditors of small corporations, for the reasons outlined above. He admits that, 'while in the public corporation context externalization of tort risk is simply a by-product of the corporation's business and affairs, in the close corporation setting externalizing such risks likely is the very purpose of incorporating.'[94] Bainbridge acknowledges that 'the tort creditor has no ability to bargain out of the default rule' of limited liability and that the company is likely to be the cheapest cost avoider (with the ability to organise insurance or take precautions to ensure the accident is prevented).[95] Nonetheless, he maintains that the veil should not be pierced because of the line-drawing issue. Despite arguments about excessive risk-taking, shareholders still have incentives to avoid the accident or to insure adequately. They will lose their investment when the defendant company is bankrupted by the plaintiff's suit.[96]

One solution that ensures compensation for tort claimants and maintains limited liability and the corporate veil is a government-funded comprehensive injury compensation scheme.[97] However, these schemes fail to deter controllers of parent companies from running underfunded and underinsured subsidiaries that engage in high-risk activities. Moreover, the New Zealand experience shows that accident compensation schemes are not always economically effective,[98] despite the litigation cost savings that such schemes bring. Even if government protection of tort claimants were to be considered, it is highly unlikely that taxpayer-funded assistance would be provided for the payment of tort claims for economic loss unrelated to personal injury or property damage.

[91] Ibid 497–8 (citations omitted).

[92] Ibid 496–7, citing Janet Cooper Alexander, 'Unlimited Shareholder Liability through a Procedural Lens' (1992) 106 *Harvard Law Review* 387, 398–9.

[93] Bainbridge, above n 2, 496–8. This addresses issues raised by Hansmann and Kraakman, 'Toward Unlimited Shareholder Liability', above n 2, 1896–901.

[94] Bainbridge, above n 2, 503–4.

[95] Ibid 504.

[96] Ibid.

[97] New Zealand has had a no-fault accident compensation scheme since 1972. Its *Accident Compensation Act 1972* (NZ) established the Accident Compensation Corporation ('ACC'). The *Injury Prevention, Rehabilitation, and Compensation Act 2001* (NZ) is now the principal Act under which the ACC operates.

[98] The scheme has been criticised as being uneconomical and subject to widespread fraud: see Stephen Todd, 'Negligence Liability for Personal Injury: A Perspective from New Zealand' (2002) 25 *University of New South Wales Law Journal* 895, 900 fn 21, where it is noted that in 1997 the unfunded liabilities from the scheme were estimated at NZ$8.2 billion.

IV PIERCING THE CORPORATE VEIL ON CORPORATE GROUPS

The justifications for and extensive literature on piercing the corporate veil on corporate groups are now examined in light of the arguments in Part III supporting veil-piercing against directors and closely held corporations in favour of tort claimants. Again, the argument will be made that the justification for limited liability — namely, that a regime of unlimited liability would make shareholders unwilling to invest and to diversify their investments because of the need to monitor the company and fellow investors — is not present in the case of corporate groups.[99]

The Companies and Securities Advisory Committee's *Corporate Groups: Final Report* ('*CASAC Report*') outlines the 'economic and commercial benefits' from operating a business through a corporate group.[100] Reasons for keeping different parts of the business separate include facilitating debt financing, preserving intangibles such as goodwill and the corporate image of acquired businesses, attaining taxation advantages and complying with regulatory requirements.[101] It is submitted that these reasons are not sufficient to warrant the grant of limited liability, lacking as they do the justifications outlined above in Part II. Interestingly, the *CASAC Report* openly acknowledges the detriment likely to be suffered by the creditors of subsidiary companies, noting that one of the listed benefits is the 'lowering [of the] risk of legal liability by confining high liability risks, including environmental and consumer liability, to particular group companies, with a view to isolating the remaining group assets from this potential liability'.[102]

However, there is a multitude of additional reasons to distinguish parent companies from individuals as shareholders so that the former do not automatically enjoy the benefits of limited liability enjoyed by the latter.[103] Holding a parent company liable for the debts of its subsidiary does not impose unlimited personal liability on any individual shareholder.[104] Collection costs for creditors are the same when recovering from the parent company as from the subsidiary.[105] As in the case of one-person companies, there is a single shareholder rather than a diverse group of individuals separated from management; the parent

[99] For the sake of the discussion, the presumption is made that the subsidiaries of the parent company are wholly owned. A 1998 study by Ramsay and Stapledon reports that '[t]he vast majority of controlled entities were wholly owned … that is, 90 per cent': Ian Ramsay and Geof Stapledon, 'Corporate Groups in Australia Research Report' (Research Report, Centre for Corporate Law and Securities Regulation, The University of Melbourne, 1998) 3.

[100] Companies and Securities Advisory Committee, *Corporate Groups: Final Report* (2000) 3–4.

[101] Ibid.

[102] Ibid 4.

[103] Blumberg, 'Limited Liability and Corporate Groups', above n 5, 623–4.

[104] Easterbrook and Fischel, *Economic Structure*, above n 23, 56.

[105] This is in contrast to recovery from a large number of individual shareholders, where the cost of taking action against them singly may exceed the benefit: Thompson, 'Unpacking Limited Liability', above n 2, 20, citing David W Leebron, 'Limited Liability, Tort Victims, and Creditors' (1991) 91 *Columbia Law Review* 1565, 1612. Under a regime of joint and several liability, this would not be a problem, but it would be if pro rata liability were introduced to alleviate some of the negative effects of unlimited liability on shareholders, as suggested by Hansmann and Kraakman, 'Toward Unlimited Shareholder Liability', above n 2.

company will be involved in important decision-making for the subsidiary, avoiding the usual 'agency cost' issue where the interests of manager and owner diverge.[106] In this matter, parent companies have much in common with directors, in respect of whom the legislature has already shown a willingness to pierce the corporate veil.

There is often a degree of economic integration between the parent company and the subsidiary, and thus no increased information costs result from the legal independence of the subsidiary.[107] As with closely held companies, 'there is no market for the subsidiary's shares,' negating the argument that unlimited liability affects the marketability of those shares.[108] Parent companies also stand to reap all the rewards from the transactions undertaken by the subsidiary,[109] further encouraging them to conduct dangerous and risky activities through subsidiary companies with minimal capitalisation and a large amount of debt. Moreover, the line-drawing problem put forward by Bainbridge does not occur when piercing the corporate veil on parent companies.[110] In the absence, therefore, of legitimating reasons to maintain the corporate veil, corporate groups should not enjoy an undisputed right to limited liability in all circumstances.

