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THE CONCEPT OF LIMITED LIABILITY AND THE PLIGHT OF CREDITORS WITHIN CORPORATE GOVERNANCE AND COMPANY LAW: A UK PERSPECTIVE

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ABSTRACT

The focus of this paper is to analyze the effects of shareholder primacy governance on creditors, the characteristics of the firm, and how creditors can protect themselves. The governance of the firm is legally vested on directors and the law places on them specific duties requiring them to act in a certain way to promote the success of the company. The governance of the firm has evolved to be known as corporate governance. The mode of corporate governance such as the shareholder oriented governance and the characteristics that come with the firm (legal personality and limited liability) have negative implications on creditors. Shareholder primacy model of corporate governance seems to find its support from the Companies Act so does limited liability which limits the liability of the Members to the subscribed shares. Legal personality of the firm means that the firm is a juristic person with rights and obligations of a natural person in that it can own its own property. The presence of limited liability brings about the shareholder primacy model of governance. The problem is not the shareholders but the foundation on which they find there protection which is the law. With the presence of the above concepts, the implication on creditors is higher risk. This paper argues that if creditors' interests are taken into account from inception, creditors will be better protected as they would be an ongoing concern for the company. Although the law provides circumstances when the corporate veil can be pierced as a mechanism to protect creditors, it is argued in this paper that clear and concise rules must be put in place as to when the veil can be pieced.

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This paper contributes to literature on the protection of creditors in light of limited liability and within corporate governance. It also makes recommendations to change the law thereby contributing to policy makers to include creditors when governing the firm.

The article uses the doctrinal approach to analyze the law on the protection of creditors by a critical examination of the section 172(1) and section 830 of the Companies Act.

KEYWORDS: *Limited Liability, Creditors, Directors, Shareholders, Financial Distress, dividends, Company Law and Corporate Governance*

1. INTRODUCTION

To begin with, it is important to state that this paper uses some of the propositions that were made by Professor Christopher J. Cowton in his article entitled: 'Putting Creditors in Their Rightful Place: Corporate Governance and Business Ethics in the Light of Limited Liability' which was published in the Journal of Business Ethics in 2011. His article was not focused on the protection of creditors per se but rather their position within issues of corporate governance and company law and the implications for this. Although Cowton did use some legal materials to emphasize the legal position of creditors created by law, his article is not a legal analysis a fact which he clearly states in the paper.[1] Nevertheless, he did raise very interesting propositions such as the shareholder primacy model of corporate governance and mechanisms creditors could use for protection. These mechanisms include capital maintenance, restriction of dividend and requirements for financial reporting. This article adopts some of these propositions and expands on them using a legal analysis.

The lack of effective control, and lack of accountability including the misuse of corporate assets by directors led to a number of corporate failures in the UK which is what led to the development of the corporate governance Codes.[2] Although the UK is generally acknowledged as the leading country in corporate governance because of its enlarging interests within corporate governance, this does not mean that there is no need for reform within corporate governance in the UK.[3] On the contrary, as the corporate world is developing, so is the need to review and improve governance practices. Although corporate

1 Cowton C. J, Putting Creditors in their Rightful Place: Corporate Governance and Business Ethics in the Light of Limited Liability , Journal of Business Ethics, 102(1), 2011, pp. 22

2 Cuomo F, Mallin C& Zattoni A, Corporate Governance Codes: A Review and Research Agenda, Corporate Governance: An International Review, 24(3) 2016, p. 222.

3 Solomon J, Corporate Governance and Accountability, 3rd ed. Chichester, 2010, p.45.

governance was practiced in the UK as long as corporate entities existed, its growth began in the twentieth century.[4] Corporate governance lacks a globally accepted definition however, the Committee on the Financial Aspects of Corporate Governance (Cadbury Report) in 1992 defined it as 'the system by which companies are directed and controlled.'[5] This article adopts the above definition even though several definitions have been written overtime. The law has always protected shareholders and has placed on directors fiduciary duties to the company except were in financial difficulties, directors are required to take into account creditors' interests.[6] While authors have been clearly divided on whether directors should perform their duties with the interests of the shareholders or the company, the law has been clear on the position of creditors which supersedes the shareholders when a company is financially distressed.[7]

