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Research Article

LIMITED LIABILITY AND CORPORATE GOVERNANCE

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A R T I C L E I N F O

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A B S T R A C T

An Economic Analysis of Limited Shareholder Liability in Contractual Claims A number of arguments have been advanced in defense of limited liability for contractual claims. First, it saves negotiations costs because it is the liability arrangement which contractual parties generally prefer. If corporation law adopts as it as the default rule, contractual parties need not incur the time and the resources to negotiate for it. Second, limited liability saves monitoring costs. Under limited liability, monitoring of corporate managers will be mostly done by the creditors, which are generally assumed to have lower information costs than the shareholders. Third, corporate default risks rest on the creditors under limited liability, which is believed to be an efficient arrangement because creditors are better able to diversify their risks than shareholders. Lastly, limited liability is pivotal to the functioning of the capital markets.

Objectives

- To study the detailed view on limited liability
- To analyse it in the legal and economic perspectives

Source of Study

Primary sources: Newspapers
Journals
Books
Government orders

Secondary sources: E-source

INTRODUCTION

This paper evaluates the economic basis for limited liability in contractual claims and proposes the introduction of unlimited liability for such claims against closely held corporations. It argues that the existing justifications for limited liability are unconvincing, and that unlimited liability is an economically more efficient rule for these corporations in light of savings in monitoring costs and more efficient allocation of risks. It rejects the frequently made argument that limited liability is justified in contractual claims because the contractual counterparty had a prior opportunity to negotiate for modifications. This argument demonstrates a fundamental misunderstanding of the nature of the bargaining process between a corporation and its various groups of contractual creditors, many of which are simply not in a position to negotiate for modifications to the default rule.

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It further examines some of the implementation problems for unlimited liability and suggests possible solutions for them. Limited liability is one of the most firmly established rules of corporation law. Despite its relatively short lineage it only became widely accepted in the mid-nineteenth century its validity as a legal rule is rarely questioned outside of academic circles. The rule does occasionally admit exceptions. Under the veil piercing doctrine, courts hold shareholders responsible for the liabilities of the corporation. Veil piercing, however, generally requires some fraudulent or inequitable conduct, or blatant disregard for the integrity of the corporation that has resulted in harm to creditor interests. Absent these circumstances, there is no mistake that limited liability is the rule. Commentators have not embraced limited liability wholeheartedly, however. As early as the 1940s, Professor Berle propounded the concept of enterprise liability, arguing that members of a corporate group should be liable for each other's debts. Professor Landers resurrected this argument in the mid1970s and engaged in a spirited debate with thenProfessor Posner about the liability of a corporate parent for its wholly owned subsidiaries.Apart from Berle, Landers, and Blumberg, there has seemed to be a consensus that limited liability is a sound rule for contractual liabilities.

