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Limited Liability: Large Company Theory and Small Firms

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Current enthusiasm for the 'enterprise culture' results in strong support for easy access to limited liability forms of business organisation. This has manifested itself in the creation of new limited liability vehicles such as the LLC and the LLP. The UK Company Law Review is examining ways of enhancing the attractiveness of the limited liability company to small business owners. This article examines the claims made for the 'efficiency' of limited liability and the applicability of these claims to small firms. It raises the importance of taking into account public policy issues beyond economic efficiency when considering the degree of risk taking and shifting to be encouraged. The article concludes that, although it is difficult to find rational methods of restricting access to limited liability, it does not follow that limited liability should be positively encouraged for all small firms. It is important to signal the limitations of limited liability.

Introduction

New limited liability forms of business organisation are in vogue. Limited liability is widely regarded as a mechanism that encourages entrepreneurship and makes a major contribution to the law of business organisations.[1] Popular and political sentiment proclaim: 'the more limited liability the better'.[2] In the USA, the Limited Liability Partnership (LLP) and the Limited Liability Company (LLC) have emerged over recent years as frequently used and strongly supported new legal forms of organisation. The UK is following suit, with its own LLP, originally intended for the regulated professions only, but now to be available to all types of user.[3] The Company Law Review Steering Group in the UK is working on the

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1 For some examples of this contention see J. Freedman and M. Godwin, 'Incorporating the Micro Business' in A. Hughes and D.J. Storey (eds), *Finance and the Small Firm* (London: Routledge, 1994) (hereafter Freedman and Godwin (1994)); A. Hicks, 'Corporate Form: Questioning the Unsung Hero' [1997] JBL 306.

2 For recent pronouncements and comments to this effect, see ns 17, 38, 132 and text to n 66 below.

3 The Limited Liability Partnerships (LLP) Bill was introduced into the House of Lords in November 1999. See also Department of Trade and Industry (DTI), *Limited Liability Partnerships Draft Regulations: A Consultation Document* URN 99/1025 (London: DTI, 1999); Trade and Industry Committee, *Fourth Report Draft Limited Liability Partnership Bill* HC 59 (1999) para 38; J. Freedman and V. Finch, 'Limited Liability Partnerships: Have Accountants Sewn up the "Deep Pockets" Debate?' 422 [1997] JBL 387; A. Griffiths, 'Professional Firms and Limited Liability: An

premise that access to limited liability should be unrestricted and attractive to small business owners.[4]

The objective of this article is to question the notion that *easy* availability of limited liability for small firms is necessarily a desirable feature of a system of business organisations. The purpose here is purely to examine the theoretical arguments on limited liability and their application to small, owner managed firms. The empirical evidence, as well as other aspects of the legal needs of small firms, are reviewed elsewhere.[5] This article does not consider whether internal governance needs might justify the introduction of specialist limited liability legal forms for small firms. This is an important question, but the preliminary issue, dealt with here, is to consider the importance of making limited liability widely available to small, closely held firms.[6]

The first part of this article poses some broad questions about the tests to be applied in assessing the value of limited liability for small firms and suggests that economic efficiency must be weighed in the balance with other factors. The second part discusses the trend towards extension of limited liability through new legal vehicles or deregulation of existing legal forms. It introduces the USA debate on LLCs in order to provide context for the later theoretical discussion, which is based in part on literature arising from the surge of interest in the applicability of limited liability to small firms in the USA inspired by the LLC. The current UK position on limited liability for small firms is also outlined. The third part of the article discusses the debate on limited liability for firms in general. It shows that the economic advantages of limited liability are now being questioned in some contexts and are, in any event, unconvincing when applied to small, closely held companies. This part goes on to describe the difficulties encountered in restricting access to limited liability to those firms for which such a regime does appear to be suitable.

The fourth part of this article considers the application of economic efficiency tests to LLCs. It questions whether the legislative popularity of the LLC in the USA can be attributed to the characteristic of limited liability rather than other factors. It argues that the development and rapid uptake of the LLC in the USA is not in itself an indication that limited liability is efficient for small firms, either for the owners or the community more generally. In part five it is concluded that limited liability is not desirable in all circumstances, whether judged by economic or non-economic tests. It is difficult to find a rational method of restricting access to limited liability forms of business organisation, but it does not follow that

Analysis of the Proposed Limited Liability Partnership' [1998] CfiLR 157; A. Griffiths, 'Structuring the Law of Private Limited Companies Through the Next Millennium' in D. Milman (ed), *Regulating Enterprise* (Oxford: Hart Publishing, 1999).

4 The Company Law Review Steering Group, *Modern Company Law for a Competitive Economy: The Strategic Framework*, (London: DTI, 1999) (hereafter *The Strategic Framework*) para 5.2.10 and question 10 and see text to n 66 below.

5 DTI *Company Law Review: The Law Applicable to Private Companies* URN 94/529 (London: DTI, 1994); J. Freedman 'Small Business and the Corporate Form: Burden or Privilege?' (1994) 57 MLR 555 (hereafter Freedman (1994)); Freedman and Godwin (1994), n 1 above; Andrew Hicks, Robert Drury and Jeff Smallcombe, *Alternative Company Structures for the Small Business* (London: Chartered Association of Certified Accountants, 1995) (hereafter ACCA Report) and contributions from a number of authors in Barry A. K. Rider and Mads Andenas (eds.), *Developments in European Company Law, Vol 2/1997: The Quest for an Ideal Legal Form for Small Businesses* (London: Kluwer Law International, 1999); *The Strategic Framework*, *ibid.*

6 The term 'closely held firms' is used here to mean firms which are owner managed with few or no outside investors. Further work is under way on the internal governance issues as part of the Company Law Review – see *The Strategic Framework*, *ibid.*

limited liability should be positively encouraged for all types of firm. The creation of new limited liability vehicles, or attempts to further increase use of existing limited liability forms by small firms, may encourage firms which were previously run as sole traderships and general partnerships to take on the mantle of limited liability. Such developments could mislead business owners about the value of limited liability for themselves as well as sending out unfortunate signals that both undermine the importance of personal responsibility for business actions and result in transfers of risk to those least able to bear them.

Limited liability: economic analysis and alternative tests

Much of the literature discussed below evaluates limited liability on the basis of economic analysis. This approach measures limited liability in terms of economic efficiency,[7] posing three central questions. First, does limited liability allocate risk to those most capable of bearing it? Secondly, does it result in optimal levels of risk taking, ensuring that ventures with a net positive value to society, but not others, are undertaken? Thirdly, does it reduce transaction and monitoring costs? In this literature, these measures of 'efficiency' operate within an overall framework of profit maximisation. All forms of satisfaction can be incorporated into this concept, but they must be given a value in monetary terms. This may lead to many interests and values being hidden or cancelled out simply in order to produce a workable model.[8] Economic analysis assumes that a society with greater wealth, measured in terms of profit maximisation, is necessarily better off than a society with less.[9] Self-interest remains the guiding force in this world: all is explained through this medium.[10] In broad terms the test of efficiency used by these analysts (the Kaldor-Hicks test) is whether the aggregate benefits of the system exceed the costs to such an extent that the winners *could* compensate the losers.[11]

As will be seen below, even accepting the measures and approach of economic analysis, there are strong arguments in support of the view that limited liability is not efficient for the smallest firms. In addition, it is argued here that efficiency is not the only test to be applied. Other values must also be weighed in the balance.[12] These other values should be seen as moderating the efficiency test, not simply contributing to it, although they are sometimes explained away in terms of efficiency by the economic analysts.[13] These underlying considerations, reflecting society's values, need to be exposed and discussed in order to ensure that legal policy does properly reflect moral and political criteria. The danger is that they will be lost under an all subsuming cloak of 'efficiency'. There may come a point at

7 For the different types of efficiency and generally an excellent discussion of the relevance of economic analysis to company law see S. Deakin and A. Hughes, 'Economics and company law reform: a fruitful partnership?' (1999) 20 *Company Lawyer* 212 (hereafter Deakin and Hughes). See also S. Deakin and A. Hughes, 'Economic Efficiency and the Procedularisation of Company Law' [1999] CfiLR 169; C.W.Maughan and S.F.Copp, 'Company law reform and economic methodology revisited' (2000) 21 *Company Lawyer* 14.

8 G Lawson, 'Efficiency and Individualism' (1992) *Duke Law Journal* 42:1 53.

9 R. Dworkin *A Matter of Principle* (Oxford: Clarendon Press, 1986) 237.

10 R. Posner, *Economic Analysis of Law* (New York: Aspen Law and Business, 5th ed, 1998) 3.

11 Note that there does not need to be actual compensation. Kaldor-Hicks efficiency is easier to achieve than Pareto efficiency, which would require someone to be better off and no-one to be worse off: see Jules L Coleman, *Markets, Morals and the Law,* (Cambridge: CUP, 1988) chapter 2; Brian R. Cheffins, *Company Law: Theory, Structure, and Operation* (Oxford: Clarendon Press, 1997) 14–16.