Nonetheless, it is submitted that there need to be concrete grounds on which the veil may be pierced. The mere fact that a subsidiary has incurred a debt which it cannot pay is not,[111] and should not be, enough to pierce the corporate veil. Otherwise, the doctrine of limited liability would have no application within corporate groups. Nor is it suggested that the sole basis of veil-piercing should be the fact that there is control or domination of the subsidiary by the parent company.[112] This would occur in almost all circumstances, so using control as

[106] Blumberg, 'Limited Liability and Corporate Groups', above n 5, 624.

[107] Ibid.

[108] Ibid.

[109] Thompson makes the point that shareholders get the residual gain from transactions undertaken on their behalf, while directors enjoy control of the decision-making. In the case of parent companies, they have both: Thompson, 'Unpacking Limited Liability', above n 2, 5.

[110] See also Strasser, above n 2, 638–9 (citations omitted):

> The core idea is that a parent company as a shareholder in its subsidiary companies is in quite a different economic role and performs quite a different management function than individual investor shareholders, including public shareholders in the parent company itself. A parent company creates, operates and dissolves subsidiaries primarily as part of a business strategy in pursuit of the business goals of the larger enterprise, which the parent and all the subsidiaries are pursuing together. The parent is not an independent investor. Whatever the corporate formalities chosen, the parent typically has very real control over the operations and decisions of the subsidiary and the extent to which the parent exercises that control is based on business strategy for the enterprise rather than meaningful separation of the legally independent corporate entities. The various companies in the corporate group are really fragments that collectively conduct the integrated enterprise under the coordination of the parent. Within corporate groups, many of the contemporary economic efficiency justifications for limited liability do not apply, and neither should the rules for applying that liability or determining its outer boundary.

[111] See *Industrial Equity Ltd v Blackburn* (1977) 137 CLR 567, 577 (Mason J); *Walker v Wimborne* (1976) 137 CLR 1, 6–7 (Mason J); *James Hardie* (1989) 16 NSWLR 549, 576–7 (Rogers AJA). See also Ramsay and Noakes, above n 1, 257–8.

[112] Cf Nina A Mendelson, 'A Control-Based Approach to Shareholder Liability for Corporate Torts' (2002) 102 *Columbia Law Review* 1203, 1271–2, who argues that the fact of control should itself be sufficient to subject shareholders to personal liability for corporate torts or statutory violations

the only test for veil-piercing would be equivalent to removing the veil altogether.[113]

In Australia, the courts will only pierce the veil if the corporate form has been used for fraud, to shield the parent company from an existing legal obligation (the 'sham/facade' basis) 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.[114] On the other hand, in the US, where courts are more willing to pierce the corporate veil than in Australia,[115] courts have considered broader factors such as fraud and misrepresentation, situations where the subsidiary has acted as an agent,[116] a lack of separation between the companies, and an undercapitalisation of the subsidiary as justification for veil-piercing.[117] These are a combination of acts of acknowledged wrongdoing and legal (if improper) behaviours, some amounting to no more than control itself.[118]

It is recommended that what is needed to pierce the veil, in addition to control, is an act of wrongdoing on the part of the parent company, either through its own actions or through the actions of the board of the subsidiary that it controls. What should be recognised in statute[119] are the substantive grounds on which the veil should be pierced, rather than the means, such as agency,[120] by which it is done.[121] Fault should be the principled basis for veil-piercing, instead of

in cases of corporate insolvency. Her emphasis is on limited liability's potential to encourage excessive risk-taking: at 1232–5. Unlimited liability eliminates this moral hazard: at 1280. In rebuttal, Millon, 'Piercing the Corporate Veil', above n 10, 49, contends that:

> she goes too far in threatening controlling shareholders with liability without regard to whether the decision in question was truly an irresponsible one. … If third-party losses were not reasonably foreseeable when those in control embarked on a particular course of action, they are not the result of efforts to take advantage of limited liability. They are instead the incidental by-product of business activity conducted by shareholders who otherwise have attempted in good faith to provide compensation for victims of known risks.

113 Bainbridge, above n 2, 507–8.

114 See John Kluver, 'Entity vs Enterprise Liability: Issues for Australia' (2005) 37 *Connecticut Law Review* 765, 766, referring to *CASAC Report*, above n 100, 15–18.

115 See Ramsay and Noakes, above n 1, 261. See also Thompson, 'An Empirical Study', above n 2, 1048.

116 This is sometimes also considered under the headings of instrumentality, alter ego or dummy for the parent company.

117 Thompson, 'An Empirical Study', above n 2, 1063.

118 See Bainbridge, above n 2, 510.

119 Part V below makes the case for veil-piercing to be done through statute rather than the common law.

120 See Neyers, above n 2, 181. Very critical of the 'agency' ground for veil-piercing, Neyers makes the point that there is nothing inherently wrong with the subsidiary being the agent of the parent company. Ottolenghi, above n 2, 339, maintains that calling a subsidiary a 'puppet', 'instrumentality' or 'sham' contradicts it being an agent of the parent company. Calling it an agent recognises its existence as a separate legal entity and attributes to it the power to negotiate and finalise contracts on behalf of the principal, whereas a sham/facade means it is not regarded as being an entity at all.

121 See Strasser, above n 2, 657–8, who states that:

> Traditional veil piercing asks abstract, generalized questions as a matter of corporate law, questions that then are to guide the results in all the substantive areas of law in which veil piercing issues arise. The core problem with this approach in corporate groups cases is that the questions it asks do not relate well to the reasons for respecting or ignoring separate corporate identities in different areas of law. No doctrine can be applied indiscriminately through the full

imposing liability according to an imprecise list of circumstances. In the same way that legislatures and courts pierce the veil to render directors liable for their wrongful conduct, it is proposed that legislation be enacted to impose upon parent companies (rather than upon their directors) the equivalent of current directors' duties — in particular, the duties of care and diligence[122] and of good faith.[123]

This would build on the present liability of parent companies as shadow directors. Under the *Corporations Act*, the term 'director' is defined to include a person in accordance with whose instructions or wishes the directors of a company are accustomed to act.[124] Therefore, a parent company in control of a subsidiary can be considered to be a shadow director of that subsidiary and thus subject to directors' duties.[125] For this reason, the changes to the legislation recommended in the next Part would not result in significant upheaval to the substance of the law. Rather, the suggested changes would act as a signalling mechanism to parent companies that their control, and their wrongdoing *through* that control, would result in a statutory piercing of the veil.