The Efficient Bargain Theory and Negotiation Costs

Bargaining Power and Negotiation Costs

One of the most commonly asserted justifications for the application of limited liability to contractual claims is what this author calls the efficient bargain theory. The crux of this theory is that the corporation and its various creditors would have bargained for limited liability even if it were not the default liability arrangement. Altering it would only create transaction costs, as parties would need to negotiate for it instead of being given it as the background corporation law rule. Therefore, the current rule is economically efficient. Professors Easterbrook and Fischel best capture the essence of this theory when they declared that "[t]here is little role for distributional arguments when all of the parties are in privity, for they can strike their own bargains and are apt to contract around any unwelcome rule purportedly designed for their benefit.This idea that corporation law, especially the limited liability rule, is a set of background rules which parties are free to contract around is echoed by then-Professor Posner, who asserts that "thus a corporation law is inefficient if it fails to provide standard implied contract terms that accord creditors the sorts of protections against default that they would normally insist upon in an express negotiation. Such a law can be criticized for creating avoidable costs of explicit negotiation. These views are not confined to the Chicago School. Other commentators less steeped in the law and economics tradition have expressed similar views.Adherents to the efficient bargain theory believe that the prevalence of limited liability in corporate contracts attests to the efficiency of the rule. If contractual parties preferred unlimited liability, more contracts providing for shareholder liability would be observed.If the default rule were shifted to unlimited liability, contractual parties would still prefer limited liability and negotiate for it.While negotiation may be relatively low-cost for financial creditors, it would be very burdensome for trade creditors and employees, who have high negotiation costs. Therefore, the legislature can save all involved substantial transaction costs by choosing limited liability as the default legal rule. The efficient bargain theory is based on the flawed premise that when two parties are in privity, they will bargain for whatever contractual term that is mutually beneficial to them. Therefore, their negotiation outcome must represent their best interests.The only relevant concern in the design of legal rules is to minimize the transaction costs that the parties incur to reach this outcome. Little empirical evidence exists that suggests that creditors of a corporation prefer limited liability. In fact, such a preference would seem counter-intuitive. Holding interest rate constant, one would expect creditors to prefer the best credit protection possible, which is available under unlimited liability.The reality is that even when two parties have an opportunity to negotiate, they will not obtain the contractual terms that they both desire. In most contractual negotiations, the two parties have antagonistic interests, as they try to maximize their benefits from the contract. A seller seeks to sell its product at a higher price, while the buyer vies for a lower price. Likewise, a seller who sells goods to a corporation on credit seeks assurances that it will be paid under all circumstances, while the buyer strives to limit the credit protection it gives to the seller.A party with greater bargaining power is more likely to reach the outcome it desires. Bargaining power is circumstance-specific and depends on a host of factors such as the availability and accessibility of alternatives, the importance of the contract to the parties, the presence and number of competitors for the contractual opportunity, etc. Most important for our present purpose, bargaining power is crucially dependent on the background legal rule of the negotiation, namely limited liability.The efficient bargain theory overlooks how the position of the default legal rule affects the parties' respective bargaining powers and negotiations costs, which in turn may change the negotiation outcome. This relationship is best illustrated by a numerical example. A party will incur the negotiation costs necessary to secure the desired negotiation outcome so long as the expected benefit from such an outcome exceeds the negotiation costs.The expected benefit of the negotiation depends on the likelihood of success. For instance, assume that a supplier is contemplating whether to negotiate for a personal guarantee from the controlling shareholder for the payment of certain goods in the amount of $50,000. He estimates the default risk to be 2%. Assume that in the event of default, the corporation will miss the entire payment. Meanwhile, the controlling shareholder has sufficient personal assets to cover this $50,000 liability. A personal guarantee from the controlling shareholder will hence be worth $1,000 to the supplier. Furtherassume that the supplier believes that he has a 20% chance of obtaining the personal guarantee through negotiation and that the costs of negotiation are $400.

Corporate Governance

Corporate governance is most often viewed as both the structure and the relationships which determine corporate direction and performance. The board of directors is typically central to corporate governance. Its relationship to the other primary participants, typically shareholders and management, is critical. Additional participants include employees, customers, suppliers, and creditors. The corporate governance framework also depends on the legal, regulatory, institutional and ethical environment of the community. Whereas the 20th century might be viewed as the age of management, the early 21st century is predicted to be more focused on governance. Both terms address control of corporations but governance has always required an examination of underlying purpose and legitimacy.

Corporate governance-academic definitions

The act of steering, guiding and piloting-describes what boards [should] do when in session. It does not describe and is not a proxy for the board itself, nor any other party or activity outside the boardroom. Regulators (to set rules), proxy advisers (lobbyists on behalf of shareholders and other interests), and shareholder meetings (communications) are all important, but none is corporate governance. "how investors get the managers to give them back their money" (Shleifer & Vishny, "A Survey of Corporate Governance, corporate governance system is the combination of mechanisms which ensure that the management (the agent) runs the firm for the benefit of one or several stakeholders (principals). Such stakeholders may cover shareholders, creditors, suppliers, clients, employees and other parties with whom the firm conducts its business.

…. deals with the conflicts of interests between the providers of finance and the managers; the shareholders and the stakeholders; different types of shareholders (mainly the large shareholder and the minority shareholders); and the prevention or mitigation of these conflicts of interests.

Corporate governance-legal definitions

Generally, corporate governance refers to the host of legal and non-legal principles and practices affecting control of publicly held business corporations. Most broadly, corporate governance affects not only who controls publicly traded corporations and for what purpose but also the allocation of risks and returns from the firm's activities among the various participants in the firm, including stockholders and managers as well as creditors, employees, customers, and even communities. However, American corporate governance doctrine primarily describes the control rights and related responsibilities of three principal groups:

1. the firm's shareholders, who provide capital and must approve major firm transactions,
2. the firm's board of directors, who are elected by shareholders to oversee the management of the corporation, and
3. the firm's senior executives who are responsible for the day today operations of the corporation.

As the Delaware Supreme Court has stated, "the most fundamental principles of corporate governance are a function of the allocation of power within a corporation between its stockholders and its board of directors.

In broad terms, corporate governance refers to the way in which a corporations is directed, administered, and controlled. Corporate governance also concerns the relationships among the various internal and external stakeholders involved as well as the governance processes designed to help a corporation achieve its goals. Of prime importance are those mechanisms and controls that are designed to reduce or eliminate the principal-agent problem.