12 Deakin and Hughes, n 7 above, 217.

13 Deakin and Hughes in CfiLR, n 7 above, 171.

which we are prepared to choose certain principles, such as 'fairness' over and above profit maximisation: 'Efficient solutions are not always just solutions. The policy maker is concerned not only with the optimal allocation of resources but also with the appropriate distribution of resources as determined by moral and political criteria. . .'.[14]

In the context of limited liability for owners of businesses, exclusive emphasis on efficiency may mask the consequences of risk shifting for certain groups who are the losers at the expense of others. Though there may be overall Kaldor-Hicks efficiency, it would be possible to decide that the distributive effect of limited liability in some circumstances was undesirable on policy grounds of fairness or because it breached principles of integrity or personal responsibility.[15] Different views might be taken upon the extent to which risk taking should be encouraged. It has been argued that 'liability limitations artificially distance individuals from the real life effects of the enterprise in which they invest, thus decreasing their acknowledged personal responsibility'.[16] There is a current political emphasis on encouraging 'a culture of enterprise' and entrepreneurship.[17] Government currently wishes to encourage risk taking, but presumably would wish to draw the line at irresponsible risk taking. Where to draw that line may not be only a question of efficiency but also of social values.

Small firms are seen as an engine of the economy, which should have access to limited liability to enable them to grow. One of the problems with this enthusiasm for entrepreneurship is that it can give a distorted image of the small business sector, which contains many firms which will never provide very much employment beyond that for their owners, nor much economic growth. This is not a matter for criticism, since these firms have a real value for their owners and users.[18] Yet it is important to note that the vast majority of firms in existence are very small,[19] and do not wish to expand.[20] Currently, the great majority of firms in

14 A. Ogus, 'Economics, Liberty and the Common Law' (1980) 15 *Journal of the Society of Public Teachers of Law* 42. See also N. Duxbury, *Patterns of American Jurisprudence* (Oxford: Clarendon Press, 1995) 394–419.

15 Robert Flannigan, 'The Economic Structure of the Firm' (1995) 33 *Osgoode Hall Law Journal* 105, 150.

16 T. Gabaldon, 'The Lemonade Stand: Feminist and Other Reflections on the Limited Liability of Corporate Shareholders' (1992) *Vanderbilt Law Review* 1387, especially 1429; K. Hall, 'Starting from Silence: The Future of Feminist Analysis of Corporate Law' (1995) 7 *Corporate and Business Law Journal* 149.

17 See, for example, DTI White Paper, *Our Competitive Future: Building the Knowledge Driven Economy* Cm 4176 (1998) para 2.7 'The Government's aim is to create a broadly-based entrepreneurial culture, in which more people of all ages and backgrounds start their own business'; Budget Statement 9 March 1999, [1999] STI 381.

18 For an elaboration of this argument see J. Freedman 'The Quest for an Ideal Form for Small Businesses – A Misconceived Enterprise?' in Barry A. K. Rider and Mads Andenas (eds), n 5 above (hereafter Freedman (1999)), 11.

19 There were 1.32 million companies on the Companies Register at the end of 1997/98 but only around 12,000 were public limited companies and only about 2,450 had their shares listed on the Stock Exchange: *The Strategic Framework* n 4 above, Annex D. Of course this is the majority only by number. By other measures such as turnover and employment the balance is different. Only about 740,000 of the companies on the register are actively trading. Of these, around 506,000 have fewer than five employees but they provide only 5.8 per cent of all employment provided by companies. The 3,380 companies with 500 or more employees provide 54 per cent of employment with companies – SME Statistics Unit, *SME Statistics for the United Kingdom 1998* (London: DTI, 1999). Nevertheless the weight of numbers of small private companies is overwhelming. It also seems that the majority of trading companies have only one or two shareholders (ICC Company Shareholders Database Breakdown prepared for the Company Law Review, 1999 <http://www.dti.gov.uk/cld/review.htm>).

20 C. Hakim, 'Identifying Fast Growth Small Firms' (1989) *Employment Gazette* 29; C. Gray, 'Growth-Orientation and the Small Firm' in K.Caley et al (eds) *Small Enterprise Development Policy and Practice in Action* (London: Paul Chapman Publishing Ltd., 1992).

the UK have unlimited liability and no employees.[21] Many small businesses are in fact providing only services or labour and could not be described as forms of entrepreneurship under most definitions of that word.[22]

The political rhetoric surrounding small businesses can lead to an undue emphasis on limited liability because this will be of value to those that do grow. As a result, the importance of catering for the non-growth business can be forgotten and growth may be highlighted at the expense of other values, such as the need to protect third parties (including other small businesses). In sum, there is an enthusiasm for limited liability as a mechanism for encouraging entrepreneurship, which does not always take into account the facts relating to the small business sector. This is an enthusiasm that is clearly present in current legal debates on business organisations.

Extending limited liability: LLCS, LLPS and deregulation

In the USA, the issue of limited liability for small firms has become topical owing to the development of new legal forms of organisation such as the LLC and the LLP. This has produced a surge of interest and much literature on the efficiency of limited liability in small firms. This part of this article shows how the development of the LLC was driven by a combination of tax considerations and inter-state competition. Nevertheless, there are some who argue that the spread of the LLC supports the notion that limited liability is efficient for very small firms. In the UK too there are strong proponents of the view that limited liability is efficient for the smallest firms.

The name of the USA limited liability company or LLC is confusing for UK readers, since this vehicle is not a corporation, although it has a legal entity distinct from its members. Great claims have been made about the theoretical basis of the LLC as a new form of business organisation for small firms wishing to combine limited liability with a partnership style of internal governance.[23] In fact, however, it seems to have been largely modelled on existing USA vehicles and tax driven in its origins.[24] Moreover, it was originally introduced at the behest of a large business.[25] There is no limit on the number of members in an LLC, nor any other size cap.[26]

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21 Twenty per cent of UK firms are companies, 61 per cent sole proprietorships and 19 per cent partnerships. Of the 3.7 million businesses in the UK in 1998, over 2.3 million were 'size class zero' businesses (sole traders or partners without employees). SME Statistics 1999, n 19 above. The US statistics also seem to show that large numbers of the self-employed act in a 'routinized service capacity' see Gabaldon, n 16 above, fn 1433.

22 On entrepreneurship see P. Moran 'Personality Characteristics and Growth-orientation of the Small Business Owner-manager' (1998) 16 (63) *International Small Business Journal* 17.

23 A number of different models are claimed for the LLC, from the Panamanian *limitadas* to the German *Gesellschaft mit besechrankter Haftung* (GmbH): Richard A. Booth, 'The Limited Liability Company and the Search for a Bright Line Between Corporations and Partnerships' (1997) 32 *Wake Forest Law Review* 79; Ernest A. Seemann, 'The Florida Limited Liability Company: An Update' (1990) 14 *Nova Law Review* 900; CCH, *Guide to Limited Liability Companies* (Chicago: CCH, 4th ed, 1997) (hereafter CCH Guide).

24 William J. Carney, 'Limited Liability Companies: Origins and Antecedents' (1995) 66 *University of Colorado Law Review* 855.

25 The Hamilton Brothers Oil Company approached Wyoming to create legislation permitting such a vehicle: Carney, *ibid* 857.

26 The rapid increase in LLCs therefore probably represents conversions from limited partnership and corporate form as well as from general partnerships and sole tradership: Larry E. Ribstein 'Statutory Forms for Closely Held Firms: Theories and Evidence from LLCs' (1995) 73 WULQ 369 (hereafter Ribstein (1995)).

In the US, corporations are subject to double taxation, taxed both at corporate and shareholder level,[27] so there are clear advantages to being taxed as an unincorporated firm.[28] The LLC is a hybrid entity designed to combine the tax advantages of partnership with the benefits of limited liability. Its favourable tax treatment was achieved by ensuring that it had more non-corporate than corporate characteristics under a 'corporate resemblance test' evolved in case law.[29] At the same time its designers tried to mirror corporate characteristics as closely as possible.[30] Once the Internal Revenue Service (IRS) confirmed, in 1988,[31] that the LLC could attain the tax transparency of an unincorporated firm, its fiscal status became the driving force behind the rapid spread of this new legal form[32] and it is now available in every state of the US.[33] Although there is now some harmonisation by virtue of the Uniform Limited Liability Company Act (ULLCA),[34] variations remain.

Initially, not all LLCs met the IRS conditions for partnership classification. It depended on their precise drafting. This resulted in uncertainty and cost, both for the IRS and the taxpayer. Eventually, so-called 'check-the box' regulations were introduced.[35] Under these provisions, certain entities, including all corporations created by state and federal statutes, are classified as taxable as corporations. All other entities may choose their desired classification. This has rendered the old classification factors less important, leading to a relaxation of the LLC statutes.[36]

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27 Boris I. Bittker and James S. Eustice, *Federal Income Taxation of Corporations and Shareholders* (Boston: Warren, Gorham & Lamont, 5th ed., 1987); Internal Revenue Code §§ 11, 301, 316. Corporations satisfying certain conditions can avoid double taxation by electing to be taxed under Sub-chapter S of the Inland Revenue Code. The conditions for this were restrictive when the LLC was first introduced- see John K. McNulty, *Federal Income Taxation of S Corporations*, (New York: Foundation Press, 1992) although they were relaxed by the *Small Business Job Protection Act* 1996 (PL 104–188).

