Cambridge Law Review (2021) Vol VI, Issue i, 137–181

Are Involuntary Creditors Adequately Protected from the Adverse Impact of the Doctrine of Limited Liability? An Analysis of the Origins of the Doctrine and its Modern Application Through the Prism of Involuntary Creditors' Protection

Mikołaj kudliński*

Abstract

The doctrine of limited liability is considered as one of the most important issues in corporate law. This is because, by limiting shareholders' exposure to risk, limited liability incentivises people to invest in corporate entities and pursue various business endeavours, which in turn stimulates economic growth. However, it is also often argued that the doctrine of limited liability is controversial, as it allows companies to easily externalise their commercial risks, which exposes the vulnerable group of involuntary creditors to significant losses. This problem is particularly evident in the context of corporate groups, where parent companies use the corporate form to insulate themselves from liability for the acts of their subsidiaries. This paper discusses the origins of the limited liability doctrine through the prism of its development in the United Kingdom, and finds that that the interests of involuntary creditors were not given adequate consideration at the time of its

* Christ Church, University of Oxford. LLB Hons (Aberdeen), LLM (Edinburgh). I am grateful to Adam Strukowski and Izabella Kuna for their help in the revision of this article. I am also indebted to the anonymous editors of Cambridge Law Review for their valuable comments on the earlier draft. Any errors remain my own. mikolaj.kudlinski@chch.ox.ac.uk.

inception. Arguably, this doctrine was never supposed to be applied in relation to this group of creditors at all. Subsequently, this paper discusses the current protection mechanism available to involuntary creditors in the United Kingdom and finds that, for various reasons, these mechanisms are not effective. This article concludes by discussing alternative approaches to limited liability and noting that the control-based presumption of parent liability would strike a fair balance between the interests of the various actors involved in the company's activity, and would provide involuntary creditors with a greater degree of protection.

Keywords: company law, limited liability, creditors, involuntary creditors, alternatives to limited liability

I. Introduction

Companies form an inextricable part of modern society. Today, corporate entities are encountered virtually everywhere; companies produce and distribute countless products, provide various services, run all types of transport, supply weapons, engage in politics, and have the ability to influence global financial markets.[1] Moreover, companies are seen as the main drivers of the globalisation process.[2] For the above reasons, corporations are "among the most powerful institutions of our time".[3]

Companies underpin the capitalist economies upon which modern societies are predicated.[4] In fact, in 2019, companies represented 72.5% of total businesses in the United Kingdom.[5] Likewise, at the end of June 2020, there were four million five hundred thousand three hundred ninety-two corporate entities on the total register of companies; four million one hundred thousand three hundred twenty-

1 Sarah Worthington, *Sealy and Worthington's Text, Cases, and Materials in Company Law* (Oxford University Press 2016) 1.

2 Stuart Kirsch, *Mining Capitalism: The Relationship Between Corporations and Their Critics* (University of California Press 2014) 1.

3 ibid. On this account, Noam Chomsky described the most powerful corporations as today's "masters of mankind". See Noam Chomsky, *Masters of Mankind: Essays and Lectures, 1969-2013* (Haymarket Books 2014).

4 Peter A Hall and David Soskice, 'An Introduction to Varieties of Capitalism' in Peter A. Hall and David Soskice (eds), *Varieties of Capitalism - The Institutional Foundations of Comparative Advantage* (Oxford University Press 2004) 6.

5 Office for National Statistics, 'UK Business: Activity, Size and Location 2019' (2 October 2019) 4 <www.ons.gov.uk/businessindustryandtrade/business/activitysizeandlocation/bulletins/ukbusinessactivitysizeandlocation/2019> accessed 25 May 2020.

three were actively trading.[6] The number of companies on the total register is growing at a steady rate and has increased since 1979 by over three million four hundred thousand.[7] During the same period, the number of companies on the effective register has grown by over three million two hundred thousand.[8] This data evidences that companies are the main vehicles through which business is carried out in the United Kingdom.[9]

Upon incorporation, a company becomes a legal person distinct from its shareholders.[10] According to Armour et al., being a legal fiction, the company can: (a) enter into contracts; (b) have rights in property; (c) sue and be sued in its own name and; (d) delegate authority to agents.[11] Thus, as a consequence of incorporation, the company has its own rights and is capable of undertaking its own obligations.[12] The doctrine of separate legal personality is therefore "fundamental"[13] to the conceptual understanding of the structure of corporate law. In addition, it is of crucial significance from the functional perspective, as the separate legal personality of the company makes it possible to distinguish the assets owned by the company's members from the assets owned by the company itself.[14]

6 Companies House, 'Official Statistics: Incorporated companies in the UK April to June 2020' (30 July 2020) <www.gov.uk/government/publications/incorporated-companies-in-the-uk-april-to-june-2020/incorporated-companies-in-the-uk-april-to-june-2020> accessed 4 August 2020.

7 Companies House, 'Official Statistics: Companies register activities: 2018 to 2019' (1 August 2019) Section 3. <www.gov.uk/government/publications/companies-register-activities-statistical-release-2018-to-2019/companies-register-activities-2018-to-2019#overseas> accessed 25 May 2020.

8 ibid.

9 Similarly, in Australia, between 2018 and 2019, companies represented 37.9% of all businesses, the largest of any type of legal organisation. See Australian Bureau of Statistics, '8165.0 - Counts of Australian Businesses, including Entries and Exits, June 2015 to June 2019' (20 February 2020) <www.abs.gov.au/ausstats/abs@.nsf/mf/8165.0> accessed 25 May 2020.

10 *Salomon v Salomon* [1897] AC 22 HL at [31] per Lord Halsbury, at [51] per Lord Macnaghten. See also Brenda Hannigan, *Company Law* (5th edn., Oxford University Press 2018) 42.

11 John Armour, Henry Hansmann, Reinier Kraakman and Mariana Pargendler, 'What is Corporate Law?' in Kraakman et al. (eds), *Anatomy of Corporate Law: A Comparative and Functional Approach* (Oxford University Press 2017) 8.

12 Phillip I Blumberg, 'Limited Liability and Corporate Groups' (1986) 11 Journal of Corporate Law 573, 577.

13 Paul Davies, *Introduction to Company Law* (Oxford University Press 2002) 9.

14 ibid 11.

This, in turn, facilitates the operation of the doctrine of limited liability, which constitutes another elemental principle of corporate law.[15]

The doctrine of limited liability is present in almost all developed legal systems in the world.[16] It presupposes that the liability of the company's members is restricted to the amount they have agreed to pay for the company's shares.[17] Consequently, shareholders will not be held personally liable for the debts of the company.[18] Thus, the existence of limited liability encourages investors to pursue business endeavours, which otherwise could be regarded as being too risky.[19] For that reason, limited liability is widely seen as a mechanism which incentivises entrepreneurship and stimulates economic development.[20]

Due to its pivotal role in encouraging business activity, the doctrine of limited liability is of crucial economic importance and has been excessively praised in this context. In fact, limited liability is often regarded as "the most important characteristic of the modern corporation",[21] "the hallmark of corporate status",[22] or "an unsung hero"[23] of free market economies. Moreover, in their appraisal of limited liability, some commentators have asserted that, in the historical development of the corporation, "no single attribute had been more significant than limited liability",[24] or that limited liability is "the most effective legal invention

15 Frank H Easterbrook and Daniel R Fischel, 'Limited Liability and the Corporation' (1985) 52(1) University of Chicago Law Review 89, 89.

16 Sung Bae Kim, 'A Comparison of the Doctrine of Piercing the Corporate Veil in the United States and in South Korea' (1995) 3 Tulsa Journal of Comparative and International Law 73, 73.

17 Armour, Hansmann, Kraakman and Pargendler (n 11) 6-10; David Kershaw, *Company Law in Context: Text and Materials* (2nd edn., Oxford University Press 2012) 20; Paul Davies and Sarah Worthington, *Gower's Principles of Modern Company Law* (10th edn., Sweet & Maxwell/Thomson Reuters 2016) 191; Easterbrook and Fischel (n 15) 89-90.

18 Davies (n 13) 60; Stefan H C Lo, 'Liability of Directors as Joint Tortfeasors' (2009) 2 Journal of Business Law 109, 119.

19 Stephen Griffin, 'Limited Liability: A Necessary Revolution' (2004) 25(4) The Company Lawyer 99, 99.

20 ibid; Andrew Hicks, 'Corporate Form: Questioning the Unsung Hero' (1997) Journal of Business Law 306, 306-307; Judith Freedman, 'Limited Liability: Large Company Theory and Small Firms' (2000) 63(3) The Modern Law Review 317, 317.

21 Stephen M. Bainbridge and M. Todd Henderson, *Limited Liability: A Legal and Economic Analysis* (Edward Elgar Publishing 2016) 19.

22 Christopher W Peterson, 'Piercing the Corporate Veil by Tort Creditors' (2017) 13 Journal of Business and Technology Law 63, 63.

23 Institute of Directors, Deregulation for Small Private Companies (IOD, 1986) quoted in Judith Freedman, 'Small Businesses and the Corporate Form: Burden or Privilege?' (1994) 57(4) Modern Law Review 555, 564.

24 Warner Fuller, 'The Incorporated Individual: A Study of the One-Man Company' (1938) 51 Harvard Law Review 1373, 1376.

of the nineteenth century".[25] Others have described the limited liability company as "the greatest single discovery of modern times",[26] which is even more important than steam or electricity. Accordingly, the nameless creator of limited liability deserves a "place of honour" among the pioneers of the Industrial Revolution, such as Watt or Stephenson.[27]

Certain scholars consider limited liability, however, as one of "the most controversial issues in corporate law".[28] In fact, it is argued that since the introduction of general limited liability into the UK law in the nineteenth century, creditors dealing with companies have been exposed to excessive risks.[29] Indeed, business activity has intrinsic costs, which upon incorporation are externalised onto the company's creditors.[30]

Within the wider group of corporate creditors, one can distinguish voluntary and involuntary creditors.[31] Voluntary creditors are able to determine the creditworthiness of a particular company and gauge the risks that could arise from their dealings with such a company.[32] Consequently, they are able to bargain with the corporation and protect themselves from the aforesaid risks through,

[25] President Charles William Eliot of Harvard University quoted in William W. Cook, 'Watered Stock Commissions Blue Sky Laws Stock Without Par Value' (1921) 19(6) Michigan Law Review 583, 583.

[26] President Nicholas Murray Butler of Columbia University quoted in William Meade Fletcher, Cyclopedia of the Law of Private Corporations (Callaghan and Company 1917) 43, 21.

[27] The Economist, 18 December 1926 quoted in Bishop Carleton Hunt, *The Development of the Business Corporation in England, 1800-1867* (Harvard University Press 1936) 116.

[28] Larry E Ribstein, 'Limited Liability and Theories of the Corporation' (1991) 50 Maryland Law Review 80, 81; Colin Mackie, 'From Privilege to Right: Themes in the Emergence of Limited Liability' (2011) 4 Juridical Review 293, 294.

[29] Bob Tricker, 'Re-Inventing the Limited Liability Company' (2011) 19(4) Corporate Governance: An International Review 384, 385-386.

[30] David Millon, 'Piercing the Corporate Veil, Financial Responsibility, and the Limits of Limited Liability' (2006) 56 Emory Law Journal 1305, 1355.

[31] Andrew Muscat, *The Liability of the Holding Company for the Debts of its Insolvent Subsidiaries* (Routledge 2016) at 4.5; Peter French, 'Parent Corporation Liability: An Evaluation of the Corporate Veil Piercing Doctrine and its Application to the Toxic Tort Arena' (1992) 5(2) Tulane Environmental Law Journal 605, 607.

[32] Henry Hansmann and Reinier Kraakman, 'Toward Unlimited Shareholder Liability for Corporate Torts' (1991) 100(7) Yale Law Journal 1879, 1919-1920.

for instance, specific contractual arrangements, securing guarantees, or charging higher rates for the credit.[33]

Involuntary creditors, on the other hand, cannot 'choose their tortfeasor' and have no means of allocating the risk of losses or injury.[34] They are therefore poor risk-bearers.[35] Moreover, involuntary creditors can only seek compensation *ex post*.[36] Because the doctrine of limited liability shields the assets of the company's owners, the wrongdoing company often may lack sufficient funds to pay out damages to the involuntary creditors affected by its actions.[37] In such instances, the creditors may be left with no compensation at all.[38] The weak position of involuntary creditors is further exacerbated by the fact that limited liability enables parent companies within a corporate group to avoid responsibility for the harm caused by their subsidiaries.[39] Namely, even though the parent company may effectively control the subsidiary, they are separate persons in the eyes of the law.[40] The parent company will therefore not be held liable for the debts of its subsidiary.[41] As a result, the subsidiary may not have enough assets to cover its liabilities.[42] For instance, in *Adams v Cape Industries plc*,[43] the parent company was able to escape liability for the debts of its insolvent subsidiary and Mr Adams, who contracted asbestosis as a result of his employment with the subsidiary, was left with almost nothing.

Another dire consequence of limited liability for involuntary creditors, and society at large, is the fact that the doctrine incentivises opportunism and corporate recklessness.[44] Namely, it is widely contended that limited liability encourages

33 See Phillip Lipton, 'The Mythology of Salomon's Case and the Law Dealing With the Tort Liabilities of Corporate Groups: An Historical Perspective' (2014) 40 Monash University Law Review 452, 481; Lo, 'Liability of Directors as Joint Tortfeasors' (n 18) 121.

34 Lipton (n 33) 481.

35 Robert B Thompson, 'Piercing the Corporate Veil: An Empirical Study' (1991) 76 Cornell Law Review 1036, 1070-1073; French (n 31) 608-609.

36 Millon (n 30) 1355.

37 Lo, 'Liability of Directors as Joint Tortfeasors' (n 18) 121.

38 ibid.

39 Blumberg (n 12) 575; Peter Muchlinski, 'Limited Liability and Multinational Enterprises: a Case for Reform?' (2010) 34(5) Cambridge Journal of Economics 915, 915-916; Lipton (n 33) 480-481; Martin Petrin and Barnali Choudhury, 'Group Company Liability' (2018) 19(4) European Business Organization Law Review 771, 773-774.

40 Andreas Rühmkorf, *Corporate Social Responsibility, Private Law and Global Supply Chains* (Edward Elgar Publishing 2015) 172.