… is a field in economics that investigates how to secure/motivate efficient management of corporations by the use of incentive mechanisms, such as contracts, organizational designs and legislation. This is often limited to the question of improving financial performance, for example, how the corporate owners can secure/motivate that the corporate managers will deliver a competitive rate of return.

Principles

Contemporary discussions of corporate governance tend to refer to principles raised in three documents released since 1990: The Cadbury Report (UK, 1992), the Principles of Corporate Governance (OECD, 1999, 2004 and 2015), the Sarbanes-Oxley Act of 2002 (US, 2002). The Cadbury and Organisation for Economic Co-operation and Development(OECD) reports present general principles around which businesses are expected to operate to assure proper governance. The Sarbanes-Oxley Act, informally referred to as Sarbox or Sox, is an attempt by the federal government in the United States to legislate several of the principles recommended in the Cadbury and OECD reports.

- ***Rights and equitable treatment of shareholders****:* Organizations should respect the rights of shareholders and help shareholders to exercise those rights. They can help shareholders exercise their rights by openly and effectively communicating information and by encouraging shareholders to participate in general meetings.
- ***Interests of other stakeholders****:* Organizations should recognize that they have legal, contractual, social, and market driven obligations to non-shareholder stakeholders, including employees, investors, creditors, suppliers, local communities, customers, and policy makers.
- ***Role and responsibilities of the board***: The board needs sufficient relevant skills and understanding to review and challenge management performance. It also needs adequate size and appropriate levels of independence and commitment.
- ***Integrity and ethical behavior****:* Integrity should be a fundamental requirement in choosing corporate officers and board members. Organizations should develop a code of conduct for their directors and executives that promotes ethical and responsible decision making.
- ***Disclosure and transparency****:* Organizations should clarify and make publicly known the roles and responsibilities of board and management to provide stakeholders with a level of accountability. They should also implement procedures to independently verify and safeguard the integrity of the company's financial reporting. Disclosure of material matters concerning the organization should be timely and balanced to ensure that all investors have access to clear, factual information.

Regulations

Corporations are created as legal persons by the laws and regulations of a particular jurisdiction. These may vary in many respects between countries, but a corporation's legal person status is fundamental to all jurisdictions and is conferred by statute. This allows the entity to hold property in its own right without reference to any particular real person. It also results in the perpetual existence that characterizes the modern corporation. The statutory granting of corporate existence may arise from general purpose legislation (which is the general case) or from a statute to create a specific corporation, which was the only method prior to the 19th century.

In addition to the statutory laws of the relevant jurisdiction, corporations are subject to common law in some countries, and various laws and regulations affecting business practices. In most jurisdictions, corporations also have a constitution that provides individual rules that govern the corporation and authorize or constrain its decision-makers. This constitution is identified by a variety of terms; in English-speaking jurisdictions, it is usually known as the Corporate Charter or the [Memorandum] and Articles of Association. The capacity of shareholders to modify the constitution of their corporation can vary substantially.

The U.S. passed the Foreign Corrupt Practices Act (FCPA) in 1977, with subsequent modifications. This law made it illegal to bribe government officials and required corporations to maintain adequate accounting controls. It is enforced by the U.S. Department of Justice and the Securities and Exchange Commission (SEC). Substantial civil and criminal penalties have been levied on corporations and executives convicted of bribery. The UK passed the Bribery Act in 2010. This law made it illegal to bribe either government or private citizens or make facilitating payments (i.e., payment to a government official to perform their routine duties more quickly). It also required corporations to establish controls to prevent bribery.

Organisation for Economic Co-operation and Development principles

One of the most influential guidelines on corporate governance are the G20/OECD Principles of Corporate Governance, first published as the OECD Principles in 1999, revised in 2004 and revised again and endorsed by the G20 in 2015. The Principles often referenced by countries developing local codes or guidelines. Building on the work of the OECD, other international organizations, private sector associations and more than 20 national corporate governance codes formed the United Nations Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR) to produce their Guidance on Good Practices in Corporate Governance Disclosure. This internationally agreed benchmark consists of more than fifty distinct disclosure items across five broad categories:

- Auditing
- Board and management structure and process
- Corporate responsibility and compliance in organization
- Financial transparency and information disclosure
- Ownership structure and exercise of control rights

The OECD Guidelines on Corporate Governance of State-Owned Enterprises are complementary to the G20/OECD Principles of Corporate Governance, providing guidance tailored to the corporate governance challenges unique to state-owned enterprises.