28 Charles E. McLure, *Must Corporate Income be Taxed Twice?* (Washington DC: The Brookings Institution,1979); Alvin Warren, 'The Relation and Integration of Individual and Corporate Income Taxes' (1981) 94 Harv L Rev 719; David G. Davies, *United States Taxes and Tax Policy*, (Cambridge, Cambridge University Press, 1986); United States Treasury Department, *Integration of the Individual and Corporate Tax Systems – Taxing Business Once* (Washington: US Treasury, 1992); John K. McNulty, 'Corporate Income Tax Reform in the United States: Proposals for Integration and Individual Income Taxes and International Aspects' (1994) 12 *International Tax & Business Lawyer* 161.

29 The four fundamental corporate characteristics were continuity of life, centralised management, limited liability and free transferability of interests: *Morrissey* v *Commissioner* 296 US 344 (1935); IRC § 7701 and Treas. Regulations promulgated thereunder (§301.7701 as it then was): see John K. McNulty, 'A Tax Experiment in the United States Federal System: Limited Liability Companies as an Escape from the Unintegrated Corporate Income Tax', in Joachim Lang (ed), *Die Steuerrechts-Ordnung in der Diskussion – Festchrift for Klaus Tipke* (Otto Schmidt: Koln, 1995).

30 Robert B. Thompson 'The Limits of Liability in the New Limited Liability Entities' (1997) 32 *Wake Forest Law Review* 1, 32.

31 Rev. Rul. 88–76

32 Ribstein (1995), n 26 above.

33 CCH Guide, n 23 above.

34 National Conference of Commissioners on Uniform State Laws, *Uniform Limited Liability Company Act* (1995) adopted by the American Bar Association in 1996. Subsequent amendments have been made to accommodate changes in the tax rules (CCH Guide, *ibid* 5).

35 T.D. 8697. Treas. Regs. § § 301.7701-1 to -3, *Simplification of Entity Classification Rules*, 61 Fed. Reg. 66,584 (1996). CCH Guide, n 23 above, 76; Roger F. Pillow, John G. Schmalz and Samuel P. Starr, 'Simplified Entity Classification Under the Final Check-the Box Regulations' (1997) *Journal of Taxation* 197; Larry E. Ribstein and Mark A. Sargent (eds) 'Check the Box and Beyond: The Future of Limited Liability Entities' (1997) 52 *The Business Lawyer* 605 (hereafter Ribstein and Sargent); CCH, 'Tax Focus – "Check – the Box" Regs Simplify Entity Classification' (1997) 84 *Standard Federal Tax Report* No. 11, Issue 13.

36 Thompson, n 30 above.

Nevertheless, the influence of the original tax requirements remains apparent and the tax status of the LLC continues to be a basic attraction.

Despite being tax driven initially, the spread of the LLC in the USA has led to claims about the efficiency and value of this new vehicle. These claims go to the heart of the more general debate discussed in this article about the role of limited liability for owner-controlled, private companies ('closely-held' firms or close corporations). The proponents of extended limited liability in the USA argue that the arrival of the LLC, together with the registered LLP, may mark the end of general partnerships and the close corporation, or, at least, much diminished use of those forms.[37] One of this group, Larry Ribstein, even argues for the limited liability sole proprietorship (LISP).[38] He argues that increased access to limited liability is welcome since this is an efficient default rule even for small businesses.[39]

Ribstein argues that the partnership form held an attraction for many firms on the margin only because of the regulatory costs of limited liability, including double corporate taxation, and limitations on organisational form.[40] These are costs that are reduced or dispensed with in the LLC. The tax problem is eliminated. The LLC is flexible in terms of its internal governance regime, which is usually left almost entirely to an operating agreement that does not have to be publicly disclosed,[41] although the statutes of most states and the ULLCA provide default provisions.[42] Like the UK partnership agreement, the operating agreement is of great importance, yet not normally mandatory. The LLC has no minimum capital requirement and may now be formed by one member in many states. Members normally have the right to manage and control the LLC, subject to contrary agreement.[43]

37 For example, Larry E. Ribstein 'The Deregulation of Limited Liability and the Death of Partnership' (1992) 70 WULQ 417 (hereafter Ribstein (1992)); Ribstein (1995), n 26 above; S. J. Orsi, 'The Limited Liability Company: An Organizational Alternative for Small Business' (1991) 70 *Nebraska Law Review* 150; Bernard Black in Ribstein and Sargent, n 35 above, 611.

38 Larry E. Ribstein in Ribstein and Sargent, *ibid* 638. This is not very far removed from the LLC in any event. See now in the UK the tentative proposals to limit the liability of bankrupt unincorporated traders by allowing them to retain up to £20,000 pound for pound matching their investment in their business: DTI Press Release, *Byers Outlines Details of Bankruptcy Study* P/99/575 2 July 1999.

39 Larry E. Ribstein, 'Limited Liability and Theories of the Corporation' (1991) 50 *Maryland Law Review* 80 (hereafter Ribstein (1991)); Ribstein (1992), n 37 above, although later writings by the same author make less firm claims for limited liability in relation to small firms see Ribstein (1995), n 26 above and R. Hillman ' Limited Liability and Externalization of Risk: A Comment on the Death of Partnership' (1992) 70 WULQ 477; Jonathan R. Macey, 'The Limited Liability Company: Lessons for Corporate Law' (1995) 73 WULQ 433.

40 Ribstein (1992), n 37 above, 417.

41 To form an LLC, articles of association must be filed with the chosen state but operations are generally governed by an operating agreement The articles usually include minimal information such as the name and registered office of the LLC and details about management and date of dissolution. They do not define the powers of the LLC. If the purposes have to be set out then this is in general terms only. Annual filing provisions are also minimal and, in particular, do not include the filing of accounts, although tax returns normally have to be kept by the LLC, available for inspection by members: CCH Guide, n 23 above, chapter 3.

42 The USA literature also discusses in detail the efficiency of the standard form defaults provided by the LLC statutes: see especially Ribstein (1995), n 26 above and Dennis S. Karjala, 'Planning Problems in the Limited Liability Company' (1995) 73 WULQ 455 (hereafter Karjala (1995)). This question is referred to where relevant but not discussed exhaustively in this article.

43 In the ULLCA 1995 the parties' choice on whether to be member-managed or manager managed controls questions of authority, fiduciary duties and dissolution characteristics, for example: see prefatory note to the Act. Most states provide for at-will or fixed term dissolution and for member management in their LLC statutes. These clauses stem from the original tax requirements that the entity should not have continuity of life or centralised management and both are now usually subject to contrary agreement, following the tax changes described above. The ULLCA default allows owners

These supposed advantages of the flexible structure of the LLC, combined with limited liability, lead some to argue that the process of jurisdictional competition for formations of LLCs between the states in the USA is leading to the creation of efficient alternative statutory standard forms.[44] By contrast, there are those who see the LLC as 'more an unfortunate product of interest-group politics than a frontier-expanding innovation'.[45] On this view, aside from its tax advantages, the LLC 'provides nothing (besides uncertainty) not already available under partnership and corporation statutes'.[46] LLCs have statutory default rules but there is uncertainty about how the courts will apply the provisions. There remains uncertainty about the judicial treatment of single-member LLCs, with some commentators suggesting that courts are more likely to pierce the veil of limited liability where there are fewer than two members.[47] This leads to the conclusion that taxation must be the main reason why the LLC is flourishing where special close corporation legislation designed for small firms failed.[48]

Much is left to the operating agreement, which increases flexibility but is also very costly to the extent that it needs to be tailor made.[49] Commercial standard forms will be provided for LLCs and the courts will develop rules, but this will take time. Some practitioners are therefore wary of the LLC as there is little precedent to guide them.[50] The critics of LLCs argue that there are now too many choices to be made between different types of entity and that the result could be confusion – a case of 'hyperlexis'.[51] The popularity of the LLC should not be exaggerated, therefore, and its rapid spread across legislatures, far from proving its efficiency, may 'suggest to some that [it] fails to strike an appropriate balance between private gain and social benefit'.[52]

Between these two camps are the agnostics holding the middle ground. They do not accept that the explosive growth of LLCs necessarily means that they are efficient for society overall: there are other explanations for their establishment and there are problems with the arguments justifying limited liability for closely held firms.[53] Nevertheless, they argue that the fact that LLCs were born as a result

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to demand payment of the fair value of their interests at any time in order to exit. If this right is excluded by agreement, an owner may apply for a judicial dissolution.