Cowton explained that there are two modes of governance in which the corporation with limited liability is managed namely when a company is financially stable and the interests of the shareholders are paramount and when it is distressed and the interests of creditors become paramount.[8] Cowton called the former as the 'normal mode' and the latter as the 'distressed mode'. Whereas Cowton is correct on the point of law concerning the modes of governance, this paper argues that if creditors' interests are taken into consideration even at the time when a company is solvent, this could reduce substantial risk on creditors. This is not to say that the company will not go into financial difficulty, but even though it does, because measures have been taken to protect creditors' interest from the time of financial stability such as withholding dividends, the risk on creditors would be reduced.

However, corporate governance in the UK is centered on the idea of shareholder value management with companies run principally for the benefit of the shareholders.[9] Armor and others argued that in the UK the shareholders' interests are paramount and tends to neglect other stakeholders.[10] That being the case, this model of governance in its current state has negative implications on

[4] Tricker B, Corporate Governance: principles, policies & practices, Oxford, 2012, p. 7.

[5] http://www.ecgi.org/codes/documents/cadbury.pdf

[6] Keay A, Directors' duties to Creditors: Contractarian Concerns Relating to Efficiency and Over-Protection of Creditors, The Modern Law Review, 66(5), 2003, p.665.

[7] Cowton C. J, Putting Creditors in their Rightful Place: Corporate Governance and Business Ethics in the Light of Limited Liability , Journal of Business Ethics, 102(1) (2011), pp. 22.

[8] Ibid

[9] Gamble A and Kelly G, Shareholder Value and the Stakeholder Debate in the UK, Corporate Governance: An International Review, 2001, 9(2), p. 110.

[10] Armour J, Deakin S & Konzelmann S. J, Shareholder Primacy & the Trajectory of UK corporate Governance, British Journal of Industrial Relations, 41(3), 2003, p. 531.

creditors. Nonetheless, Company law was the foundation feature of corporate governance,[11] and it is a body of statutes, supporting rules and regulations that regulate corporate activities.[12] Understanding corporate governance needs the understanding of a 'corporate' itself as an entity.

A company has been known to be a juristic person since the landmark case of *Salomon v A. Salomon & Co Ltd*.[13] Since the inception of the concept of limited liability in the mid-19th century, doing business with incorporated companies meant that creditors risk was increased.[14] The introduction of limited liability meant that creditors' claims could not extend to shareholders but was limited to company property.[15] The nature of a company in law comes with two major characteristic namely limited liability and legal personality.[16] The Member's liability is limited to the subscribed shares only and the legal personality of the company entails that a company is separate from its members and has its own rights and obligations. Limited liability entails that creditors' claims could no longer extend to the shareholders personal property but limited to company assets as the company owns property in its own name.[17] The shareholders are protected by what is known as the corporate veil of incorporation as a result of limited liability and legal personality.[18] Consequently, although this is a known risk to creditors, it is harmful to their business.

However, there are certain instances in which the courts have lifted or pierced the veil to hold the shareholders liable for the actions of the company but this is a rare occurrence surrounded by irregularities. Although this can be seen as a mechanism to protect creditors, there are other mechanisms that creditors could use for their protection in the face of limited liability.

This article has three sections. The first section focuses on the modes of corporate governance in the UK and how this implicates creditors based on section 172 of the Companies Act 2006. The second section analyses the concept of limited liability and the legal personality of a corporation and the third section analyses the law on dividends and followed by conclusions on the article.

[11] Tricker B, Re-Invention the Limited Liability Company, Corporate Governance An International Review, 19(4), 2011, p. 386.

[12] Tricker B, Corporate Governance: principles, policies & practices, Oxford, 2012, p. 8.

[13] [1897] AC 22 (House of Lords)

[14] Tricker B, Re-Invention the Limited Liability Company, Corporate Governance An International Review, 19(4), 2011, p. 385.

[15] Hansmann H, Law and the Rise of the Firm, Harvard Law Review,, 119(5) 2006, p. 1334.

[16] Sealy L & Worthington S, Cases and Materials in Company Law, Oxford, 2013, p.33.