It is not easy to use fault as a reason to pierce the corporate veil when shareholders are individuals. Attributing fault and calculating the degree of participation in the affairs of the company — elements necessary to attract liability — are complicated questions.[126] However, it is much easier to determine when there is a single parent company as shareholder.[127] Easterbrook and Fischel make a strong case for parent–company liability related to fault in the broad sense of the word:

> the moral-hazard problem is probably greater in parent–subsidiary situations because subsidiaries have less incentive to insure. In publicly held corporations, the inability of managers to diversify their firm-specific investments in human capital creates incentives to insure. The same is not true for managers of subsidiaries if, as often will be the case, they are also managers of the parent. Bankruptcy of the subsidiary will not cause them to lose their positions in the parent or suffer any other loss of firm-specific human capital (though they might suffer a reputational loss). If limited liability is absolute, a parent can form a subsidiary with minimal capitalization for the purpose of engaging in risky activities. If things go well, the parent captures the benefits. If things go

> spectrum of the many discrete legal areas of procedure, jurisdiction, tax, and substantive law, not to mention statutory law of general application. The only transcendental principle universally applicable is that the decision to respect or ignore separate corporate identities in corporate groups cases in different substantive legal areas should be guided by the policies of those areas, not by the abstract and generalized ideas at the core of the traditional doctrine.

Millon's idea of a coherent principle is to pierce the veil where a company has not behaved in a 'financially responsible' manner: Millon, 'Piercing the Corporate Veil', above n 10, 46.

[122] *Corporations Act* s 180.

[123] *Corporations Act* s 181.

[124] *Corporations Act* s 9 (definition of 'director' para (b)(ii)).

[125] These are contained in *Corporations Act* pt 2D.1 div 1 and elsewhere, including the duty to prevent insolvent trading under s 588G.

[126] Gelb, above n 2, 18.

[127] However, Bainbridge makes the case for direct liability for shareholders at fault even where the shareholder is an individual: Bainbridge, above n 2, 516–17.

> poorly, the subsidiary declares bankruptcy, and the parent creates another with the same managers to engage in the same activities. This asymmetry between the benefits and costs, if limited liability were absolute, would create incentives to engage in a socially excessive amount of risky activities.
>
> It does not follow that parent and affiliate corporations routinely should be liable for the debts of those in which they hold stock. Far from it. Such general liability would give small or unaffiliated firms a competitive advantage.[128]

The justification for statutory rather than common law veil-piercing will be examined in the next Part. What follows here is a consideration of some of the possible grounds for breach of those sections. Tort would be an obvious place to start. Part III considered the theoretical justifications for piercing the corporate veil where a company had committed a tort. Those same reasons apply where the parent company has effective control of the subsidiary.[129] Parent companies can ensure that their subsidiaries do not engage in excessively risky activities and carry an adequate amount of insurance to cover foreseeable risks.[130] It appears to be almost universally accepted that the corporate group form will be used precisely to quarantine the assets of the parent from the risky behaviour of the subsidiary, without any consideration for the harm to be suffered by the subsidiary's creditors, especially its tort creditors.[131] As discussed above, Thompson and other commentators have demonstrated that the principles of separate legal entity and limited liability were not brought into the law with the idea of corporate groups in mind. Corporate groups are the accidental beneficiaries of these principles, and thus the availability of the corporate group form should not be taken as licence to abuse the creditors of a parent company's subsidiaries.[132]

Undercapitalisation is another area of fault where the parent company could be considered to have breached its duties of good faith or care and diligence to the

[128] Easterbrook and Fischel, *Economic Structure*, above n 23, 56–7 (citations omitted).

[129] Strasser, above n 2, 658 (citations omitted), comments:

> For the tort claimant, the core tort policies of compensating injured parties, allocating costs to the activities that cause them, and discouraging negligent or intentionally harmful conduct are key. In corporate groups cases, whether the parent company should be liable to the subsidiary's tort claimant should be based on the extent to which such liability furthers these policies.

[130] Thompson, 'Unpacking Limited Liability', above n 2, 37–9.

[131] Thompson's empirical study was confirmed by Ramsay and Noakes's own observations. Ramsay and Noakes, above n 1, 258, quoting Thompson, 'An Empirical Study', above n 2, 1071, stated:

> Furthermore, courts appear reluctant to become involved in cases where parties have clearly reached a contractual bargain in relation to which piercing the corporate veil would produce a different result.
>
> As Professor Thompson notes:
>
> > Because the market-related reasons for limited liability are absent in close corporation[s] and corporate groups, the most important justification for limited liability is permitting parties in a consensual relationship to use the corporate form to allocate the risks of the transaction and the enterprise.

Interestingly, the opposite situation applies in some jurisdictions in Europe: Hertig and Kanda, above n 36, 96.

[132] See also below n 181.

subsidiary.[133] This is particularly relevant to creditors in various situations: where the transaction is too small to justify a full examination of the company's finances; where the creditor lacks the requisite bargaining power to demand financial information or a personal guarantee from a director; and where the case involves involuntary tort creditors and employees. Undercapitalisation could occur because of a lack of initial capital or a reduction in the subsidiary's assets over time because of siphoning, commingling of assets of the parent company and subsidiary[134] or excessive dividends. Present legislation such as *Corporations Act* s 588V, which imposes liability on parent companies for the insolvent trading of their subsidiaries, fails to address the core issues surrounding undercapitalisation. Such legislation only applies to debts incurred by the subsidiary when there are reasonable grounds for suspecting its insolvency.[135] It does not capture any of the prior transactions taking place while the subsidiary was solvent, which may have nevertheless contributed to its later insolvency.

The question necessarily arises as to what would amount to adequate capitalisation.[136] The advantage of imposing the equivalent of directors' duties on parent companies is that the amount would not need to be specified in advance.[137] Just as the law of directors' duties has worked effectively without the need to specify exactly which actions would cause a breach, so too the parent company equivalent would allow courts to consider the circumstances of a particular group at the time of the alleged breach to determine the adequacy of capitalisation. Adequacy might not refer to whether the subsidiary has sufficient capital to cover a possible loss[138] but rather whether there exists enough of the share-

[133] While this is a recognised ground of veil-piercing in the US, it has not been accepted by Australian courts: *CASAC Report*, above n 100, 18.