44 See n 198 below and text thereto.

45 Saul Levmore, 'Partnership, Limited Liability Companies, and Taxes: A Comment on the Survival of Organizational Forms' (1992) 70 WULQ 489, 492; Hillman n 39 above; R. Hamilton and L. Ribstein (a debate) 'Limited Liability and the Real World' (1997) 54 *Washington and Lee Law Review* 687; Mark J. Roe, '*Chaos and Evolution in Law and Economics*' (1996) 109 Harvard Law Review 641. On interest group theories see also Macey, n 39 above, W. Bratton and J. McCahery 'An Inquiry into the Efficiency of the Limited Liability Company: Of Theory of the Firm and Regulatory Competition' [1997] 54 *Washington and Lee Law Review* 629. For a more general discussion of interest group theories see R. Baldwin and M. Cave, *Understanding Regulation* (Oxford: OUP, 1999) chapter 3 and works cited there.

46 Karjala (1995), n 42 above, argues that similar internal structural freedom could already be achieved under modern corporation statutes.

47 CCH Guide, n 23 above,18; Ribstein and Sargent, n 35 above 637. A few states spell out the position in their LLC enabling statute – CCH Guide, n 23 above, 44.

48 See Dennis S. Karjala, 'A Second Look at Special Close Corporation Legislation', (1981) 58 Tex L Rev. 1207; Ian Ayres 'Judging the Close Corporation in the Age of Statutes' (1992) 70 WULQ 353.

49 CCH Guide, n 23 above 18; Michael Bamberger in Ribstein and Sargent, n 35 above, 626.

50 Karjala (1995), n 42 above; Ribstein and Sargent *ibid.*

51 Walter D. Schwidetzky in Ribstein and Sargent *ibid* 617. Schwidetzky ascribes the term 'hyperlexis', meaning 'pathological condition caused by an over-active law-making gland' to Bayless Manning.

52 Allan W. Vestal, ' "Assume a Rather Large Boat": The Mess We Have Made of Partnership Law' (1997) 54 Wash & Lee L Rev. 487 (hereafter Vestal) 516.

53 Bratton and McCahery, n 45 above. Note that their discussion is purely in terms of economic efficiency.

of the combination of tax and regulatory issues and the actions of interest groups does not necessarily mean that they are inefficient; they may develop into efficient business organisations. In the view of some authors, this development may necessitate intervention by the courts to take into account the interests of those who had no say in the original lobbying process.[54]

The LLC is not the only limited liability legal vehicle being developed in the USA to accommodate firms which require a partnership tax and governance regime coupled with limited liability. For example, the limited liability partnership is now also available in most states.[55] Sometimes, as in New York, it is confined to professional partnerships, but elsewhere, as in Iowa, it is available to all partnerships.[56] The USA LLP raises many issues similar to those discussed here in connection with LLCs.[57]

In the UK, the position is not entirely comparable with that in the USA. There is already very easy access to limited liability for small firms through the ordinary limited liability company. The UK system of corporate taxation attempts to integrate the corporate and personal tax systems so that double taxation is avoided.[58] The incentive to avoid incorporation for tax reasons is therefore much less than in the USA and there may even be tax advantages to incorporation in some circumstances.[59] The UK private limited liability company has no minimum capital requirement and flexible internal governance rules. External regulation, in particular accounting requirements such as the statutory audit,[60] has also been reduced over recent years. There is, however, continued pressure for simplification of the legal rules for small companies in the interests of entrepreneurship.[61]

The UK Company Law Review Steering Group[62] does not support the introduction of a new free standing limited liability legal form for small firms,[63] although it describes various free-standing legal vehicles for small business.[64] The Strategic

54 Macey, n 39 above; Thompson, n 30 above.

55 Born in Texas in 1991: see R Hamilton, 'Registered Limited Liability Partnerships: Present at the Birth (Nearly)' (1995) 66 *U Colorado Law Review* 1065. The level of protection bestowed by the limited liability rules for LLPs vary from state to state and may well not be as comprehensive as for LLCs.

56 CCH Guide, n 23 above, 72.

57 For reasons of space these are not discussed further in this article.

58 See John Tiley and David Collison, *Tiley & Collison's UK Tax Guide 1999–2000* (London: Butterworths, 1998), chapter 23, although the logic of this so called 'imputation system' has been broken down by recent tax reforms: see Finance (No. 2) Act 1997 and Finance Act 1998.

59 There are tax advantages and disadvantages of incorporation under the UK tax system which does not achieve complete neutrality: Graham Buckell, 'Incorporation Tactics' (1998) *Taxation* 278. Changes in the 1999 Finance Act further tip the balance in favour of incorporation since a new 10 per cent tax rate is to be introduced for companies with low profits from April 2000 but the effect is relatively small. National Insurance considerations make incorporation costly for large partnerships, which is one reason why the UK pressure for LLPs has come from large professional partnerships.

60 See Companies Act 1985, ss 249A–249E as amended; Freedman (1999), n 18 above, 29.

61 Freedman (1999), *ibid.*

62 *The Strategic Framework*, n 4 above. The author was an adviser on the Working Groups on the needs of small and closely held firms both prior to and subsequent to publication of *The Strategic Framework* but her views do not necessarily represent those of those Working Groups nor of the Steering Group.

63 It calls for flexibility and options for such companies within a broad framework. See also Freedman (1994), n 5 above and Freedman (1999), n 18 above.

64 The Strategic Framework, n 4 above. Consultees responding to the DTI's initial consultative paper, *Modern Company Law for a Competitive Economy*, March 1998 suggested LLCs as an option for the UK – for example Graham Mather, *A Company Law Fit for the Millennium* (London: European Policy Forum, 1998) and the response of Professor P. Willoughby, 'Offshore Trusts and Companies: A Consumer's Guide' (copy kindly supplied by author).

Framework recognises that unlimited liability business vehicles might be more suitable for some types of business, but shows no enthusiasm for restricting access to limited liability vehicles. The thrust of the paper is that the standard UK limited liability company should be made as freely accessible, simple and burden free as possible for the small business. The (rather leading) question posed to consultees is 'Is it agreed that it is not desirable to restrict access to limited liability?'[65] The great majority of respondents agreed with this view, often in resounding terms.[66] The Confederation of British Industry, for example, stated that 'Incorporation encourages innovation'. The Institute of Directors commented, 'Limited liability has played a key role in creating a dynamic private sector since its inception, and its benefits should be open to all those who wish to set up a legitimate going concern'. In many cases, however, this support for limited liability was coupled with a call for appropriate obligations to be imposed on those gaining the benefits of limited liability and on proper creditor protection.

Although the Company Law Review Group seems unlikely to recommend a totally new limited liability legal form for small firms, the announcement that the proposed LLP is to be available to all firms[67] will fuel the notion that it might be adapted for small businesses. As it stands, however, the proposed LLP has not been designed to be particularly user friendly to small firms, so development would be required to make it so.[68] There are good arguments for not restricting the LLP to regulated or even to large firms. It does not necessarily follow that it should be developed to encourage firms, which might otherwise operate as general partnerships, to obtain limited liability.[69] This encouragement should be given only if there will be benefit to the business owners and third parties. Although the context is very different, the limited liability arguments surrounding the adaptation of LLPs for small firms and the deregulation of company law for the smallest companies are similar to those discussed in the USA literature on LLCs.

In both the USA and the UK there is a tendency simply to make assumptions about the efficiency and desirability of limited liability for small firms, although, in the USA, the development of the LLC has triggered a renewed interest in the theoretical arguments on this area. It is these arguments that are investigated further in the following parts of this article.

The limited liability debate – applying general argument to small firms

The virtues of limited liability have been debated since the idea was first mooted. The dominant, though not unopposed, view has been that limited liability was an

65 *The Strategic Framework*, 68, *ibid* question 10(a).

66 These responses are available in the DTI library.

67 See n 3 above and *DTI's Response to the Fourth Report of the Trade and Industry Committee* (1999) <*http://www.parliament.the-stationery-office.co.uk/pa/cm199899/cmselect/cmtrdin/52905.ht*>, para 27 et seq. It was argued, logically, by consultees that there was no good reason to offer only regulated professions the advantages of a partnership structure and partnership taxation combined with limited liability. This might give regulated firms a competitive advantage.

68 For example it provides no standard form partnership agreement covering internal governance but see HL Deb vol 610 col 846 *et seq* 6 March 2000. See also N. Beresford, 'The draft limited liability partnership bill: a good deal for small business?' (1999) NLJ 1647.

69 To the extent that firms would otherwise be operating as limited companies, LLP status under the new proposals could be preferable from the point of view of third parties, since the limited liability it would bestow would be less complete than that of a limited company.

invention central to the creation of a modern capitalist economy.[70] The standard law and economics analysis supporting the value of limited liability has been widely accepted for around the last three decades, but recently some writers have begun to question this. There have always been those who have argued that limited liability is too freely available to small firms.[71] They believe that encouraging small firms to incorporate with limited liability may create traps for the unwary, both for business owners and those to whom they transfer risks.[72] Others, however, consider any curtailment of access to limited liability to be a serious block on enterprise and even suggest that more sole traders and partnerships should be encouraged to incorporate.[73] It has been remarked upon that it is an irony that the proliferation of the LLC statutes, which give easier access to limited liability for small firms, has coincided with developments in the economics based literature which raise questions about the value of limited liability for *all* firms.[74]

To investigate these conflicting views further, this part of this article begins by examining the general arguments in the law and economics literature for and against limited liability, and then proceeds to consider the application of these arguments to small firms. It evaluates the law and economics arguments largely on their own terms, leaving consideration of the alternative values outlined above to part five.

