companies for failing to prevent bribery by a person associated with the company. The associated person could be simply an employee or agent of the company. The liability arises only if the associated person was intending to obtain a business advantage for the company. More important, it is a defence for the company if it has in place adequate procedures designed to prevent bribery by employees and agents. In essence, the threat of criminal liability is used to induce companies to put in place adequate internal controls over bribery, presumably on the theory that the company as employer is better able to control the activity than anyone else. This incentive rationale for imposing criminal liability for failure to prevent crime could be used extensively in relation to crime committed within the scope of a company's business. Subject to the "adequate procedures" defence, the result might be something like vicarious criminal liability.

Conclusion

7–51 As we observed at the beginning of this chapter, since the company is a separate but artificial legal person, it can act only through natural legal persons. From this trite proposition a complex body of law has emerged to determine which people in which circumstances can be regarded as having acted as or on behalf of the company. Nevertheless, some lines on the map are clear. In relation to contracting the modern tendency has been to promote the security of third parties' transactions by reducing the impact of restrictions in the company's constitution upon the effectiveness of the contracting process. As far as directors are concerned, the operation of the rules of agency normally means they are not liable or entitled on the resulting contracts, but only the company is. By contrast, in the area of tort and crime the personal liability of those acting on behalf of the company is the normal rule. The tendency has been to extend somewhat corporate liability in tort and crime in recent years, and even the individual criminal and tortious liability of directors and managers.

Across the field, the interaction of common law doctrines (agency, vicarious liability, accessory liability, statutory interpretation) with the doctrine of separate corporate legal personality is important in setting the basic structure of the law. However, constructive notice of the company's public documents, the indoor management rule and s.40 are central, company-specific rules in the area of contracting and the identification rule and the Corporate Manslaughter and Corporate Homicide Act 2007 likewise in the area of criminal liability.

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Chapter 8

LIMITED LIABILITY AND LIFTING THE VEIL

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The Rationale for Limited Liability

8–1 The company laws of all economically advanced countries make available corporate vehicles through which businesses can be carried on with the benefit of limited liability for their members. For shareholders this means that their liability for the company's debts is limited to the amount they have paid or have agreed to pay to the company for its shares. For most shareholders this means that, once the shares have been paid for, whether they were acquired directly from the company or from an existing shareholder, the worst fate that can befall them if the company becomes insolvent is that they lose the entire value of their investment.[1] However, their other assets—their homes, pension funds, domestic goods—will be unaffected by the collapse of the company in which they have invested. To put the matter from the creditors' perspective, their claims are limited to the assets of the company and cannot be asserted against the shareholders' assets. This can be regarded as a strong rule because, if the opposite economic development occurs and the company is highly successful, the shareholders are likely to receive all the residual benefit of that success, once the creditors have been satisfied.[2] This, at

[1] Insolvency Act 1986 s.74(2)(d). In the case of a company limited by guarantee the member's obligation will be limited to the amount of the guarantee (normally minimal): ibid. s.74(3).
[2] Insolvency Act 1986 s.107.

least, is the rule which is applied in the admittedly unlikely event of such a successful company being wound up; whilst it is a going concern the shareholders will receive healthy dividends or capital appreciation of their shares. So, there is an apparent asymmetry in the risks and rewards which are allocated to shareholders: they benefit, through limited liability, from a cap of their down-side risk, whereas the chance of up-side gain is unlimited. There is no such asymmetry for creditors: their downside exposure is capped at the amount they are owed by the company but that amount is equally the limit of their claim on the company. Since, however, all modern company law systems permit trading on the basis of limited liability, it might be wondered whether its rationale is worth further analysis. It is suggested that some further analysis is worthwhile because the rationale so identified is likely to be helpful in determining the terms and conditions upon which limited liability is made available and, more importantly the protections which should be put in place to guard against the abuses of limited liability.