41 ibid.

42 ibid.

43 *Adams v Cape Industries plc* [1990] Ch. 433.

44 Hansmann and Kraakman (n 32) 1920; Ribstein (n 28) 81.

companies to engage in hazardous behaviour,[45] as the potential liability of their owners is considerably restricted.[46] For example, following the Bhopal disaster in December 1984, which claimed the lives of over twenty-two thousand people, in 2012, a US district court held that Union Carbide Corporation had no liability related to the plant site owned by its Indian subsidiary, and thus could not be held liable for any pollution-related damage.[47] This was, *inter alia*, because the parent company and the subsidiary were separate persons in the eyes of the law.

For the above reasons, it is argued that the application of the doctrine of limited liability has been extended beyond its original purpose.[48] It is no longer used as a mechanism that stimulates business activity, but is rather used as a vehicle through which "irresponsibility is institutionalised".[49] Today, limited liability allows companies to benefit from the diversification of risks, which in turn exposes involuntary creditors to an excessive danger of loss or harm.[50] In this regard, it is worth noting that the existence of insurance cannot address this problem on its own. Namely, it can hardly be argued that involuntary creditors could predict their injury, and thus could insure themselves, before they were injured. Likewise, from a practical point of view, it is virtually impossible to insure every potential

45 For instance, in a type of behaviour that is dangerous to the environment, see Nick Grant, 'Mandating Corporate Environmental Responsibility by Creating a New Directors' Duty' (2015) 17(4) Environmental Law Review 252, 252-254.

46 Davies and Worthington (n 17) 194; Bainbridge and Henderson (n 21) 49-51; Carsten Gerner-Beuerle and Michael Anderson Schillig, *Comparative Company Law* (Oxford University Press 2019) 46; David Campbell and Stephen Griffin, 'Enron and the End of Corporate Governance?' in Sorcha MacLeod (ed), *Global Governance and the Quest for Justice: Volume II Corporate Governance* (Hart Publishing 2006) 48; Easterbrook and Fischel (n 15) 103-104; David W. Leebron, 'Limited Liability, Tort Victims, and Creditors' (1991) 91(7) Columbia Law Review 1565, 1565; Andrew Price, 'Tort Creditor Superpriority and Other Proposed Solutions to Corporate Limited Liability and the Problem of Externalities' (1995) 2 George Mason Law Review 439, 441-442; Muchlinski, 'Limited Liability and Multinational Enterprises: a Case for Reform?' (n 39) 915-916; Lipton (n 33) 480-481.

47 *Janki Bay Sahu and others v Union Carbide Corporation and Warren Anderson* (2012) No. 04 Civ. 8825 (JFK). On the legal aspects of the Bhopal disaster, see Jamie Cassels, 'The Uncertain Promise of Law: Lessons from Bhopal' (1991) 29(1) Osgoode Hall Law Journal 1.

48 Blumberg (n 12) 575.

49 Paddy Ireland, 'Limited Liability, Shareholder Rights and the Problem of Corporate Irresponsibility' (2010) 34(5) Cambridge Journal of Economics 837, 838. See also Tricker (n 29) 386.

50 Charlotte Villiers, 'Corporate Law, Corporate Power and Corporate Social Responsibility' in Nina Boeger, Rachel Murray and Charlotte Villiers (eds), *Perspectives on Corporate Social Responsibility* (Edward Elgar Publishing 2008) 95.

involuntary creditor against every potential risk of injury. Moreover, in certain large cases, a company's liability may considerably exceed its insurance coverage.[51]

Given the aforementioned factors, this article considers the question whether involuntary creditors are appropriately protected by the law of the United Kingdom. This will be done through the prism of the origins of the doctrine of limited liability and its modern application. Part II of this paper will analyse the manner in which the doctrine of limited liability has developed in the UK, and whether the interests of involuntary creditors were given adequate consideration at the time of its inception. Part III will outline the economic rationale behind limited liability and will examine the protection mechanisms available to involuntary creditors today, such as piercing the corporate veil, bypassing limited liability under tort law, and s.172(1) of the Companies Act 2006. It will be concluded that the current protection mechanisms are not effective, and that involuntary creditors are continuously exposed to excessive risks. On this account, Part IV will evaluate the alternatives to limited liability from the perspective of involuntary creditors, such as pro rata liability of shareholders, giving preference to involuntary creditors on insolvency, and the control-based liability system coupled with the control-based presumption of parent liability. Arguably, involuntary creditors would be afforded a greater degree of protection under the last of these approaches, which, given the slow transition process of the UK economy from a pure profit-orientated system towards a more stakeholder-inclusive one, could potentially be introduced in the future.

II. The Historical Development of the Doctrine of Limited Liability in the United Kingdom: An Analysis Through the Prism of Involuntary Creditors' Protection

Jean du Plessis begins his analysis of the history of UK company law by stating that "[i]t cannot be disputed that corporate law cannot be understood without a proper knowledge of the historical context in which it developed".[52] In this statement, du Plessis posits that an understanding of the historical

[51] Cassels (n 47) 9.

[52] Jean du Plessis, 'Corporate Law and Corporate Governance Lessons From the Past: Ebbs and Flows, But Far From the "End of History": Part 1' (2009) 30(2) Company Lawyer 43, 45.

development of company law is necessary for the proper comprehension of its modern framework.[53] Later, du Plessis adds, quoting William Ashley,[54] that

> "[i]n corporate law history [...] it has been observed that 'in every stage of social evolution there are particular needs which have to be met, and particular tendencies in human character which call either for repression or stimulus'".[55]

In the above extract, du Plessis argues that company law has developed in certain patterns, which reflected the specific needs of society at a given point in time.[56] In sum, in the foregoing passages, du Plessis suggests that modern company law cannot be properly understood without a prior understanding of the "particular needs"[57] of society that corporate law has attempted to remedy throughout its history. This is particularly true when one embarks upon an analysis of the development of the doctrine of limited liability in the United Kingdom, which was highly influenced by the peculiar social, economic, and political climate of contemporary Britain.[58] Accordingly, the following paragraphs will consider, through the lens of involuntary creditors' protection, the manner in which the

[53] John Armour agrees that registered companies cannot be properly conceptualised under English law without the prior understanding of their historical development: John Armour, 'Companies and Other Associations' in Andrew Burrows (ed), *English Private Law* (Oxford University Press 2013) at 3-44.

[54] William J Ashley, *An Introduction to English Economic History and Theory* (3rd edn, Vol.1, Longmans Green & Co. 1894) 167-168.

[55] Jean du Plessis, 'Corporate Law and Corporate Governance Lessons From the Past: Ebbs and Flows, But Far From the "End of History": Part 2' (2009) 30(3) Company Lawyer 72, 73.

[56] Jonathan C Hardman, 'Resolving Agency Costs in United Kingdom Private Companies' (Phd thesis, University of Glasgow 2020) 72.

[57] ibid.

[58] See Mackie (n 28) 294-295.

concept of limited liability has evolved in the UK and the purposes for which it was introduced.

A. The origins of the doctrine of limited liability in the UK

Arguably, the principle of limited liability can be traced back to Roman times.[59] In this context, legal historians often invoke the concept of a *peculium.*[60] Moreover, Roman law recognised certain non-human entities, such as *universitas personarum*, which were treated by law like real persons; such entities had legal capacity and could undertake their own duties.[61] In this regard, Ulpian's well-known maxim stated that where something was owed by the 'corporation', it was not owed by its members, but by the 'corporation' itself.[62] This maxim can therefore be considered as an early promulgation of the doctrines of separate legal personality and limited liability.

In medieval and early modern England, corporations were "direct outgrowths of the state" created under Royal Charters.[63] The early corporations, such as guilds, existed almost exclusively for the benefit of the public, and not for the private benefit of their members.[64] Due to their intrinsic public purpose and their public functions, the early corporations did not engage in risky profit-generating endeavours and rarely incurred debt.[65] For that reason, the early corporate forms

59 Robert W Hillman, 'Limited Liability in Historical Perspective' (1997) 54 Washington and Lee Law Review 615, 616-619.

60 This mechanism allowed the head of a Roman family ("Paterfamilias" in Latin) to entrust his slave, or another member of his family, with an amount of capital in order for the grantee to carry out trading on his behalf. Crucially, the assets remained the property of the paterfamilias, and he was only liable for the debts incurred by the grantee in the course of business to the extent of the peculium. The peculium was therefore an excellent limited liability mechanism, which facilitated commerce: see Henry Sumner Maine, *Ancient Law and the Origins of Human Society* (5th edn., John Murray, London 1888) 129; Bainbridge and Henderson (n 21) 22; David V. Snyder, 'The Case of Natural Obligations' (1995) 56 Louisiana Law Review 423, 429; Hillman (n 59) 616-619.

61 Laura Macgregor, 'Partnerships and Legal Personality: Cautionary Tales from Scotland' (2020) 20(1) Journal of Corporate Law Studies 237, 248-249. See also Leonardo Davoudi, Christopher McKenna and Rowena Olegario, 'The Historical Role of the Corporation in Society' (2018) 6.s1 Journal of the British Academy 17, 22-23.

62 "*Si quid universitate debetur singuli non debetur; nec quod debet universitas singuli debent*": The Digest of Justinian 3.4.7.1. (Ulpianus).

63 Bainbridge and Henderson (n 21) 27.

64 Colin Arthur Cooke, *Corporation, Trust & Company: An Essay in Legal History* (Manchester University Press 1950) 51; Hardman (n 56) 73.

65 Phillip Lipton, 'The Introduction of Limited Liability into the English and Australian Colonial Companies Acts: Inevitable Progression or Chaotic History' (2017) 41 Melbourne University Law Review 1278, 1286.

had no need to externalise risks, and limited liability was not of major significance to them.[66]

Subsequently, together with the rapid geographical expansion of the 16th and 17th centuries, commercial joint-stock companies emerged with an aim to accumulate capital from investors in order to fund business activity overseas.[67] Notably, these associations were established with the purpose to maximise the private financial gains of their members, as the development of foreign trade significantly increased the potential for wealth creation.[68] Business activity abroad, however, was associated not only with substantial gains but also with considerable political and commercial risks.[69] For that reason, the problem of investors' liability became an important issue at the time.[70] One of the possibilities available to investors in order to minimise the risk of future liabilities was incorporation, which could be obtained either under a Royal Charter or an Act of Parliament.[71]

Upon incorporation, a joint-stock company became an artificial person and the charter conferred numerous benefits, such as the monopoly of trade, upon the corporation's members.[72] Incorporation was therefore regarded as an important privilege, which was "jealously guarded".[73] In fact, the process of obtaining a charter was expensive and notoriously difficult.[74] Furthermore, after the introduction of the Bubble Act 1720, incorporating a company became even harder and unincorporated joint-stock companies were declared illegal.[75] As a result, the majority of contemporary joint-stock companies traded without incorporation through the use of trusts, and their functioning was regulated by the

66 ibid 1286-1287.

67 Igho Lordson Dabor, 'Limited Liability: A Pathway for Corporate Recklessness?' (Phd thesis, University of Wolverhampton 2016) 17.

68 ibid.

69 Vyuptakesh Sharan, *International Business: Concepts, Environment And Strategy* (Pearson Education India 2008) 9. See also Markéta Kadlecová, 'England and the Promotion of Trade in 16th and 17th Centuries' (2014) 2(4) West Bohemian Historical Review 13, 13-28.

70 Lipton (n 65) 1286-87.

71 Laurence C B Gower, 'The English Private Company' (1953) 18 Law and Contemporary Problems 535, 535.

72 Armour (n 53) 3-37, 3-45.

73 Frederick G Kempin Jr, 'Limited Liability in Historical Perspective' (1960) 4(1) American Business Law Association Bulletin 11, 13.

74 Hardman (n 56) 73-74; Adrian Henriques, Corporate Impact: *Measuring and Managing Your Social Footprint* (Earthscan 2010) 14.

75 In fact, the purpose for which the Bubble Act 1720 was introduced is debatable: Dabor (n 67) 50; Hardman (n 56) 74-76; Kirstin Olsen, *Daily Life in 18th-century England* (2nd edn., ABC-CLIO 2017) 107. See also Ron Harris, 'The Bubble Act: Its Passage and its Effects on Business Organization' (1994) 54(3) Journal of Economic History 610, 610-627.

relevant deeds of settlement.[76] Such companies, however, were *de facto* and *de jure* unlimited.[77]

In regard to incorporated companies, the treatment of limited liability at that time was unclear.[78] Various scholars assert that, by the end of the seventeenth century, limited liability was seen as a common benefit of incorporation.[79] For instance, in 1662, the Act Declaratory Concerning Bankrupts provided the shareholders of the East India Company, the Royal African Company, and the Royal Fisheries Company with a form of limited liability from losses incurred by these companies in the course of trading.[80] Likewise, in *Edmunds v Brown and Tillard*, the King's Bench held that members of a chartered corporation could not be held liable, in their personal capacities, for debts of the dissolved corporation.[81]

Conversely, it is also argued that limited liability was not "a necessary incident of incorporation" at the time,[82] and thus the concept was relatively unimportant.[83] Indeed, in defining the characteristics of the corporation, the contemporary legal commentary did not refer to limited liability.[84] For example, Blackstone wrote that an incorporated body had perpetual succession, it could sue and be sued, it could have rights in property, and it had a common seal.[85] Blackstone did not, however, make a reference to limited liability in his work. According to Blumberg, neither Sir Edward Coke,[86] writing before Blackstone, nor Stewart Kyd,[87] writing after him,

76 Armour (n 53) 3-44-3-45; John D Turner, 'The Development of English Company Law Before 1900' in Harwell Wells (ed), *Research Handbook on the History of Corporate and Company Law* (Edward Elgar Publishing 2018) 128-129; Hardman (n 56) 76.

77 Turner (n 76) 129.

78 Armour (n 53) 3-38.

79 William Searle Holdsworth, *A History of English Law* (5th edn., Sweet & Maxwell 1973) 484; Laurence Cecil Bartlett Gower et al., *Principles of Modern Company Law* (4th edn., Stevens and Sons 1979) 26; Lipton (n 65) 1287. See also Samuel Williston, 'History of the Law of Business Corporation Before 1800' Part 2 (1888) 2.3 Harvard Law Review 149, 161-162.

