# CREDITORS' RIGHTS OF RECOVERY: ECONOMIC THEORY, CORPORATE JURISPRUDENCE AND THE ROLE OF FAIRNESS

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*[This article investigates the role played by substantive fairness in the determination of corporate law principles as they relate to particularly vulnerable creditor cohorts. The meaning and relevance of fairness is discussed, and the article examines economic theory both to show which creditors may not be adequately protected* ex ante*, as well as to evaluate measures of economic efficiency as a determinant of the law. Established legal doctrines are also considered to assess their impact on these vulnerable creditor groups. Commentary on fairness is examined, before concluding that the law needs to take into account economics, traditional corporate jurisprudence and aspects of fairness relating to creditors' vulnerability and expectations. To ensure fairness to directors, their fault should also be considered before liability is imposed on them.]*

## CONTENTS



## I INTRODUCTION

The relationships between corporations and corporate stakeholders are governed in a variety of ways — contractually, by common law and by statute. Each of these is underpinned by established legal doctrines, such as the limited liability of shareholders, the separate legal entity of the company and the organic theory of the company, and these in turn are shaped by practical economics in the form of the shareholder wealth maximisation objective.

However, there is no explicit or implicit recognition in corporate law of the issue of whether the outcome of these rules, as opposed to the process by which they are achieved, is fair. This leads to a series of questions — what does fairness in a corporate context mean; should corporate law be fair; and ought fairness to be relevant along with traditional legal doctrines and considerations of economic theory?

The lack of explicit recognition of fairness may be explained by the difficulties in characterising substantive fairness. Given that academic commentators struggle to identify its requirements, it is hardly surprising that courts and

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legislatures overlook the matter. Perhaps it is simply assumed that the law is 'just' and 'fair', or is at least attempting justice and fairness — but cases, legislation and its explanatory memoranda rarely allude to substantive fairness as an objective of the law.

It should be noted that both the Corporations and Markets Advisory Committee ('CAMAC')[1] and the Parliamentary Joint Committee on Corporations and Financial Services have recently initiated inquiries into 'corporate social responsibility'.[2] Relevant to both inquiries is the question of whether company directors should be permitted or mandated to consider the interests of parties other than shareholders when making decisions. The basis for such consideration is the power of companies to affect the interests of these non-shareholder constituencies, particularly those that are vulnerable to any abuse of that power. While the economic dimension is one consideration, there is also a question of fairness.

It will be argued here that the law should be fair, and that fairness should be considered by judges and legislators in developing corporate law rules. An examination of the deficiencies of economic theory and legal doctrine supports the search for a further basis for deciding the direction of corporate law. This article suggests that this additional basis should be fairness.

While consideration of economic theories is useful in understanding market mechanisms, and the established legal doctrines are fundamental to incorporation, neither are sufficient to ensure that the outcome of corporate law is fair. This article will concentrate on creditors, a group that is particularly vulnerable to unfair treatment. While a company is a going concern and the creditors are being paid, the question of substantive fairness generally does not arise, but when the company is unable to pay its debts, those cohorts of creditors who lack the capacity to protect themselves contractually from the risk of non-payment — such as employees, small trade creditors and tort claimants — may be treated unfairly.

Allowing liquidators, and in some circumstances creditors, to recover on the basis of, for example, insolvent trading, might be seen as an attempt to 'be fair' to them. But giving a remedy to one party means the imposition of a liability on another party, in this example, on directors. Fairness involves the consideration of the position of *all* the parties concerned: the creditors who have suffered the loss, the parties who are required to remedy that loss, and others who are indirectly affected by the claim. It will be seen that it is directors who bear the majority of the burden when courts or legislatures do give recovery rights to creditors. The consequences of the imposition of liability on them flow through

[1] CAMAC has been asked by the Parliamentary Secretary to the Treasurer to examine whether 'the *Corporations Act* [should] be revised to require directors to take into account the interests of specific classes of stakeholders (other than shareholders) or the broader community when making corporate decisions.': Letter from Chris Pearce to CAMAC, 23 March 2005.

[2] The Parliamentary Joint Committee on Corporations and Financial Services has called for submissions on corporate responsibility and triple bottom line reporting. Their initial report was due 29 November 2005. This has now been extended until 19 June 2006: see Joint Committee, *Inquiry into Corporate Responsibility* (2005) Parliament of Australia <http://www.aph.gov.au/senate/committee/corporations_ctte/corporate_responsibility/index.htm>.

to their companies and shareholders. Whether this is fair will be considered below.

Part II addresses the meaning and relevance of fairness in the corporate law context. Part III examines briefly current law and economics discourse to determine which parties may be disadvantaged by the terms of their contracts, and to assess the adequacy of economic theory to guide the determination of creditors' rights. Following on from this, Part IV gives an overview of the jurisprudence governing corporations. Finally, Part V examines the theoretical aspects of fairness, and in particular, will address the questions of whether recovery by creditors of their unpaid debts is necessary to achieve fairness, and if directors are the appropriate parties from whom that recovery should be sought.

The aim of this article is to stimulate debate on the deficiencies of economic theories and traditional legal doctrines as determinants of corporate law, as well as to argue for the importance of substantive fairness despite its present lack of recognition by the law. It does not attempt to suggest ways in which fairness in a corporate context can be achieved. If the relevance of fairness can be accepted and its absence from current common law and legislation acknowledged, practical solutions for the benefit of vulnerable cohorts of creditors may follow.

## II THE MEANING AND RELEVANCE OF FAIRNESS

In order to substantiate the place of fairness in corporate law, it is first necessary to define it. It then needs to be asked why corporate law ought to be fair, and whether fairness ought to be considered in place of, or alongside, considerations of economic theory and traditional legal doctrines.

Procedural fairness is well accepted and needs no explanation. On the other hand, the principal difficulty with the discussion of substantive fairness is to identify what is meant by the term. It is therefore hardly surprising that its application in positive corporate law is not readily apparent.

Described by Lawrence E Mitchell as 'one of the great unexplained mysteries of corporate law',[3]

> [f]airness, as defined by and as used throughout our legal system, is a concept of balance, of proportionality among the parties to a transaction or proceeding. It is a concept that largely has developed in connection with questions of the justice of contractual or procedural arrangements. It is a concept that, in our society, focuses on process, rather than substance.[4]

In the context of determining a fairness test for corporate fiduciaries, he notes:

> The attempt to identify and articulate the content of the fairness test is, predictably, frustrating. Courts and commentators have long decried [its] ephemeral nature … One could dismiss the project by resorting to trite comments about equity in general or by rationally placing confidence in the judgment and 'case feel' of courts long … accustomed to dealing with such matters. That ap-

[3] Lawrence E Mitchell, 'Fairness and Trust in Corporate Law' (1993) 43 *Duke Law Journal* 425, 428.

[4] Ibid 426 (citations omitted).

> proach, however, would ignore what is most significant about the fairness principle: it is not only a judicial test of the legality of behaviour but also a standard of conduct. As a test of litigation, it may appropriately set forth circumstances in which legal liability will be imposed.[5]

For the purpose of this article, Mitchell's notion of balance and proportionality will be adopted. Despite the difficulties with defining the precise meaning of fairness, it is submitted here that it is not fair that the corporate structure and corporate law should be a means of disadvantaging claimants in contract or in tort, especially when companies become insolvent. Unfairness occurs because there is a lack of balance between companies and their directors on the one hand, and those affected by their decisions on the other. The relevance of fairness as a means of determining the content of corporate law lies first in the failure of either economic theory or traditional legal doctrines to reflect the true state of the present environment in which they operate, and second in the emerging consideration and importance of non-shareholder stakeholders in corporate law.

It is not suggested that the concept of fairness should be a determinant of the rights of a claimant against a company or its directors in a particular case.[6] Rather, this article will suggest that it is unfair for the situation of vulnerable creditor cohorts to be ignored, and that any attempt to remedy this lack of fairness needs to be undertaken by courts and legislatures in formulating and applying specific principles and tests of liability. For example, the interpretation of the doctrine of limited liability currently operates in a manner which is unfair to tort claimants as against directors, and this would be an appropriate place for the law to use fairness as a consideration.[7]

Part III of this article will examine neoclassical economic theory, which concentrates on the attainment of economic efficiency and the role of corporate law in that process. This discussion will look at the parties that are inadequately compensated in their dealings with companies, as well as the inability of neoclassical economic theory to provide a means of protecting them. It will be shown that this theory is based on a series of false assumptions — that all parties are able to protect themselves through contract and that parties have access to the necessary information to inform their judgements about appropriate contractual terms.

In particular, it will be shown that the traditional means of assessing economic efficiency, the Kaldor-Hicks analysis,[8] is unable to determine the appropriate

[5] Ibid 444–5 (citations omitted). See also Andrew Keay, 'Directors' Duties to Creditors: Contractarian Concerns Relating to Efficiency and Over-Protection of Creditors' (2003) 66 *Modern Law Review* 665, 678–9, which remarks upon the definitional difficulties and observes that:

> The problem is that there is a profound lack of any explanation as to what is meant by the word; writers gloss over what is meant by it, assuming that we know what the term entails. … Undoubtedly, one reason for this is the fact that 'fairness' is intuitive. … [W]e must accept that fairness is incapable of precise definition.

[6] See, eg, *Muschinski v Dodds* (1985) 160 CLR 583.

[7] See below Part IV.

[8] This is named for Nicholas Kaldor, 'Welfare Propositions of Economics and Interpersonal Comparisons of Utility' (1939) 49 *Economic Journal* 549, and John Hicks, 'The Foundations of Welfare Economics' (1939) 49 *Economic Journal* 696.

allocation of responsibility when a company becomes insolvent. It then will be asked whether it is proper for there to be rights of recovery for creditors against directors.