[134] Gevurtz, above n 2, 875.

[135] *Corporations Act* s 588V(1)(c).

[136] See generally Freedman, above n 35, 335–8, discussing the practical and theoretical objections to minimum capital requirements.

[137] Gevurtz, above n 2, 884, asks:

> Does either the existence of [laws requiring minimum capital amounts] or their disappearance tell us anything about legislative views of piercing for inadequate capital? The answer is probably no. The problem with legislative minimum capitalization requirements is that different businesses have different capital needs. Hence, the old statutes set a token sum suitable for the smallest venture. This is hardly a legislative determination as to what is adequate capital for any corporation, no matter what its business. The repeal of these provisions simply recognizes the futility of attempting to attack the adequate capital question through across-the-board legislative requirements. Case-by-case judicial evaluation through piercing decisions is a different matter.

[138] See Millon, 'Piercing the Corporate Veil', above n 10, 28 (citations omitted), who notes that:

> If the point of the court's reliance on the undercapitalization idea is that the shareholders are expected not only to contribute initially but also to maintain at all times a particular net worth in the corporation for the benefit of corporate creditors, such a requirement would not differ fundamentally from a rule of unlimited liability. Either way, the shareholders would function as personal guarantors of corporate obligations. The cost of such a requirement to the shareholders could be prohibitively high, and the benefit of limited liability as a risk reallocation device would be lost. The threat of veil-piercing should not amount to a requirement that all corporations maintain a shareholder-financed insurance fund.

holders' own money at stake to give them an incentive not to engage in excessively risky activities.[139]

A subsidiary's lack of insurance might be another ground for finding that the parent company did not act with care and diligence. This would interact with the issue of capital adequacy, as sufficient insurance coverage renders capitalisation less relevant. Like putting some of the shareholders' own capital at risk, insurance can work as a deterrent against excessive risk-taking, as accident prevention measures help to reduce the cost of the premiums.[140] In the context of directors' liability in tort, Vanessa Finch comments that:

> Personal liability may leave risk evaluation and spreading to those individuals who are the best acquirers of information concerning corporate risks, levels of capitalisation, internal control systems and insurance. It thus offers firms a flexibility of response that may be preferable to externally-imposed rules on minimum insurance or adequate capitalisation. Making the director liable thus 'protects against legislative over-or-under provision for tort risks, and it permits managers to select the optimal strategy for covering risk from among insurance, self-insurance or risk-reduction though the control of firm activities.'[141]

Fraud and misrepresentation would also be factors in a court pronouncement that a parent company as shadow director did not act in good faith. This may link with undercapitalisation but obviously would go further. Misrepresentation could take many forms: it could relate to the particular entity with whom the external party is doing business, the level of capitalisation of that entity or the actual transaction entered into by the parties.

The advantage of a legislative response to the question of piercing the corporate veil on parent companies as outlined above is that all of the circumstances which justify piercing the corporate veil do not need to be spelt out in advance.

[139] Easterbrook and Fischel, *Economic Structure*, above n 23, 59 (citations omitted), recommend that:

> The firm should have a duty to notify the creditor of any unusual capitalization. It is cheaper for the firm (which has the best information about its capital structure) to notify creditors in the unusual case than for creditors to investigate in all cases. … Allowing creditors to look beyond the assets of the undercapitalized corporate debtor provides the debtor with the incentive to disclose its situation at the time of the transaction. The creditor then can decide not to transact or charge increased compensation for the increased risk. Alternatively, the creditor could ask for prepayment, personal guarantees, or other security. Under any of these alternatives, the debtor will have to pay for engaging in risky activities and thus will have better incentives to balance social benefits and costs.

[140] Gevurtz, above n 2, 887. Some authors argue that insurance actually encourages risky behaviour rather than deters it. In the context of directors' liability, see Vanessa Finch, 'Personal Accountability and Corporate Control: The Role of Directors' and Officers' Liability Insurance' (1994) 57 *Modern Law Review* 880, 888–9. For discussion of mandatory insurance, see Freedman, above n 35, 340–2.

[141] Finch, above n 140, 883 (citations omitted).

V THE CASE FOR STATUTORY VEIL-PIERCING FOR CORPORATE GROUPS

This Part makes the case for legislation to be enacted to pierce the corporate veil on corporate groups in the circumstances specified in Part IV, rather than leaving the task to the common law. There are three reasons for doing so. First, it would overcome one of the principal objections to veil-piercing, namely, that veil-piercing is uncertain, discretionary and therefore costly and unreliable. Secondly, through its new clarity, it would provide effective deterrence, reliable compensation and minimal litigation costs. Thirdly, while courts would be left to determine the circumstances under which the parent company had failed to comply with its duty of care or good faith to the subsidiary, the clear signal from the legislature that it is appropriate to pierce the corporate veil would potentially overcome the judiciary's demonstrated reluctance to do so.

In the US, the concept of statutory 'enterprise liability' has a long history.[142] This is not the case in Australia.[143] In the *CASAC Report*, the single enterprise principle for corporate groups was rejected.[144] Piercing the corporate veil in relation to torts committed by subsidiary companies was considered undesirable, as 'this liability would undermine the separate entity principle and could have negative consequences for the economy'.[145] The report then suggested that 'this area should be dealt with by specific legislation where the extension of liability beyond the tortfeasor company is desirable in the public interest'.[146] However, the Corporate Responsibility and Employment Security Bill 2002 (Cth) ('CRES

[142] Blumberg notes that entity law became an 'insuperable barrier to effective federal regulation', so from 1933 various pieces of legislation by the US government ignored the separate legal entity of the company and focused on control as well as a range of other factors indicating integration of the parent company and the subsidiary: Blumberg, 'Transformation', above n 6, 608–10. Even so, Blumberg observes that when financial liability is at stake, rather than disputes over jurisdiction and other procedural matters, entity law generally prevails: at 611. See also Phillip I Blumberg, 'The Increasing Recognition of Enterprise Principles in Determining Parent and Subsidiary Corporation Liabilities' (1996) 28 *Connecticut Law Review* 295. See generally Adolf A Berle Jr, 'The Theory of Enterprise Entity' (1947) 47 *Columbia Law Review* 343.