General advantages and disadvantages of limited liability – applying the 'efficiency' test

A contractarian analysis provides the now orthodox law and economics explanation of the value of limiting shareholder liability. This economic theory of the firm explains the company as a nexus of contracts joining inputs to produce output.[75] Equity investment is just one of those inputs. It is against the background

70 See P. Halpern, M. Trebilcock and S. Turnbull 'An Economic Analysis of Limited Liability in Corporation Law' (1980) 30 *University of Toronto Law Journal* 117 (hereafter, Halpern et al) citing *The Times* of 1824 opposing limited liability and *The Economist*, December 18, 1926 which put this 'invention' on a par with the work of Watt and Stephenson. Acceptance of the principle was slower in the UK than in the USA: Kevin Forbes, 'Limited Liability and the Development of the Business Corporation' (1986) 2 *Journal of Law, Economics and Organization* 163. For a flavour of the early debates see Bramwell, 'The Law of Limited Liability' (1888) 9 J. Inst. Bankers 373; C.A. Cooke, *Corporation, Trust and Company* (Manchester: Manchester University Press, 1950).

71 See the historical discussion in J. Freedman (1994), n 5 above and, for example, Otto Kahn-Freund, 'Some Reflections on Company Law Reform' (1944) MLR 54; Jacob S. Ziegel 'Is incorporation (with limited liability) too easily available?' (1990) 31 *Les Cahiers de Droit* 1075; Andrew Hicks, 'Limiting the Rise of Limited Liability' in R. Baldwin (ed) *Law and Uncertainty* (London: Kluwer, 1997); Vestal, n 54 above; Lawrence E. Mitchell, 'Close Corporations Reconsidered' (1989) 63 *Tulane Law Review* 1143.

72 See Vestal, 'New and Revised American Laws for Unincorporated Firms Create Significant Traps for the Unwary' in Patfield (ed) *Perspectives in Company Law: II* (London: Kluwer, 1997); Henry Hansmann & Reinier Kraakman 'Toward Unlimited Shareholder Liability for Corporate Torts' (1991) 100 Yale LJ 1879 (hereafter Hansmann and Kraakman).

73 For example, Institute of Directors, *Deregulation for Small Private Companies* (London: IOD, 1986); Mather, n 64 above; J.J. Henning, 'Close Corporations and Private Business Corporations – The Southern African Solution', in Rider and Andenas (eds), n 5 above; John Lowry, 'In Defence of Salomon: Promoting the Corporate Veil' in Rider and Andenas (eds), n 5 above; Ribstein (1991), n 39 above; Ribstein (1995), n 26 above; Macey, n 39 above. B. Pettet in 'Limited Liability – A Principle for the 21st Century?' in Freeman and Halson (eds) (1995) 48 *Current Legal Problems* Part 2, 148 argues that abolition of limited liability would create problems but urges the use of insurance to protect tort creditors. See also n 68 above and text thereto.

74 Bratton and McCahery, n 45 above.

75 The classic articles include M. Jensen and W. Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure' (1976) 3 J Fin Econ 305 and E. Fama and M. Jensen, 'Agency Problems and Residual Claims' (1983) 26 J L & Econ 327. For a general critique see W. Bratton, 'The "Nexus of Contracts" Corporation: A Critical Appraisal' (1989) *74 Cornell Law Review* 407.

of this model that the virtues of limited liability for equity investors are extolled in terms of efficiency.[76]

The theory of the firm arguments in favour of limited liability can be summarised briefly as follows. First, limited liability decreases the need to monitor agents.[77] The less risk the shareholder bears, the less it is worth monitoring the agent. With a quantified risk, the shareholder can decide that the cost of monitoring at a certain level would exceed the potential loss. Secondly, shareholders with limited liability also have less need to monitor other shareholders, since the wealth of those others is irrelevant. Thirdly, limited liability promotes free transfer of shares. Shares with limited liability are fungible; they trade at one price regardless of the identity of seller or purchaser so limiting the amount of investigation and negotiation needed on the part of the buyer. This facilitates the control of agents (managers) through the market price of those shares. Fourthly, limited liability facilitates diversification of portfolios. Investors in a limited liability company reduce their risk through diversification, but in an unlimited liability regime diversification increases risk because the investor could lose all his wealth on the failure of any one firm. Diversification by investors in turn enables managers to enter into risky ventures without risking the entire wealth of their investors. This, therefore, increases the capital available for potentially risky projects. This is efficient provided those projects have a positive net present value and so are beneficial uses of capital.

The above summary represents a widely shared understanding of the contribution made by limited liability, but it is not universally accepted. One view is that since the parties can contract around either a limited or an unlimited liability regime, the liability regime chosen initially is insignificant.[78] The counter to this is that the cost of contracting will vary depending upon which liability regime is chosen,[79] and that risk may be borne better by creditors than by shareholders alone.[80] The writing of Hansmann and Kraakman[81] raises questions about the efficiency of limited liability in respect of corporate torts in all types of company.

Recent work on the theory of the firm threatens to disturb some of the underlying assumptions behind the standard analysis of the value of limited liability.[82] The 'orthodox' economic analysis of law has absorbed theory of the

76 H. Manne, 'Our Two Corporation Systems: Law and Economics' (1967) 53 Va. L. Rev 259; Halpern et al n 70 above; F. Easterbrook and D. Fischel, 'Limited Liability and the Corporation' (1985) 52 *University of Chicago Law Review* 89; R. Posner, n 10 above, chapter 14; Cheffins, n 11 above.

77 This, and the summary of the arguments which follows, are taken mainly from Frank H. Easterbrook and Daniel R. Fischel, *The Economic Structure of Corporate Law* (Cambridge, Massachusetts: Harvard University Press, 1991) (hereafter Easterbrook and Fischel), Posner n 10 above and Manne, *ibid.*

78 R. J. Mofsky and R. Tollinson 'Piercing the Veil of Limited Liability' (1979) 4 *Delaware Journal of Corporate Law* 351 also contend that limited liability does not arbitrarily impose unwarranted costs on involuntary creditors because the cost to consumers will reflect where the tort risk falls.

79 Kevin F. Forbes, 'Limited Liability and the Development of the Business Corporation' (1986) 2 *Journal of Law, Economics and Organisation* 163; Halpern et al, n 70 above.

80 Easterbrook and Fischel, n 77 above, 45, discussed further below.

81 Hansmann and Kraakman, n 72 above. But see Grundfest, 'The Limited Future of Unlimited Liability: A Capital Markets Perspective' (1992) 102 Yale L J 387; H. Hansmann and R. Kraakman, 'Do the Capital Markets Compel Limited Liability? A Response to Professor Grundfest' (1992) 102 Yale LJ 427; D. Leebron, 'Limited Liability, Tort Victims and Creditors' (1991) 91 Colum L Rev 1565.

82 Bratton and McCahery, n 45 above, 640 *et seq* who show, for example, that this literature questions the assumption of the 'first generation agency theory' of Jensen and Meckling and others that a single optimal capital and ownership structure for the firm exists as a theoretical proposition. They cite Joseph T. Williams, 'Perquisites, Risk and Capital Structure' (1987) 42 J Fin 29; Oliver Hart, *Firms, Contracts and Financial Structure* (New York: Clarendon Press, 1995) .

firm but not its subsequent development. Bratton and McCahery show, for example, that some of the more recent literature suggests that diversification of shareholdings is not necessarily desirable. Concentration of holdings might be a better way to deal with the monitoring problem, since an owner will have a greater incentive to monitor without others free-riding on his efforts.[83] This notion is consistent with real developments such as the concentration of shareholdings in the hands of the institutions, although it is not entirely clear that these institutions are eager to play an active monitoring role.[84] These developments in the economic literature give grounds, then, for questioning the assumption that limited liability enhances productivity by discouraging concentration and encouraging diversification and suggest that limited liability cannot be assumed to be the optimum arrangement for business organisations in all circumstances. Other work on the theory of the firm may result in further questioning of the assumptions about ownership structure which underlie the efficiency theory applied by the law and economics analysts.[85]

Even the current 'mainstream' law and economics literature raises arguments against limited liability in some circumstances. The primary argument against limited liability is that it shifts the risk of failure onto creditors from shareholders, creating potential moral hazard.[86] In response to this, Easterbrook and Fischel reply that, when a limited liability firm fails, the loss is 'swallowed' rather than shifted.[87] Due to the legal rules governing priorities, they argue, the shareholder of a failing company loses his investment before the creditor. Each investor in fact has a cap on the loss he will bear. Posner, on the other hand, does describe limited liability as a means of risk shifting.[88] The ability of the shareholder to limit his risk must have some effect on the risk to others, although it is true that this may not create any greater moral hazard than would arise if an investor in an unlimited regime had insufficient resources to cover his liabilities. Once these resources run out, the risk will be borne by creditors in an unlimited liability system also.[89]