A number of commentators have championed the cause of fairness in the determination of appropriate corporate regulation. Rizwaan Mokal maintains that consideration of the substantive goal of the law, justice, must always precede the issue of efficiency.[9] Mokal further argues that liability should not be imposed on the person who is most able to bear it, or lie where it falls as the cheapest alternative, unless justice is achieved in doing so.[10] He argues that

> efficiency can never be a *substantive* goal of the law. … However, efficiency — understood properly — is quite indispensable as a procedural goal. Once a set of substantive goals has been exogenously specified (eg using a theory of justice), efficiency can be used to judge between various proposed schemes for implementing it.[11]

David Millon questions why considerations of economic efficiency dominate discussions as to the meaning of fairness. He argues that

> under some circumstances, people are entitled to more than they can bargain for. … [I]t is the contractarians who ought to justify their insistence on a relentless commitment to market-defined outcomes. References to efficiency simply beg the underlying question of why efficiency should provide the sole normative criterion. As a society, we have not embraced the market as a totalizing model for the definition of rights and responsibilities.[12]

F H Buckley notes that '[w]hile efficiency refers to the size of the joint contractual gains, distributional justice concerns the division of the gains between the parties'[13] and that 'the criterion of fairness is whether contractual gains are divided in an equitable manner.'[14]

Part IV of this article looks at traditional legal doctrines of separate legal entity, limited liability and the organic theory. These are squarely based on the notion of protecting a company's members from liability, as a means of encouraging business and investment. However, while these doctrines provide a vital framework for the law, they originated at a time when companies were very different to the present. Large corporations wield huge economic and social power, which, if abused, can have catastrophic consequences on many non-shareholder constituencies. This is recognised by the growth of discussion of corporate social responsibility as well as by more recent economic theories such as team production theory and communitarianism.[15] These acknowledge both the

[9] Rizwaan Mokal, 'On Fairness and Efficiency' (2003) 66 *Modern Law Review* 452, 457.

[10] Ibid.

[11] Ibid (emphasis in original). However, Mokal stresses that the achievement of justice must nonetheless be cost-effective, so that the costs in determining who is most worthy of recovery should not consume too much of the limited funds available for distribution: at 457–9.

[12] David Millon, 'Communitarians, Contractarians, and the Crisis in Corporate Law' (1993) 50 *Washington and Lee Law Review* 1373, 1385–6 (citations omitted).

[13] F H Buckley, 'Three Theories of Substantive Fairness' (1990) 19 *Hofstra Law Review* 33, 34, referring to the seminal work of John Rawls, *A Theory of Justice* (1971) 85–9.

[14] Buckley, above n 13, 35.

[15] See discussion in below Part V.

vulnerability of non-shareholder corporate stakeholders as well as the contributions they make to the success and profitability of companies, and therefore find that such stakeholders are as worthy of protection by the law as shareholders and the companies themselves.

## III Economic Theory in Corporate Law

The contribution of economic theory to positive corporate law is largely limited to the objective of shareholder wealth maximisation. However, economics scholars have written widely on the theoretical question of whether creditors should be able to recover their unpaid debts. Many argue that recovery is not necessary because creditors can protect themselves against the risk of nonpayment by the company. The following discussion will concentrate on the contribution made by economic analysis in the identification of vulnerable creditor groups, as well as its deficiency in protecting those groups.

It is often maintained that protection can be afforded by the terms of the contracts creditors negotiate with companies. David Wishart asserts:

> 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.[16]

Frank Easterbrook and Daniel Fischel echo these sentiments when they say 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.'[17]

In addition to the capacity to price-protect, some creditors can 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.[18] Other means of protection against loss include a creditor's ability to diversify their client base so that nonpayment by one debtor does not lead to the creditor's own financial ruin.

[16] David Wishart, 'Models and Theories of Directors' Duties to Creditors' (1991) 14 *New Zealand Universities Law Review* 323, 335 (citations omitted). He argues that the imposition of a duty on directors to act in the interests of various stakeholders in the company, such as creditors, 'fails the test of economics. It does not cope with the idea of remuneration for risk — that the law should find which party most efficiently deals with uncompensated risk': at 338.

[17] Frank Easterbrook and Daniel Fischel, *The Economic Structure of Corporate Law* (1991) 50. See also Ross Grantham, 'Directors' Duties and Insolvent Companies' (1991) 54 *Modern Law Review* 576, 579. In Richard A Posner, 'The Rights of Creditors of Affiliated Corporations' (1976) 43 *University of Chicago Law Review* 499, 501, he comments 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 notes research in Brian Cheffins, *Company Law: Theory, Structure, and Operation* (1997) 501, which established that 'there is little evidence that creditors charge a higher interest rate when dealing with a limited liability company, compared to other creditors.': Keay, above n 5, 689.

[18] Posner, 'The Rights of Creditors of Affiliated Corporations', above n 17, 504.

Additionally, creditors may have short-term credit periods, which allow them to carefully assess creditworthiness with current information about the company's financial stability.

The contention that creditors can protect themselves by contract stems from the most widely-accepted neoclassical economic model of corporations: the 'nexus of contracts' or 'contractarian' theory. Rather than the company being a separate entity, the contractarian views it as an abstraction to combine inputs and facilitate express and implied contracts[19] between various parties. Shareholders and creditors are factors of production, and their contribution of equity and loan capital are merely types of input into the final product.[20]

Contractarians admit that not all contracts between creditors and companies are actually negotiated — the issue is 'whether the distributive implications of the [contract] are "priced", that is, reflected in the terms of the exchange.'[21] The aim of contractarian analysis is theoretical economic efficiency, not positive reality. This is one reason why this school of economic thought is deficient as a determinant of corporate law.

Theoretical efficiency is achieved by maximising the joint gains of the parties through contract, termed 'private ordering' in the economic literature, although it does not seek to ensure that those gains are shared equitably. For the contractarian, the only acceptable role of corporate law is to reduce the costs of making the bargain, namely, transaction costs.[22] The Coase theorem, one of the foundations of the contractarian approach, holds that the imposition of additional duties on parties such as directors increases transaction costs and therefore prevents resources being used by the company in the most economically efficient way.[23] Contractarians therefore favour default rules, which may be avoided in individual contracts.

The theoretical ability of creditors to self-protect may indicate that their protection at common law or under statute is unnecessary. However, as noted above, contractarian analysis is concerned with theoretical economic efficiency, rather than the reality of individual contracts concerning creditors. The self-protection

19 The word 'contracts' is not meant literally in this context. Instead it refers to the various relationships between the parties. Companies also have relationships with the eventual consumers of their products despite a lack of privity of contract between them. Companies have relationships with the community at large, for example in their environmental responsibilities: see Christopher A Riley, 'Contracting Out of Company Law: Section 459 of the *Companies Act 1985* and the Role of the Courts' (1992) 55 *Modern Law Review* 782, 785–6. The communitarian view of corporations is discussed later: see below Part V.

20 William W Bratton Jr, 'The "Nexus of Contracts" Corporation: A Critical Appraisal' (1989) 74 *Cornell Law Review* 407, 420.

21 Michael Whincop, 'Painting the Corporate Cathedral: The Protection of Entitlements in Corporate Law' (1999) 19 *Oxford Journal of Legal Studies* 19, 31.

22 Transaction costs are the costs of ensuring that each party's interests under the contract are protected. For example, when a creditor makes a contract with a company, one of its costs is assessing the creditworthiness of the company. This type of transaction cost is called a monitoring cost: see Oliver Williamson, 'The Vertical Integration of Production: Market Failure Considerations' (1971) 61(2) *American Economic Review* 112; Oliver Williamson, 'Markets and Hierarchies: Some Elementary Considerations' (1973) 63(2) *American Economic Review* 316, 317–18.

23 Ronald Coase, 'The Problem of Social Cost' (1960) 3 *Journal of Law and Economics* 1, 1. Whincop comments that '[t]he Coase theorem resembles a theory of motion that assumes the absence of friction.': Whincop, above n 21, 21.

argument is predicated on an 'efficient markets' hypothesis: that is, 'that all relevant information will be available to the market and that the market rapidly, if not instantaneously, digests all information as it becomes available.'[24] However, even the proponents of self-protection are prepared to admit that markets do not always work efficiently.[25] The contention does not take into account situations where there is incomplete information regarding the investment or the borrowing company's financial position. In this regard, creditors are affected by the size of the company with which they are dealing.[26] Small closely-held companies are more likely to deprive creditors of vital information about solvency than larger companies with mandated public disclosure or a board well separated from its shareholders.[27] Creditors charge for the risks that they are aware of taking. If additional risks are taken by directors and the creditors have not foreseen them, the creditors will have failed to charge an adequate premium.[28]

In any event, it is not possible to generalise about creditors in terms of their need for recovery. Not all creditors are able to protect themselves, as they are not able to make their own bargains. Indeed, the ability of some creditors to protect themselves, for example, with charges over company assets or loan covenants, increases the risk to weaker parties who cannot negotiate such security.[29] This article looks at the three cohorts of creditors who are particularly vulnerable because of their inability to protect themselves *ex ante* by contract, namely small trade creditors, employees and tort claimants.[30]

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

25 Wishart, above n 16, 336. See also Ross Grantham, 'The Judicial Extension of Directors' Duties to Creditors' [1991] *Journal of Business Law* 1, 2–3.

26 The vast majority of companies in Australia are not listed on the Australian Stock Exchange. As at 30 June 2004, there were approximately 1 309 870 companies in Australia, of which approximately 1 291 110 were proprietary companies and 18 670 were public companies. Approximately 1400 public companies are listed on the Australian Stock Exchange: Email from Debbie Cowley (Product Team, Australian Securities and Investment Commission) to Helen Anderson, 6 December 2004.