During the battle for legislative acceptance of the principle of limited liability in the middle of the nineteenth century,[3] the argument which seems to have weighed most heavily with the legislator was that limited liability would facilitate the investment by members of the public, who were not professional investors, of their surplus funds in the many large capital projects which companies were being set up to carry out at that time, in particular the construction of a national network of railways. Members of the public, whose primary activity and expertise did not lie with the running of companies, would be much less likely to be willing to buy shares in such companies if the full range of their personal assets were to be put at risk. They might be prepared to become lenders of money to such companies,[4] but not necessarily to become shareholders, and it was the flexibility of investment of risk capital through shares which those companies sought.[5]

More recently, Halpern, Trebilcock and Turnbull[6] have pointed out that limited liability, in addition, facilitates the operation of public securities markets, because it relieves the investor of the need to be concerned about the personal wealth of fellow investors. Under a rule whereby the shareholders were jointly and severally liable for a

[3] For an account, see the sixth edition of this book at pp.40–46.

[4] It is possible to conceive of the law imposing liability upon a lender, beyond loss of the amount of the loan or deposit, if the borrower becomes insolvent, but since the lender has limited access to the up-side benefit of corporate success, the argument for imposing this liability does not have much force. Such a rule would be likely to choke off the supply of debt to companies, since debt investors are usually seeking relatively modest returns for relatively modest risk. However, "lender liability" is imposed if the lender involves itself in the running of the company to the extent of becoming a "shadow" director (see para.9–7), but this is precisely because the lender has moved out of that limited role and involved itself in the central management of the company.

[5] The distinction between equity and debt is discussed further in Ch.31, below.

[6] "An Economic Analysis of Limited Liability" (1980) 30 *University of Toronto* L.J. 117.

company's debts, my shares would be more valuable to me if the wealth of my fellow investors increased (because I would be less likely to have to pay more than the proportion of the company's debts which my shares constituted of the company's total share capital), and vice versa if the wealth of my fellow shareholders decreased. So limited liability facilitates the trading of the company's shares at a uniform price on the public exchanges. This adverse effect of unlimited liability could be mitigated, of course, by making the shareholders liable only on a proportionate basis (i.e. liability on the part of each investor only for his or her "share" of the company's debts).[7]

Further, limited liability encourages equity investment by those of modest means by facilitating diversification of investment across a number of companies in different sectors and perhaps countries, thus reducing the investor's company-specific and country-specific risks. Under a regime of unlimited liability, investors would be incentivised to monitor closely the companies in which they were invested and this would push them towards reducing the range of their investments in order to reduce monitoring costs.

8–2 Two things are apparent about these two rationales for limited liability. The first is that they support limited liability for companies which have offered their shares to the public, but are hardly persuasive for companies which have not and do not plan to do so, i.e. for all private companies (which constitute the overwhelming number of companies on the register)[8] and even for some public companies. Yet, as we saw in Ch.2, a great deal of effort was expended on the part of practitioners in the second half of the nineteenth century in securing the extension of limited liability to all companies, including the smallest, a goal achieved when the House of Lords handed down its decision in *Salomon v Salomon*,[9] and the legislature did not reverse that decision. That decision has remained controversial,[10] but so entrenched in our law is the principle of limited liability for all companies, large or small, that nobody seriously advocates the reversal of *Salomon*.

Rather, there are two lines of contemporary debate. One is the argument that the flexibility of organisational rules, which those running small businesses seek, should be provided outside company law, through a new and optional organisational form with unlimited liability, whilst those who seek limited liability should have to accept the burdens of company law, which indeed might well be somewhat

[7] Though the current rule of insolvency law, if limited liability does not apply, is joint and several liability: IA 1986 s.74(1).

[8] See above, Ch.1.

[9] [1897] A.C. 22, above, para.2–1.

[10] In (1944) 7 M.L.R. 54, Otto Kahn-Freund described it as "calamitous".

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enhanced, especially in relation to minimum capital requirements.[11] The Company Law Review, anxious not to place barriers in the way of the organic growth of small companies, rejected the arguments for a separate form of incorporation,[12] and in fact, under the banner "Think Small First", proposed some further deregulation of company law as it applies to small companies.[13] However, as we saw in Ch.1,[14] the Government can be said to have provided a separate and highly flexible form of business organisation—but, crucially, with limited liability—through the limited liability partnership, introduced by the Act of 2000.