[143] Similarly, in the UK, courts are reluctant to pierce the veil within corporate groups. In *Adams v Cape Industries plc* [1990] 1 Ch 433, 543–4, 547, 549 (Slade LJ for Slade, Mustill and Ralph Gibson LJJ), the Court of Appeal refused to pierce the corporate veil to find that a British parent company was the principal (for the purposes of claiming agency) of a US subsidiary merely because it exercised extensive control over the subsidiary. The Court would only do so if the subsidiary was a mere facade or sham. See also Freedman, above n 35, 342–3.

[144] *CASAC Report*, above n 100, 39–40. The Committee did recommend that the law 'should provide that a wholly-owned corporate group can "opt-in" to be a consolidated corporate group for all or some of the group companies, by resolution of the directors of each relevant group company': at 39. This would entail the parent company and each group company being collectively liable for the contractual (but not tortious) debts of all group companies, subject to contrary agreement. This was not made into law. Their recommendation on pooling, at 176 (recommendation 22), was enacted through the passing of the *Corporations Amendment (Insolvency) Act 2007* (Cth) sch 1 item 133, which inserted div 8 into pt 5.6 of the *Corporations Act*. This allows pooling of corporate group assets when each of the companies in a group is being wound up and where there is the approval of eligible creditors: s 571(1). This legislation, however, is not relevant to the theme of this article, which is concerned with the creditors of insolvent subsidiaries having access to the assets of *solvent* parent companies.

[145] *CASAC Report*, above n 100, 122.

[146] Ibid.

Bill'),[147] which would have permitted veil-piercing of solvent parent companies with respect to employee entitlements in specified circumstances,[148] was not passed.[149] The *Corporations Amendment (Insolvency) Act 2007* (Cth), which allows pooling of the assets of companies within an insolvent group, did not address the issue of contribution orders being made against the assets of solvent companies within a group.

Blumberg, arguably one of the world's leading scholars on corporate groups, remarks that in the US '"piercing" has led to hundreds, if not thousands, of irreconcilable cases … each year',[150] describing it as 'jurisprudence by metaphor or epithet.'[151] Easterbrook J stresses, in relation to the 'laundry list' approach to veil-piercing grounds, that:

> Such an approach, requiring courts to balance many imponderables, all important but none dispositive and frequently lacking a common metric to boot, is quite difficult to apply because it avoids formulating a real rule of decision. This keeps people in the dark about the legal consequences of their acts …[152]

As noted above, Australia has far fewer veil-piercing cases[153] — Australia does not have the extensive and growing 'laundry list' of factors justifying veil-piercing,[154] and the courts have shown reluctance to pierce the corporate veil in

[147] No Explanatory Memorandum was provided for the Bill and it was not read a second time. It follows earlier versions of the Bill, and Riley noted that they 'have never been seriously debated': Joellen Riley, 'Industrial Legislation in 2001' (2002) 44 *Journal of Industrial Relations* 198, 207. Another version of the Bill was introduced in 2003 but was again unsuccessful.

[148] See CRES Bill sch 2 item 2, inserting s 178A, which provided for employee entitlements against the company.

[149] The CRES Bill differed from the contributions power under the New Zealand companies legislation, which does not require proof of fault or day-to-day control over the actions of the related company: see *Companies Act 1993* (NZ) s 271(1). This article does not recommend no-fault veil-piercing. CRES Bill sch 1 item 1, inserting s 588YA(2), would have allowed the court to consider both the extent of control by the related company over the insolvent company and 'the extent to which the circumstances that gave rise to the winding up of the company are attributable to the actions of the related body corporate or an officer or officers of the related body corporate'.

[150] Blumberg, 'Transformation', above n 6, 612.

[151] Phillip I Blumberg, *The Law of Corporate Groups: Procedural Problems in the Law of Parent and Subsidiary Corporations* (1983) 8.

[152] *Secon Service System Inc v St Joseph Bank & Trust Co*, 855 F 2d 406, 414 (Easterbrook J) (7th Cir, 1988). Strasser, above n 2, 637, notes that in the US,

> [a]lthough there is near unanimity among the commentators that the present rules neither guide good decision-making nor produce consistent or defensible results, and there are many proposals for reform or abolition of the present law, one sees little discernable movement in the case law toward a better approach.

See also Thompson, 'Unpacking Limited Liability', above n 2, 23; Gevurtz, above n 2, 857–8.

[153] However, in relation to the 'agency' basis of veil-piercing in Australia there is a continuing debate over the application of *Smith, Stone & Knight Ltd v City of Birmingham* [1939] 4 All ER 116: see Jason Harris, 'Lifting the Corporate Veil on the Basis of an Implied Agency: A Re-Evaluation of *Smith, Stone & Knight*' (2005) 23 *Company and Securities Law Journal* 7; Anil Hargovan and Jason Harris, 'The Relevance of Control in Establishing an Implied Agency Relationship between a Company and Its Owners' (2005) 23 *Company and Securities Law Journal* 459, 459.

[154] See above n 10 and accompanying text.

the case of corporate groups.[155] There was considerable confusion over the correct test to apply when considering whether directors can do what they believe to be in the best interests of the group as a whole, or whether they must take into account only the interests of each individual company, regardless of the effect on other companies in the group and their related creditors.[156] In *Briggs v James Hardie & Co Pty Ltd* ('*James Hardie*'), Rogers AJA said:

> The proposition that a company has a separate legal personality from its corporators survived the coming into existence of the large numbers of fully owned subsidiaries of companies and their complete domination by their holding company … There was continued adherence to the principle recognised by *Salomon*, notwithstanding that for a number of purposes, legislation recognised the existence of a group of companies as a single entity.[157]

That particular question was answered by the insertion of s 187 into the *Corporations Act*.[158] Moreover, in *Qintex Australia Finance Ltd v Schroeders Australia Ltd*, Rogers CJ Comm D noted with concern that 'there is today a tension between the realities of commercial life and the applicable law'.[159] His Honour complained that '[t]he result has been unproductive expenditure on legal costs, a reduction in the amount available to creditors, a windfall for some, and

[155] An example is the High Court's decision in *Walker v Wimborne* (1976) 137 CLR 1, 6–7, where Mason J said that

> the emphasis given by the primary judge [in that case] to the circumstance that the group derived a benefit from the transaction tended to obscure the fundamental principles that each of the companies was a separate and independent legal entity, and that it was the duty of the directors of Asiatic to consult its interests and its interests alone in deciding whether payments should be made to other companies. … The creditor of a company, whether it be a member of a 'group' of companies in the accepted sense of that term or not, must look to that company for payment. His interests may be prejudiced by the movement of funds between companies in the event that the companies become insolvent.