27 Wishart, above n 16, 336.

28 Melvin Aron 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 Kenneth Arrow, 'Risk Perception in Psychology and Economics' (1982) 20 *Economic Inquiry* 1, 5 where he comments that '[i]t is a plausible hypothesis that individuals are unable to recognise that there will be many surprises in the future; in short, as much … evidence tends to confirm, there is a tendency to underestimate uncertainties.' See also Posner, 'The Rights of Creditors of Affiliated Corporations', above n 17, 504–5; Mark Byrne, 'An Economic Analysis of Directors' Duties in Favour of Creditors' (1994) 4 *Australian Journal of Corporate Law* 275, 277.

29 Keay, above n 5, 688. See also Judith Freedman, 'Limited Liability: Large Company Theory and Small Firms' (2000) 63 *Modern Law Review* 317, 351.

30 Jonathan Lipson labels these creditors 'low VCE creditors', who 'lack volition, cognition and exit': Jonathan Lipson, 'Directors' Duties to Creditors: Power Imbalance and the Financially Distressed Corporation' (2003) 50 *UCLA Law Review* 1189, 1193. 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: at 1193.

Some trade creditors[31] may lack the knowledge and expertise needed to make accurate assessments of risk and furthermore would be unable to calculate an appropriate premium to compensate for it. Because the size of these creditors' individual debts are comparatively insignificant, the cost of obtaining information about the risk may be prohibitive. They lack information about their fellow trade creditors to enable them as a group to negotiate collectively[32] for fuller particulars of risk, or for protection from that risk. While Mark Van Der Weide argues that short-term trade creditors 'can quickly respond to bad firm behavior by taking their business elsewhere',[33] Andrew Keay describes this as 'typical of the gross overstatements that pervade some works that have contributed to the law-and-economics literature.'[34]

Employees face special problems as creditors of insolvent companies because, unlike trade creditors, they were never in a position to diversify their risk.[35] While some are compensated for this by having superior access to information about their employer's financial position,[36] not all employees are in this favourable position. Indeed, the employees who are most likely to need the protection of the law[37] are also the ones least likely to be privy to the company's undisclosed financial troubles.

The involuntary tort creditor is in an even more vulnerable position than employees and trade creditors. Where the company is insolvent, uninsured[38] and

[31] Steven Schwarcz cautions that it is not even possible to make generalisations about the vulnerability of trade creditors, 'as many trade creditors are themselves major corporations, such as IBM': Steven Schwarcz, 'Rethinking a Corporation's Obligations to Creditors' (1996) 17 *Cardozo Law Review* 647, 663 (citations omitted). However, his comments about the ability of trade creditors to protect themselves appear to demonstrate that he has made the opposite generalisation — that trade creditors all have the bargaining power of major corporations — when he said at 663 (citations omitted) that

> trade creditors have various ways to protect themselves at the initial transaction stage, such as shortening payment terms or requiring contemporaneous or even prior payment. Trade creditors seeking additional protection can even demand purchase money security interests to secure repayment.

[32] Gerard Hertig and Hideki Kanda, 'Creditor Protection' in Reinier Kraakman et al (eds), *The Anatomy of Corporate Law* (2004) 71, 72.

[33] Mark Van Der Weide, 'Against Fiduciary Duties to Corporate Stakeholders' (1996) 21 *Delaware Journal of Corporate Law* 27, 49.

[34] Keay, above n 5, 697.

[35] Paul Halpern, Michael Trebilcock and Stuart Turnbull, 'An Economic Analysis of Limited Liability in Corporation Law' (1980) 30 *University of Toronto Law Journal* 117, 149.

[36] Ibid 143.

[37] Note, however, employee protection under the *Corporations Act 2001* (Cth) pt 5.8A which was introduced by the *Corporations Law Amendment (Employee Entitlements) Act 2000* (Cth). It aims 'to protect the entitlements of a company's employees from agreements and transactions that are entered into with the intention of defeating the recovery of those entitlements.': *Corporations Act 2001* (Cth) s 596AA(1). In addition, employees can claim part of their entitlements under the General Employee Entitlements Redundancy Scheme ('GEERS'), which began on 11 September 2001. GEERS provides for the payment of all unpaid wages, all accrued annual leave, all accrued long service leave, all accrued pay in lieu of notice and up to eight weeks of redundancy entitlements. There is a cap on entitlements derived from the *Workplace Relations Act 1996* (Cth) s 170CC(3)(b): $75 200 for 2001–02, $81 500 for 2002–03, $85 400 for 2003–04, $90 400 for 2004–05 and $94 900 for 2005–06. The protection of employees will be discussed further in Part V.

[38] Easterbrook and Fischel argue that economic theories take into account the protection of tort creditors. They contend that if the compensation of tort creditors could affect the financial viability of the company, the directors will ensure that adequate insurance is maintained: Easter-

unable to pay damages to an injured plaintiff, these creditors have a need for compensation, yet have no ability to diversify their risk and no *ex ante* information about the financial position of the company. Indeed, for the tort victim, this *ex ante* information is meaningless.

It can therefore be argued that the vulnerability of these groups means that they should be able to recover with respect to their uncompensated losses. However, this does not answer the question posed by contractarian analysis as to whether recovery from directors would be economically efficient. The generally accepted measure[39] of economic efficiency is Kaldor-Hicks analysis.[40] It is achieved where resources are arranged in such a way that the benefit to those who are better off exceeds the harm to those that are worse off.[41] This would include where the losers in the transaction are compensated by the winners. However, it is not a requirement of Kaldor-Hicks efficiency that this compensation occur.

Presently, the doctrine of limited liability means that shareholders have no liability for creditor claims beyond their subscribed capital. Directors are only liable where the common law or statute lifts the corporate veil. An example is the imposition of a fiduciary duty on directors to consider the interests of creditors.[42] Whether lifting the corporate veil here to achieve creditor recovery by imposing director liability is economically efficient in terms of Kaldor-Hicks analysis will now be considered.[43]

brook and Fischel, *The Economic Structure of Corporate Law*, above n 17, 52–4. However, as the recent James Hardie asbestos claims illustrate, it is not always possible to estimate the amount of compensation which may be required. See William Birnbauer, 'James Hardie Finally Agrees on Payout for Asbestos Victims', *The Sun Herald* (Sydney), 19 December 2004, 5. See also Peter Prince, Jerome Davidson and Susan Dudley, 'In the Shadow of the Corporate Veil: James Hardie and Asbestos Compensation' (Research Note No 12, Parliamentary Library, Parliament of Australia, 2004–05).

39 The other frequently cited measure of efficiency is Pareto efficiency. In the context of contractarian theory, this looks at whether the contract in question not only makes one party better off but makes no other parties worse off. Daniel Farber comments that 'Pareto superiority is an intuitively appealing standard, since at least one person is better off because of the change and no one else is hurt. Essentially, the Pareto standard avoids the need for interpersonal comparisons by giving each person a veto over changes.': Daniel Farber, 'What (if Anything) Can Economics Say about Equity?' (2003) 101 *Michigan Law Review* 1791, 1795. Uncompensated externalities, meaning uncompensated costs to parties which cannot be dealt with, or internalised by the terms of a contract, are Pareto inefficient, and therefore Pareto optimality is difficult to achieve in practice. The ability to veto changes is also more theoretical than real.

40 See above n 8.

41 See Kaldor, above n 8; Hicks, above n 8. See also Ian Ward, *An Introduction to Critical Legal Theory* (1st ed, 1998) 129.

42 It is now clear that this duty is not owed directly to creditors: *Spies v The Queen* (2000) 201 CLR 603. See also Len Sealy, 'Directors' "Wider" Responsibilities — Problems Conceptual, Practical and Procedural' (1987) 13 *Monash University Law Review* 164; John Dyson Heydon, 'Directors' Duties and the Company's Interests' in P D Finn (ed), *Equity and Commercial Relationships* (1987) 120; Wishart, above n 16; Byrne, above n 28; Janine Pascoe and Helen Anderson, 'Personal Recovery Actions by Creditors against Company Directors' (2002) 10 *Insolvency Law Journal* 205; Keay, above n 5.

43 Quantifying the benefits and detriments of a particular transaction for the purpose of Kaldor-Hicks analysis is difficult, and it may not be possible to weigh them against each other when they are not in monetary terms. Even assuming that this analysis can be applied in an individual transaction, it is at best an approximation as a guide to the formation of policy with respect to classes of transactions where the particular circumstances differ: Richard Posner, 'The Ethical and Political Basis of the Efficiency Norm in Common Law Adjudication' (1980) 8 *Hofstra Law Review* 487, 489.

Directors are under a duty to act in the best interests of the company, not its creditors. Creditors therefore incur a type of transaction cost called a 'monitoring cost' in trying to ensure that their funds are not used improperly. This is a real risk due to the significant divergence of interest between the directors, the company and the creditors. Debt money is used by the directors not for the benefit of creditors, but for the benefit of the company and its shareholders by way of increased profitability and dividend.[44] The extra profit generated by the debt capital does not flow back to creditors, yet creditors share the losses of a company's liquidation. The creditors' monitoring costs may be passed on to the company[45] if the creditor has the contractual power to do so, as the cost of their capital might incorporate a premium to cover the possibility of residual loss. The shareholders pay this premium by way of a reduced dividend.