Stock exchange listing standards

Companies listed on the New York Stock Exchange (NYSE) and other stock exchanges are required to meet certain governance standards. For example, the NYSE Listed Company Manual requires, among many other elements:

- Independent directors: "Listed companies must have a majority of independent directors...Effective boards of directors exercise independent judgment in carrying out their responsibilities. Requiring a majority of independent directors will increase the quality of board oversight and lessen the possibility of damaging conflicts of interest." (Section 303A.01) An independent director is not part of management and has no "material financial relationship" with the company.
- Board meetings that exclude management: "To empower non-management directors to serve as a more effective check on management, the non-management directors of each listed company must meet at regularly scheduled executive sessions without management." (Section 303A.03)
- Boards organize their members into committees with specific responsibilities per defined charters. "Listed companies must have a nominating/corporate governance committee composed entirely of independent directors." This committee is responsible for nominating new members for the board of directors. Compensation and Audit Committees are also specified, with the latter subject to a variety of listing standards as well as outside regulations.

Benefits of Corporate Governance

1. Good corporate governance ensures corporate success and economic growth.
2. Strong corporate governance maintains investors' confidence, as a result of which, company can raise capital efficiently and effectively.
3. It lowers the capital cost.
4. There is a positive impact on the share price.
5. It provides proper inducement to the owners as well as managers to achieve objectives that are in interests of the shareholders and the organization.
6. Good corporate governance also minimizes wastages, corruption, risks and mismanagement.
7. It helps in brand formation and development.
8. It ensures organization in managed in a manner that fits the best interests

CONCLUSION

This Article proposes the adoption of unlimited liability for closely held corporations. Given the venerable status of limited liability and the powerful constituencies in support of it, the political resistance to change is likely to be overwhelming. In light of the expected resistance to reform, it is important to choose the most promising avenue for it. There are two possible avenues, one through contract law and the other through corporation law. States will have few incentives to amend their corporation law statutes.Unless there is a concerted effort on the part of a majority ofstates to enact this reform, unilateral introduction will simply result in the relocation of closely held corporations to limited liability states. This is perhaps the reason that Hansmann and Kraakman suggest that their reform proposal be introduced under state tort law. States have much greater interest in ensuring that their tort judgments are fully enforced, and are therefore more willing to consider introducing unlimited liability. However, contract law does not offer the same promising avenue for reform. The governing law for a tort is the law of the state in which it takes place. In contrast, contractual parties are free to choose whichever state's contract law govern their contract. What this means is that the party with the greater bargaining poweris likely to dictate the choice of law. This would render the proposal in this Article meaningless, as it would merely transpose the choice of liability rule from a corporation law issue to a choice of law issue. Therefore, for the proposal in this Article to be effective, it needs to be implemented through corporation law. Moreover, implementing unlimited liability through corporation law allows judgment collection to be done through an assessment mechanism, which avoids many of the procedural obstacles for unlimited liability identified by commentators.The proposal presented in this Article is no doubt controversial. Past commentators have argued for unlimited liability for corporate torts and enterprise. An Economic Analysis of Limited Shareholder Liability in Contractual Claimsliability within a corporate group, but have not suggested a general rule of unlimited liability for contractual claims in closely held corporations. Given the primacy of limited liability as a corporation law rule, and the powerful constituencies in support of it, the likelihood of this proposal's enactment is admittedly low.It is hoped that this

Article will at least spur efforts to reexamine the current theoretical consensus on limited liability for corporate contractual liabilities. It is also hoped that this Article has offered some useful criticisms of the theoretical basis for limited liability and the argumentation commonly found in the existing literature to demonstrate the efficiency of legal rules. In particular, it is unsound to assume that the outcomes we observe must represent the most efficient state of affairs or else the parties can negotiate for a different outcome. There are many reasons that such an outcome may not be reached.

The imbalance of bargaining power, combined with an unfavorable default legal rule, often conspires to preventthe weaker party from negotiating for its desired outcome. Negotiation costs are asymmetrically aligned, and the position of the default legal rule affects negotiation costs. Moreover, it is important to remember that limited liability was not adopted because it was economically efficient. It was adopted to facilitate the nation's economic development, even though it results in externalization of business costs. If contractual parties cannot freely negotiate around it, there is no reason to infer its efficiency from its continual prevalence. This mode of argumentation of presumptive efficiency is not only found in corporation law. It is commonplace in other areas of market regulation such as antitrust law and securities law. In securities regulation, thereis the efficient market hypothesis, which has attracted a considerable number of detractors after the recent financial crisis. In antitrust law, some commentators have argued against government intervention on the grounds that firms know best what is the most economically efficient for them and the market. If consumers or upstream and downstream firms are unhappy with what is being offered, they can always choose another competitor. As is the case with the efficient bargain justification for limited liability, the situation is often more complicated than is assumed. The tendency to presume the efficiency of the prevailing practice must be viewed with a critical eye and evaluated against a more nuanced understanding of commercial realities. Only then will legal rules create truly efficient outcomes for society.

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