[17] Smith B, Legal Personality, Yale Law Journal, 37(3), 1928, P. 283.

[18] Ibid

2. SHAREHOLDER PRIMACY MODEL OF CORPORATE GOVERNANCE

Clearly corporate governance deals with the governance of the firm but this beg the question as to what the objective of the firm is. What is it that directors must work towards in order to ensure that they achieve this ultimate objective? Keay stated that determining the corporate objective is vital because it underpins the type of corporate governance to be implemented as well as inform the kind of responsibilities to impose on directors.[19] Monks and Minow stated that a company is established by law to allow different parties to contribute capital, expertise, and labor for the maximum benefit of all of them.[20] To answer the question of the objective of the law, the first place to look is the law. What exactly does the law provide for as the objective of the firm? The law states that:

'A director of a company must act in a way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole……'[21] To start with, directors are required to promote the success of the company for the benefit of its members as a whole which arguably has an implication that shareholders are the ultimate beneficiaries. The duty placed on directors to promote the success of the company is the main objective but eventually it is for the ultimate benefits of the shareholders hence directors taking their interests as paramount.

However, this is not an absolute duty at all times because when the company is in financial difficulties, the law requires that the directors take the interests of the creditors as paramount. This evidently neglects creditors as they are only considered when the company is financially struggling and there is a possibility of them losing their funds. Nevertheless, while shareholder primacy is founded on the law, the legal characteristics of a company make it clear that they cannot own the company because it is a separate entity with its own rights. Therefore they argue that by virtue of owning equity interest in the firm, they hold residual rights which entitle them (arguably) to be owners. Constantly Hansmann et al referred to shareholders as owners of the firm because it is a legal entity simply protecting or shielding its owners from liability.[22] Also it was argued that shareholders possess the greatest incentives to maximize the

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[19] Keay A, Ascertaining the Corporate Objective: An Entity Maximisation and Sustainability Model, 71(5), 2008, p. 663.

[20] Monks R. A. G and Minow N, Corporate Governance, Chichester, 2011, p.4.

[21] Section 172(1) UK Companies Act, 2006

[22] Hansmann H, Kraakman and Squire R, Law and the Rise of the Firm, Harvard Law Review, 119(5), 2006, p.1333.

wealth of the company because of their investment.[23] Easterbrook and Fischel argue that residual bearers have contracted for a promise to maximize profits for a long term which maximizes the value of the stock.[24] They went further to contend that maximizing profits for equity investors automatically assures the rest of the stakeholders including creditors that their fixed claims would be successful.[25] Nonetheless, this cannot be asserted to be true in all instances because in cases of insolvency where unsecured creditors are much more than company assets, they certainly become bearers of residual risk. Cowton wrote that this argument might seem ethical considering the nature of their residual position although when the company has no assets to settle unsecured creditors, the shareholders will not be bearers of risk.[26] Despite the debates surrounding the ownership of the company, the law is clear on its intention to impose legal personality on the company which means that the assets of the company are independent of its members.

3. THE LEGAL PERSONALITY OF AN ENTITY, THE CONCEPT OF LIMITED LIABILITY AND CREDITORS

The concept of the company being a legal person in its own right whereby it can sue and be sued in its own name is what gives the company the legal personality. The company as a juristic person was illustrated in *Salomon v A. Salomon & Co Ltd*[27] where Lord Macnaughten stated that: *"the company is at law a different person altogether from the subscribers …..; and, though it may be that after incorporation the business is precisely the same as it was before, and the same persons are managers, and the same hands receive the profits, the company is not in law the agent of the subscribers or trustee for them. Nor the subscribers liable, in any shape or form, except to the extent and in the manner provided by the Act*".[28] The important thing to ascertain is the existence of the legal attributes of the company. Salomon's case illustrated that a company is a separate legal entity which permits the corporation to own property. This is argued to be for functions which tend to ignore the individuals in

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23 Yan M, Agency theory Re-examined: an agency relationship and residual claimant, International Company and Commercial Law Review, 26(4), 2015, P. 139.