In times of doubtful solvency, when the interests of creditors ought to receive more attention than usual, directors may act opportunistically to benefit shareholders or strategic, powerful creditors. Their behaviour may deteriorate in respect of protecting particularly vulnerable creditors, in a last ditch attempt to preserve the company, and to save the funds of the shareholders. If the company survives its brush with insolvency, the shareholders will benefit. If it does not, the shareholders have lost their money anyway and the doctrine of limited liability prevents them from losing any more. The imposition of personal liability on directors for losses may benefit the creditors because potentially it makes directors risk averse.[46] But there may be two contradictory outcomes from this cautious behaviour. The company may survive to the benefit of both the creditors and the shareholders, or it may fail, with creditors perhaps recovering part of their debts and shareholders losing everything. Kaldor-Hicks analysis fails here as it is unable to identify quantifiable and predictable benefits and detriments from the imposition of personal liability on directors to consider creditor interests when the company faces insolvency.

It should also be noted that, in quantifying benefits and losses of transactions for the purpose of Kaldor-Hicks analysis, there is also potentially a cost to the creditor for the benefit of a regime of director liability for company debts. This may be because creditors are unable to charge as much for their capital where the directors have given a personal guarantee over their own assets. The benefit here

[44] Halpern, Trebilcock and Turnbull observed that the limited liability of shareholders enables them 'to effect uncompensated transfers of business risks to creditors, thus creating incentives for excessive (inefficient) allocations of social resources to risky economic activities.': Halpern, Trebilcock and Turnbull, above n 35, 126.

[45] Other creditors may incur monitoring costs but be unable to pass this cost on to the company because this would drive their goods or services out of the market.

[46] Victor Yeo and Joyce Lin, 'Insolvent Trading — A Comparative and Economic Approach' (1999) 10 *Australian Journal of Corporate Law* 216, 234; Byrne, above n 28, 283–4; Dale Oesterle, 'Corporate Directors' Personal Liability for "Insolvent Trading" in Australia, "Reckless Trading" in New Zealand and "Wrongful Trading" in England: A Recipe for Timid Directors, Hamstrung Controlling Shareholders and Skittish Lenders' in Ian Ramsay (ed), *Company Directors' Liability for Insolvent Trading* (2000) 19, 34; Justin Dabner, 'Trading whilst Insolvent — A Case for Individual Creditor Rights against Directors' (1994) 17 *University of New South Wales Law Journal* 546, 562. It should be noted here that despite these commentators noting that directors become risk averse when liability is imposed or increases, they cite no empirical evidence to support this contention.

accrues to the company, but the detriment is suffered by both the creditor (who charges less) and the director (if the company does default and the loan is called in).[47]

In addition, it must be remembered that imposition of personal liability on directors as a device to reduce the transaction costs of the company dealing with creditors also affects the transaction costs and relationship between the directors and the company. This is because the contractual transaction is between the company and the creditors, not the directors and the creditors. From the directors' perspective, there is very little to be gained in operating under a regime imposing personal liability for company debts in the absence of the payment of a generous salary by way of compensation.

The Kaldor-Hicks argument, therefore, must ask whether the net benefit to the company (and through it, to its shareholders) from a situation of 'no director liability' exceeds the net harm that this causes to the creditors. Alternatively, the question could be phrased as being whether the net benefit to the creditors from a situation of having director liability exceeds the net harm that this causes to the company through its adverse effect on director behaviour and demand for compensation.[48] This is impossible to quantify with confidence.

One problem that immediately stems from the use of contract to define the relationship of the parties is the determination of the content of these agreements. Lewis Kornhauser remarks that:

> Complications arise in corporate transactions … because the relevant 'agreement' is generally unwritten, frequently ambiguous or contradictory and often not an agreement at all. Rather, the nexus of contracts approach *constructs* an agreement out of the interests of the relevant parties.[49]

The lack of normative utility of contractarian theory and its measures of efficiency have been observed by commentators. Harold Demsetz comments that it is

> a mistake to confuse the firm of [orthodox] economic theory with its real-world namesake. The chief mission of neoclassical economics is to understand how the price system coordinates the use of resources, not … the inner workings of real firms.[50]

Stephen Bainbridge argues that any model of the company, beset as it is with simplifying assumptions, 'is properly judged by its predictive power with respect

[47] See Henry Hansmann and Reinier Kraakman, 'Agency Problems and Legal Strategies' in Reinier Kraakman et al (eds), *The Anatomy of Corporate Law* (2004) 21, 22.

[48] Net effects need to be examined because each party suffers both positive and negative consequences from each choice. For example, when a company operates under a no director liability regime, the creditors, where possible, will charge more for the extra risk involved, but this may be offset by the advantages to the company in terms of less compensation for directors and more entrepreneurial behaviour by them. Likewise the company will be unwilling to pay as much for its goods or services under a 'director liability' regime, because it will have additional costs in the form of director remuneration as well as perhaps lesser returns from a risk averse director.

[49] Lewis Kornhauser, 'The Nexus of Contracts Approach to Corporations: A Comment on Easterbrook and Fischel' (1989) 89 *Columbia Law Review* 1449, 1451 (emphasis in original).

[50] Harold Demsetz, 'The Structure of Ownership and the Theory of the Firm' (1983) 26 *Journal of Law and Economics* 375, 377.

to the phenomena it purports to explain, not by whether it is a valid description of an objective reality.'[51] He conceded that 'the nexus-of-contracts model is properly viewed as a metaphor rather than as a positive account of economic reality.'[52] He also granted that 'Economic Man', the 'autonomous individual who makes rational choices that maximize his satisfactions' would be 'a feral monster with no partners and no customers.'[53]

It can be seen, therefore, that the main reason for dissatisfaction with contractarianism is its inability to take into account the realities of authentic business transactions.[54] Apart from asymmetries of information, the creditor may face pricing pressure because of competition, and suffer from a lack of bargaining power to be able to charge for the actual costs of the transaction. These include the legal and time costs of drafting the contract, as well as monitoring costs. Even with bargaining power, creditors have imperfect foresight regarding future risks and the moral hazards facing the directors, especially if the corporate governance of the company is controlled entirely by the shareholders.[55]

These factors make under-compensation a significant risk for creditors, and contractarian theory does not suggest how these deficiencies can be overcome. Moreover, for involuntary creditors with no capacity to negotiate *ex ante* compensation for their risk of nonpayment, the theory provides no guidance whatsoever for the determination of the law. Tort creditors are not a factor of production and contribute nothing to the company's bottom line. The company as a nexus of contracts therefore lacks normative value and does not ensure adequate compensation for all creditors in the event of a company's insolvency.

Therefore, while neoclassical economic analysis identifies parties who are vulnerable, its main weaknesses in recognising and protecting unsecured claimants are the fallacy of the self-protection notion under real contracting conditions, information asymmetry between creditors and the company, and the particular position of involuntary creditors.

## IV CORPORATE LAW DOCTRINES

It might be expected that legal doctrines would focus on fairness, but in fact the concepts of limited liability, separate legal entity and the organic theory have

[51] Stephen Bainbridge, 'The Board of Directors as Nexus of Contracts' (2002) 88 *Iowa Law Review* 1, 3.

[52] Stephen Bainbridge, 'Community and Statism: A Conservative Contractarian Critique of Progressive Corporate Law Scholarship' (1997) 82 *Cornell Law Review* 856, 871.

[53] Ibid 871–3. In defence of the contractarian point of view, however, Bainbridge maintains that 'rational choice encompasses all incentives to which humans respond, including such things as risk aversion and even a generalized sense of fairness' so that the criticism of contractarianism, that it fails to consider notions other than economic efficiency, is unjustified: at 872.

[54] Even Posner is aware of the dangers of reductionist theory; however in Richard Posner, *Economic Analysis of Law* (5th ed, 1998) 18, he argues in its defence that

> [a] greater danger of positive economics in general, and the positive economic theory of law … in particular, is the opposite of reductionism: Call it complicationism. When the economic analyst seeks to make a very simple economic model more complex, for example by bringing in … risk aversion and information costs, he runs the risk finding himself with too many degrees of freedom: that is, with a model so flexible that no empirical observation can refute it — which means that no observation can support it, either.

[55] Whincop, above n 21, 28.

their origins and justification in practical economics. They are not concerned with the need for recovery by creditors who may be uncompensated by contract for the risk of nonpayment of their debts.[56]

Fundamentally, the economic objective of shareholder wealth maximisation underlies the doctrines of limited liability and separate legal entity — without these, shareholders would be much less willing to entrust their funds to companies. From the contractarian perspective, these legal doctrines are regarded as hypothetical bargains — rules the parties would have agreed to if they had negotiated the matter. While contractarians might see any judicial discretion in the application of these rules as interfering with the contractual equilibrium that parties have achieved, because discretion introduces uncertainty, they nonetheless concede their economic value.[57]

However, the legal doctrines which govern corporate law predate their law and economics analysis and operate independently of it. Positive economics is acknowledged in cases concerning the fiduciary duty to consider creditor interests near insolvency, in occasional references to residual risk on the part of creditors,[58] but normative theories are not discussed. Courts rely on the longstanding legal doctrines of limited liability, separate legal entity and the organic theory, but they do not generally question whether these work to achieve either economic efficiency or fairness.[59] Indeed, these basic notions of corporate law which are intended for shareholder protection[60] are often misunderstood by courts and frequently lead to courts refusing[61] to impose liability on directors.[62]

56 John Farrar notes the 'heuristic inadequacy of the concept' of the separate legal personality of the company and 'how courts have attempted to deal with manifest injustices in its application, inevitably resulting from the lack of coherent principle and policy behind its adoption as orthodox legal doctrine.': John Farrar, 'Frankenstein Incorporated or Fools' Parliament? Revisiting the Concept of the Corporation in Corporate Governance' (1998) 10 *Bond Law Review* 142, 144.