Within company law proper the debate, therefore, moved on to a second area, which is the nature of the provisions which should be included within company law to counteract the potential abuse of limited liability. In particular, there is an interesting discussion between those who would like to strengthen the rules which apply at the point of incorporation (ex ante protection) and those who prefer to rely on rules which come into play only if limited liability is abused (ex post protection). We shall look at these rules in the subsequent chapters of this Part of the book. Amongst the legal strategies which could be implemented, though has not been in this country, is the removal of limited liability, not against certain types of companies, but in favour of certain types of creditor, notably "involuntary" or "non-adjusting" creditors.

The second matter which is apparent about the rationales for limited liability, identified above, is that they work better, perhaps even assume, that the shareholders are natural persons. However very many businesses are today carried on through a group of holding and subsidiary companies rather than through a single company.[15] This raises the question of whether the doctrine of limited liability should apply only as between the holding company and its shareholders or also within the group, i.e. between the holding company and the subsidiaries and among the subsidiary companies. In fact, the doctrine does apply within groups, a conclusion which the courts have arrived at without any deep consideration of the matter as an inevitable consequence of the doctrine of separate legal personality.

However, a rationale for limited liability has been advanced which would justify it both generally and within groups. This is the "asset partitioning" rationale.[16] What limited liability facilitates, together

[11] This case has been put in its most attractive form by A. Hicks, R. Drury and J. Smallcombe, *Alternative Company Structures for the Small Business*, ACCA Research Report 42 (1995). On minimum capital requirements see Ch.11, below.

[12] Strategic Framework, Ch.5.2.

[13] Final Report I, Ch.2.

[14] See above, para.1–3.

[15] See further below at paras 8–8 and 9–17.

[16] H. Hansmann and R. Kraakman, "The Essential Role of Organizational Law" (2000) 110 Yale L.J. 387.

with the concept of separate legal personality, is the segregation of collections of assets between investors and the company, in the case of a single company, or as among different companies in corporate groups. Although this situation is normally presented as one which hinders the enforcement of claims by corporate creditors, it can be argued that it works to their benefit. Just as limited liability prevents a creditor of a company, or of one of a number of companies in a group, from asserting its claims against the shareholders' assets, so also the doctrine of the company as a separate legal person prevents the creditors of a shareholder, individual or corporate, from asserting their claims against the company's assets. In other words, a creditor of the company does not have to face competition from the shareholder's creditors, in exchange for not competing with the creditors of the shareholder. Further, the continuity of the company as a functioning business is protected even if a major shareholder becomes bankrupt, because the shareholder's insolvency does not imperil the company's assets. Each set of creditors is thus safe in confining their monitoring efforts to the company's or the shareholder's assets, as the case may be, and creditors may be expected to specialise in these different forms of monitoring. Of course, the proponents of this rationale do not deny that the operation of limited liability may give rise to possibilities for abuse, which the law should control,[17] but they do argue that the application of limited liability is in principle justified.

8–3 An alternative or supplementary way of looking at limited liability departs from the fact that it is not a mandatory rule. The incorporators themselves may opt out of limited liability across-the-board, by forming an unlimited liability company—though this occurs but rarely.[18] Alternatively, particular creditors may contract with the company and its shareholders on the basis that both will be liable on the obligations undertaken. Where the rationales for limited liability are most in question, in relation to groups and small companies, it is in fact common for some creditors to contract out of limited liability. Those setting up small companies, into which they are not willing to inject a significant amount of share capital, will usually find that a bank will not lend money to the company unless the shareholders give a personal guarantee of the loan to the company.[19] In this way, the personal assets of the shareholders become available to the bank if there is default on the loan; the bank is not confined to the assets of the company. Equally, those dealing with an undercapitalised com-

[17] See Ch.9, below.

[18] See para.1–21.

[19] Cf. the facts of *Regal (Hastings) Ltd v Gulliver* [1942] 1 All E.R. 378, HL, one of the leading cases on directors' fiduciary duties, but where the underlying problem arose out of the third party's request for a personal guarantee which the directors were unwilling to give.

