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The Concept of Limited Liability and the Plight of Creditors within Corporate Governance and Company Law: UK Perspective

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Introduction and scope the study

- UK is generally acknowledged as the leading country in corporate governance. (***Solomon 2010***)

- The enlarging interests within corporate governance such as the protection of stakeholders e.g. employees. (***Mallin 2013)***

- The paper focuses on shareholder primacy model of corporate governance, the concept of limited liability and legal personality of the company and its implications for creditors while highlighting certain mechanisms available for creditor protection in the UK
- The aim is to analyse how creditor protection can be improved

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- Corporate governance is the system by which companies are run and directed. (***Cadbury Report 1992***)

- The governance of the firm is vested in the board of directors

- Legal personality of a company entails the separateness of the entity from the shareholders

- The introduction of limited liability in the mid 19^{th} century meant that creditors claims were limited to company assets

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- The objective of the firm is at the centre of governance in relation to directors' duties to ensure they achieve this ultimate objective.

- 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. (***Keay 2003, Keay 2008***)

Directors' duties and creditors

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- The law requires directors to promote the success of the company for the benefit of its members as a whole which has an implication that shareholders are the ultimate beneficiaries. (***Section 172(1) UK Companies Act, 2006)***

- The success of the company is the main objective but eventually it is for the ultimate benefits of the shareholders.

- This duty is placed on directors hence taking the interests of the shareholders as paramount.

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- However, when the company is in financial difficulties, the law requires that directors take the interests of creditors as paramount. (***section 172(3), Companies Act, 2006***)

- This means that during financial difficulties, creditors' interests supersede those of the shareholders thereby establishing their place in law.
- This evidently, creditors interests are considered within the vicinity of insolvency.
- It is argued in this paper that creditors' interests must be taken into account from the beginning when the company is financially stable.

Early consideration of creditors' interests

- A company must project its risk assessments which must include creditors, identifying the exposures and measures taken for control purposes.

- Whereas creditors are aware of risks, legal provisions to ensure that mitigating finances have been put in place to deal with creditors can enhance creditor protection (both before and after insolvency).

- This ought to be before the vicinity of insolvency so that risk of loss is reduced.

Two modes of governance

- The 'normal mode' and the latter as the 'distressed mode'.

- The normal mode is during financial stability when the interests of the shareholders are paramount and during the distressed mode when creditors' interests become paramount. (***Cowton 2011***)

- 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.

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- 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, or prohibition of huge allowances for directors, the risk on creditors would be reduced.
- A company must put in place an effective well structured risk management policy.

Shareholder primacy

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- While shareholder primacy is arguably founded on the law, the legal characteristics of a company make it clear a company is incapable of being owned because it is a separate entity from its subscribers.
- Shareholders don't own the firm even though others like Hansmann referred to shareholders as owners of the firm because it is a legal entity simply protecting or shielding its owners from liability. (***Hansmann 2006)***
- The proponents of shareholder primacy contend that cumulative profits for equity investors automatically assures the rest of the stakeholders including creditors that their fixed claims would be successful. (***Easterbrook & Fischel 1985***)

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Separate legal entity

- Whereas shareholder primacy is evident under section 172 of the Companies Act 2006, a company is a separate legal entity which permits the corporation to own property in its own name distinct from its Members. ***(Salomon v A. Salomon & Co Ltd (1897)AC 22 (HL)***

- 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. (***Smith 1928***)

- These legal relations relate to the abstractions of legal science like title, possession, rights and duties which links to title or ownership of property.

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- Neither a member nor a creditor unless secured has an incurable interest in the assets of the company. (***Sealy & Worthington 2013***)

- In ***Prest v Petrodel (2013) UKSC 34,*** 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.

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- While others have argued restriction of company assets from the shareholders is a mechanism to protect creditors, it could be argued that this is a legal way of extorting creditors by protecting the shareholders.

- It has been argued that the invention of limited liability was a significant concession of the society which promoted economic activities with clear objectives but today the concept has become besmirched. (***Tricker 2011)***

Directors' guarantees

- 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.
- Directors might be induced into signing guarantees just to secure the loan and it so happens that at the time of insolvency, there is not enough to settle the debts.
- Perhaps the law should allow the shareholders to sign personal guarantees to secure a debt by waiving the protection of the corporate veil by free will. In this case, directors can sign personal guarantees to reimburse the shareholders if company assets are mismanaged.

Proposed contribution

- This paper will contribute to literature on how creditor protection can be improved in light of limited liability and within corporate governance.
- The paper also recommends that the sanctity of the corporate veil by courts be abolished in order to hold shareholders liable for debts of the company through signing of personal guarantees.
- It is also recommended that section 172 of the companies Act 2006 be amended to clarify the law on shareholder primacy

Limitation

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- This paper is not limited to the UK corporate sector because most common-law countries adopt the UK approach in terms of corporate governance.

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Thank you

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