57 Frank Easterbrook and Daniel Fischel, 'The Corporate Contract' (1989) 89 *Columbia Law Review* 1416. Because these are the rules that most parties would agree to if they could bargain, they are termed 'the majoritarian default': Stephen Bainbridge, 'Abolishing Veil Piercing' (2001) 26 *Journal of Corporation Law* 479, 486.

58 See, eg, *Brady v Brady* [1989] AC 755, 773 (Lord Oliver); *Kinsela v Russell Kinsela Pty Ltd (in liq)* (1986) 4 NSWLR 722, 729 (Street CJ).

59 In Farrar, 'Frankenstein Incorporated or Fools' Parliament?', above n 56, 149, he notes:

> While there is some justification for [the separate legal personality of the corporation] as a legal proposition it scarcely stands as a proposition of social or political philosophy or social fact. Even the justification as a legal proposition rests on tautology, and the courts have found it necessary to supplement with other doctrine on occasion.

60 For a summary of the economic advantages brought about by limited liability for shareholders, see David 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, 438–9.

61 Sealy has argued the contrary proposition, namely that 'the one unassailable concept in our company law appears to be that of limited liability' and that it is the absolute protection accorded to shareholders that diverts judicial attention to the only other parties who could be responsible, namely the company's directors: Sealy, above n 42, 180.

62 The problem is particularly prevalent in cases concerning directors' liability for torts committed by them while acting on behalf of the company. For example, Redlich J in *Johnson Matthey (Aust) Pty Ltd v Dascorp Pty Ltd* (2003) 9 VR 171, 227 noted:

> There is an obvious jurisprudential distinction to be drawn between those who by choice enter into contractual arrangements with a corporate entity and should thus be taken to have ac-

Limited liability is arguably the link between theoretical contractarianism and practical jurisprudence. As indicated above, contractarians believe that the role of corporate law is to provide default rules that are applicable where the parties either cannot, or do not, make their own contractual arrangements. In the allocation of risk, limited liability is the default rule dictating that the risk of loss will fall on the creditor if the company is unable to pay — regardless of the circumstances, shareholders are not liable for the debt.[63] It can be contracted around by a creditor obtaining personal guarantees from the directors of the company.

On the other hand, the doctrine of separate legal entity is in total contrast to the theoretical analysis of the company as a nexus of contracts. *Salomon v Salomon & Co Ltd*[64] established that an act committed in the name of the company is regarded as its own act by virtue of the company's separate personality as a distinct legal entity.[65] Courts are reluctant to lift the corporate veil and hold a director personally liable, because to do so would undermine the separate legal entity doctrine.[66] This is on the basis that the creditor's contract is with the company and not the director who is merely acting on the company's behalf.

An adjunct to the separate legal entity doctrine is the organic theory,[67] which imputes the actions of the company's directors to the company. The original purpose of the organic theory, which considers a company's directors to be the

> cepted limited liability and those who have had no dealings with a company and whose only interest is not to be harmed by the conduct of anyone.

In *Mentmore Manufacturing Co Ltd v National Merchandising Manufacturing Co Inc* (1978) 89 DLR (3d) 195, 202, one of the seminal cases on directors' tortious liability, Le Dain J noted the particular difficulty of balancing the separate legal entity concept with a director's personal liability for his own tortious wrongs (*alterum non laedere*). In another leading case concerning the negligence liability of a director of a one-man company, Hardie Boys J in *Trevor Ivory Ltd v Anderson* [1992] 2 NZLR 517, 525 said: 'The problem that has vexed the common law courts in this area is that of respecting the doctrine of separate corporate personality on the one hand, and of allowing an adequate remedy on the other'. In response to such comments, Susan Watson and Andrew Willekes, 'Economic Loss and Directors' Negligence' [2001] *Journal of Business Law* 217, 218 remarked that 'despite an increasingly widespread perception to the contrary, tortious liability of directors to tort victims has nothing to do with protecting shareholders from liability, which is what the corporate veil from *Salomon* onwards was intended to do.'

63 See Keay, above n 5, 673. See also Whincop, above n 21, 28, where he has said that 'the basic structure of the limited liability company provides a sophisticated standard form contract between shareholders and creditors with respect to corporate assets. Replicating that allocation of risk by express contract would be costly'.

64 [1897] AC 22.

65 The conceptualisation of the company as a separate legal person is known as reification, the process of making an abstract idea real or concrete.

66 Wishart, above n 16, 335.

67 The theory originated in *Lennard's Carrying Co Ltd v Asiatic Petroleum Co Ltd* [1915] AC 705, 713–14 (Viscount Haldane LC). In *H L Bolton (Engineering) Co Ltd v T J Graham & Sons Ltd* [1957] 1 QB 159, 172, Lord Denning stated that:

> Some of the people in the company are mere servants and agents who are nothing more than hands to do the work and cannot be said to represent the mind or will. Others are directors and managers who represent the directing mind and will of the company, and control what it does. The state of mind of these managers is the state of mind of the company and is treated by the law as such.

directing mind and will of the company,[68] was to attribute their mental states and actions to the company, to ensure that the company would be also liable for the directors' actions. This is known as the identification doctrine.[69] However, courts have often used the organic theory as justification for exculpating directors from personal liability for their actions.[70]

Some commentators argue that the sanctity of the corporate veil must be maintained, and that attempts to make directors personally liable for their actions threaten the very notion of incorporation. The debate arises most commonly in the context of liability for torts committed by directors while acting on behalf of the company. For example, Ross Grantham and Charles Rickett assert:

> While on occasion there may be sound policy reasons why liability should be imposed on directors personally for torts committed in the course of operating the company, *prima facie*, company law doctrines must necessarily be accorded primacy. While such a claim may seem imperialistic, such primacy is inherent in the very nature of company law. The primary purpose of the set of rules which makes up company law is to ensure that principles of law generally applicable, such as those of torts, are applied to a different and non-natural entity in a particular manner, which usually means that the scope of their application is limited. Thus, although, necessarily, a director may be the actual tortfeasor or the individual responsible for a contract, 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. To refuse to accept that these general principles are modified is not only to deny the primacy inherent in the rules of company law, but in a sense it is to deny the company's very existence.[71]

Neil Campbell and John Armour respond to Grantham and Rickett thus:

> This passage is only partly correct … 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 li-

[68] Not all the company's directors will necessarily be the directing mind and will of the company. This depends on the role taken by the director on the board and whether the director takes an executive role.

[69] Neil Campbell and John Armour, 'Demystifying the Civil Liability of Corporate Agents' (2003) 62 *Cambridge Law Journal* 290, 292.

[70] See, eg, the House of Lords in *Williams v Natural Life Health Food Ltd* [1998] 2 All ER 577, 577 (Lord Steyn); see also *Trevor Ivory Ltd v Anderson* [1992] 2 NZLR 517, 518 (Cooke P). More recently, however, it has been confirmed that organic theory is for the purpose of attributing mental states to the company, rather than actions. According to Stephen J in *Smorgon v Australia & New Zealand Banking Group Ltd* (1976) 134 CLR 475, 483 (emphasis added), 'it has been in areas in which the ends of justice have been thought to require the attribution of *mental states* to corporations that the organic theory has been employed and developed'. See also Lord Hoffman's judgment in *Meridian Global Funds Management Asia Ltd v Securities Commission* [1995] 2 AC 500, 505.

[71] Ross Grantham and Charles Rickett, 'Directors' "Tortious" Liability: Contract, Tort or Company Law?' (1999) 62 *Modern Law Review* 133, 139 (citations omitted).

> ability law nor company law has 'primacy' — there is no inconsistency between the two.[72]

The doctrines of separate legal entity and limited liability are concerned with safeguarding the personal assets of those who invest in businesses, as a means of encouraging diverse investment, rather than the protection of the managers of those businesses. Susan Watson and Andrew Willekes argue that:

> It is entirely possible to apply tort law principles in a consistent manner in a company context, without derogating from the principles of company law. …
>
> The reason for the difficulty is that there are two pervasive misconceptions that operate in the company law context and colour any thinking in this area. The first misconception is that tortious liability of directors in some way attacks the notion of separate legal entity. The second misconception is that individuals acting as directors can never be liable to third parties for their negligence, as their actions are those of the company itself.[73]

In reference to the separate legal entity doctrine, John Farrar comments:

> Given the lack of a coherent basis for *Salomon* in principle and policy it is perhaps inevitable first that injustice can arise in its application and secondly that the courts' departures from it have not been easy to explain and justify in terms of principle and policy. We lack a clear idea of the legitimate ends of corporations.[74]

It can be seen, therefore, that the legal doctrines of limited liability, separate legal entity and the organic theory are the key rules of corporate jurisprudence which have ensured that directors do not bear liability for their behaviour whilst acting on behalf of the company. They emphasise the protection of shareholders, and do not take into account the need for compensation of creditors who are unable to protect themselves *ex ante* through contract. It will be argued in the next section that a consideration of fairness is necessary to redress the imbalances in the law caused by these traditional corporate law doctrines.

## V RECONCILING ECONOMIC THEORY, LEGAL DOCTRINE AND FAIRNESS

The inability to define what amounts to fairness or what a consideration of fairness demands is one reason that some scholars resort to economics as a yardstick for assessing the outcomes of legal rules. Therefore much of the law and economics discussion is based on teleology, that is, that the law is, or should be, moving towards an end point, or *telos*, where economic equilibrium and efficiency can be achieved. It evaluates theories and philosophies of law in the context of the economic consequences that they will accomplish. This is in

72 Campbell and Armour, above n 69, 296 (emphasis in original). The authors label the misunderstanding of the identification doctrine 'the dis-attribution heresy'. 'We have no doubt that the heresy is based on a misunderstanding of the identification principle, and cannot otherwise be supported': at 295.