24 Easterbrook F. H and Daniel F, The Economic Structure of Corporate Law, Harvard, 1991, p. 187.

25 Ibid

26 Cowton C. J, Putting Creditors in their Rightful Place: Corporate Governance and Business Ethics in the Light of Limited Liability, Journal of Business Ethics, 102(1), 2011, p. 22.

27 [1897] AC 22 (House of Lords)

28 Ibid

the corporate group but foster functions for responsible corporate activities.[29] It has been argued that the intention is to impose or accord certain attributes on the company that enable it to create legal relations just like a natural person.[30] These legal relations relate to the abstractions of legal science like title, possession, rights and duties which links to title or ownership of property.[31] This means that the property belongs to the company and not to its members. Neither a member nor a creditor unless secured has an incurable interest in the assets of the company.[32]

It seems correct to assume that the restriction of company assets from the shareholders is a mechanism to protect creditors and an illustration of this was in the case of *Prest v Petrodel*[33] where it was stated that having more control of the company or owning a lot of shares in it is not an equitable interest in relation to company assets.[34] It must be understood that the shareholders equitable interest is in the shares of the stock that they subscribe to but does not extend to company property. However, this has not been an effective means of enhancing creditor protection because of the concept of limited liability. The purpose of incorporating companies with limited liability was to promote corporate activities for the shareholders and in the process protect them from liability.[35] Tricker argued that the invention of limited liability was a significant concession of the society which promoted economical activities with clear objectives but today the concept has become besmirched.[36] This was fuelled by the desire to accelerate business activity which was inspired and generated by the industrial revolution and it has been argued that this concept was very successful and precise as to the purpose until later when it started being exploited to the detriment of creditors.[37] This was a period of economic growth and there was a reasonable need for external capital in order to expand businesses faster and yield profits.[38]

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29 Smith B, Legal Personality, Yale Law Journal, 37(3), 1928, P. 283.

30 Ibid

31 Ibid

32 Sealy L & Worthington S, Cases and Materials in Company Law, Oxford, 2013, p.41.

33 [2013] UKSC 34

34 Ibid

35 Tricker B, Re-Invention the Limited Liability Company, Corporate Governance An International Review, 19(4), 2011, p. 386.

36 Ibid

37 Ibid

38 Tricker B, Corporate Governance: principles, policies & practices, Oxford, 2012, p. 38.

However, the law provides for exceptions in which the veil of incorporation can be pierced so as to protect creditors. Cowton suggested that when creditors request the directors to sign guarantees against a loan, this could be piercing the veil to the extent, perhaps, if the company is small with some of the shareholders as directors. Clearly piercing the corporate veil in the legal sense is removing the limitation of the liability from the shareholders in order to hold them responsible for the activities of the company. The directors are not protected by the veil unless they are also shareholders of the same corporation. It is quite interesting how the law protects shareholders with the corporate veil yet it allows directors who do not participate in any profits of the company to put their own personal property on the line for the company. Although it is an enforceable agreement, this could be argued to be another loophole created by law to yet again expose creditors to more risk. Directors might be induced into signing guarantees just to secure the loan and it so happens that at the time when the company goes into insolvency, the personal property is not enough to settle the debts. Perhaps the law should allow the shareholders to sign personal guarantees to secure a debt in that way they will still be protected by the veil but there would a contractual obligation against their property in case the company goes under. The question is whether shareholders will still be willing to embark on risky business ventures if they had their personal property at risk. Clearly this concept of limited liability is a legal way of expropriation from creditors.

However, some economists have claimed that limited liability is not absolute because the veil of incorporation can be pierced and shareholders held liable for actions of the company. Easterbrook argued that this makes limited liability not an absolute concept for redirection of risk and argues that the manner in which it happens is unprincipled.[39] He argued that it is done like lightning and it is severe which causes confusion within corporate law.[40] On the contrary, literature has indicated a lot of difficulties when it comes to lifting the veil as the judiciary faces an uncertainty. Lifting the veil has been argued to lack definite methods a burden which the courts have not yet resolved.[41] Supporting this view Bainbridge describes it as unjustifiable and arbitrary in the sense that it is vague and only creates uncertainty as it leaves the judges with great discretion instead of achieving its purpose which is an effective policy outcome

[39] Easterbrook F. H and Fischel D, Limited liability and the Corporation, University of Chicago Law Review, 52(1), 1985, pp. 89.