80 William R Scott, *The Constitution and Finance of English, Scottish and Irish-Joint Stock Corporations to 1720* (Cambridge University Press 1910–12) 1, 270; Lipton (n 65) 1287.

81 *Edmunds v Brown and Tillard* (1667) 83 E.R. 385.

82 Robert A Kessler, 'With Limited Liability for All: Why Not a Partnership Corporation?' (1967) 36(2) Fordham Law Review 235, 241.

83 Armand Budington DuBois, *The English Business Company after the Bubble Act, 1720–1800* (Commonwealth Fund 1938) 93-94; Merrick E Dodd, 'The Evolution of Limited Liability in American Industry: Massachusetts' (1948) 61 Harvard Law Review 1351, 1351; Blumberg (n 12) 579.

84 Blumberg (n 12) 579-580.

85 Sir William Blackstone, *Commentaries on the Laws of England*, Book 1 (Oxford Clarendon Press 1753) 464-465.

86 Edward Coke, *First Part of the Institute of the Laws of England or A Commentary Upon Littleton* (1628) 6, 412.

87 Stewart Kyd, *Corporations* (1793) 103.

listed limited liability as an essential characteristic of the corporation.[88] Moreover, in the *Sutton's Hospital* case, the King's Bench did not include limited liability in its list of the crucial features of a corporate body.[89] In addition, despite the general view that the debts of a corporation were not the debts of its members, in *Dr. Salmon v The Hamborough Company*, the House of Lords held that when the charter so specifies, the corporation could make a "leviation" upon its members in order to satisfy its liabilities towards the creditors.[90] Therefore, the above observations support the view that the instances where limited liability applied at the time were in fact rare,[91] and the actual meaning of this doctrine was unclear.[92]

It follows from the foregoing that the treatment of limited liability in the 17th and 18th centuries was ambiguous.[93] Arguably, the existence of limited liability was dependent upon the wording of the relevant charter, and whether this privilege was expressly granted therein.[94] The Crown, however, took an inconsistent approach towards inserting limited liability clauses in the incorporation charters; some charters contained an express clause limiting direct shareholder liability, and others did not.[95] Nevertheless, according to Harris, the benefit of limited liability associated with incorporation was slowly becoming a crucial motive for obtaining a charter towards the end of the eighteenth century.[96] In fact, when the Warmley Company applied for incorporation in 1768,[97] its representative stated in the

88 Blumberg (n 12) 579-580.
89 *Sutton's Hospital* (1612) 10 Coke Reports 23a. See also Kessler (n 82) 240.
90 *Dr. Salmon v The Hamborough Company* (1671) 22 E.R. 763 at [764]. See Armour (n 53) 3-38.
91 DuBois (n 83) 94.
92 Turner (n 76) 131.
93 Blumberg (n 12) 578-580. See also Oscar Handlin and Mary F Handlin, 'Origins of the American Business Corporation' (1945) 5(1) Journal of Economic History 1, 9-10.
94 Ron Harris, *Industrializing English Law: Entrepreneurship and Business Organization, 1720-1844* (Cambridge University Press 2000) 128-129; Armour (n 53) 3-38; Turner (n 76) 124.
95 Blumberg (n 12) 580.
96 Harris (n 94) 129-131.
97 The Warmley Company had a leading position in the copper industry in the first half of the eighteenth century. See Barrie Charles Blake-Coleman, *Copper Wire and Electrical Conductors: The Shaping of a Technology* (CRC Press 1992) 101.

petition that limited liability was of substantial importance to the company, and was thus one of the main rationales for incorporation.[98]

Among the main reasons for which shareholders sought limited liability was protection from personal bankruptcy.[99] Therefore, at that time, limited liability was already used as a mechanism through which shareholders externalised the risks of doing business; when the relevant charter provided for limited liability, the commercial risks were shifted, with the approval of the state, onto the corporation's contractual creditors. Notably, limited liability became an even more important consideration in the nineteenth century together with the rapid pace of industrialisation.

B. The nineteenth century debate: were the interests of involuntary creditors adequately considered?

At the beginning of the nineteenth century, business was primarily carried out by partnerships and individuals trading with unlimited liability.[100] At that time, limited liability was still a "rare and dubious privilege",[101] which was available only to certain corporations at the discretion of the state. Due to the lack of the possibilities whereby commercial risks could be reduced, business ventures were considered unsafe, and thus not many people were willing to put their capital at stake.[102] That being said, in the early nineteenth century, an active market for shares emerged for the first time since the Bubble Act 1720.[103] As a result, shares in joint-stock companies became liquid assets that could easily be realised on the market.[104] This new economic reality, stimulated by industrial development, required the law to evolve in a manner that would facilitate enterprise and investment.

The first major change came with the Joint Stock Companies Registration and Regulation Act 1844, which stated that a joint-stock company could become incorporated upon registration, provided that it had satisfied a number of

98 DuBois (n 83) 95; Phillip L Cottrell, *Industrial Finance, 1830-1914: The Finance and Organization of English Manufacturing Industry* (Routledge 2013) 9. See also Ben Pettet, 'Limited Liability—A Principle for the 21st Century?' (1995) 48(2) Current Legal Problems 125, 125-159. Unfortunately for the members of the Warmley Company, the petition was rejected. This was a calamitous event for the company, as it was subsequently dissolved in 1769. See Blake-Coleman (n 97) 102.

99 Lipton (n 65) 1287.

100 ibid 289.

101 Marie-Laure Djelic, 'When Limited Liability was (Still) an Issue: Mobilization and Politics of Signification in 19th-Century England' (2013) 34(5-6) Organization Studies 595, 599.

102 Harris (n 94) 143; Lipton (n 65) 1289.

103 Armour (n 53) 3-47. See also Harris (n 94) 218–223.

104 Armour (n 53) 3-47.

requirements.[105] After the statute was enacted, incorporating a company became much easier and the number of corporate entities in the early nineteenth century started growing gradually.[106] Therefore, there is some merit in the words of John Morley, who wrote that the introduction of the act "marked the rising dawn of an economic era".[107]

Nevertheless, the new act did not provide for general limited liability,[108] and thus shareholders could still be held responsible for debts of the company.[109] Notably, the principle of limited liability was discussed by the Gladstone Committee in the report that preceded the 1844 Act.[110] The main purpose of the report was to "inquire into the state of the laws respecting joint-stock companies with a view to foster public security",[111] as it was contended that the contemporary incorporation regime could be easily abused by fraudsters. In regard to the doctrine of limited liability, the proponents of its general introduction asserted that this principle would "induce persons of respectability"[112] to invest their money in companies, and thus capital would circulate more easily on the market. Moreover, it was argued that limited liability would allow for a better diversification of risks associated with commercial activities.[113] Therefore, the advocates of general limited liability recognised its extensive economic benefits and argued that such benefits could

[105] Joint Stock Companies Registration and Regulation Act 1844, s. 1. See also Mackie (n 28) 295.

[106] Harris (n 94) 272.

[107] John Morley, *The Life of Gladstone* (Macmillan Company 1903) 1, 247.

[108] Alan Dignam and John Lowry, *Company Law* (8th edn., Oxford University Press 2014) 16; Lorraine Talbot, *Critical Company Law* (2nd edn., Routledge 2015) 30; Rob McQueen, *A Social History of Company Law: Great Britain and the Australian Colonies 1854–1920* (Routledge 2016) 45; Armour (n 53) 3-22.

[109] For a good example of how limited liability was treated by the judiciary following the introduction of the Joint Stock Companies Registration and Regulation Act 1844, see *In the Matter of The Sea Fire and Life Assurance Company of The Joint Stock Companies Winding-up Acts, 1848 and 1849* (*Greenwood's Case*) (1854) 43 E.R. 180, where Lord Cranworth said at [188] that "(...) it is clear that the liability to creditors is not materially affected, and the Legislature has not only not exempted the shareholders from their ordinary obligations as partners, but has expressly enacted that they shall remain liable, subject only to the limitation as to three years in a particular case, which is not now in question". See also Lord Turner's comments at [191]-[193].

[110] Parliamentary Committee to Inquire Into the State of the Laws Respecting Joint Stock Companies, with a View to the Greater Security of the Public HC 119 (1841-43) 51.

[111] ibid. See also McQueen (n 108) 45.

[112] Thomas H Bothamley cited in Matthew Baillie Begbie, *Partnership "en Commandite" or Partnership with Limited Liabilities (according to the Commercial Practice of the Continent of Europe and the United States of America) for the Employment of Capital, the Circulation of Wages and the Revival of Our Home and Colonial Trade* (Effingham Wilson 1848) 239-240.

[113] John Duncan cited in Begbie (n 112) 240-241.

be of great advantage to the general public.[114] The opponents of limited liability contended, however, that there was "no immediate occasion"[115] for the change in the existing law, or that such a change was not "expedient".[116] Furthermore, an argument was put forward that the introduction of limited liability would incentivise speculation, and thus the doctrine would constitute a threat to public security.[117] What is worth mentioning here is that the Committee did not consider the risks that limited liability could pose to involuntary creditors. Instead, the discussion revolved around the idea that limited liability would create a considerable threat to the general public due to its potential to incentivise speculation and fraud.

Ultimately, the 1844 Act did not introduce general limited liability and it subsequently turned out to be a failure, as it proved to be economically inefficient and prone to abuse.[118] As Pleydell-Bouverie commented, the 1844 Act "deterred prudent men of capital"[119] from investing, and thus it hampered the economic development of the country.

In the early 1850s, limited liability attracted the attention of the Parliament due to the work of the Christian Socialist movement, whose members sought to improve the living conditions of the working class and to reduce class tensions within the society by, *inter alia*, allowing employees to own shares in their employer's business through the introduction of general limited liability.[120] As a result of their efforts, limited liability became a subject of heated debate in the United Kingdom.[121]

In this debate, opponents of the introduction of general limited liability echoed the argument that general limited responsibility of shareholders would increase the risk of excessive speculation, and would consequently cause a floodgate of bankruptcies.[122] Likewise, some members of the contemporary

[114] ibid. See also McQueen (n 108) 45.

[115] George Larpent cited in Begbie (n 112) 238.

[116] Kirkman Finlay cited in Begbie (n 112) 238.

[117] John Hodgkin cited in Begbie (n 112) 238.

[118] Dabor (n 67) 87-89.

[119] HC Deb 29 June 1855, Vol.139, cols 321-322. This argument was echoed by Richard Malins, HC Deb 29 June 1855, Vol.139, col. 340.

[120] Djelic (n 101) 602-606; Lipton (n 65) 1290. For a comprehensive discussion of the influence of the Christian Socialist movement on the development of the doctrine of limited liability in the UK see Julia Chaplin, 'The Origins of the 1855/6 Introduction of General Limited Liability in England' (Phd thesis, University of East Anglia 2016) 171-251.

[121] Hunt (n 27) 118; William Cornish et al., *Law and Society in England 1750-1950* (Bloomsbury Publishing 2019) 248-249.

[122] John Ramsay McCulloch, *Considerations on Partnerships with Limited Liability* (Longman, Brown, Green and Longmans 1856) 4-5, 11.

business community argued that the significant progress of the UK economy had been achieved under unlimited liability, and thus there was no economic incentive to alter the law.[123] This criticism is often attributed to the fact that contemporary businessmen were afraid of the competition that might have potentially come from joint-stock companies trading with limited liability.[124]

Another criticism of the introduction of general limited liability came from the judiciary. In particular, Lord Curriehill put forward an argument that limited responsibility of partners[125] was against natural justice and the obligation to pay debts.[126] Moreover, his Lordship argued that there was "no rule"[127] in UK law that would allow partners to be relieved from the liability for the debts of the partnership. At that time, however, various railway, canal, and mining companies operated with limited liability granted by Parliament under statutes because of the huge capital that was at stake in those companies.[128] Thus, the rule that shareholders' liability for the corporation's debts could be limited already existed in the law.[129] In addition, Lord Curriehill argued that limited liability would: (a) encourage fraud on creditors;[130] (b) increase the potential for excessive speculation[131] and; (c) create unfair competition for credit on the market, as some traders may, for various reasons, wish to opt out from limited liability, and thus end up in a worse business position.[132]

In sum, the argument against limited liability was based on the presumption that limited liability would be an unnecessary threat to public security due to its

[123] Sir Thomas Baring, HC Deb 27 June 1854, vol. 134 col. 685. See also The Royal Commission on Mercantile Law, First Report of the Commissioners Appointed to Inquire and Ascertain How Far the Mercantile Laws in the Different Parts of the United Kingdom of Great Britain and Ireland May Be Advantageously Assimilated and Also Whether Any and What Alterations and Amendments Should be Made in the Law of Partnership as regards the Question of the Limited or Unlimited Responsibility of Partners (1854) 7-8.

[124] McQueen (n 108) 81-86; James B Jefferys, 'Trends in Business Organization in Great Britain Since 1856, with Special Reference to the Financial Structure of Companies, the Mechanism of Investment and the Relations between the Shareholder and the Company' (PhD thesis, University of London, 1938) 41.

[125] As the major part of the nineteenth century debate concerned the introduction of partnerships *en commandite* into the law of the United Kingdom.

[126] The Royal Commission on Mercantile Law (n 123) 11.

[127] ibid.

[128] The privilege of limited liability was granted to these companies under the Chartered Companies Act 1837 and the Joint Stock Companies Registration and Regulation Act 1844. See Dabor (n 67) 110.

[129] ibid.

[130] The Royal Commission on Mercantile Law (n 123) 15-17.

[131] ibid 17-18.

[132] ibid 17.

potential to encourage speculation, harm creditors, and distort the market. On this account, it was postulated that its introduction would be detrimental to the entire nation.