73 Watson and Willekes, above n 62, 218–19.

74 Farrar, 'Frankenstein Incorporated or Fools' Parliament?', above n 56, 157.

contrast to the deontological school of thought that focuses on the justifiability of the means to achieve those consequences.

The Coase theorem is teleologically based, and holds that within a single transaction, efficiency can be realised — the parties reach an agreement which allocates their respective rights and entitlements in a way that is satisfactory to both parties and maximises the total output of the transaction.[75] This transaction could also be considered fair,[76] under the assumption that both parties have bargained to attain an equitable share of the utility, or benefit, from the transaction.

In terms of economic teleology, an outcome is both Kaldor-Hicks efficient as well as fair and just if it brings about a net benefit to society, even though some people may be much worse off.[77] The rights of the individual are set aside in the pursuit of a 'greater good', so that a result that is Kaldor-Hicks efficient in economic terms is fair in legal terms.

This school of thought has its roots in utilitarian philosophy as well as economics.[78] If the benefit to society outweighs the detriment to the individual, the overall result is seen as fair.[79] Conversely, it is unfair to recognise the rights of one person if that harms the wellbeing of the rest of society. An example is the frequently cited argument that a finding of personal liability on the part of directors in favour of creditors will cause directors to become risk averse, to the detriment of the company, its shareholders and society as a whole.[80]

In this context, however, it must be remembered that creditors suffering loss can produce a consequential economic effect on society just as the imposition of liability on directors can. Under-compensated trade creditors who are unable to recover may themselves be unable to pay their employees and creditors. The cost of compensating tort victims is born by society, perhaps incompletely, through the welfare system, insurance and workers' compensation. Moreover, the success of utilitarianism is difficult to assess, as M D A Freeman notes:

75 See above Part III.

76 Note that fairness is not a stated aim of the Coase theorem. See Michael Swygert and Katherine Earle Yanes, 'A Unified Theory of Justice: The Integration of Fairness into Efficiency' (1998) 73 *Washington Law Review* 249, 266 where the authors comment that '[w]hile the Coase Theorem can help us to understand what is efficient, it alone cannot and was not meant to tell us what would be a "fair" allocation of resources among or between the parties.'

77 Farber, above n 39, 1795.

78 Jeremy Bentham, *An Introduction to the Principles of Morals and Legislation* (first published 1780), quoted in Larry A DiMatteo, 'The Norms of Contract: The Fairness Inquiry and the "Law of Satisfaction" — A Nonunified Theory' (1995) 24 *Hofstra Law Review* 349, 364. Bentham's theory of utilitarianism recommends that all action be directed towards the greatest good for the greatest number of persons.

79 Farber, above n 39, 1791.

80 The converse can also be argued. If liability is only imposed on directors where their behaviour involves fault, as defined by statute or the common law, it should not result in risk aversion per se, but rather the avoidance of clearly delineated behaviours. This may well result, and is in fact intended to result, in the avoidance of corporate collapses and the loss of shareholder funds. In addition, economic benefits may well flow to shareholders as credit should be cheaper for the company to obtain under more cautious stewardship, resulting in better profits and larger dividends. Necessarily, however, all such analysis of the imposition of liability assumes that parties are in possession of full information of risk and can appropriately quantify its extent and cost. Thus the deficiencies of neoclassical economic analysis flow through to their application in utilitarian philosophy.

> One of the problems with utilitarianism is the lack of a method for calculating the effect of a decision or policy on the total happiness of a relevant population. It offers no reliable technique for measuring change in the level of satisfaction of one individual relative to a change in the level of satisfaction of another. … Problems such as this had led economists to attempt to make utility arguments more rigorous.[81]

The Kaldor-Hicks analysis also fails to answer satisfactorily the question of whether the imposition of director liability to creditors will achieve the objective of economic efficiency by reducing transaction costs.[82] More importantly, economics does not answer a key question — why should liability be imposed on directors, when the benefits from that imposition of liability flow to the company, its shareholders and its creditors, and not to the directors?[83]

For this reason, some academics eschew economics in favour of substantive fairness as an objective of the law. For example, Michael Swygert and Katherine Earle Yanes remark that:

> In contrast to the late-twentieth-century emphasis on justice as efficiency by certain theorists, justice as fairness has been a theme of the common law from its earliest times through the present. Equality-seeking and redistributive principles of justice, although of ancient origin, are always undergoing new packaging. At times, notions of justice have centered primarily on form and process, on dispensing justice 'according to the rules'. More recently, the focus on fairness has included a greater emphasis on substantive notions and on a perceived need to use the law for redressing and adjusting inequalities of both the opportunities for seeking society's scarce resources and the resulting allocation of those resources.[84]

Daniel Farber also comments that 'Kaldor-Hicks improvements are arguably fair when everyone had an equal chance beforehand of being on the winning side, but this is not always a realistic assumption.'[85] Kaldor-Hicks efficiency does not safeguard the position of creditors who are unable to protect their positions *ex ante* by contract. As noted earlier, a transaction can be Kaldor-Hicks efficient even if the winners from the transaction do not compensate the losers.[86] While the company is solvent, the winners from under-compensated contracts are the company and its shareholders, who are getting the benefit of capital for a cheaper price. The analysis breaks down in the case of an insolvent company failing to pay contract or tort creditors. As Jason Neyers remarks, '[e]conomists may be able to tell us what is prudent and efficient but they cannot tell us what is just or owed as a matter of right.'[87]

[81] M D A Freeman, *Lloyd's Introduction to Jurisprudence* (7th ed, 2001) 557.

[82] See above Part III.

[83] Equally, it does not address the adverse consequences when they fall on creditors. Easterbrook and Fischel claim that company law 'is not a branch of poverty law': Easterbrook and Fischel, *The Economic Structure of Corporate Law*, above n 17, 23.

[84] Swygert and Yanes, above n 76, 288.

[85] Farber, above n 39, 1795–6.

[86] Whincop, above n 21, 33.

[87] Jason Neyers, 'Canadian Corporate Law, Veil-Piercing and the Private Law Model Corporation' (2000) 50 *University of Toronto Law Journal* 173, 213.

Keay also stresses the need for 'distributional justice'[88] in circumstances of under-compensation by contract, holding that the need for the economic imperative of efficiency needs to be tempered with fairness.[89] The market imperfections noted earlier in this article — of information asymmetries, powerlessness, lack of knowledge of later risky conduct — mean that creditor self-protection is not available in all situations. Keay highlights for all creditors the risks of confusion as to their legal rights, saying 'creditors will often not appreciate the state of the law and fail, consequently, to make provision for it and thus obtain a redistribution of benefits and burdens.'[90]

Keay concludes that creditors should have a means of recovery on the basis of their expectations and vulnerability:

> Of relevance to our discussion is the fact that fairness is often used to refer to how wealth is distributed in society. So, unlike efficiency, fairness is concerned with the end effect of wealth distribution. … Also, fairness in our legal tradition assumes support for those who are vulnerable and the meeting of people's reasonable and legitimate expectations.[91]

The under-compensated trade creditor enters into its transaction with a company voluntarily and indeed the transaction may be wealth maximising from an economic standpoint — both parties are prospectively better off when they make the transaction because the trader has sold its goods at a profit and the company has had the benefit of those goods. But if the trade creditor is exposed to risks for which they cannot charge because of market pressures from competitors, it is unfair if all the surplus benefit from the transaction flows to the company, while the risk of nonpayment remains with the creditor.[92]

Clearly, on the basis of expectation and vulnerability, creditors uncompensated or under-compensated by contract deserve to recover. The question that then arises is whether that recovery should be from directors or from some other party.

It was observed above that fairness involves the consideration not only of the position of the person suffering the loss but also of the person required to compensate that loss. Under-compensated contract creditors, such as employees or trade creditors, are vulnerable to the improper actions of directors. Trade creditors in particular may be powerless to demand full information about their risks from directors because it is financially unviable to do so.[93] The directors may increase the risk of nonpayment after the contract has been concluded. Also, they may transfer assets from the company to another entity to deny the creditors' claims. While creditors do not expect to recover personally from directors simply because of the company's insolvency, they are reasonably entitled to

[88] Keay, above n 5, 677.
[89] Ibid.
[90] Ibid. For the ways in which creditors can make provision for risks, see above n 18 and accompanying text.
[91] Ibid 679 (citations omitted).
[92] See generally Swygert and Yanes, above n 76, 262.
[93] Hertig and Kanda, above n 32, 72.

expect that directors will be held accountable for any actions deliberately or carelessly prejudicing their interests. Keay contends:

> The result of all this is that directors can act as they choose, even though they are doing it with the creditors' money. Fairness dictates that the actions of management do not directly or indirectly transfer wealth from creditors to shareholders, either by the shifting of funds or causing an increase in risk. In not having regard for creditor interests when resources are scarce, such as when the company is near to, or in, insolvency, it might be argued that the directors are cheating as they are effecting a wrongful distribution of wealth away from those who are the residual claimants of company property. All that the law can do, apart from requiring that creditors be treated equally at the time of contracting, is to impose some form of *ex post* judgment to redress unfairness.[94]

Trade creditors and employees are not wholly without protection. Small trade creditors may have some ability to diversify their client base *ex ante*, and will have the *ex post* advantage of recovery by the liquidator on their behalf pursuant to a variety of common law and statutory causes of action.[95] An example is directors' personal liability for insolvent trading, which has been consistently made stricter, as the debts incurred by directors as a company fails are most likely to attract society's disapprobation.[96]

Yet, no consideration is given to the need or lack thereof of the creditors who are the beneficiaries of insolvent trading action. Presently the law concentrates on the type of behaviour of the director rather than the type of creditor who is affected by that behaviour.[97] However, recovery by the company's liquidator and a partial distribution *pari passu*[98] may not be sufficient to achieve fairness,[99] because it can result in overcompensation of those already price-protected by their contracts and under-compensation of those who are not. The plaintiff arguably most in need of compensation, the involuntary tort claimant, is unable

94 Keay, above n 5, 679 (citations omitted).

95 These include, amongst others, the fiduciary duty to consider creditor interests when the company approaches insolvency as discussed in *Kinsela v Russell Kinsela Pty Ltd (in liq)* (1986) 4 NSWLR 722, 732 (Street CJ), action for breach of *Corporations Act 2001* (Cth) s 588G (insolvent trading), and breaches of civil penalty provisions under *Corporations Act 2001* (Cth) pt 9.4B.