In *Industrial Equity Ltd v Blackburn* (1977) 137 CLR 567, 577, Mason J also upheld the separate legal entity principle in relation to the dividends which could be distributed by a parent company, despite its complete control over the funds of the subsidiary. See also *Pioneer Concrete Services Ltd v Yelnah Pty Ltd* (1986) 5 NSWLR 254, 264 (Young J).

[156] One test to decide this derives from *Walker v Wimborne* (1976) 137 CLR 1 and appears in the quote above in n 155. The other comes from *Charterbridge Corporation Ltd v Lloyds Bank Ltd* [1970] Ch 62, 74, where Pennycuick J held:

> Each company in the group is a separate legal entity and the directors of a particular company are not entitled to sacrifice the interest of that company. This becomes apparent when one considers the case where the particular company has separate creditors. The proper test, I think, in the absence of actual separate consideration, must be whether an intelligent and honest man in the position of a director of the company concerned, could, in the whole of the existing circumstances, have reasonably believed that the transactions were for the benefit of the company.

[157] (1989) 16 NSWLR 549, 576 (citations omitted).

[158] Section 187 provides:

> A director of a corporation that is a wholly-owned subsidiary of a body corporate is taken to act in good faith in the best interests of the subsidiary if:
>
> (a) the constitution of the subsidiary expressly authorises the director to act in the best interests of the holding company; and
>
> (b) the director acts in good faith in the best interests of the holding company; and
>
> (c) the subsidiary is not insolvent at the time the director acts and does not become insolvent because of the director's act.

[159] (1990) 3 ACSR 267, 268.

an unfair loss to others. Fairness or equity seems to have little role to play.'[160] Ian Ramsay and David Noakes remark that:

> Comments such as those of Rogers CJ, and a general concern resulting from holding companies walking away from insolvent subsidiaries leaving creditors of the subsidiaries unpaid, led to the Australian Commonwealth Parliament amending the *Corporations Law* in 1993 to introduce s 588V.[161]

The idea of comprehensive legislation in Australia to relax the separate legal entity principle for corporate groups is not new; the *Harmer Report*, which preceded the passage of *Corporations Act* s 588V, was in favour of piercing the veil where the court was satisfied that it was just to do so.[162] Three specific criteria to which the court should have regard in making this determination were specified. These were:

- the extent to which the related company took part in the management of the company
- the conduct of the related company towards the creditors of the [defaulting] company and
- the extent to which the circumstances that gave rise to the winding up of the company are attributable to the actions of the related company.[163]

The *Harmer Report* made it clear that '[i]t should not, of course, be sufficient that creditors have merely relied on the assets of the related company in their decision to deal with the company.'[164] However, this recommendation was not adopted.

The legislation proposed in this article is narrower than that suggested by the *Harmer Report* and more likely to be accepted as it simply codifies the existing, but little utilised,[165] shadow director liability.[166] At present, there is only one section within the *Corporations Act* that mentions the expression 'shadow director'.[167] Even the section that allows for the existence of shadow directors —

[160] Ibid 269.

[161] Ramsay and Noakes, above n 1, 259. See also Ian M Ramsay, 'Holding Company Liability for the Debts of an Insolvent Subsidiary: A Law and Economics Perspective' (1994) 17 *University of New South Wales Law Journal* 520.

[162] Law Reform Commission, *General Insolvency Inquiry*, Report No 45 (1988) vol 1, 146 ('*Harmer Report*').

[163] Ibid. See also the draft legislation in *Harmer Report*, vol 2, 73.

[164] Ibid vol 1, 147.

[165] See, eg, *Emanuel Management Pty Ltd (in liq) v Foster's Brewing Group Ltd* (2003) 178 FLR 1, 70–4 (Chesterman J). See also *Standard Chartered Bank of Australia v Antico [Nos 1 and 2]* (1995) 38 NSWLR 290; *Australian Securities Commission v AS Nominees Ltd* (1995) 62 FCR 504; *Bluecorp Pty Ltd (in liq) v ANZ Executors & Trustee Co Ltd* (1994) 13 ACSR 386; *Hill v David Hill Electrical Discounts Pty Ltd (in liq)* (2001) 37 ACSR 617; *Forge v Australian Securities and Investments Commission* (2004) 213 ALR 574; *Harris v S* (1976) 2 ACLR 51; *Ho v Akai Pty Ltd (in liq)* (2006) 24 ACLC 1526.

[166] When it is raised, it is often in tandem with a discussion of the liability of individuals as 'de facto' directors. For a detailed analysis of the difference between shadow and de facto directors, see Chris Noonan and Susan Watson, 'The Nature of Shadow Directorship: Ad Hoc Statutory Intervention or Core Company Law Principle?' [2006] *Journal of Business Law* 763.

[167] *Corporations Act* s 729(1) mentions the term 'shadow director' in the note.

Corporations Act s 9 — does not use the term.[168] This is in stark contrast to parallel legislation in the United Kingdom which uses the term 29 times, in many cases to stress that the liability to be imposed on directors has application also to shadow directors.[169] This is in addition to numerous references to shadow directors in other British corporate legislation.[170]

Both cases and commentary on liability as shadow directors generally concentrate on the difficulties in establishing the requisite degree of control by the individual or parent company over the decision-making of the subsidiary.[171] For this reason, a codification of the law could not only bring the availability of the remedy against the parent company into prominence but also clarify its requirements. This would operate in the same manner as the introduction of s 588V,[172] which not only signalled to parent companies that the insolvent trading liability of s 588G could be extended to them directly, rather than through the mechanism of identification as a shadow director of the subsidiary, but also clarified what would need to be proven against the parent company.