Whether this effect is described as risk shifting or risk sharing, it is argued by proponents of limited liability to be a more efficient arrangement than one in which shareholders bear all the risk. For one thing, creditors, such as banks, will often have specialist knowledge and skills, so that they will be better equipped than shareholders to monitor managers. Voluntary creditors can build the risk of

83 Bengt Holmstrom, 'Moral Hazard in Teams' (1982) 13 Bell J Econ 324 discussed in Bratton and McCahery, *ibid*, 649.

84 On institutional shareholders and corporate governance see Paul L. Davies 'Institutional Investors in the United Kingdom' in D. Prentice (ed) *Contemporary Issues in Corporate Governance* (Oxford: OUP, 1993); Paul L. Davies 'The United Kingdom' in T. Baums and E. Wymeersch (eds) *Shareholder Voting Rights and Practices in Europe and the United States* (London: Kluwer Law International, 1999); V. Finch 'Company Directors: Who Cares about Skill and Care? (1992) 55 MLR 179; Committee on Corporate Governance, *The Combined Code* June 1998. A Committee of Inquiry into UK Vote Execution has recommended that 'regular, considered voting should be regarded as a fiduciary responsibility' for institutional investors: National Association of Pension Funds Press Release, 5 July 1999.

85 For example see Andrew Winton, 'Limitation of Liability and the Ownership Structure of the Firm' (1993) 48 J Fin 487. He considers that increased shareholder liability could have productivity benefits and is interconnected with the efficient choice of ownership structure (discussed in Bratton and McCahery, n 45 above, 651).

86 Particularly in relation to private, undercapitalised companies and groups: Halpern et al, n 70 above, discussed further below; Jonathan M. Landers, 'A Unified Approach to Parent, Subsidiary, and Affiliate Questions in Bankruptcy' (1975) 42 U Chi L Rev 589.

87 Easterbrook and Fischel, n 77 above, 44.

88 Posner, n 10 above, 432.

89 Easterbrook and Fischel, n 77 above, 50.

insolvency into the interest they charge and can demand protection in the form of collateral, minimum capitalisation or some other protection. This may have attached costs but these will be lower than those of monitoring the wealth of a changing body of shareholders that would be incurred in an unlimited liability regime.[90]

There are two major problems with this argument. First, it is much less convincing for trade creditors than for large specialist creditors such as banks. Arguably shareholders are superior risk bearers to the former although not the latter. One issue is whether these different types of voluntary creditor are given appropriate weightings in the economic analysis literature.[91] Secondly, this argument cannot justify the consequences of limited liability for involuntary creditors for whom there is no option to contract around this status. Considering this, Hansmann and Kraakman argue that a rule of *pro rata* liability for corporate torts would be a plausible alternative regime to limited liability.[92] Proportionate liability would avoid the problem of imposing additional costs on the wealthy shareholder. They are not persuaded by the suggestion that *pro rata* unlimited liability for torts would discourage shareholder investment. The exception would be in the case of firms which impose net costs on society, where the disincentive to invest would be a good thing. In their view, capital markets would only be affected by the lowering of share prices to reflect the full social costs of corporate activities; again a good thing.

Hansmann and Kraakman conclude that the retention of limited liability is not justified, despite the practical, administrative and enforcement difficulties of operating a regime of pro rata unlimited liability for corporate torts. They admit, however, that they lack the statistical evidence and case studies that would be needed to decide policy finally and this leads to rejection of their theory by the mainstream.[93] The criticisms of their thesis, however, relate mainly to the position of corporations with liquid, actively traded equity. Grundfest argues, for example, that modern financial markets would respond to a move to proportionate liability in such a way as to undermine its effects.[94] Posner responds to the suggestion that the corporate veil should be lifted in favour of tort victims by pointing out the practical difficulties this would create in identifying and tracking down the relevant shareholders in a system in which shares turn over frequently.[95] For close corporations, the arguments in favour of proportionate liability for corporate torts seem to have more credibility.[96]

So, standard efficiency theory of limited liability is questionable in the context of corporate torts. In addition, those propounding the theory usually do not consider in detail the effect of limited liability on voluntary creditors who do not

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90 Posner, n 10 above, ch 14.

91 It would be possible for economic analysis to take into account the trade creditor's lack of information and weak bargaining position through concepts such as that of asymmetric information and barriers to contractual cooperation but some of the literature on limited liability seems to assume a model without these complications: see Deakin and Hughes, CfiLR, n 7 above, 171.

92 Hansmann and Kraakman, n 72 above, 1933.

93 Posner, n 10 above; Grundfest and Leebron, n 81 above. Ribstein has remarked that the tort system may also not get the balance of liabilities right – Ribstein and Sargent, n 35 above, 643.

94 See the exchange between Grundfest and Hansmann and Kraakman, n 81 above.

95 Posner, n 10 above, 448. He also rejects insurance as a satisfactory alternative since the managers might fail to take out adequate insurance and there might be reasons why the insurance company would not cover or pay up on a particular tort. See too Bratton and McCahery, n 45 above, 655, who question whether the insurance market could handle the increased levels of risk and demand which they believe would follow a shift to an unlimited liability regime.

96 Bratton and McCahery, *ibid* 639.

have the bargaining power or resources to protect themselves through contract. Current orthodox thinking is that the benefits of limited liability outweigh the costs despite the above objections. There is a danger, however, that this approach will so far permeate our thinking that we will not stop to question its relevance to all situations.

Limited liability, efficiency and close corporations

The LLC makes formation with limited liability more flexible and tax efficient for small firms – how far is a move in this direction justified on grounds of economic efficiency? To what extent should the UK attempt to make incorporation with limited liability for small firms even more attractive and simple than it is already? The arguments of mainstream law and economics analysis in favour of limited liability are based on the use of incorporation to raise capital from outsiders. It is therefore worth questioning what, if anything, this analysis has to tell us about limited liability for shareholders of small, private, closely held firms.

Contractarian economic analysis has been explicit in distinguishing closely held, or owner-managed, corporations from public, quoted corporations.[97] The tendency has been towards a simplified model, however: one in which these two types of firm are quite distinct and easily categorised.[98] In practice, it is clear that firms need to be described in terms not of a dichotomy (large or small, public or private) but as dynamic entities along a continuum, often with hybrid characteristics or in stages of transition.[99] In addition, the law and economics analysts are concerned primarily with public quoted corporations, precisely because their theories are designed to explain that phenomenon. By definition, their theories lead to the subordination of the needs of closely held corporations to those of the public corporation. The result is that the close corporation is seen as something of an irritant, a problem for the theorists or an exception to a general rule rather than a widespread phenomenon in its own right which appears in numerous forms.

It is widely accepted that many small close corporations and those dealing with them do not benefit from the advantages of limited liability identified by the standard analysis.[100] The first of these, it will be recalled, is the reduction of the need to monitor 'agents' – the managers. In close corporations, owners and managers may be an identical group, perhaps even a single person. If there is no separation of ownership and control, this supposed benefit of limited liability falls away. Monitoring costs would be low without limited liability, because few people are involved. Secondly, because the number of shareholders is small the shareholders are often in a position to monitor each other. Thirdly, the shares are not marketed and are usually not freely marketable, so there is no control of agents

97 For example, Manne, n 76 above; Fama and Jensen, n 75 above; Easterbrook and Fischel, n 76 above; Frank H. Easterbrook and Daniel R. Fischel 'Close Corporations and Agency Costs' (1986) 38 Stan L Rev 271 (hereafter Easterbrook and Fischel 1986); Halpern et al, n 70 above.

98 These analysts do not purport to be describing the 'real world' but argue that a lack of realism is a precondition of theory. An attempt to reproduce the complexity of the empirical world would be a description and not a theory see Posner, n 10 above, 18. The value of the theory may be questionable if the models are too far removed from reality, however and it may be better to produce a less clear but also less misleading analysis: – see Deakin and Hughes, n 7 above, 215.

99 Freedman (1994), n 5 above; T. O'Neill, 'Toward a New Theory of the Closely-Held Firm' (1993) *Seton Hall Law Review* 603.

100 See Easterbrook and Fischel, n 77 above, 56; Easterbrook and Fischel 1986, n 97 above and Halpern et al, n 70 above for discussions of the arguments summarised here.

through the market price of the shares. Such control is not necessary to the extent that investors and managers are a single group.