[40] Ibid

[41] Mujih, E. C, Piercing the Corporate Veil as a Remedy of Last Resort after Prest v Petrodel Resources Ltd: Inching Towards Abolition: Limited Liability, Company Lawyer, 37(2) 2016, p. 39.

which can protect businesses.[42] Others have advocated for its abolition because it exists as an exception to the general rule of limited liability and almost impossible to be used effectively.[43] Precedence has indicated that there is no straight forward route to be followed hence the courts have adopted a tendency to use metaphysical terms such as 'mere fraud' 'sham', 'dummy', or 'alter ego' in their judgements which indicates the challenges they are facing.[44]

Although the courts have made several attempts to explain the circumstances in which the veil can be lifted, Digman argues that none of them has been satisfactory, a view which was also taken by Griffin.[45] Cases such as fraud, tax evasion or where a company acts as an agent for another are examples of the scenarios in which the courts can lift the veil of incorporation notwithstanding that in certain similar circumstances they have refused to do so. It is submitted that piercing the veil is supposed to be a mechanism to help creditors but on the contrary, it leaves them in a wavering position which still leaves them searching for better protection from risks they face as a result of limited liability.

However to enhance the protection of creditors in the face of limited liability, the law must give directors duties that include creditors from the time of financial stability. And if any company goes into insolvency with unsettled creditors, then the corporate veil must be pierced to recover the outstanding debts for the creditors as a class. This will put the directors in a position where before embarking on risky ventures, they have to consider the implications of a failed project and put in place mitigating factors for creditors. That will provide better protection to creditors as there interests will be an ongoing concern of the company thereby ensuring that there is a relationship that must be natured for purposes of business in order to promote the success of the company.

Nonetheless, Cowton suggested that creditors are protected by other mechanisms found in company and commercial law.[46] These include capital maintenance and restriction of dividend payouts as well as the use of information in the financial reports. Cowton writes that that capital maintenance measures have been made to avoid inappropriate reduction of company assets to the ad-

42 Bainbridge S. M, Abolishing Veil Piercing, Journal of Corporate Law, 2000, 26, p. 479.

43 Mujih, E. C, Piercing the Corporate Veil as a Remedy of Last Resort after Prest v Petrodel Resources Ltd: Inching Towards Abolition: Limited Liability, Company Lawyer, 37(2) 2016, p. 39.

44 Gallagher L and Ziegler P, Lifting the Corporate Veil in the Pursuit of Justice, Journal of Business Law, 1990, p. 292.

45 Griffin S, Company Law: Fundamental Principles, Pearson, 2006, p. 15.

46 Cowton C. J, Putting Creditors in their Rightful Place: Corporate Governance and Business Ethics in the Light of Limited Liability , Journal of Business Ethics, 102(1) (2011), pp. 22

vantage of creditors. For instance, to safeguard creditors' rights, re-purchasing of company shares has been restricted to prescribed rules. The law provides that a limited company may not purchase its own shares unless they are fully paid and the shares must be paid for on purchase.[47] Any repurchases of own shares must be financed from distributable profits or from the proceeds of a fresh issue of shares made specifically for financing the purchase.[48] The re-purchasing of own shares has a negative implication on the capital of the company in that it will be reducing the capital and by this, the leverage ratio of the company would be increased which represents more risk for both current and potential creditors. Nonetheless, Cowton went further to argue that this mechanism is not free from challenges of implementation because of the difficulty in the definitions of profit, capital and insolvency.[49] The law has also restricted the payment of dividends to be done from profits only and Cowton suggested that although this helps creditors to an extent as well as the shareholders so that they are not misled to thinking that the company is performing well when in fact it is not. The law provides that:

> *'A company may only make a distribution out of profits available for the purpose. A company's profits available for distribution are its accumulated, realized profits, so far as not previously utilized by distribution or capitalization, less its accumulated, realized losses, so far as not previously written off in a reduction or reorganization of capital duly made'.*[50]

Any distribution that is made contrary to the provisions of the law is an unlawful dividend and the shareholder is to pay it back if at the time of the distribution, he had knowledge or reasonable grounds for knowing that it was made unlawful. Although it is the rights of the shareholders to receive a dividend for stokes, where external finance is involved, creditors should have more rights to have greater influence on the dividend pay-out policy. They must be able to demand that firms pay lower dividends as their position is legally weak or they are in a weak position in terms of legal protection.