Conversely, the argument of the advocates of limited liability was largely based on the economic rationale. In particular, it was argued that contemporary investors tended to invest their capital only in corporations, which operated with limited liability.[133] Likewise, those who would have to risk "losing their last shilling and their last acre"[134] in the course of business would simply not invest.[135] In this regard, The Times described the unlimited liability laws as having "a murderous character".[136] Similarly, The Economist referred to the contemporary state of the law as being, in principle and in practice, "bad".[137] In fact, there was evidence that the benefits conferred by limited liability upon shareholders encouraged numerous British companies to seek incorporation in the United States or in France.[138]

Moreover, it was argued that limited liability would protect innocent shareholders from the negative impact of fraudulent investors' activities, which was not the case under unlimited liability.[139] Furthermore, George Bramwell put forward an argument that the members of society should have a right to "the unrestrained and unfettered exercise of their own talents and industry", which, in Bramwell's view, was of greater importance for the community than the protection of contractual creditors.[140] This argument based on democratisation of capitalism was echoed by The Times, whose editors stated that limited liability would not only facilitate entrepreneurship, but would also encourage the middle class to engage in investing and wider commercial activities.[141]

Notably, involuntary creditors' protection was completely absent from the foregoing debate. Even though the law in the nineteenth century recognised that corporations could be held liable in tort, for example, a corporation could be sued in trover[142] or it could be held responsible for trespass,[143] the potential

133 Dabor (n 67) 99-100.

134 Robert Slaney, HC Deb 20 February 1851, vol. 114, col 846.

135 Report of the Select Committee on the Savings of the Middle and Working Classes HC 508 (6 June 1850) 109.

136 The Times, 28 July 1855.

137 The Economist Vol. XII, 1854, 698.

138 The Royal Commission on Mercantile Law (n 123) 239.

139 ibid 101.

140 ibid 23.

141 The Times, 27 July 1855, page 8. See also Kershaw (n 17) 24.

142 *Yarborough and Others v The Governor and Company of the Bank of England* (1812) 104 E.R. 991 at [991]-[993] per Lord Ellenborough C.J. A similar conclusion was reached by the court in *Duncan and Another v The Company of Proprietors of the Surrey Canal* (1821) 171 E.R. 763.

143 *Maund v The Monmouthshire Canal Company* (1842) 134 E.R. 186.

impact of the introduction of general limited liability on tort victims and other involuntary creditors was overlooked during the debate.[144] In turn, the debate centred around the economic aspects of the doctrine and its potential detrimental impact on contractual creditors.[145] For instance, in the Royal Commission's report, Lord Curriehill referred to "the temptation to embark on hazardous adventures"[146] encouraged by general limited liability. The risk of such activities, in his Lordship's opinion, would have to be borne by contractual creditors, as the potential for speculation would increase.[147] Unfortunately, Lord Curriehill did not consider the impact of 'hazardous adventures' on other types of creditors.

Arguably, in the nineteenth century, no one thought that the doctrine of limited liability could be extended in the future to shield the company's owners from the claims brought by third parties for the negligent acts of the company. This was because the concept of negligence, which is of crucial importance today, was not a fully developed legal principle at that time.[148] Furthermore, there was not a single case in the UK, where a company was rendered insolvent as a consequence of a tort claim.[149] As a result, involuntary creditors' protection was of considerably smaller importance at the time than contractual creditors' protection.[150]

Despite the lack of consensus on the question of whether general limited liability should be introduced into the law of the United Kingdom,[151] a sudden change took place and the law 'turned itself upside down' together with the introduction of general limited liability under the Limited Liability Act 1855 and the Joint Stock Companies Act 1856.[152] The reasons for this sudden reform and its unusually rapid pace are often attributed to various economic, social, and political

[144] Muscat (n 31) at 4.5.4; Pettet (n 98) 152.

[145] See in general, the comments of Lord Curriehill: The Royal Commission on Mercantile Law (n 123) 15-22. See also Robert A Bryer, 'The Mercantile Laws Commission of 1854 and the Political Economy of Limited Liability' (1997) 50(1) The Economic History Review 37, 46-48.

[146] The Royal Commission on Mercantile Law (n 123) 18.

[147] ibid 18.

[148] Muscat (n 31) at 4.5.4. In fact, the modern tort of negligence was not a fully developed legal doctrine until 1932, when this concept was expressly recognised by the judiciary in *Donoghue v Stevenson* [1932] AC 562. See Stefan HC Lo, *In Search of Corporate Accountability: Liabilities of Corporate Participants* (Cambridge Scholars Publishing 2016) 145.

[149] Muscat (n 31) at 4.5.4.

[150] ibid.

[151] The Royal Commissioners stated in their report that they were "embarrassed" by the contrariety of opinion on this matter: The Royal Commission on Mercantile Law (n 123) 5. In fact, three members of the Royal Commission ultimately voted in support of the doctrine of limited liability, whereas five members voted against its general introduction.

[152] Cottrell (n 98) 54.

factors, such as the wide support of the general public for limited liability,[153] the need of the government to find revenue to fund the Crimean War,[154] and the dominance of the liberal 'laissez-faire' approach in the contemporary political arena.[155] Accordingly, together with the enactment of these statutes, limited liability was no longer a privilege that was available only to a few members of society, but rather it became an easily available legal right.[156] In fact, during the debate on the Joint Stock Companies Bill, Robert Lowe argued that people should have liberty to deal with whom they wish without the unnecessary intervention of the state,[157] and that limited liability is "not a question of privilege; if anything, it is a right".[158]

What is of crucial importance, however, is that yet again neither the House of Commons nor the House of Lords considered the impact of the reform on involuntary creditors.[159] In turn, both Houses focused primarily on the risks posed by the introduction of general limited liability to contractual creditors.[160] The focus of Parliament on contractual creditors' protection is clearly evidenced by the words of Robert Lowe, who argued "in favour of human liberty" and in favour of the right of people to deal with whom they wish;[161] this emphasis on dealing indicates that the consequences that might arise from the application of the principle of limited liability to the contractual relationships between people were at the focal point of the Parliamentary discussion.[162] It can therefore be argued that the provisions of the new statutes were not intended to apply to involuntary creditors at all.[163]

It is worth noting that the new acts were not received well in all circles. For instance, for certain members of the House of Lords, it was "absurd"[164] that such an important change in the legislation was being passed so quickly. Indeed, the Bills were rushed through Parliament by the government at "almost indecent haste".[165] In addition, Edmund Phillips mocked the Limited Liability Bill, which, in his

153 As Viscount Palmerston stated during the debate on the Limited Liability Bill in the House of Commons: "[Limited liability] is well understood by every man in the country (...)" HC Deb 26 July 1855, vol.139, col.1390.

154 Mackie (n 28) 296-301.

155 ibid 301-305; Lipton (n 65) 1292.

156 Djelic (n 101) 599.

157 HC Deb 1 February 1856, Vol.140, col.131.

158 ibid col.129.

159 Muscat (n 31) at 4.5.4; Mackie (n 28) 308.

160 Mackie (n 28) 308.

161 See Robert Lowe (n 157).

162 Mackie (n 28) 308.

163 ibid 295.

164 Earl Grey, HL Deb 7 August 1855, Vol.139, col.1905.

165 Laurence C B Gower, Ben Pettet and Daniel D Prentice, *Principles of Modern Company Law* (5th edn., Sweet and Maxwell 1992) 44-45; John Saville, 'Sleeping Partnership and Limited Liability' (1956) 8(3) Economic History Review 418, 430; Mackie (28) 299.

view, should have rather been called "An Act for the better enabling Adventurers to interfere with, and ruin, established traders, without risk to themselves".[166] Likewise, The Law Times described the Joint Stock Companies Act 1856 as being "monstrous in conception", undermining all safeguards against "fraud, folly and abuse".[167] Two years later, the same gazette referred to the 1856 Act as a "rogues' charter", which had proved to be a failure by allowing a man to avoid responsibility for his debts and liabilities.[168]

The discontent with the introduction of general limited liability could also be seen among some members of the public. For example, Gilbert and Sullivan wrote an operetta called *Utopia, Limited* where they satirised the idea of a limited liability company.[169] In the operetta, the king of a fictional state, Utopia, decrees that the entire kingdom, and all of its citizens, should become limited liability corporations in order to free themselves from any responsibilities. Notably, in Utopia, Gilbert and Sullivan question the appropriateness of the general application of limited liability by stating that its benefits are unjustified "unless accompanied by high standards of responsibility on the part of the corporate management".[170] Thus, the operetta argues for a wider protection of creditors, who, in the view of the authors, are prone to abuse under the doctrine.[171]

Nevertheless, the introduction of general limited liability in 1856 rendered the law of the United Kingdom as "the most permissive commercial law in Europe".[172] The main purpose of the reform was to stimulate economic growth by incentivising commercial activities.[173] Arguably, the new legal regime was

[166] Edmund Phillips, *Bank of England Charter, Currency, Limited Liability Companies, and Free Trade* (Richardson Brothers 1856) 36.

[167] 'The Law and the Lawyers' The Law Times, (London 26 July 1856) page 205. See also Djelic (n 101) 615.

[168] 'Anticipation and Experience' The Law Times (London 27 March 1854) 14. See Louis de Koker, 'Limited Liability Act of 1855' (2007) 26(5) The Company Lawyer 130, 130-131.

[169] William Schwenck Gilbert and Arthur Sullivan, Utopia Ltd (1893).

[170] Albert I Borowitz, 'Gilbert and Sullivan on Corporate Law' (1973) 59 American Bar Association Journal 1276, 1279.

[171] McQueen (n 108) 231.

[172] Cottrell (n 98) 41.

[173] Griffin (n 19) 99.

not intended to apply to involuntary creditors and their interests were not given adequate consideration during the debate.

C. *Salomon v Salomon* through the lens of involuntary creditors' protection

The judgment of the House of Lords in *Salomon v Salomon*[174] underpinned the development of the law on limited liability in the UK and the Commonwealth.[175] Because of its tremendous conceptual significance and vast practical implications, this decision has "stood the test of time"[176] and is considered today as "the key principle of company law".[177] Unfortunately, not much has been said about the wider impact of this decision on involuntary creditors.

In *Salomon*, the House of Lords took a literal approach towards statutory interpretation.[178] Because the language of the Companies Act 1862[179] only required seven persons associated for a lawful purpose to hold at least one share each in the company, the court ruled that the intention of the Parliament was to extend the benefit of incorporation (and thus of limited liability) to 'one-man' companies, as the statutory requirements were satisfied on the facts of the case.[180] The approach of the House of Lords was neatly summarised in the words of Lord Halsbury, who said that "the true intent and meaning of the Act" could only be derived from the Act itself.[181]

Notably, the House of Lords' judgment contrasts strikingly with the earlier decision of the Court of Appeal, where Lindley LJ held that "the legislature never contemplated an extension of limited liability to sole traders or to a fewer number

[174] *Salomon* (n 10).

[175] Susan Barber, *Company Law* (4th edn, Old Bailey Press 2003) 5; Hannigan (n 10) 42; Ross Grantham and Charles Rickett, *'The Bootmaker's Legacy to Company Law Doctrine' in Ross Grantham and Charles Rickett (eds), Corporate Personality in the 20th Century* (Hart Publishing 1998) 1; Lipton (n 33) 453-454; Eneless Nyoni and Tina Hart, 'The Concept of Limited Liability and the Plight of Creditors within Corporate Governance and Company Law: A UK Perspective' (2018) 5(2) INTEREULAWEAST - Journal for International and European Law, Economics and Market Integrations 309, 312.

[176] Davies and Worthington (n 17) 200.

[177] Lord Cooke of Thorndon, *The Hamlyn Lectures: Turning Points of the Common Law* (Sweet & Maxwell 1997) 17.

[178] Roman Tomasic, Stephen Bottomley and Rob McQueen, *Corporations Law in Australia* (Federation Press 2002) 33-34. Ernest Lim, 'Of "Landmark" or "Leading" Cases: Salomon's Challenge' (2014) 41(4) Journal of Law and Society 523, 534: Lipton (n 33) 469.

[179] Ss. 6 and 8 in particular.

[180] *Salomon* (n 10) at [29]-[33] per Lord Halsbury, at [37]-[40] per Lord Watson, at [45]-[47] per Lord Herschell, at [51] per Lord Macnaghten, at [54] per Lord Davey. See Lim (n 178) 534.

[181] *Salomon* (n 10) at [31] per Lord Halsbury.

than seven",[182] and although in the *Salomon* case there were seven members, "six of them were members simply in order to enable the seventh himself to carry on business with limited liability".[183] Ultimately, his Lordship held that the sole intention of Mr Salomon was to obtain the benefit of limited liability to "defraud creditors".[184] Lindley LJ's approach was, however, firmly rejected by the House of Lords and the Court of Appeal's decision was unanimously reversed.[185]

It is argued that in *Salomon*, the application of the literal approach led to absurdity.[186] Namely, it is highly doubtful that the true intention of the Parliament was to extend the benefit of limited liability to one-man companies.[187] In fact, it is evident that Parliament's view was that the benefit of limited liability was available only to large businesses, and not to small private companies or sole traders.[188] Therefore, in the opinion of one commentator, in rejecting the clear meaning of the statute, the House of Lords showed severe "jurisprudential ineptitude".[189]

Moreover, Kahn-Freund described the *Salomon* judgment as "calamitous"[190] on the ground that the House of Lords allowed a sole trader, or groups of traders, to carry out business through a limited liability company in cases where there is no need for outside capital and where no specific business risk is involved. Therefore, in such cases, the economic benefits of limited liability are lost and the application of the doctrine seems unjustified. In addition, according to Kahn-Freund, the law has failed to give adequate protection to creditors, which should be the corollary of

[182] *Broderip v Salomon* [1895] 2 Ch. 323 at [337].

[183] ibid.

[184] ibid at [339]. Lopes LJ said in this regard that "it would be lamentable if a scheme like this could not be defeated": ibid at [340]-[341].

[185] See, for example, *Salomon* (n 10) at [31] per Lord Halsbury, at [38] per Lord Watson, at [45]-[46] per Lord Herschell, at [51]-[52] per Lord Macnaghten. See also Lim (n 178) 532.

[186] Ross Charnock, 'Lexical Indeterminacy: Contextualism and Rule-Following' in Anne Wagner, Wouter Werner and Deborah Cao (eds), *Interpretation, Law and the Construction of Meaning. Collected Papers on Legal Interpretation in Theory, Adjudication and Political Practice* (Springer 2006) 23-24.

[187] ibid.

[188] Paddy Ireland, 'The Rise of the Limited Liability Company' (1984) 12 International Journal of the Sociology of Law 239, 241-244; Lim (n 178) 534.