Elements from *Corporations Act* ss 9, 180 and 588V could be used to craft such a provision dealing with a failure to use care and diligence. One possibility is the following:

> A corporation contravenes this section if:
>
> (a) the corporation is the holding company of a company; and
>
> (b) at that time, the directors of the company are accustomed to act in accordance with the corporation's instructions or wishes; and
>
> (c) having regard to the nature and extent of the corporation's control over the company's affairs and to any other relevant circumstances, the corporation, or one or more of its directors, fails to exercise their powers or

168 The predecessor to s 9 was *Corporations Law* s 60(1). Note the words of sub-s (b) (emphasis added): 'a person in accordance with whose *directions* or instructions the directors of the body are accustomed to act'. The present section — *Corporations Act* s 9 (definition of 'director' para (b)(ii)) — uses the expression 'instructions or wishes'.

169 *Companies Act 2006* (UK) c 46; see, eg, s 239(5)(a). For an excellent exposition of the UK provisions and their use, see the leading case of *Secretary of State for Trade and Industry v Deverell* [2001] Ch 340. See generally Noonan and Watson, above n 166.

170 See, eg, *Insolvency Act 1986* (UK) c 45, ss 6A, 206, 208, 210–11, 214, 216, 249, 251; *Company Directors Disqualification Act 1986* (UK) c 46, ss 4, 6, 8–9, 22. Leading cases in the UK include: *Re Lo-Line Electric Motors Ltd* [1988] 1 Ch 477; *Re Unisoft Group Ltd [No 3]* [1994] 1 BCLC 609; *Re Hydrodam (Corby) Ltd* [1994] 2 BCLC 180; *Re PFTZM Ltd (in liq)* [1995] 2 BCLC 354; *Secretary of State for Trade and Industry v Deverell* [2001] Ch 340. See also *Kuwait Asia Bank EC v National Mutual Life Nominees Ltd* [1991] 1 AC 187.

171 See, eg, Michael D Hobson, 'The Law of Shadow Directorships' (1998) 10 *Bond Law Review* 184, 187, 191–2; Robert Baxt, 'Liability of Shadow Directors for Insolvent Trading — Australian Authorities Starting to Bite' (1996) 14 *Company and Securities Law Journal* 121, 123–4; Martin Markovic, 'The Law of Shadow Directorships' (1996) 6 *Australian Journal of Corporate Law* 323, 327–32, 336–47; Robyn Carroll, 'Shadow Director and Other Third Party Liability for Corporate Activity' in Ian M Ramsay (ed), *Corporate Governance and the Duties of Company Directors* (1997) 162, 175–83; Pearlie M C Koh, 'Shadow Director, Shadow Director, Who Art Thou?' (1996) 14 *Company and Securities Law Journal* 340, 343–51. The other main issue concerning commentators is the liability of parties, such as banks, who appoint directors to the board or who require companies to act in a specified way in order to qualify for financial assistance. An example of such a case is *Kuwait Asia Bank EC v National Mutual Life Nominees Ltd* [1991] 1 AC 187.

172 *Corporations Act* s 588V was inserted by *Corporate Law Reform Act 1992* (Cth) s 111.

> discharge their duties as a shadow director of the company with the degree of care and diligence that a reasonable person would exercise if they:
>
> (i) were a director of the company in the company's circumstances; and
>
> (ii) occupied the office held by, and had the same responsibilities within the company as, the director.

Similar provisions could be drafted with respect to the other directors' duties. One of the advantages of the proposed legislation is that it would not be the equivalent of the American 'laundry list'. The difference is that courts would not be looking at grounds for piercing as such but rather would be looking to see whether there was a lack of good faith and due care and diligence on the part of the parent company, just as courts already do in relation to directors' duties to their companies. Any apparent harshness arising from such a provision would be ameliorated by the application of the 'business judgment rule' (as applies to directors' duties),[173] adapted to the particular circumstances of corporate groups. The proper plaintiff to take action against the parent company would be the subsidiary or, if it is insolvent, its liquidator.

The certainty provided by the enactment of such legislation would send a crucial message of deterrence to controllers of parent companies who might otherwise choose to use the corporate group form to engage in excessive risk-taking. Easterbrook and Fischel extol the virtues of such deterrence:

> We also use deterrence (say, the threat of punishment for fraud) rather than other forms of legal control when deterrence is the least-cost method of handling a problem. Deterrence is a particularly inexpensive method. The expensive legal system is not cranked up unless there is evidence of wrongdoing; if the anticipated penalty (the sanction multiplied by the probability of its application) is selected well, there will not be much wrongdoing, and the costs of the system are correspondingly small. A regulatory system (one entailing scrutiny and approval in advance in each case) ensures that the costs of control will be high; they will be incurred even if the risk is small.[174]

At the same time, the flexibility afforded by a section equivalent to directors' duties would ensure that the technicalities in highly specific legislation are not exploited. In relation to the drafting question, Thompson comments on why legislation leaves fraud undefined in securities law: '[t]he reason is clear, a fear that a more specific definition will provide a roadmap for fraud as planners devote their energy to schemes that are within the spirit of the law but cleverly fall outside the proscribed definition.'[175] This is one of the reasons why more targeted legislative solutions are undesirable. The discussion of undercapitalisa-

[173] *Corporations Act* s 180(2).

[174] Easterbrook and Fischel, 'Corporate Contract', above n 14, 1421. See also Neyers, above n 2, 178.

[175] Thompson, 'Is the Common Law the Problem?', above n 2, 625.

tion above[176] illustrates the potential difficulties that can arise when legislation is unduly prescriptive.

Moreover, there can be difficulties in framing actions against corporate controllers under existing legislation. An example is the use of s 52 of the *Trade Practices Act 1974* (Cth) ('*TPA*') to deal with misrepresentations to creditors about the capitalisation or creditworthiness of the subsidiary. Liability is imposed on the company, but other parties involved in the contravention can be liable as well.[177] However, for liability to be imposed, proof of subjective knowledge on the part of the other parties is required. In *Yorke v Lucas*, the High Court held that even in strict liability provisions, where contravention by the principal does not require proof of intent, the liability of the accessory requires proof of knowledge.[178] This finding was based on the interpretation of the meaning of the expression 'person involved in the contravention'.[179] The requirement of proving knowledge can be avoided by invoking the state equivalents of the *TPA*,[180] but the example demonstrates the types of difficulties creditors might face if they frame their claim against the parent company under legislation not designed to deal with it. Even if misrepresentations were adequately dealt with under trade practices legislation, other aspects of default or neglect on the part of the parent company, such as a failure to adequately insure the subsidiary, are not captured by existing legislation.