It can be submitted in this study that if creditors have legal standing to alter dividend policy, that could be a form of protection. In that way, the shareholders are aware that if the interests of creditors are not taken into consideration, they will not be receiving their dividends. This is still not sufficient protection for creditors because if the firm makes a loss and fails to settle its obligations,

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47 Section 691, Companies Act, 2006

48 Section 692, Companies Act, 2006

49 Cowton C. J, Putting Creditors in their Rightful Place: Corporate Governance and Business Ethics in the Light of Limited Liability , Journal of Business Ethics, 102(1) (2011), pp. 22

50 Section 830, UK Companies Act, 2006

the shareholders will have nothing to lose as compared to creditors. La Porta, Lopezi-de-Silanes, Shleifer and Vishny[51] Easterbrook,[52] Byrne and O'Connor,[53] have all argued that the dividend has been highly influenced by the corporate need to strengthen the protection of providers of capital. Literature has indicated that one of the ways in which the shareholders can handle the agency problem is by way of dividends and debt.[54] Jensen contends that using the distribution of dividends as a mitigating factor is not effective but rather debt be used to substitute large dividends.[55] Jensen further argues that by so doing the creditors will have the right to take the firm to court if they do not pay back the principle and the interests promised by the managers. In order to prevent the harm creditors are exposed to, it was established that weak creditor rights only enhances the possibility of the managers to make dividends.[56] Creditors need to demand stronger control rights because with inadequate legal protection, they continue to bear the risk of doing business with incorporated companies.

4. CONCLUSION

The first conclusion is that the shareholder primacy model of corporate governance is harmful to creditors. Directors who by law are responsible for governing the company have specific duties in law. It is from these duties that the shareholder primacy model of governance starts from as they carry out their duties to promote the success of the company for the benefit of the shareholders. However in financial difficulties this duty is suspended by the fact that creditors' interests become paramount. This establishes a place for creditors in law and yet they are not adequately recognized in the mode of governance until the firm is in financial difficulties. It is submitted that if creditors' interests are recognized from the very beginning, the amount of risk would ultimately be reduced.

51 La Porta R, Lopez-de Silanes F, Shleifer A, & Vishny R, Investor Protection and Corporate Governance, Journal of Corporate Finance 58(1), 2000, p. 1.

52 Easterbrook F. H and Fischel D. R, Limited Liability and the Corporation University of Chicago Law Review, 52(1), 1985, p.89.

53 Byrne J and O'Connor T, Creditor Rights and Outcome Model Dividends, Quarterly Review of Economics and Finance, 52(1), 2012, P. 227.

54 Ibid

55 Jensen M. C, Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers (1986) The American Economic Review, 76(2), 1986,p. 323.

56 Brockman P and Unle E, Dividend Policy, Creditor Rights, and the Agency Costs of Debt, Journal of Financial Economics, 92(1), 2009, p. 276.

The second conclusion is that the law must be revised on directors signing personal guarantees for company debts. It must be for the partakers of dividends to put their personal property at risk for the company they claim to be theirs? If the law cannot allow this, alternatively there should be more clear and straight forward rules on lifting the veil of incorporation to protect creditors such as every company that goes in to insolvency with less assets and more debt to have the veil pierced for purposes of the outstanding debt. This is because although limited liability is an advantage of incorporation and backed for purposes of economic development at the time of inception in the UK, it is a burden for creditors who ensure that there is corporate finance for business activities. While it works perfectly as a safe haven for the shareholders, it is an impediment for creditors although they already know this but should they stop doing business? There will be no source of external finance. This is why it is submitted that even dividend rights must be restricted in order to protect creditors. It is also submitted that the law must impose on directors' duties that incorporate creditors' interest from the time of financial stability so as to reduce the amount of risk when the company goes into insolvency. This will ensure that financial risk is not externalized on creditors without adequate protection.

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