[189] Patrick F Higgins, *The Law of Partnership in Australia and New Zealand* (Sydney, Law Book Company of Australasia 1963) 16. See also Paul Halpern, Michael Trebilcock, and Stuart Turnbull, 'An Economic Analysis of Limited Liability in Corporation Law' (1980) 30(2) The University of Toronto Law Journal 117, 119.

[190] Otto Kahn-Freund, 'Some Reflections on Company Law Reform' (1944) 7.1/2 The Modern Law Review 54, 54-55. See also Simon Goulding, *Principles of Company Law* (Cavendish Publishing Limited 1996) 49; Gonzalo Villalta Puig, 'A Two-Edged Sword: Salomon and the Separate Legal Entity Doctrine' (2000) 7.3 Murdoch University Electronic Journal of Law 1, 17-18. <www5.austlii.edu.au/au/journals/MurdochUeJlLaw/2000/32.html> accessed 1 August 2020.

limited liability.[191] Indeed, creditors have to bear the risks associated with dealing with limited liability corporations.[192] While large contractual creditors, such as banks, are able to protect themselves against said risks, tort creditors and other types of involuntary creditors cannot.[193]

In justifying the impact of the doctrine of limited liability on unsecured creditors, Lord Macnaghten said that Salomon Ltd.'s creditors "may be entitled to sympathy, but they have only themselves to blame for their misfortunes".[194] This is because they had a long relationship with Mr Salomon and they "had full notice"[195] that they were dealing with a company rather than with an individual. In the modern market reality, however, it is questionable whether Lord Macnaghten's statement is still relevant. In particular, it is doubtful whether involuntary creditors, especially tort victims, ever had any notice that they were dealing with a company before they were injured. It is therefore highly questionable that tort creditors have "themselves to blame".[196] Hence, it can be argued that the principle of limited liability should have never been extended to involuntary creditors, as neither the judiciary, nor the Parliament had such an extension of the application of the doctrine in mind.[197] Instead, in creating the limited liability regime, the intention of the lawmakers was to encourage people to freely engage in commercial activities.[198] Indeed, Lord Macnaghten mentioned Salomon Ltd.'s unsecured creditors, who had notice that they were dealing with a limited liability company;[199] they had

[191] Kahn-Freund (n 190) 55. This argument was echoed by Scanlan, who stated that "the law needs to go further in providing a means of protection for the unsecured creditor of private limited companies" Gary Scanlan, 'The Salomon Principle' (2004) 25.7 The Company Lawyer 196, 198.

[192] Puig (n 190) 19.

[193] ibid; Lo (n 18) 121; Lipton (n 33) 482.

[194] *Salomon* (n 10) at [53].

[195] ibid.

[196] Ewan McGaughey, 'Donoghue v Salomon in the High Court' (2011) 4 Journal of Personal Injury Law 249, 253.

[197] ibid; Lo (n 148) 146. The problems associated with the application of the limited liability principle to torts were already noticed by Edward Cox, who wrote that, in practice, "no person will bring an action (in tort) against a company from which he can recover nothing". Edward Cox, *The Law and Practice of Joint Stock Companies* (London, Law Times Office 1856) 5.

[198] Griffin (n 19) 99.

[199] *Salomon* (n 10) at [53].

therefore chosen to enter into a commercial relationship with it.[200] Likewise, in the Parliament, Robert Lowe argued for the "right of people"[201] to choose with whom they wish to deal. Again, therefore, the emphasis on the ability to choose with whom one wanted to enter into commercial relationships was of paramount importance. Involuntary creditors, however, cannot choose with whom they want to deal;[202] they cannot bargain with the corporation,[203] and thus they cannot protect themselves from the risks associated with the application of the doctrine of limited liability.[204]

D. Interim conclusion

In sum, today the doctrine of limited liability transfers business risks from investors to involuntary creditors without compensation.[205] This, in turn, incentivises corporate recklessness, as the corporate veil protects investors from any liabilities arising from the company's activity.[206] This problem is exacerbated by multinational corporate groups, as parent companies often use the benefit of limited liability for the sole purpose of avoiding responsibility for the wrongs done

[200] It is argued that unsecured creditors "bargain with the corporation", see Thomas H Jackson, 'Bankrupcy, Non-Bankrupcy Entitlements, and the Creditors' Bargain' in Richard A Posner (ed), *Corporate Bankruptcy: Economic and Legal Perspectives* (Cambridge University Press 1996). For a well-thought critique of unsecured creditors' bargain, see Lynn M LoPucki, 'The Unsecured Creditor's Bargain' (1994) 80(8) Virginia Law Review 1887. For a response to LoPucki's arguments, see Susan Block-Lieb, 'The Unsecured Creditor's Bargain: A Reply' (1994) 80(8) Virginia Law Review 1989.

[201] See Robert Lowe (n 157).

[202] McGaughey (n 196) 253-254.

[203] Leebron (n 46) 1639-40; LoPucki (n 200) 1897-1898.

[204] Lo (n 148) 145-146.

[205] Janet Cooper Alexander, 'Unlimited Shareholder Liability Through A Procedural Lens' (1992) 106 Harvard Law Review 387, 390; Lo (n 18) 121; Puig (n 190) 19.

[206] Hansmann and Kraakman (n 32) 1920; Ribstein (n 28) 81; Leebron (n 46) 1565; Price (n 46) 441-442; Ireland (n 49) 838; Muchlinski (n 39) 915-916; Lipton (n 33) 480-481.

by their subsidiaries.[207] These are the consequences of limited liability, which, as the foregoing discussion has shown, were not foreseen by its inventors.[208]

III. Involuntary Creditors' Protection Under the Modern Doctrine of Limited Liability

A. The economic rationale behind limited liability

The foregoing analysis evidenced that the doctrine of limited liability was introduced in the UK with the purpose of stimulating economic growth. This analysis also showed that the interests of involuntary creditors were not given adequate consideration when the doctrine was introduced. Subsequently, the principle has been extended to shield a company's owners from liabilities towards this particular group of creditors, which was not the intention of the lawmakers.

That being said, limited liability is considered today as a "birth right"[209] of a corporation as well as its most attractive feature.[210] In fact, in modern times, most companies decide to conduct their businesses under limited liability.[211] For instance, from 2004, limited companies have consistently accounted for over 96% of all corporate bodies in the UK.[212] In contrast, between 2017 and 2018, only four thousand three hundred seventy-four companies traded in Britain with unlimited

[207] See the comments of Templeman LJ in *Re Southard & Co. Ltd* [1979] 1 W.L.R. 1198, who stated at [1208] that "A parent company may spawn a number of subsidiary companies, all controlled directly or indirectly by the shareholders of the parent company. If one of the subsidiary companies, to change the metaphor, turns out to be the runt of the litter and declines into insolvency to the dismay of its creditors, the parent company and the other subsidiary companies may prosper to the joy of the shareholders without any liability for the debts of the insolvent subsidiary". See also Rühmkorf (n 40) 183-184; Peter Muchlinski, 'Holding Multinationals to Account: Recent Developments in English Litigation and the Company Law Review' (2002) 23 The Company Lawyer 168, 168-169.

[208] It is argued that, in the modern times, "limited liability has been carried unthinkingly beyond the original objective of insulating the ultimate investor from the debts of the enterprise": Blumberg (n 12) 575.

[209] Leebron (n 46) 1569.

[210] Harry G Henn, *Handbook of the Law of Corporations and Other Business Enterprises* (West Publishing Company 1970) 96; David H Fater, *Essentials of Corporate and Capital Formation* (John Wiley & Sons 2009) 16.

[211] Ali Imanalin, 'Rethinking Limited Liability' (2011) 7 Cambridge Law Review 89, 89-90.

[212] Companies House, 'Official Statistics: Companies register activities: 2019 to 2020' (25 June 2020) <www.gov.uk/government/publications/companies-register-activities-statistical-release-2019-to-2020/companies-register-activities-2019-to-2020> accessed 13 July 2020.

liability.[213] Thus, it is clear that a limited liability company is the most popular business vehicle in the UK.

One of the main reasons for the prominence of the doctrine of limited liability and its widespread acclamation[214] is the fact that it stimulates economic growth by incentivising business endeavours.[215] Namely, because there is a linear relationship between returns on a particular asset and its systematic risks, high returns from an investment cannot be achieved without accepting the substantial risk of potential financial losses.[216] Thus, because investors tend to be risk averse,[217] they may often feel discouraged from putting their personal assets at stake in a risky business venture, as these assets are not protected from the claims raised by the company's creditors. In this regard, the doctrine of limited liability provides that the liability of the company's members is restricted to the amount invested in the company.[218] Consequently, the shareholders will not be held personally liable for a sum greater than what they have already invested; their personal assets will remain shielded from the claims of the company's creditors.[219] Effectively, the doctrine of limited liability shifts the risk of potential financial losses away from shareholders and places it upon creditors.[220] As a result, investors can 'sleep more easily at night' knowing that limited liability protects them from the risk of bankruptcy.[221] Also, the principle of limited liability allows shareholders to diversify their portfolios

213 Companies House, 'Official Statistics: Companies register activities: 2017 to 2018' (28 June 2018) <www.gov.uk/government/publications/companies-register-activities-statistical-release-2017-to-2018/companies-register-activities-2017-to-2018> accessed 13 July 2020.

214 See Bernard F Cataldo, 'Limited Liability with One Man Companies and Subsidiary Corporations' (1953) 18(4) Law and Contemporary Problems 473, 473-474.

215 Davies and Worthington (n 17) 191-192; Griffin (n 19) 99.

216 Ronald J Gilson, 'Value Creation by Business Lawyers: Legal Skills and Asset Pricing' (1984) 94 Yale Law Journal 239, 313.

217 Bainbridge and Henderson (n 21) 47. For a thorough analysis of risk aversion of human beings, see Elke U Weber, Ann-Renee Blais and Nancy E Betz, 'A Domain-Specific Risk - Attitude Scale: Measuring Risk Perceptions and Risk Behaviors' (2002) 15(4) Journal of Behavioral Decision Making 263, 263-290. See also Laura Concina, Risk Attitude & Economics (FonCSI 2014) 12-16.

218 Davies and Worthington (n 17) 191.

219 Davies (n 13) 60; Bae Kim (n 16) 73; Peterson (n 22) 63.

220 Lewis D Solomon et al., *Corporation Law and Policy* (2nd edn., West Pub. Co 1988) 242; Bainbridge and Henderson (n 21) 47; Millon (n 30) 1355.

221 William Reader, 'Versatility Unlimited: Reflections on the History and Nature of the Limited Liability Company' in Tony Orhnial (ed), *Limited Liability and the Corporation* (London: Croom Helm 1982) 191.

more easily, which reduces the shareholders' company-specific risks, and thus their potential financial losses.[222]

Moreover, the doctrine diminishes monitoring costs that investors would otherwise have to incur to monitor managerial behaviour.[223] Namely, directors may sometimes act in a manner detrimental to the interests of shareholders.[224] When shareholders' personal liability is not limited, there is a risk that they would have to bear the costs of the directors' course of conduct.[225] For that reason, shareholders would have to actively monitor directors' decision-making, which is a costly, complicated, and time-consuming process.[226] Accordingly, the doctrine of limited liability eliminates shareholders' personal liability for the company's debts, and thus active monitoring is no longer necessary.[227] Likewise, limited liability diminishes the costs of monitoring other shareholders.[228] Namely, when the liability of the company's members is not limited, the obligation to pay off the company's debts could be disproportionally imposed upon the wealthier shareholders.[229] As a result, the company's members would have to monitor each other to anticipate potential liabilities.[230] Under the doctrine of limited liability this problem ceases to exist, as the identity of other shareholders becomes irrelevant.[231]

In addition to the benefits mentioned above, limited liability incentivises managerial efficiency,[232] facilitates optimal investment decision-making,[233] encourages public investment,[234] and enables smooth transferability of shares on the market.[235] To put it briefly, the doctrine of limited liability incentivises investments that would not otherwise take place.[236] Given its salient economic role, limited

222 Davies and Worthington (n 17) 192; Easterbrook and Fischel (n 15) 96; Price (n 46) 448-449.
223 Easterbrook and Fischel, 'Limited Liability and the Corporation' (n 15) 94-95.
224 Kershaw (n 17) 25.
225 ibid.
226 Millon (n 30) 1312-1313.
227 ibid. It is worth noting here that oftentimes diminished monitoring costs open up a path for directorial fraud, see Burcu S Avci, Cindy A Schipani, and H Nejat Seyhun. 'Do Independent Directors Curb Financial Fraud: The Evidence and Proposals for Further Reform' (2018) 93 Indiana Law Journal 757.
228 Easterbrook and Fischel (n 15) 95. See also Halpern, Trebilcock, and Turnbull (n 189).
229 Frank H Easterbrook and Daniel R Fischel, *The Economic Structure of Corporate Law* (Harvard University Press 1996) 42.
230 ibid.
231 ibid.
232 ibid.
233 ibid 43-44.
234 Davies (n 13) 63-65.
235 Price (n 46) 444-445; Millon (n 30) 1313.
236 Millon (n 30) 1312.

liability is rightly regarded as the "distinguishing feature" of corporate law,[237] which "has made much of our economic progress possible".[238] Consequently, limited liability forms an inextricable part of modern capitalism and modern society.

Despite the plethora of economic benefits induced by the doctrine of limited liability, it is evident that the principle also has its costs.[239] As this paper has already discussed, the doctrine allows companies to easily externalise their business risks and incentivises corporate recklessness.[240] Consequently, the doctrine puts involuntary creditors in danger, as it shifts risks away from shareholders onto involuntary creditors without compensation.[241] It is therefore worth considering how the modern law protects involuntary creditors from the negative impact of the application of the doctrine of limited liability, and whether these protection mechanisms are effective.

B. Modern involuntary creditors' protection mechanisms

(i) Piercing the Corporate Veil

In certain instances, the court may 'pierce the corporate veil', and may thus hold the company's shareholders liable for the debts of the corporation by denying that a company is a separate person in the eyes of the law.[242] Traditionally, UK courts were willing to 'pierce the veil' in "appropriate circumstances".[243] For instance, the veil will be pierced when a statute so permits, e.g., directors can be found personally liable for wrongful trading.[244] Likewise, anyone who knowingly

237 Easterbrook and Fischel, *The Economic Structure of Corporate Law* (n 229) 40.

238 John Hicks, 'Limited Liability: the Pros and Cons' in Tony Orhnial (ed), *Limited Liability and the Corporation* (London: Croom Helm 1982) 12.