96 For a detailed discussion of the evolution of the insolvent trading provisions, see Dabner, above n 46, 552–7; see also Niall Coburn, 'Insolvent Trading in Australia: The Legal Principles' in Ian Ramsay (ed), *Company Directors' Liability for Insolvent Trading* (2000) 73, 74; Australian Law Reform Commission, *General Insolvency Inquiry*, Report No 45 (1988) [277]–[280] ('*The Harmer Report*'); *Southern Cross Interiors Pty Ltd v Deputy Commissioner of Taxation* (2001) 53 NSWLR 213, 218–25 (Palmer J).

97 According to Hertig and Kanda, '[j]urisdictions tend to employ qualitatively similar legal strategies to protect all corporate creditors, regardless of vulnerability to shareholder opportunism.': Hertig and Kanda, above n 32, 77.

98 *Corporations Act 2001* (Cth) s 556(1).

99 See Rizwaan Mokal, 'Priority as Pathology: The *Pari Passu* Myth' (2001) 60 *Cambridge Law Journal* 581, 613.

to utilise the action at all, and can only participate in the liquidator's distribution if there is fortuitously some act of insolvent trading.[100]

Similarly, employees are not wholly without protection. As noted earlier, there is liability imposed on directors with respect to both unpaid employee entitlements, as well as a government scheme to ensure the partial payment of those entitlements in the event of corporate failures.[101] However, neither of these guarantee that employees are fully compensated. Liability under *Corporations Act 2001* (Cth) Part 5.8A is based on a finding of a subjective intention to deprive employees of their entitlements.[102] This would be a singularly difficult task, yet it may contribute to a fear of liability for which directors will demand additional compensation from the company or which may lead to liability avoidance behaviour.[103] It does not ensure that employees will be able to recover their entitlements from directors. In addition, the cost of employee recovery through the government-funded GEERS scheme is born by the taxpayer, while its monetary cap means that employees do not necessarily recover their full entitlements.

A significant aspect of the fairness of imposing liability on directors is deterrence. As Keay notes, it is the directors who make the decisions to improperly strip assets from failing companies, and directors who choose to trade whilst insolvent or in breach of their fiduciary duties.[104] Deterrence of improper behaviour *ex ante* is an important aspect of the protection of under-compensated creditors. It is fair that directors who fail to be deterred from their improper behaviour be personally liable *ex post* for its consequences?

[100] It is generally accepted that tort claims are not within the meaning of 'incurring a debt' to attract insolvent trading liability under *Corporations Act 2001* (Cth) s 588G. Mandie J in *Australian Securities and Investment Commission v Plymin* (2003) 46 ACSR 126, 247 examines the previous authorities, before concluding that

> the exercise of choice will often be relevant to the question as to when a company has incurred a debt. For example, in the case of obligations incurred by revenue law, the choice will of course not be exercised in relation to incurring the taxation liability, but there will still be a choice exercised, namely, the decision to continue trading or the decision to proceed with whatever activity is likely to attract or involve the attraction of the relevant impost.

[101] See above n 37.

[102] *Corporations Act 2001* (Cth) s 596AB(1) states that:

> A person must not enter into a relevant agreement or a transaction with the intention of, or with intentions that include the intention of:
> (a) preventing the recovery of the entitlements of employees of a company; or
> (b) significantly reducing the amount of the entitlements of employees of a company that can be recovered.

[103] Parliamentary Joint Committee on Corporations and Financial Services, Parliament of Australia, *Corporate Insolvency Laws: A Stocktake* (2004) 174, notes examples of the structuring of businesses to circumvent potential liability:

> For example, under one form a management company will own the assets and equipment used to run the business while a separate phoenix company will operate the business and employ the workers but have no assets. When the phoenix company accumulates debts and goes into liquidation as an assetless company, the management company continues to trade. Another form involved a management company, a sales company and a labour hire company.

[104] Keay, above n 5, 679.

Deterrence is even more crucial in the protection of tort creditors. John Goldberg notes that:

> the nature of the compensatory remedy demonstrates that the ad hoc legislation undertaken within tort [court] cases is inherently capable of promoting only two goals: deterrence of antisocial conduct and compensation for those who have been injured. Because they have the power to order defendants to pay damages, courts can, in principle, deter the defendant and other similarly situated actors from engaging in conduct they deem undesirable; at least insofar as the threat of damages awards affects actors' decisions and the court can rely on future courts to permit or impose sanctions on such actors. Likewise, courts can compensate at least some injured persons.[105]

A complication which may appear to undermine the deterrent quality of personal liability is the possibility that directors may avoid having to pay claims against them because they hold professional indemnity insurance. However, the many exclusions found in directors and officers' insurance[106] means that it is unlikely that directors would act improperly with impunity. In addition, the payment of the actual damages claim is only one aspect of a finding of liability against a director. When directors act in breach of the law, they may be subject to prosecution. They risk damaging their reputations and their ability to obtain other directorships. They risk increased insurance costs in the future as well as the possibility of insurance being unattainable.

It is fair that directors who personally commit torts in their capacity as directors, or who sanction the commission of those torts in their subordinates, should face personal liability. Tort victims are vulnerable in the event of the company's insolvency due to their inability to be compensated *ex ante* for the risk of loss. In addition, they have a reasonable expectation that, if company directors commit torts while acting as directors, they will be as liable for the consequences as other human beings would be. They would not expect that directors would be able to shelter behind the fact that their acts were for separate legal entities[107] — after all, agents of non-corporate legal entities would be personally liable, even if the principal entities were vicariously liable as well. They would not expect that the doctrine of limited liability would be used to deny their claims. A rule designed to protect shareholders should not be relevant to a claim against a director.

Yet, the highly unsettled common law rules concerning the attribution to company directors of liability for their actions means that this vulnerable cohort of creditors is left with the least protection. At least four tests exist to determine when liability will be attributed to directors for their tortious action.[108] In cases

[105] John Goldberg, 'Twentieth-Century Tort Theory' (2003) 91 *Georgetown Law Journal* 513, 525.

[106] It was noted in CAMAC, *Directors and Officers Insurance Report* (2004) 8–9 ('*CAMAC Report*') that in practice, insurers frequently have a host of exclusions, whether the insurance is taken out by the company or by directors themselves. These may include prospectus liability, insider trading liability, liability for shareholder claims, dishonesty or fraud, as well as liability for insolvent trading.

[107] The experience of the James Hardie claims has amply demonstrated this point: see, eg, New South Wales, Special Commission of Inquiry into the Medical Research and Compensation Foundation, *Report* (2004) vol 2, 413.

[108] The tests are examined extensively in *Root Quality Pty Ltd v Root Control Technologies Pty Ltd* (2000) 177 ALR 231 and *Johnson Matthey (Aust) Pty Ltd v Dascorp Pty Ltd* (2003) 9 VR 171.

of negligent misstatement by the director of a one-man company, the director will only attract personal liability if a personal, as opposed to corporate, assumption of responsibility can be established.[109] This is very difficult to establish. In *Trevor Ivory Ltd v Anderson*, Hardie Boys J noted that the use of a company to carry on the business could in fact be seen as a personal disclaimer, rather than the basis for imputing an assumption of responsibility.[110] In other words, why else would someone incorporate himself, as in *Salomon v Salomon & Co Ltd*,[111] if not to escape from personal responsibility and liability?

Contractarian theory as previously outlined[112] was seen to deny the rights of non-shareholder constituents on the basis that they interfered with the attainment of economic efficiency. However, it should be noted here that another currently popular school of thought looks at the role of non-shareholder constituents in the company, and is discussed by scholars under the names of communitarianism[113] and team production theory.[114] These theories consider the role of parties such as creditors, customers, employees and the community at large, in contributing resources to achieve the company's objectives.

The rationale for both theories is that the long-term viability of the corporate enterprise relies on the cooperation of a range of corporate stakeholders.[115] In order to achieve this cooperation, ethics and fairness must be considered as a means of fostering trust and reducing risk and its associated costs. While directors are allowed to favour one cohort of corporate stakeholders over another, this is only permissible where this is in the long-term interests of the company. Peter Konstant remarked that this view 'provides a new and more inclusive paradigm of corporate governance in which stakeholder voice and loyalty are crucial.'[116] The aim of the theory is therefore to move the focus of directors away from the shareholder wealth maximisation objective.[117]

See also Helen Anderson, 'The Theory of the Corporation and Its Relevance to Directors' Tortious Liability to Creditors' (2004) 16 *Australian Journal of Corporate Law* 73.

109 *Trevor Ivory Ltd v Anderson* [1992] 2 NZLR 517, 518 (Cooke P). See John Farrar, 'The Personal Liability of Directors for Corporate Torts' (1997) 9 *Bond Law Review* 102, 108–10.

110 [1992] 2 NZLR 517, 528.

111 [1897] AC 22.

112 See above Part III.

113 See Peter Konstant, 'Team Production and the Progressive Corporate Law Agenda' (2002) 35 *UC Davis Law Review* 667; Cynthia Williams, 'Corporate Social Responsibility in an Era of Economic Globalization' (2002) 35 *UC Davis Law Review* 705; Kent Greenfield, 'Using Behavioral Economics To Show the Power and Efficiency of Corporate Law as Regulatory Tool' (2002) 35 *UC Davis Law Review* 581; Millon, above n 12.