Finally, the proposed legislation would overcome the judicial reluctance to pierce the veil on corporate groups evinced by Australian courts. Thompson quotes an American court, which appears to sum up nicely the position of its Australian counterparts:

> The doctrine of limited liability is intended precisely to protect a parent corporation whose subsidiary goes broke. That is the whole purpose of the doctrine,

[176] See above nn 133–9 and accompanying text.

[177] The damages remedy under s 82(1) of the *TPA* provides for an action to be taken 'against that other person [the company] or against any person involved in the contravention.' Pursuant to s 75B of the *TPA* the latter is defined as:

> a person who:
> (a) has aided, abetted, counselled or procured the contravention;
> (b) has induced, whether by threats or promises or otherwise, the contravention;
> (c) has been in any way, directly or indirectly, knowingly concerned in, or party to, the contravention; or
> (d) has conspired with others to effect the contravention.

[178] (1985) 158 CLR 661, 670 (Mason ACJ, Wilson, Deane and Dawson JJ). This is consistent with the decision in *Giorgianni v The Queen* (1985) 156 CLR 473.

[179] This interpretation was determined from an examination of the meaning of the expression in the legislation: *TPA* ss 82, 75B. Section 75B was inserted by *Trade Practices Amendment Act 1977* (Cth) s 45, and was based on ss 76 and 79(1), as they then existed. They in turn were based on *Crimes Act 1914* (Cth) s 5, repealed by *Law and Justice Legislation Amendment (Application of Criminal Code) Act 2001* (Cth) sch 1 item 1.

[180] For example, under s 11 of the *Fair Trading Act 1999* (Vic) liability is imposed directly on 'a person'.

> and those who have the right to decide such questions, that is, legislatures, believe that the doctrine, on the whole, is socially reasonable and useful.[181]

It is therefore recommended that in order to overcome the moral hazard arising from the use of the corporate group form[182] Parliament should enact legislation as suggested above to pierce the corporate veil on parent companies.

VI CONCLUSION

This article considered the liability of parent corporations within corporate groups. It began with an examination of the theory behind limited liability and maintaining the veil of incorporation. Despite creditors facing problems with the limited liability of shareholders, as an issue of balance, it remains the majoritarian default. Essentially, this is because the difficulties for shareholders with an unlimited liability regime exceed the difficulties for creditors with a limited liability regime. Such difficulties include a disproportionate loss for shareholders should the company fail, the requirements of monitoring and intervening in management to avoid this eventuality, and a disincentive to diversify, leading to capital markets being starved of investment.

However, scholars and courts, particularly in the US, show some support for veil-piercing where some or all of the elements which are used to justify limited liability and the veil of incorporation are not present. This occurs where there is effective control of the operations of the company by the directors or the shareholders, or where there is a lack of ability for the creditors to self-protect *ex ante* against the risk of loss. The balance between the objective of shareholder wealth maximisation and the protection of those adversely affected by the activities of the corporation therefore tips in favour of the creditors.[183]

Three instances of veil-piercing were examined: where the veil is pierced in order to reach the directors of the company, where the company is closely held and where the company has committed a tort. Directors face personal liability so that the law can both correctly attribute liability to the party responsible for wrongdoing, either at common law or under statute, as well as deter actions which are detrimental to the company and other corporate stakeholders, such as

[181] *Radaszewski v Telecom Corporation*, 981 F 2d 305, 311 (8th Cir, 1992) (Arnold CJ), quoted in Thompson, 'Corporate Shareholders as Mere Investors', above n 2, 388.

[182] See Department of Premier and Cabinet (NSW), *The Report of the Special Commission of Inquiry into the Medical Research and Compensation Foundation* (2004) vol 1, 74. It is interesting to note that in relation to the James Hardie asbestos claims this report stated:

> Save for the possibility that [James Hardie Industries Ltd ('JHIL')] was a shadow director of Coy, no basis appears for finding that the relationship between those companies was other than an ordinary relationship between parent and subsidiary unattended by fiduciary duties of the kind the Foundation sought to establish.

Then, at vol 1, 98, the Commissioner, David Jackson QC, stated:

> I am satisfied that JHIL was a shadow director of Coy at the relevant times. The directors of Coy were, in my view, accustomed to act in accordance with JHIL's instructions on the payment of dividends and management fees, in strategic restructuring of the James Hardie group, and on the acquisition of assets for use in Coy's Building Boards Australia business. Of course, it does not follow that there was a breach of those duties.

[183] See above nn 16, 40–1 and accompanying text.

creditors. In the case of closely held companies, the reasons for shareholders needing limited liability as an encouragement to invest — namely, the need to monitor and its cost, the disinclination to diversify and the inability to freely transfer shares — are absent. As regards tort creditors, their lack of consent to the majoritarian default term of limited liability and their inability to self-protect *ex ante* makes them worthy claimants. A removal of limited liability would encourage more acceptable levels of risk-taking or the introduction of protection strategies such as adequate capitalisation or insurance.

Corporate groups have much in common with directors and closely held companies, and many of the same reasons for piercing the corporate veil apply to corporate groups. The point was made that holding a parent company liable for the debts of its subsidiary does not impose unlimited personal liability on any individual shareholder, thus removing one of the most persuasive grounds for maintaining the corporate veil. Nor is monitoring an issue, due to the control of the subsidiary by the parent company. A common rule for all parent companies would remove the line-drawing problem that exists for closely held companies. However, this article does not advocate control as the sole ground for piercing the corporate veil on parent companies.

It was recommended that legislation be passed to recognise the substantive grounds on which the veil should be pierced, rather than the means by which it is done. The directors' duties to act with care and diligence and in good faith were suggested as the model of liability for parent companies facing piercing of the corporate veil. This approach would build on and codify the present liability of parent companies as shadow directors. What would amount to a breach of the duty would be left for courts to decide, as they presently do in the case of directors' duties. However, a number of areas of likely breach were suggested, drawn from the literature concerning the 'laundry list' of factors which underpins American veil-piercing. These included tort, undercapitalisation, lack of adequate insurance of the subsidiary, and fraud or misrepresentation.

Finally, the case was made for legislation to be enacted to pierce the corporate veil on corporate groups, rather than leaving it to the common law to do so. This would overcome the uncertainty of present veil-piercing in Australia, provide effective deterrence and reliable compensation, and minimise litigation costs. Such legislation would send a clear signal to the courts that it is appropriate to pierce the corporate veil.