239 Peterson (n 22) 64.

240 Hansmann and Kraakman (n 32) 1920; Muchlinski (n 39) 915-916.

241 Lo (n 18) 121.

242 *Prest v Petrodel Resources* [2013] 2 A.C. 415 at [16] per Lord Sumption. Davies and Worthington (n 17) 197-198; Dmitry Vlasov, 'Liability of a Puppeteer for a Puppet: a Recent Development in Law on Piercing the Corporate Veil' (2012) 33 The Company Lawyer 356, 356; Andrew Bowen, 'Concealment, Evasion and Piercing the Corporate Veil: Prest v Petrodel Resources Ltd' Business Law Bulletin (April 2014) 1.

243 *Customs and Excise Commissioners v Hare* [1996] 2 B.C.L.C. 500 at [511] per Rose LJ.

244 Insolvency Act 1986, s. 214 as amended; *Re Produce Marketing Ltd* [1989] BCLC 520; *Re Continental Assurance Company of London Plc (Signer v. Beckett)* [2007] B.C.L.C. 287.

contributed to the fraudulent business conduct of the company can be held personally liable for fraudulent trading.[245]

The corporate veil can also be pierced by the courts under common law principles. Namely, under the law of agency, owners of a company can be found liable for the company's actions, provided that the actions were within the scope of actual[246] or ostensible[247] authority.[248] For instance, in *Smith Stone & Knight Ltd v Birmingham Corporation,* Atkinson J. held that the subsidiary company was so closely connected with the parent company that it was in fact operating as the parent's agent.[249] Normally, however the presumption of an agency relationship is difficult to establish without an express agreement between the interested parties.[250] Indeed, in *Adams v Cape Industries*, the argument based on agency failed completely, as no contractual relationship that could amount to a parent-agent relationship was found between the parties even though the subsidiaries were wholly owned by the parent.[251] Such cases are therefore very fact-sensitive.[252]

In the context of corporate groups, in *DHN Food Distributors Ltd v Tower Hamlets London Borough Council*,[253] Lord Denning advanced the "single economic unit" argument, which initially was seen as undermining the rigidity of the *Salomon* judgment.[254] In this case, Lord Denning, with whom Lords Goff[255] and

245 Insolvency Act 1986, s. 213 as amended. For example, in *Re Gerald Cooper Chemicals Limited (in Liquidation)* [1978] 1Ch 262 it was the creditor, who was found liable for breaching s. 213.

246 *Hely-Hutchinson v Brayhead Ltd* [1968] 1 Q.B. 549 at [583] per Lord Denning. See, in general, Peter Watts and Francis M B Reynolds, *Bowstead and Reynolds on Agency* (21st edn., Sweet & Maxwell 2018) at 3.001-3.006.

247 *Freeman & Lockyer (A Firm) v Buckhurst Park Properties (Mangal) Ltd. and Another* [1964] 2 Q.B. 480 at [503]-[506] per Lord Diplock; *Hely-Hutchinson* (n 246) at [583] per Lord Denning. See also Kershaw (n 17) 112-120.

248 On agency law in general, see Davies and Worthington (n 17) 149-191.

249 *Smith Stone & Knight Ltd v Birmingham Corporation* [1939] 4 All E.R. 116 at [121]-[122].

250 *Southern v Watson* [1940] 3 All E.R. 439; Davies and Worthington (n 17) 203.

251 *Adams* (n 43) at [545]-[550] per Slade L.J; Kershaw (n 17) 58; Davies and Worthington (n 17) 203.

252 Atkinson J himself admitted that the question in *Smith Stone & Knight Ltd* was one of fact: *Smith Stone & Knight Ltd* (n 249) at [121]. In this regard, Kerr LJ stated in *JH Rayner (Mincing Lane) Ltd v Department of Trade & Industry* [1989] Ch 72 (CA) at [190] that the facts of *Smith Stone & Knight* were so unique that "no conclusion of principle could be derived from that case".

253 *DHN Food Distributors Ltd v Tower Hamlets London Borough Council* [1976] 1 WLR 852 (CA).

254 David Sugarman and Frank Webb, 'Three-in-One: Trusts, Licences and Veils' (1977) 93 Law Quarterly Review 170, 175.

255 Lord Goff's reasoning was based on the facts that the subsidiaries were wholly owned by the parent company and that that there was no business activity in them: *DHN* (n 253) at [860]-[866]; Kershaw (n 17) 63.

Shaw[256] agreed, held that because the parent company wholly owned shares in the subsidiaries and had complete control over them, justice required that the three companies should be treated as one; they constituted one economic entity.[257] However, this principle has subsequently been considerably qualified. In *Woolfson v Strathclyde Regional Council*, Lord Keith distinguished *DHN* on the facts and held that the court in *DHN* did not apply the law correctly, as the corporate veil could only be pierced in special circumstances indicating the existence of "a mere façade concealing the true facts".[258] Moreover, in *Adams*, Slade L.J. held, citing Roskill L.J. in *Albacruz (Cargo Owners) v Albazero*,[259] that it is a fundamental principle of the law that each company in the group of companies is a separate legal person.[260] Accordingly, the court is "not free" to disregard the *Salomon* principle merely because justice so requires.[261] For those reasons, even though the 'single economic unit' principle has never been completely rejected,[262] the judgment in *DHN* is often seen as an "aberration",[263] which is strictly confined to its facts.[264] Therefore, the 'single economic unit argument' is of little practical relevance today.[265] From the perspective of involuntary creditors this is unfortunate, because, had Lord

[256] Shaw LJ focused on the fact that the subsidiary did not engage in any kind of trading and had no real business: *DHN* (n 253) at [866]-[868].

[257] ibid at [860]. Thomas K Cheng, 'The Corporate Veil Doctrine Revisited: A Comparative Study of the English and the US Corporate Veil Doctrines' (2011) 34 Boston College International and Comparative Law Review 329, 331-332.

[258] *Woolfson v Strathclyde Regional Council* [1978] S.C. (H.L.) 90 at [95]-[96].

[259] *Albacruz (Cargo Owners) v Albazero* [1977] AC 774 at [807]: "Each company in a group of companies is a separate legal entity possessed of separate legal rights and liabilities so that the rights of one company in a group cannot be exercised by another company in that group even though the ultimate benefit of the exercise of those rights would ensure beneficially to the same person or corporate body irrespective of the person or body in whom those rights were vested in law".

[260] *Adams* (n 43) at [532].

[261] ibid [536]-[537]. See also the comments of Munby J in *Ben Hashem v Ali Shayif* [2009] EWHC 864 (Fam) at [160].

[262] Kershaw (n 17) 69-70.

[263] F G Rixon, 'Lifting the Veil Between Holding and Subsidiary Companies' (1986) 102 Law Quarterly Review 415, 422.

[264] Ernest Lim, *Sustainability and Corporate Mechanisms in Asia* (Cambridge University Press 2020) 247.

[265] See, for instance, the case of *Gripple Ltd v Revenue and Customers Commissioners* [2010] EWHC 1609 (Ch) at [23]-[24], where Henderson J firmly rejected the "single economic unit" argument put forward by the counsel for the appellant and described such an argument as "an adventurous submission". See also the comments of Flaux J in *Linsen International Ltd and others v Humpuss Sea Transport Pte Ltd and others* [2012] Bus. L.R. 1649 at [19], [39], [58] and [126].

Denning's argument been accepted by the courts, it would arguably have given involuntary creditors a considerable degree of protection.

Furthermore, separate legal personality of a company can be disregarded in cases where the company was a "sham",[266] a "cloak",[267] a "mask",[268] a "puppet",[269] or a "mere façade",[270] which was used solely as a stratagem to conceal the true facts, such as the existence of fraud, or to evade existing liabilities.[271] The above epithets are considered as synonymous.[272] Nevertheless, what they really mean is incredibly unclear.[273] In this regard, in *Adams*, the court stated that the authorities give "rather sparse guidance" as to what kind of arrangement amounts to a "façade".[274] It did not, however, provide any clarification on this issue.[275]

In *Prest v Petrodel Resources*, which is the leading case on piercing the veil in the UK, Lord Sumption stated, having reviewed the authorities on this issue, that piercing the veil is an applicable remedy only in cases where a person tries to deliberately evade existing legal obligations, or liabilities, through relying on the corporate form for an improper purpose.[276] His Lordship also held that, in numerous instances, an evident legal relationship exists between the company and its owners, which makes it unnecessary to pierce the corporate veil at all; the same outcome can be reached through "more conventional"[277] methods, such as the law of agency. Therefore, the veil will be pierced only when doing so is absolutely necessary.[278] Consequently, following *Prest*, the scope of the doctrine has become

266 *Gilford Motor Company, Limited v Horne* [1933] Ch. 935 at [961] per Lord Hanworth MR, at [965] per Lawrence LJ, at [969] per Romer LJ.
267 ibid at [961] per Lord Hanworth MR, at [965] per Lawrence LJ, at [969] per Romer LJ.
268 *Jones v Lipman* [1962] 1 WLR 832 at [836] per Russell J.
269 *Wallersteiner v Moir* [1974] 1 W.L.R. 991 at [1013] per Denning MR.
270 *Woolfson v Strathclyde Regional Council* [1978] S.C. 90 (HL) at [96] per Lord Keith with whom Lord Wilberforce, Lord Fraser of Tullybelton and Lord Russell of Killowen agreed.
271 ibid; *Trustor AB v Smallbone and others (No 2)* [2001] 1 W.L.R. 1177 at [20] per Sir Andrew Morritt V-C. See also Paweł Słup, 'Piercing the Corporate Veil – A Common Pattern?' (2018) 24.1 Comparative Law Review 287, 298.
272 *Ben Hashem* (n 261) at [150] Mr Justice Munby.
273 Davies and Worthington (n 17) 202.
274 *Adams* (n 43) at [543] per Slade LJ; Davies and Worthington (n 17) 202.
275 *Adams* (n 43) at [543] per Slade LJ.
276 *Prest* (n 242) at [35].
277 ibid. Lord Neuberger agreed with Lord Sumption on this issue, see para [62].
278 ibid at [35] per Lord Sumption; Pey Woan Lee, 'The Enigma of Veil Piercing' (2015) 26(1) International Company and Commercial Law Review 28, 33.

extremely narrow, and piercing the veil can be regarded as a "remedy of last resort".[279]

The foregoing suggests that piercing the corporate veil might not be an appropriate remedy for involuntary creditors. Namely, the above discussion evidenced that courts are very reluctant to disregard the corporate form, and will only do so in "exceptional" circumstances.[280] In fact, following *Prest*, the veil will only be pierced when the corporate form is used to evade existing legal obligations;[281] the scope of the doctrine has thus become very narrow.[282] Therefore, because future torts cannot be regarded as existing obligations, involuntary creditors will not be able to request the court to disregard the corporate form and hold the company's owners liable for the wrong done by the company or its subsidiary.[283] Moreover, piercing the veil involves a considerable degree of judicial discretion and it is hard to anticipate *ex ante* whether the veil will be pierced, which leads to uncertainties and increases the costs of fact-specific litigation.[284] For the above reasons, the veil piercing doctrine is a "remedy of last resort",[285] which is rarely successful. Even though the single economic unit argument could initially be seen as a light at the end of the tunnel for involuntary creditors, the importance of this principle has been considerably limited. On this account, the veil piercing doctrine does not allow even the most deserving victims, such as the employees who contracted asbestosis in the case of *Adams*, to be duly compensated for their losses.[286]

(ii) Bypassing Limited Liability under Tort Law - Chandler v Cape Plc

Holding a parent company directly liable for the harm caused by its subsidiary is an alternative approach to the issue of involuntary creditors' protection available under tort law. Namely, in *Chandler v Cape Plc*, Wyn Williams J

279 Lee (n 278) 33; Alexander Schall, 'The New Law of Piercing the Corporate Veil in the UK' (2016) 13(4) European Company and Financial Law Review 549, 555-556; Edwin Mujih, 'Piercing the Corporate Veil as a Remedy of Last Resort after Prest v Petrodel Resources Ltd: Inching towards Abolition?' (2016) 37(2) The Company Lawyer 39, 49.

280 Muchlinski (n 39) 919; Ernest Lim, 'Salomon Reigns' (2013) 129 Law Quarterly Review 480, 483; Petrin and Choudhury (n 39) 775.

281 *Prest* (n 242) at [34]-[35] per Lord Sumption, at [81] per Lord Neuberger.

282 Lee (n 278) 30; Schall (n 279) 552-553; Stefan H C Lo, 'Piercing of the Corporate Veil for Evasion of Tort Obligations' (2017) 46.1 Common Law World Review 42, 45.

283 Lipton (n 33) 480; Phillip Morgan, 'Vicarious Liability for Group Companies' (2015) 31 Journal of Professional Negligence 276, 283; Lo (n 282) 44; Christopher Arvidsson, 'The Piercing Doctrine: Re-examining Evasion' (2019) 40(10) The Company Lawyer 320, 322.

284 Muchlinski (n 39) 923.

285 Schall (n 279) 555-556.

286 For a similar argument, see Imanalin (n 211) 90.

held, relying on the tripartite test established in *Caparo v Dickman*,[287] that the parent company owed a duty of care to the employee, who contracted asbestosis in the course of his employment with the subsidiary.[288] Following *Caparo*, a duty of care arises provided that (a) the harm suffered is reasonably foreseeable; (b) there is a high degree of "proximity" between the parties and; (c) the imposition of the duty is "fair, just and reasonable".[289] Accordingly, in *Chandler*, the court found that the harm was reasonably foreseeable, as the parent company had knowledge of the working conditions of the subsidiary's employees.[290] Moreover, the court found that, because the parent company dictated policy in regard to health and safety measures of the subsidiary, the parent retained responsibility for the safety of the subsidiary's employees.[291] Therefore, a degree of proximity existed between the parties.[292] Furthermore, the court firmly admitted that imposing a duty of care in relation to exposure to asbestos was fair, just and reasonable.[293] Ultimately, it was held that the parent company owed a duty of care to the subsidiary's employees. This judgment was subsequently affirmed on appeal.[294]

In its decision, the Court of Appeal elaborated on Mr Justice Wyn Williams's approach and put forward a four-part test, under which the law can impose responsibility for the safety of the subsidiary's employees upon the parent company.[295] Accordingly, once it is established that the parent is in "relevant control of the subsidiary's business",[296] the parent's responsibility will be assumed when: (a) the business of the parent and the subsidiary are in a relevant respect the same; (b) the parent has "superior knowledge" of the health and safety standards in the relevant industry; (c) the parent has superior knowledge of the subsidiary's working conditions and; (d) "the parent knows or ought to have foreseen that the subsidiary

287 *Caparo v Dickman* [1990] 2 A.C. 605 at [617]-[618] per Lord Bridge of Harwich.