114 See Margaret Blair and Lynn Stout, 'A Team Production Theory of Corporate Law' (1999) 85 *Virginia Law Review* 247.

115 Konstant, above n 113, 669.

116 Ibid 674. Konstant rejects suggestions that the communitarian view is utopian. He maintains that 'the currently dominant academic model of corporate law is such a caricature of selfishness that the ameliorative mechanisms that corporate communitarians propose can seem real, grounded, and morally refreshing': at 676.

117 Ibid 674. At 676, Konstant says:

> Serious application of TPM [the team production model of Blair and Stout] offers at least the possibility that public corporations can achieve some meaningful increase in fairness for all corporate constituents. Such fairness can be accomplished without changing legal rules, but by encouraging directors and all corporate constituents to act in accordance with TPM under the existing law.

The mechanisms by which progressives believe this paradigm will be achieved are less clear. Cynthia Williams asserts that disclosure and transparency are key determinants of directors' actions, and that scrutiny by corporate stakeholders will foster beneficial norms of behaviour.[118] Kent Greenfield contends that, if corporate actions are perceived to be substantively fair, the behaviour of others improves to the benefit of all stakeholders.[119] Konstant recommends the appointment of an independent board, which 'can check opportunistic abuses by powerful inside senior managers, and which can give voice and procedural fairness to all constituents.'[120] An independent board is also regarded as desirable because it lacks any personal financial incentive to benefit its members from its actions, and risks damage to its reputation from breaches of the law.

The implementation of these mechanisms requires no change to the existing law, and thus some communitarians regard the theory as both positively descriptive and normatively useful. Communitarians are characterised by their 'willingness to use legal intervention to overcome the transaction costs and market failures that impede self-protection through contract.'[121]

Millon contends:

> If one discards the view that bargaining is sufficient to mediate among those interests, reform of the rules structuring corporate governance presents an opportunity to develop rational, well-considered regulation of relations among shareholders and non-shareholders. Perhaps supplemented by public law interventions, this approach seems preferable to a number of uncoordinated, ad hoc reform efforts, in various discrete areas of the law, that ignore the need for systematic balancing of shareholder and nonshareholder interests.[122]

It should be that fairness is considered alongside traditional economics and doctrine.[123] The economic analysis of risk and compensation is useful for identifying those who are in need of the law's protection. Doctrines of separate legal entity and limited liability should remain the bedrock of incorporation, to protect shareholders and encourage investment by them. But these alone are demonstrably insufficient as determinants of corporate law, because they fail to take adequate account of the situation of vulnerable creditor groups. This deficiency can be remedied by a consideration of fairness to achieve a balance and proportionality between different corporate stakeholders.

[118] Williams, above n 113, 711–17.

[119] Greenfield, above n 113, 642.

[120] Konstant, above n 113, 683.

[121] Millon, above n 12, 1379. Communitarianism is also sometimes known as the 'concession theory of the firm'. It sees incorporation as a privilege bestowed by the government, thereby justifying government interference. Cohen, above n 60, 444 explained 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 which 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.

[122] Millon, above n 12, 1386–7.

[123] Swygert and Yanes consider that fairness should be an issue both of deontology as well as teleology: the means by which a dispute is decided, as well as being the consequence or outcome of that dispute: Swygert and Yanes, above n 76, 251.

Guido Calabresi and A Douglas Melamed[124] propose as a solution a 'theory of entitlements'.[125] While economic efficiency might favour the rights which are cheapest to enforce, and allow the loss to lie where it falls,[126] the authors preferred 'distributional goals'.[127] These occur where a party is given an entitlement to recover because the choice expresses society's collective desire,[128] or because it would simply maintain consistency with other entitlements in society.[129]

The way to combine efficiency, doctrine and fairness under a theory of entitlements is a 'two-step' approach[130] — private law rules of contract *ex ante* which permit the parties to focus on the efficient allocation of resources, followed by a system which allows for the equitable redistribution of gains *ex post*. In order to achieve substantive fairness, the second stage *ex post* redistribution must acknowledge the expectations and vulnerability of the cohorts of creditors identified above as uncompensated or under-compensated *ex ante*.[131]

## VI Conclusion

Discussion of the rights of creditors against directors is common in the economic literature, and is a debate about the extent to which recognising the liability of directors will damage the economic efficiency of the corporation. Consideration of the appropriateness of legal doctrines to creditor claims usually ignores the particular vulnerability of certain creditor cohorts; this vulnerability is illustrated by an examination of economic theory. This article has sought to bring these threads together and to make a case for the consideration of fairness as a further determinant of corporate law by highlighting the deficiencies of both economic theory and traditional corporate jurisprudence.

It is submitted that unless fairness takes its place alongside economics and established corporate jurisprudence, the law will not achieve a just result for creditors in their dealings with companies. This article began with the meaning of fairness in a corporate context and asked whether corporate law should be fair, and whether fairness ought to be relevant along with traditional legal doctrines and considerations of economic theory.

[124] Guido Calabresi and A Douglas Melamed, 'Property Rules, Liability Rules, and Inalienability: One View of the Cathedral' (1972) 85 *Harvard Law Review* 1089.

[125] Whincop asserts that contractarian theory has a role to play, supplemented by the Calabresi and Melamed theory of entitlements. He argues that a 'theory of entitlements offers both a stronger lens with which to examine where the contracting process begins and ends, as well as those situations where it never really occurs at all, other than in highly abstracted theories.': Whincop, above n 21, 28.

[126] Calabresi and Melamed, above n 124, 1093.

[127] Ibid 1098.

[128] Ibid 1100. This desire is usually expressed through legislation.

[129] Ibid 1102–4. Calabresi and Melamed, however, justify this on the grounds of pragmatism, rather than as consistency for justice's sake. Arguably, it is easier to introduce a rule which is consistent with another because it will need little explanation. It also makes obedience easier if society is familiar with similar rules.

[130] Russell Korobkin and Thomas Ulen, 'Efficiency and Equity: What Can Be Gained by Combining Coase and Rawls?' (1998) 73 *Washington Law Review* 329, 331. See also Swygert and Yanes, above n 76.

[131] While *Corporations Act 2001* (Cth) s 556 does this to some extent, it is by no means sufficient.

Following on from this was an examination of law and economics. Economic theory was used to identify the cohorts of creditors whose contractual dealings with a company did not sufficiently compensate them for the risk of nonpayment of their debts. Small trade creditors and employees were seen to be particularly vulnerable in this regard.

However, economic models of the company do not acknowledge that those creditors were entitled to compensation beyond what they could bargain for. Indeed the nexus of contracts theory considered mandatory corporate rules to run counter to the achievement of economic efficiently through private ordering. The position of involuntary tort creditors, while sometimes recognised as a difficulty, was not dealt with by contractarianism.

Kaldor-Hicks analysis also faces significant obstacles in determining the economic efficiency of liability rules concerning recovery by creditors from directors. Because of the doctrine of limited liability, the potential losers upon a company's insolvency are either creditors or directors, but never the company's members. However, while directors may be compensated for facing potential personal liability, vulnerable cohorts of creditors are by definition uncompensated. The effect that the imposition of liability might have on the behaviour of directors, in making them risk averse to the detriment of the shareholder wealth maximisation objective, was not adequately considered by Kaldor-Hicks analysis.

Established corporate law doctrines such as the separate legal entity and limited liability doctrines, on the other hand, were shown explicitly to protect shareholders above all other parties. It was observed that judicial misunderstanding of these doctrines sometimes operated to exculpate directors from liability for their actions while acting on behalf of a company.

It is suggested that fairness has an important role to play in the determination of the rights of creditors. Fairness in this context should not be assessed according to Benthamite notions of utilitarianism but rather be based on the expectations of the parties and their vulnerability. Small trade creditors and employees who lack the capacity to protect themselves adequately *ex ante* through contract are particularly vulnerable in the event of nonpayment of their debts. Involuntary tort creditors are even more vulnerable in this regard and moreover would expect that directors should not be able to shield behind legal doctrines which are intended for shareholder protection.

The present law fails to deliver fairness to vulnerable creditor groups. Remedies available to small trade creditors and employees do not ensure adequate compensation. The government scheme for payment of outstanding employee entitlements shares the burden of their costs across society but does not ensure full recovery of those entitlements. The requirement to prove a subjective intent to defeat creditor claims renders *Corporations Act 2001* (Cth) Part 5.8A potentially worthless as a means of recovery of employee entitlements. Tort claimants are at a particular disadvantage due to the judicial misconception of the doctrines of limited liability, separate legal entity and organic theory, as well as the multiplicity of tests for the attribution of liability.

Fairness, however, must also consider the position of the party on whom liability is to be imposed. If directors are to be held liable for their actions while acting as directors, they will seek remuneration to compensate themselves for facing this risk. The greater the extent of liability, the greater the remuneration that will be sought. This cost may reduce the company's profit and will be passed on to shareholders by way of reduced dividends. In addition, excessive liability may result in risk averse behaviour which will adversely impact the directors' pursuit of shareholder wealth maximisation. It is important therefore for economic reasons that director liability should not be determined purely on the basis of the need of the creditor.

Therefore, it is suggested that any liability imposed on directors must be with respect to those actions involving fault on the part of the director. What amounts to fault is a matter for the courts and legislatures to determine. Nonetheless, it is proposed that to ensure fairness to creditors, directors and company shareholders, creditors who are uncompensated or under-compensated by contract *ex ante* should be able to recover their debts from directors at fault *ex post*.