Fourthly, diversification is less of an issue for owner managed firms than for those where ownership and management are separated. Under a limited liability regime, the owners of an owner managed firm may be able to avoid investing their entire wealth in the firm, thereby containing the level of risk they undertake, whereas in an unlimited liability regime they would have to commit all their assets. In practice, however, they may have little choice if called upon for personal guarantees. Security of this type is likely to be requested where the firm, with non-marketable shares, has no additional shareholders to call upon and so has limited funds. The facility for diversification will be of little assistance in these circumstances. Moreover, as the owners are also the managers, they will be investing their own human capital in the firm, which reduces their ability to diversify the risk of business failure, despite limited liability.[101]

Fifthly, and perhaps most significant, efficient risk bearing may not be achieved by limited liability in close corporations. Owner-managers have a stronger incentive to attempt to invest insufficient capital to support the ventures they undertake than do those who are diversified shareholders and non-shareholding managers. Where the direct investment of the shareholder is very small, even negligible, as is often the case in a small private company,[102] risk is not shared at all, but shifted to others. To prevent this, major lenders and others in a contractual relationship of importance will often contract round the limited liability with resulting transaction costs.[103] Such contracts will shift a large part of the risk back on to the shareholders, who may then have a major part of their wealth tied up in one venture. Trade creditors with less bargaining power, and involuntary creditors will not be in a position to shift back the risk.

Limited liability with partial reversal through contract does not seem to ensure allocation of risk to those most capable of bearing it. Initially, the owners of the firm believe they have a measure of limited liability,[104] but they may end up investing more and more of their personal wealth in the business through personal guarantees, especially if it gets into difficulties, so they do not necessarily benefit from this regime. Nor does the risk shift onto superior risk bearers. Small creditors least able to monitor and assess risk and to contract out of limited liability may in fact pick up any remaining losses. It is mainly the sophisticated creditor with bargaining power who seems to gain.

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101 Easterbrook and Fischel, n 76 above, 107. Leebron, n 81 above, 1628 argues to the contrary that diversification is more important in close corporations, but he may underestimate the extent to which shareholders in such companies are required to give personal guarantees. Much may depend on the precise size and type of company under discussion.

102 Survey evidence supports the impression that private companies are frequently undercapitalised, both in terms of formal and informal capital: Freedman and Godwin (1994), n 1 above, 258 et seq; ACCA Report, n 5 above, 13–15.

103 If the loan is small, even banks will not find the transaction costs of taking security worthwhile: see R. Cressey, 'Overdraft Lending and Business Starts: An Empirical Investigation on UK Data', in F. Chittenden, M. Robertson and D. Watkins (eds), *Small Firms: Recession and Recovery* (London: Paul Chapman Publishing Ltd, 1993). Where there is a larger loan, lenders will use fixed and floating charges. A range of devices is available to trade creditors: see V. Finch, 'Security, Insolvency and Risk: Who Pays the Price?' (1999) 62 MLR 633.

104 See Freedman and Godwin (1994), n 1 above, 246 for empirical evidence of the failure of small business owners to understand the consequences of this contractually modified limited liability regime. UK banks and other lenders may have a greater tendency to contract around limited liability by taking personal guarantees than in other countries such as Germany: Martin Binks, 'Small Businesses and their banks in the year 2000' in J. Curran and R. A. Blackburn (eds), *Paths of Enterprise: The Future of the Small Business* (London: Routledge, 1991).

The law intervenes in the UK to protect creditors where fraudulent or wrongful trading by directors can be proved.[105] This, though, is an ex post facto exercise and enforcement can be costly and uncertain even if the conditions for liability seem to be satisfied. Not every case where risk is shifted by limited liability will amount to wrongful or fraudulent trading. Even where there is a good case, there are not always funds to bring such actions, which may mean that the smallest creditors will still not be as well protected as banks and major trade creditors, who will have covered themselves through a range of security devices.[106] Consequently those bearing the greatest risk may be those least able to do so. In these circumstances, it is difficult to see that the disadvantage of creating a moral hazard is outweighed by any benefits, either to the owners or to others.

Thus limited liability for close corporations may have few of the benefits claimed for it in open corporations and a number of disadvantages. Not only may it create a moral hazard for third parties, but it may also increase costs both for third parties who seek to contract around this regime and for the firm's owners themselves. Some economic analysts assume that where there is no actual limited liability or no true separation of ownership and control, the associated costs will not be incurred. Fama and Jensen have commented that in close corporations, where ownership and control are not separated, agency problems are avoided and so are 'costly mechanisms for separating the management and control of decisions'.[107] Unfortunately, this is an over-simplification: if the legal form of business organisation recognises the *possibility* of ownership and control separating, those mechanisms may need to be in place. Similarly, if the business organisation used is designed to give limited liability, the close corporation owners may end up paying for a layer of regulation designed to protect third parties from the effects of limited liability (such as disclosure requirements) without gaining the main benefits of such a regime. At the same time, the protection may be insufficient to provide for those third parties due to the strong incentive for owners to enter into risky transactions for which they need bear no costs.

Despite these apparent disadvantages, many owner-managed firms continue to form companies, sometimes through lack of information, in the belief that they will be able to limit their liability more effectively than they actually can. In addition, they seek perceived benefits which may have very little to do with those described by the economic analysts. Empirical work has shown that prestige and credibility, for example, are high on the list of reasons for incorporating a limited liability company.[108] Irrational though they may seem, these are real motivating forces and

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105 Insolvency Act 1986, ss 213 and 214. See Paul L. Davies, *Gower's Principles of Modern Company Law* (London: Sweet and Maxwell, 6th ed, 1997), 151–155 and J.H. Farrar and B.M Hannigan, *Farrar's Company Law* (London: Butterworths, 4th ed, 1998) 737–740 for discussion of the relevant case law. Also V. Finch 'Directors' Duties: Insolvency and the Unsecured Creditor' in A. Clarke (ed.) *Current Issues in Insolvency Law* (London: Stevens, 1991).

106 See S. Wheeler, 'Swelling the Assets for Distribution in Corporate Insolvency' [1993] JBL 256; A. Hicks, 'Wrongful Trading – Has it been a failure?' (1993) *Insolvency Law and Practice* 134. Now, however, if sums are recovered under sections 213 or 214, it seems they are available to the unsecured creditors, not the holder of a charge – see for example *Re Oasis Merchandising Services Ltd, Ward* v *Aitken* [1997] 1 All ER 1009 (CA) cited by Farrar and Hannigan, *ibid* in support of this point; D. Milman, 'Wrongful Trading Actions: Smoke without Fire?' (1995) *Palmer's In Company* (September) and R. Parry, 'Funding Litigation in Insolvency' [1998] CfiLR 121 who argues that the attitude shown by the Court of Appeal in recent cases provides some cause for optimism that innovative funding mechanisms might be supported in future.

107 Fama and Jensen, n 75 above.

108 In the author's survey 66 per cent gave limited liability as a reason for incorporating and 50 per cent prestige and credibility: Freedman (1994), n 5 above. See also ACCA Report, n 5 above; Manchester Business School, *Your Business Legal Structure* (Manchester: The Forum of Private Business, 1991).

result in a situation in which the vast majority of limited liability companies are small, private companies which do not appear to derive the benefits of limited liability which are extolled by the theorists.[109] Economics and law commentators find it difficult to fit this factual information into their scheme of things. Both Manne and Posner, for example, state that the principal inducements to form a close corporation are tax advantages, perpetual existence and only a curtailed degree of limited liability. Manne recognises the mismatch between reality and theory, stating:

> Probably the greatest single mystery in corporation law is why, with a significant number of small corporations in existence, the statutes which developed in the 19th century dealt so exclusively with the problems of the large company . . . [J]ust as the underlying principles of the existing corporate system were not understood, their inapplicability to small corporations was overlooked. With hindsight, we can see that the problems that began to develop for small corporations were logically predictable.[110]

Manne refers to historical evidence that some parties consciously fought for the extension of the availability of limited liability and the corporate form to small firms.[111] Those who support limited liability generally for public corporations as being necessary for the functioning of an efficient capital market, but who accept that the reasoning does not apply to close corporations, are faced with a problem. Not only do small private firms wish to incorporate with limited liability, and in fact do so, but it is also very difficult to devise a workable system to distinguish and exclude firms for which such a regime is efficient from those for whom it is not. It might also be perceived as discrimination to exclude small firms from limited liability despite the fact that this will often not achieve the benefits for them that they expect.[112]

The moral hazard argument and the consequent costly attempts by creditors to contract round limited liability, lead Halpern et al,[113] in their seminal work on limited liability, to form an 'empirical intuition' that, on balance, an unlimited liability regime is the most efficient regime for small, closely held companies. They acknowledge difficulties, however, not least that it would be necessary to distinguish large and small firms in order to apply different liability regimes to different sized firms. Halpern et al recognise that such a distinction 'may induce some perverse and wasteful incentive effects as firms seek to manipulate internal structures to ensure compliance with the requirements of the preferred regime'.[114]

This tension between the theoretical ideal and the practicalities can be seen in the work of other writers also. Various options are discussed in the literature for alleviating the problem of access to limited liability where it does not seem to be the most efficient liability regime and yet is being chosen by the business owners.[115] The

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109 For the statistics, see n 19 above.

110 Manne, n 76 above.

111 Manne, *ibid* 277 on the USA. On the UK see Freedman (1994), n 5 above, P. Ireland 'The Triumph of the Company Legal Form, 1856–1914' in J. Adams (ed), *Essays for Clive Schmitthof* (London: Professional Books, 1983).