288 [2011] EWHC 951 (QB) at [77] per Mr Justice Wyn Williams. For a detailed analysis of this judgment, see Martin Petrin, 'Assumption of Responsibility in Corporate Groups: Chandler v Cape plc.' (2013) 76(3) The Modern Law Review 603, 607-609.

289 *Caparo* (n 287) at [617]-[618] per Lord Bridge of Harwich.

290 *Chandler* (n 288) at [73]-[74] per Mr Justice Wyn Williams.

291 ibid at [71] and [75] per Mr Justice Wyn Williams.

292 ibid at [75] per Mr Justice Wyn Williams.

293 ibid at [76] per Mr Justice Wyn Williams.

294 *Chandler v Cape Plc* [2012] 1 W.L.R. 3111 (CA).

295 ibid at [80] per Arden LJ with whom Moses LJ and McFarlane LJ agreed. See Rühmkorf (n 40) 175-176.

296 *Chandler* (n 294) at [46] per Arden LJ. See also Petrin (n 288) 610-611.

or its employees would rely on its using that superior knowledge for the employees' protection".[297]

Because of its wide implications, the judgment in *Chandler* marked an important step in holding the parent company liable for the injury sustained by its subsidiary's employees in the course of their employment.[298] Accordingly, it gives involuntary creditors a possibility to sue the parent company under tort law, which effectively bypasses the separate legal personality of the company and circumvents the doctrine of limited liability. Therefore, following *Chandler*, things might have changed, and the tide of the conflict between tort law and company law, wherein company law for long took the upper hand, might have turned as well.[299]

However, *Chandler* does not in fact establish any clear principle according to which future cases could be decided.[300] Namely, it is unclear what the Court of Appeal meant by 'relevant control'; it is unclear how much 'control' is sufficient for responsibility to be assumed.[301] Likewise, under this approach, it is arguably not necessary to show that the parent company exercised control over the subsidiary's health and safety standards.[302] In turn, showing that the parent company had 'a general practice' of intervening in the management of the subsidiary will be enough to satisfy the test.[303] In addition, as Petrin and Choudhury argue, this approach is both underinclusive and overinclusive.[304] It is underinclusive because establishing that the parent company failed to exercise "relevant control" should not automatically exempt the parent from incurring liability.[305] It is overinclusive because virtually all corporate groups have certain uniform group policies, and thus practically every parent company will satisfy the 'control' requirement.[306] Moreover, following *Chandler*, the existence of the duty of care will be highly dependent on the nature of the relationship between the parent company and the subsidiary; such a relationship must be sufficiently close.[307] For example, in *Thompson v The Renwick Group Plc*, it was held that the fact that the parent company merely held shares in the subsidiary was not enough to impose liability under tort

[297] ibid at [80] per Arden LJ.
[298] Rühmkorf (n 40) 176-177; Julian Fulbrook, 'Chandler v Cape Plc: Personal Injury: Liability: Negligence' (2012) 3 Journal of Personal Injury Law C135-C139.
[299] McGaughey (n 196) 249.
[300] Petrin and Choudhury (n 39) 778.
[301] ibid; Petrin (n 288) 612.
[302] Petrin (n 288) 613.
[303] *Chandler* (n 294) at [80] per Arden L.J; Petrin (n 288) 613; Petrin and Choudhury (n 39) 778.
[304] Petrin and Choudhury (n 39) 778.
[305] ibid.
[306] ibid.
[307] Peter Rott, 'Directors' Duties and Corporate Social Responsibility under German Law - Is Tort Law Litigation Changing the Picture' (2017) 1 Nordic Journal of Commercial Law 11, 22.

law upon the parent.[308] Furthermore, given the inherent lack of clarity of the *Chandler* approach,[309] it is difficult to anticipate *ex ante* what kind of a relationship would give rise to a duty of care.[310] This, coupled with the fact that the burden of proof in such cases falls on the claimant, means that raising a successful claim proves problematic. For the above reasons, although bypassing limited liability under tort law is an option for some involuntary creditors, it cannot be deemed to be a robust protection mechanism.

(iii) Deterring Companies from Engaging in Hazardous Behaviour - Section 172(1) of the Companies Act 2006

Because limited liability allows companies to easily diversify their risks, it is widely contended that the doctrine incentivises companies to engage in overly hazardous activities.[311] In this respect, it is even argued that, on numerous occasions, limited liability "has caused unlimited harm".[312] In this regard, s.172(1) of the Companies Act 2006 was enacted to encourage a company's board to consider the long-term impact of its decisions, which, in theory, should limit the risk of companies engaging in hazardous activities.

Section 172(1) reflects the inclusive "enlightened shareholder value"[313] approach, which posits that long-term relationships are more beneficial for a company than short-term financial gains.[314] Accordingly, the introduction of

308 [2014] EWCA Civ 635 at [37] per Tomlinson LJ.

309 On the contrary, it is sometimes asserted that the lack of clarity of the *Chandler* approach could be ameliorated by the categorisation of the circumstances where the parents' direct tortious liability could be recognised, see Daisuke Ikuta, 'The Legal Measures against the Abuse of Separate Corporate Personality and Limited Liability by Corporate Groups: The Scope of Chandler v Cape Plc and Thompson v. Renwick Group Plc.' (2017) 6 UCL Journal of Law & Jurisprudence 60, 82-88.

310 Rühmkorf (n 40) 177.

311 Halpern, Trebilcock, and Turnbull (n 189) 148; Leebron (n 46) 1565; Ribstein (n 28) 81; Muchlinski, 'Limited Liability and Multinational Enterprises: a Case for Reform?' (n 39) 915-916; Lipton, 'The Mythology of Salomon's Case and the Law Dealing With the Tort Liabilities of Corporate Groups: An Historical Perspective' (n 33) 480-481; Ireland, 'Limited Liability, Shareholder Rights and the Problem of Corporate Irresponsibility' (n 49) 838.

312 Katharina Pistor, 'Limited liability is causing unlimited harm' (*Social Europe*, 11 February 2020) <www.socialeurope.eu/limited-liability-is-causing-unlimited-harm> accessed 28 July 2020.

313 The Company Law Review Steering Group, Modern Company Law for a Competitive Economy: The Strategic Framework (URN 99/654 DTI 1999) 5.1.11-5.1.12. See also Mary Arden, *Common Law and Modern Society: Keeping Pace with Change* (Oxford University Press 2015) 228; Parker Hood, 'Directors' Duties Under the Companies Act 2006: Clarity or Confusion?' (2013) 13(1) Journal of Corporate Law Studies 1, 16.

314 Andrew Keay, 'Section 172(1) of the Companies Act 2006: An Interpretation and Assessment' (2007) 28.4 The Company Lawyer 106, 107.

s.172(1) was supposed to bring "a cultural change" in the way in which corporate business was done by placing greater emphasis on long-term considerations and wider stakeholders' interests.[315] Thus, s.172(1) was arguably going to pave the way for "an enlightened"[316] company law system.

On this account, s.172(1) requires a director of a company to "act in the 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, and in doing so have regard, amongst other matters, to" a number of factors.[317] Accordingly, this provision states that the director should no longer act merely for the benefit of the company's owners, but rather he should act in a responsible and forward-looking manner, and should reflect the interests of a wider group of stakeholders in his decision-making.[318] Therefore, s.172(1) aims to discourage management from engaging in hazardous activities, which should subsequently decrease the number of instances where involuntary creditors are harmed by reckless profit-orientated corporate actions.

It is often argued, however, that s.172(1) is ineffective in "any practical sense".[319] For instance, the scope of the director's duty under this section is very vague.[320] Namely, it is ambiguous what 'success of the company' entails and how 'success' ought to be achieved.[321] The focus of the duty is in fact extremely narrow.[322] Moreover, it is not known what the phrase "have regard to" means, and thus it is unclear how specifically directors should "have regard" to the factors listed

315 See the Ministerial Statement of Rt. Hon Margaret Hodge, Minister of State for Industry and the Regions, UK Department of Trade and Industry (now Department for Business Innovation & Skills), 'Companies Act 2006: Duties of Directors' (Ministerial Statement June 2007) 2. <www.dti.gov.uk/files/file40139.pdf> accessed 28 July 2020. See also Andrew Keay, 'The duty to promote the success of the company: is it fit for purpose?' (2010) University of Leeds School of Law, Centre for Business Law and Practice Working Paper, 11. <ssrn.com/abstract=1662411> accessed 8 August 2020.

316 Grant (n 45) 255.

317 See John Birds et al., *Annotated Companies Legislation* (2nd ed, Oxford University Press 2012), para 10.172.02.

318 Nicholas Grier, 'Enlightened shareholder value: did directors deliver?' (2014) 2 Juridical Review 95, 96.

319 Elaine Lynch, 'Section 172: a Ground-Breaking Reform of Director's Duties, or the Emperor's New Clothes' (2012) 33(7) The Company Lawyer 196, 202; See also Grant (n 45) 255.

320 Grier (n 318) 97.

321 ibid; Andrew Keay, 'Section 172(1) of the Companies Act 2006: An Interpretation and Assessment' (n 314) 109.

322 Alistair Alcock, 'An Accidental Change to Directors' Duties?' (2009) 30 The Company Lawyer 362, 367.

in s.172(1).[323] Furthermore, the list of factors that should be taken into account by a director is subordinated to the duty to promote the success of the company.[324] As a result, the interests of stakeholders will be given consideration insofar as doing so will ultimately promote the success of the company.[325] Therefore, s.172(1) merely gives "an illusion" that the interests of stakeholders will be considered in the corporate decision-making.[326] In addition, most stakeholders lack *locus standi* to enforce breaches of s.172(1), as only "members of the company", that is, present and future shareholders,[327] can bring a statutory derivative action under Part 11 of the Companies Act 2006.[328] It is therefore unlikely that the shareholders would be willing to enforce breaches of s.172(1) in the name of non-shareholders.

Placing s.172(1) in the context of involuntary creditors' protection, it is difficult for involuntary creditors to rely on this section, as this particular group is not expressly listed under the provision. Even though the list is non-exhaustive, it is unlikely that the company's board would "have regard" to the interests of involuntary creditors, as, in most cases, there would be no economic incentive to do so, and thus giving due consideration to involuntary creditors' interests would not "promote the success of the company". Additionally, involuntary creditors lack standing to enforce the provision, as this possibility is available only to the members of the company. For those reasons, s.172(1) has "raised expectations that it cannot

323 Andrew Keay, 'Having Regard for Stakeholders in Practising Enlightened Shareholder Value' (2019) 19(1) Oxford University Commonwealth Law Journal 118, 120; Grant (n 45) 255.

324 Davies and Worthington (n 17) 502-503; Robin Hollington, Hollington on Shareholders' Rights (8th ed, Sweet & Maxwell 2017) para 4-38; Keay, 'Section 172(1) of the Companies Act 2006: An Interpretation and Assessment' (n 314) 108; Hood (n 313) 18-19.

325 Armour (n 53) 3.72; Talbot (n 108) 141. This issue is well-illustrated by the case of *R. (on the application of People & Planet) v HM Treasury* [2009] EWHC 3020 (Admin) at [34] per Mr Justice Sales.

326 Georgina Tsagas, 'Section 172 of the Companies Act 2006: Desperate Times Call for Soft Law Measures' in Nina Boeger and Charlotte Villiers (eds), *Shaping the Corporate Landscape: Towards Corporate Reform and Enterprise Diversity* (Bloomsbury Publishing 2018) 146.

327 See *Gaiman v National Association for Mental Health* [1971] Ch 317 at [330] per Megarry J.

328 John Lowry, 'The Duty of Loyalty of Company Directors: Bridging the Accountability Gap Through Efficient Disclosure' (2009) 68(3) The Cambridge Law Journal 607, 618; Grier (n 318) 98.

deliver",[329] and thus it cannot be regarded as an effective mechanism which limits the risk of the company engaging in reckless behaviour.

IV. Alternatives to Limited Liability from the Involuntary Creditors' Perspective

The doctrine of limited liability has tremendous economic benefits, as it encourages capital investment in corporate entities by limiting shareholders' personal exposure.[330] The above discussion evidenced, however, that limited liability makes involuntary creditors prone to an increased risk of harm, and that the law does not offer sufficient protection to this particular group of creditors. On this account, it is argued that, in modern times, limited liability is applied beyond its original purpose, as it is no longer merely used as a mechanism that stimulates economic growth.[331] In turn, it allows companies to easily diversify their commercial risks, which exposes involuntary creditors to excessive losses.[332] Consequently, because of the significantly weaker position of involuntary creditors, shifting the risk away from companies onto this specific group seems to be unjustified.[333] In fact, no one would admit that the law on limited liability, created largely in the nineteenth century, appropriately accommodates all social costs involved in the activities of modern multinational corporations.[334] Indeed, in its report on the reform of UK company law, the Company Law Review Steering Group (CLRSG) acknowledged that because a parent company can shield itself from liability for the wrong done by its subsidiary, involuntary creditors are exposed to an increased risk of being left with no compensation.[335] The CLRSG chose, however, not to address this particular problem on the ground that undercapitalisation of subsidiaries is a matter of insolvency law rather than company law.[336] Moreover, it found that there was no evidence that corporate groups abuse the corporate form in order to avoid

329 Stephen F. Copp, 'S. 172 of the Companies Act 2006 fails people and planet?' (2010) 31(12) The Company Lawyer 406, 408; Philip Ashton, 'How Fred the Shred Got Away with It: Loud Calls for Company Law Reform' (2013) 1 Birkbeck Law Review 187, 200.