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pany in a group of companies may obtain a guarantee from the parent company[20] or, less securely, the parent company may issue a "letter of comfort" to the subsidiary's auditors, allowing them to certify the subsidiary's accounts on a going concern basis, or to a third party contemplating contracting with the company.[21] The implication of the contractual approach might be thought to be that there is no need for the law to control limited liability for it lies in the hands of those contracting with the company to protect their interests themselves. In the case of large or frequent creditors this is very often true. But not all creditors can adjust their contractual relations with the company so as to reflect the riskiness of their situation and for such "non-adjusting" creditors, notably tort victims, the default rule of the law is a crucial determinant of the legal position.[22]

Finally, sight should not be lost of the argument that the incentives to take risks, associated with the asymmetric position of the shareholders (see para.8–1), has a positive value. The purpose of commercial companies is to embark on risky ventures. A company dominated by risk-averse creditors might not add much to the store of social wealth.

Legal Responses to Limited Liability

8–4 Thus, the case for limited liability is strong, but not so strong that there are no arguments against removing its protection in certain cases and, in any event, the costs of the doctrine, in terms of the opportunistic behaviour it facilitates, should be reduced by the law as far as possible. The techniques available to the law to achieve these goals are various. Most obviously, the law could in certain situations remove the protection of the doctrine so as to make the shareholders personally liable to the creditors of the company. However, in many cases the opportunistic conduct induced by the doctrine is not initiated by the shareholders directly but by the directors of the company, acting in the interests of the shareholders. In this situation the law may want to reduce the incentives of the directors to respond to this particular shareholder interest. In that case, as we shall see,[23] the response of the law to abuses of the limited liability doctrine will

[20] See *Polly Peck International Plc (in administration), Re* [1996] 2 All E.R. 433 (involving a single purpose finance vehicle which had no substantial assets of its own).

[21] *Augustus Barnett & Son Ltd, Re* [1986] B.C.L.C. 170; *Kleinwort Benson Ltd v Malaysia Mining Corp Bhd* [1989] 1 W.L.R. 379, CA (letter of comfort not intended in this case to create legal relations).

[22] It has been suggested that limited liability should not apply to involuntary creditors: H. Hansmann and R. Kraakman, "Towards Unlimited Shareholder Liability for Corporate Torts" (1991) 100 Yale L.J. 1879.

[23] A clear example is the liability on directors created by the doctrine of wrongful trading. See para.9–6.

create liabilities for the directors rather than the shareholders of the company.

However, perhaps the first and most obvious response of the law is to require publicity for the fact that corporate creditors' claims are confined to the assets of the company, since knowledge of that fact is an essential pre-requisite for any effective self-help action on the part of creditors. The legislature has always made it an essential condition of the recognition of corporate personality with limited liability that it should be accompanied by wide publicity. Although third parties dealing with the company will normally have no right of resort against its members, they are nevertheless entitled to see who those members are, what shares they hold and, in the case of a listed company, who holds the beneficial interests in those shares, if substantial, so that they can know who is in ultimate control of the company. They are also entitled to see who its officers are (so that they know with whom to deal), what its constitution is (so that they know what the company may do and how it may do it), and what its capital is and how it has been obtained (so that they know whether to trust it). And unless it is an unlimited company they are also entitled to see its accounts, or at least a modified version of them—again in order to know whether to trust it. The exemption of the unlimited company from the obligation to file accounts with the Registrar[24] is a particularly strong illustration of the link between publicity and limited liability.

Normally, however, third parties are neither bound nor entitled to look behind such information as the law provides shall be made public; in addition to the veil of incorporation, there is something in the nature of a curtain formed by the company's public file in the companies registry (or with the regulator of the stock exchange), and what goes on behind it is concealed from the public gaze.[25] But sometimes this curtain also may be raised. For example, inspectors may be appointed to investigate the company's affairs,[26] in which case they will have the widest inquisitorial powers; indeed they may even be appointed for the purpose of going behind the company's registers to ascertain who are its true owners.

If it is decided to go beyond publicity and to remove the veil of incorporation and so make the shareholders liable for the debts and other obligations of the company or to impose liabilities on directors in respect of abuses of limited liability, there are two ways in which this may happen: as a result of judicial creativity and as a result of

[24] s.448.

[25] As we saw in the previous chapter, this may sometimes benefit the third party: the limitation of the outsider's knowledge to what is stated in the constitution is the foundation of the rule in *Royal British Bank v Turquand*, above, para.7–5.

[26] See below, Ch.18. Furthermore, the mandatory disclosure of beneficial ownership of shares in listed companies (see para.26–18) is an example of disclosure beyond what is in the company's file with the Registrar.

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