330 Alexander (n 205) 390; Millon (n 30) 1309; Peterson (n 22) 63.

331 Blumberg (n 12) 575.

332 Villiers (n 50) 95.

333 Stefan H.C Lo, 'Liability of Directors as Joint Tortfeasors' (n 18) 121.

334 Bryan Horrigan, 'Directors' Duties and Liabilities - Where Are We Now and Where Are We Going in the UK, Broader Commonwealth, and Internationally?' (2012) 3(2) International Journal of Business and Social Science 21, 41.

335 The Company Law Review Steering Group, Completing the Structure (URN 00/1335 DTI 2000) para 10.58.

336 ibid para 10.59.

liability.[337] It can be argued, however, that the CLRSG's latter conclusion was based on a false assumption; using the corporate structure for the purpose of avoiding liability is sometimes the main reason why the corporate form is implemented.[338] It is therefore worth looking at the alternatives to limited liability, which would reallocate commercial risks back to the company, and could provide involuntary creditors with a better degree of protection in the modern market reality.

With this purpose in mind, it must be noted that the complete abolition of the doctrine of limited liability and the unlimited liability regime resulting therefrom would discourage people from investing their capital in corporate entities,[339] and would severely hamper governance of companies.[340] The unlimited liability system is therefore not desirable from the commercial point of view.[341]

That being said, Leebron acknowledges that limited liability of shareholders seems to be unjustified in relation to tort victims, who are poor risk-bearers.[342] On this account, Leebron,[343] as well as Hansmann and Kraakman,[344] argue that shareholders should be held liable for corporate torts on a pro rata basis. Under this approach, when the tort claim exceeds the assets of the company, the company's shareholders would be held liable for a share of the company's debt proportionate to the share of their equity ownership.[345] Arguably, this approach would improve the position of involuntary creditors, as the company's owners would have an incentive to consider the interests of this particular group of creditors alongside their own. Moreover, the economic benefits of limited liability would not be lost, as this approach would not increase the shareholders' monitoring costs.[346] In fact, as Blumberg observes, a pro rata liability system was in place in California between

[337] ibid para 10.59; Rühmkorf (n 40) 183-185. See also Muchlinski, 'Holding Multinationals to Account: Recent Developments in English Litigation and the Company Law Review' (n 207) 173.

[338] Rühmkorf (n 40) 183-185; Hansmann and Kraakman (n 32) 1912; Muchlinski, 'Holding Multinationals to Account: Recent Developments in English Litigation and the Company Law Review' (n 207) 168-169.

[339] Bainbridge and Henderson (n 21) 59-60; Richard A. Posner, 'The Rights of Creditors of Affiliated Corporations' (1976) 43 University of Chicago Law Review 499, 502.

[340] See Stephen M Bainbridge, 'Privately Ordered Participatory Management: An Organizational Failures Analysis' (1998) 23 Delaware Journal of Corporate Law 979, 1055–1057.

[341] For a comprehensive critique of the unlimited liability system, see Muchlinski (n 39) 925-926.

[342] Leebron (n 46) 1601.

[343] ibid 1565-1650.

[344] Hansmann and Kraakman (n 32) 1879-1934.

[345] ibid 1892-1894. See also Xue Feng, 'Corporate Liability Towards Tort Victims in the Personal Injury Context' (Phd thesis, Queen Mary University of London 2018) 48-53.

[346] Leebron (n 46) 1605-1608. For an interesting discussion on the impact of pro rata unlimited liability of shareholders on the market, see Graeme G Acheson, Charles R Hickson, and John D Turner, 'Does Limited Liability Matter? Evidence From Nineteenth-Century British Banking' (2010) 6(2) Review of Law & Economics 247, 247-273.

the nineteenth and twentieth centuries, and the existence of such a system did not hinder the economic growth of this state.[347]

However, the pro rata system has various practical shortcomings. For example, because in certain cases individuals are able to obtain shares for non-cash consideration, imposing financial liability upon them might render the pro rata system highly arbitrary.[348] Moreover, such a system would arguably be ineffective in relation to controlling shareholders, who could dilute their shareholding in the subsidiary, but at the same time they would be able to retain control over the subsidiary through a minority interest.[349] In addition, given the large numbers of shareholders that certain companies have, the *pro rata* system would increase litigation costs for involuntary creditors,[350] and it would be very difficult, if not impossible, for the claimant to enforce pro rata liability of shareholders against foreign corporations for procedural reasons.[351]

On a different note, because involuntary creditors are poor risk-bearers and cannot bargain with the corporation,[352] numerous American scholars argue for this group of creditors to be given preference over the company's secured and unsecured creditors[353] when the company becomes insolvent.[354] According to the proponents of this approach, since voluntary creditors can protect themselves from potential losses more easily,[355] they are much better risk-bearers than involuntary creditors.[356] Additionally, this solution, unlike pro rata unlimited liability, would not suffer from various practical shortcomings, as it only concerns the basic relationship between

347 Blumberg (n 12) 597-599; Muchlinski (n 39) 926. Similar findings were reached by Patterson, see Mark R Patterson, 'Is Unlimited Liability Really Unattainable: Of Long Arms and Short Sales' (1995) 56 Ohio State Law Journal 815.

348 Henry G Manne, 'Our Two Corporation Systems: Law and Economics' (1967) 53.2 Virginia Law Review 259, 262.

349 Muchlinski (n 39) 926.

350 ibid; Manne (n 348) 262; Nina A Mendelson, 'Control-Based Approach to Shareholder Liability for Corporate Torts' (2002) 102 Columbia Law Review 1203, 1284-88.

351 Alexander (n 205) 429-431.

352 French (n 31) 608-609; Leebron (n 46) 1639-40; LoPucki (n 200) 1897-1898.

353 It is worth noting that in the UK, a company's employees are given preferential treatment on insolvency, see Insolvency Act 1986, Schedule 6 paras 9 and 10.

354 Leebron (n 46) 1643-1646; LoPucki (n 200) 1913; Barry E Adler, 'A World Without Debt' (1994) 72 Washington University Law Quarterly 811, 825-827; Price (n 46) 470; Rebecca J. Huss, 'Revamping Veil Piercing for All Limited Liability Entities: Forcing the Common Law Doctrine into the Statutory Age' (2001) 70(1) University of Cincinnati Law Review 95, 132-133; Hannoch Dagan, 'Restitution in Bankruptcy: Why All Involuntary Creditors Should be Preferred' (2004) 78 American Bankruptcy Law Journal 247, 277. For a comprehensive discussion of the corporate credit system, see Christopher M.E. Painter, 'Tort Creditor Priority in the Secured Credit System: Asbestos Times, the Worst of Times' (1984) 36 Stanford Law Review 1045, 1045-1085.

355 Huss (n 354) 133.

356 Posner (n 339) 503.

the specific groups of creditors.[357] However, giving preference to involuntary creditors on insolvency would mean that various debt-lending institutions, such as banks, would no longer be guaranteed repayment. Consequently, these institutions would likely charge extreme interest rates in order to compensate for the increased risk of non-payment, or would simply not be willing to lend money at all.[358] Such an outcome would have disastrous consequences for companies attempting to raise money through debt.[359] Thus, despite being theoretically sound, this approach would likely not work in practice.[360]

It is also argued that involuntary creditors would be afforded a better degree of protection under a control-based shareholder liability system.[361] Under this approach, joint and several liability would be imposed upon shareholders, who had the 'capacity to control' the company, and can thus be held responsible for the company's acts.[362] The 'capacity to control' would be established in cases, where a given shareholder possesses a large amount of stock in the company, or exercises actual control over that company.[363] Notably, this approach would not suffer from the shortcomings of the pro rata liability system, as it would be able to hold the company's controlling shareholders accountable for the wrongful acts of the company. Moreover, the economic benefits of limited liability would not be lost, as small shareholders, who did not exercise any control over the company, would be exempt from liability.[364]

It is worth noting that this approach would prove particularly useful in the context of corporate groups, which tend to profit the most from externalisation of risks.[365] Namely, according to Muchlinski, a legal presumption of parent responsibility should be introduced to challenge the problems existing under the current law on limited liability.[366] Such a presumption would arise based on the

[357] Price (n 46) 464.

[358] For a discussion of the ways in which secured creditors minimise risks of non-payment and the concept of secured credit in general, see Thomas H Jackson and Anthony T Kronman, 'Secured Financing and Priorities among Creditors' (1979) 88 Yale Law Journal 1143.

[359] This problem is particularly evident in the context of small companies, which prefer to opt against equity financing in order to avoid share dilution.

[360] Such a system has not in fact been implemented anywhere, see Robert K Rasmussen, 'Resolving Transnational Insolvencies Through Private Ordering' (2000) 98(7) Michigan Law Review 2252, 2269.

[361] Mendelson (n 350) 1271-1274. See also Jonathan Crowe, 'Does Control Make a Difference? The Moral Foundations of Shareholder Liability for Corporate Wrongs' (2012) 75(2) The Modern Law Review 159, 159-179.

[362] Mendelson (n 350) 1271-1272.

[363] ibid.

[364] ibid.

[365] Muchlinski (n 39) 918-920.

[366] ibid 923-924.

actual or potential control exercised by the parent company over the subsidiary.[367] Consequently, this control element would give the parent sufficient notice about the potential liability resulting from the acts of its subsidiary.[368] In addition, the onus of proof would be placed on the parent company to rebut the presumption by giving evidence of the independence of the subsidiary, for example, by proving that the third party entered into the transaction with the subsidiary having full knowledge that the parent's liability was limited.[369] This approach would therefore strike a fair balance between companies, their voluntary, and involuntary creditors. Namely, the company would, in appropriate circumstances, have the possibility of rebutting the presumption of liability by proving the independence of the subsidiary; the company's voluntary creditors would be able to assess their commercial risks, and thus they would have an opportunity to take necessary precautions; and the vulnerable involuntary creditors would have a chance of being adequately compensated for their losses, as it would be extremely difficult for the parent company to rebut the presumption of strict liability in relation to this particular group of creditors.[370] Furthermore, because the onus of proof would be on the parent company, this approach would significantly lower litigation costs for involuntary creditors;[371] high litigation costs are in fact one of the biggest shortcomings of the pro rata liability system. Moreover, the presumption of parent liability would enhance the clarity of the law as to the outcome of litigation, which would constitute a significant improvement compared to the current uncertain veil piercing approach.[372] Additionally, this solution would likely incentivise companies to internalise their risks and would consequently deter them from engaging in hazardous activities. Thus, the control-based presumption of parent liability would strike a fair balance between the interests of the various actors involved in the company's activity, and would be able to retain the economic benefits of limited liability.

Therefore, given the considerable benefits of this approach, the unjust outcomes in cases such as *Adams* could be avoided. However, because courts in the United Kingdom are very reluctant to disregard the *Salomon* principle,[373] such a tremendous change in the law would have to be introduced by Parliament.[374] In fact,

367 ibid 923-924.
368 ibid.
369 ibid 924.
370 ibid.
371 ibid.
372 ibid.
373 Lim (n 280) 483. See, in general, Alan Dignam and Peter B Oh, 'Disregarding the Salomon Principle: An Empirical Analysis, 1885–2014' (2019) 39(1) Oxford Journal of Legal Studies 16, 16-49.
374 Muchlinski (n 39) 924.

the importance of the *Salomon* case and the doctrine of limited liability cannot be overstated in an evaluation of the development of the UK's capitalist economy. That being said, given the slow transition process of the British economy from a pure profit-orientated system towards a more stakeholder-inclusive one,[375] this change might not be so far away as it seems today.[376]

V. Conclusion

At the end of the previous millennium, the Economist wrote that "the modern world is built on two centuries of industrialisation. Much of that was built by equity finance which is built on limited liability".[377] This is indeed true; limited liability has played a tremendous role in the economic development of the modern world. Namely, by limiting shareholders' personal exposure, limited liability incentivises people to invest in corporate entities and pursue various business endeavours, which in turn stimulates economic development.[378] In this regard, the doctrine is therefore rightly heralded as "the most important characteristic of the modern corporation".[379] The doctrine, however, is also rightly regarded as controversial.[380] Namely, limited liability allows companies to easily externalise their commercial risks, which exposes the vulnerable group of involuntary creditors to significant losses. This problem is particularly evident in the context of corporate groups, where parent companies use the corporate form to insulate themselves from liability for the acts of their subsidiaries. For those reasons, this article has attempted to answer the question of whether involuntary creditors are adequately protected by the current law.

In Part II, this article has analysed the development of the limited liability principle in the UK and has shown that the interests of involuntary creditors were not given adequate consideration at the time of its inception; potentially, the doctrine was never supposed to be applied in relation to this group at all. In Part III, this paper has briefly outlined the economic rationale behind limited liability and has analysed the modern protection mechanisms available to involuntary

[375] Evidenced, for instance, by the introduction of s.172 of the Companies Act 2006.

[376] See Andrew Keay, 'Moving Towards Stakeholderism - Constituency Statutes, Enlightened Shareholder Value, and More: Much Ado About Little' (2011) 22 European Business Law Review 1, wherein it was argued that this transition process cannot be achieved in a blink of an eye, and will likely take time.

[377] 'The Key to Industrial Capitalism: Limited Liability' *The Economist* (London, 23 December 1999) <www.economist.com/finance-and-economics/1999/12/23/the-key-to-industrial-capitalism-limited-liability> accessed 11 February 2021.

[378] Griffin (n 19) 99; Peterson (n 22) 63.

[379] Bainbridge and Henderson (n 21) 19.

[380] Ribstein (n 28) 81.

creditors, such as veil piercing, bypassing limited liability under tort law, and s.172(1) of the Companies Act 2006. It has been found that these mechanisms have numerous shortcomings and do not afford involuntary creditors with an adequate degree of protection. Consequently, Part IV of this paper has evaluated various alternative approaches to limited liability, which could potentially enhance the position of involuntary creditors. Among pro rata liability, giving preference to involuntary creditors on insolvency, and the control-based liability system coupled with the control-based presumption of parent liability, this paper argues for the implementation of the last of these approaches, as it would strike a fair balance between the interests of the various actors involved in a company's activity, and would retain the economic benefits of limited liability. Crucially, given the growing importance of stakeholders' interests in the UK, such a solution might potentially be introduced in the future. On a final note, the limited liability company was a brilliant invention. Similar to various technological novelties, however, once it is applied beyond its purpose, limited liability becomes dangerous.