112 Gabaldon, n 16 above, 1434. Some firms would benefit from being excluded from limited liability in the long run but others would lose and the difficulty, once again, is to draw the line between them.

113 Halpern et al, n 70 above.

114 Halpern et al, *ibid* 148.

115 Some of these writers also consider the need for different governance rules for close corporations, for example special exit mechanisms for oppressed minorities or removal of the board of directors with management directly in the hands of the shareholders. These devices might be seen as justifying a separate legal form for these firms, or a special subset of rules as found in USA Close Corporations statutes and chapters, but this is for the purpose of internal relationships (as to which see Freedman (1994), n 5 above: this topic is not discussed further in this article).

main suggestions are a minimum capital requirement, contracting round limited liability, unlimited liability to tort creditors, mandatory insurance and piercing the corporate veil or imposing liability on managers or shareholders in some other way.[116] None of these suggestions, however, provides a sure guide to drawing the line between those firms for whom limited liability is efficient and those for whom it is not. These issues will be discussed in turn.

Reducing access to limited liability

A minimum capital requirement

One apparently obvious measure to prevent small, undercapitalised firms from incorporating with limited liability would seem to be the imposition of a minimum capital requirement. Such a requirement exists in many jurisdictions for private as well as public companies,[117] but is not part of the Anglo-American tradition. This creates a distinction in approach that is a matter of more than detail: it reflects a deep cultural divide as regards attitude to limited liability. It is not surprising, then, that we find Kahn-Freund, who came to the UK from the continental European tradition, arguing for the introduction of a minimum capital in the UK to make the formation of companies more difficult and more expensive in order to 'restore the limited company its original function, and to the partnership its proper place in business life'.[118]

The minimum capital requirement is still seen by some in continental Europe as an important barrier to incorporation to protect creditors, although there are critics of the requirement in those countries also.[119] In Sweden, for example, the level of capital required for private companies has just been raised.[120] Denmark raised its

116 Another suggestion which has been made is that directors should not be appointed to limited liability companies unless they pass an examination or show fitness to run a company in some other way such as attending a course: see J. Hudson, 'The Limited Liability Company: Success, Failure and Future' (1989) 161 *Royal Bank of Scotland Review* 26; Finch, n 84 above; IOD Press Release July 1999, *New Standard for Company Directors* (announcing new qualification for directors which would not, however appear to be suitable for start ups since it requires three years experience). These proposals, though, do not relate to economic suitability – one may be very aware but still dishonest!

117 Within the European Union only the UK and Ireland do not have a minimum capital requirement for private companies: the Second Directive on Company Law requires a minimum capital for public companies. The idea of extending the Second Directive to private companies has been floated but rejected to date. See Boden de Bandt de Brauw, Jeantet and Uria, *Second Directive's Extension to other Types of Companies* (Brussels, 1992); University of Manchester Centre for Law and Business, *Company Law in Europe: Recent Developments,* (DTI/University of Manchester, 1999) (hereafter University of Manchester).

118 Kahn-Freund, n 71 above.

119 See Boden de Bandt de Brauw et al, n 117 above and note the criticisms of the Belgium minimum capital requirement, for example, as having only an illusory protective role: J. Wouters, 'Towards a European Private Company? A Belgian Perspective' in H-J De Kluiver and W. Van Gerven (eds) *The European Private Company?* (Antwerp: Maklu, 1995) 166. More important, in Belgium, as Wouters notes, is the requirement that the company's founders must present a business plan to the notary public in which they justify the amount of capital in the light of the company's projected activities. In addition the founders are liable in the event of bankruptcy within three years after the formation of the company if the capital on formation was manifestly insufficient for the normal exercise of the projected activity for a minimum of two years. Presumably this second provision would be unnecessary if the first was truly effective, but this does seem to be a significant restriction on limited liability.

120 This decision is, however, the subject of criticism within Sweden. I am grateful to Professors Claes Norberg and Per Thorell for informing me of this debate. The arguments against the minimum capital requirement in the Nordic countries appear to be heavily influenced by the law and economics analysis described here as well as by the practical problems companies are experiencing in doubling their share capital from 50,000 SEK to 100,000 SEK (£3,750 to £7,500). The time period for implementation of the new levels has had to be extended to allow the smallest companies to adapt to this requirement.

minimum capital requirement for private companies in 1991. In 1992, the Danish Trade and Companies Board refused registration of a branch in Denmark of a UK company, Centros Ltd, which did not trade in the UK. The grounds for this refusal were essentially that this was an attempt to circumvent the Danish minimum capital rules. Eventually this refusal was brought before the European Court of Justice, which held that it was contrary to Articles 52 and 58 of the EC Treaty.[121] This could be construed as giving the green light to incorporation in the UK by firms actually intending to operate in other European Union states but wishing to avoid paying a minimum share capital. Denmark, in fact reduced its minimum capital requirement in 1996 as part of a general simplification of private company law[122] which could be a result of downwards competitive pressure, as revealed by this case. Equally, there could be pressure from the other member states on the UK to raise its requirement if other member states continue to see the minimum capital as important.

The law and economics writers reject a minimum capital requirement as a solution, giving theoretical backing to the pragmatic reasoning which can be found in the UK debates. A minimum capital requirement for private companies has been considered on various occasions in the UK. The Jenkins Committee favoured the introduction of such a requirement in principle but 'reluctantly [came] to the conclusion that its purpose would be too easy to evade' and so did not recommend it.[123] The problem they foresaw was that it would be impossible to prevent the company from returning cash to the promoters in exchange for assets or by way of loan, for example. Nevertheless, a White Paper in 1973[124] took the view that a minimum paid-up capital of perhaps £1,000 would not only help to 'ensure some minimum financial substance as a proper qualification for the protection of limited liability but it would also act as a deterrent to frivolous incorporations'. This idea was lost with the 1974 General Election and has not been revived since. The current Company Law Review Group has not encouraged commentators to propose a minimum capital requirement. Most respondents have supported barrier free access to limited liability, but a significant minority have shown support for a minimum capital requirement.[125]

There are clear theoretical arguments supporting the current UK opposition to the introduction of a minimum capital for private companies. The main problems are twofold. First, how would the level be set? Secondly, once the minimum capital had been paid in, could it be retained in the company so as to protect creditors and, if so, at what cost? On the first point, Easterbrook and Fischel argue that there is a danger that the level required will be set too high so as to impede desirable new entries and permit existing firms to charge monopoly prices. Hansmann and Kraakman also reject minimum capitalisation, largely on the practical grounds of the difficulty of setting the level appropriately for different industries and the

121 *Centros Ltd and Erhvers-og Selskabsstyrelsen* Case C-212/97, ECJ. Judgment 9 March 1999 [1999] ECR 1–1459.

122 University of Manchester, n 117 above.

123 *Company Law Committee Report* (chairman Lord Jenkins) Cmnd. 1749 (1962) at para 27.

124 DTI, *Company Law Reform White Pape*, Cmnd 5391 (1973).

125 *The Strategic Framework* (1999), n 4 above asks (a)*'Is it agreed that it is not desirable to restrict access to limited liability? (b) If not, then what constraints should be considered?'* (Question 10). For the answers to (a) see text to n 66 above. Where constraints were thought desirable, a minimum capital was the most popular approach, supported by the Institute of Chartered Accountants of Scotland, The Association of Chartered Certified Accountants, the Institute of Credit Management and the Labour Finance and Industry Group amongst others.

problems of enforcement.[126] Undoubtedly, if one is regarding the minimum capital as a tool of creditor protection, the level has to be reasonably high to be of any use, but the appropriate level for a manufacturing company generally would be much too high for a service company, for example. If the level was set too high generally, or too high for a particular group, this could set up barriers to entrepreneurs that would be costly in social terms. Once again, the problem is of drawing the line between those firms that should, and those that should not, have access to limited liability. A minimum capital requirement does not solve this problem, but merely poses it in a different way.

This analysis does not, however, deal with the somewhat different purpose of deterring frivolous incorporations – the justification given in the 1973 White Paper. Those writing from an economic analysis perspective focus on model rational players. This practice may cause them to forget that ease of incorporation encourages some to incorporate who would not do so if they had full information and understanding of the situation. A minimum capital requirement of a modest amount, which would not deter any serious player from entering business, could do much to alert a person for whom incorporation is wholly inappropriate, to the seriousness of that course of action.[127] It would not prevent fraud or recklessness, for which other mechanisms are needed, but it might cut down on foolishness and misapprehension, especially if used as an opportunity also to explain the implications of forming a company with limited liability to the business owners. The purpose of such a requirement could be seen as providing a signal that limited liability cannot be obtained without some level of the personal responsibility being assumed by the business owners.[128] This requirement would be backed up by all the existing provisions, legislative and contractual, which protect creditors once the business has been embarked upon and, particularly, once it goes wrong. The fact that, at present, a company may be purchased off the shelf at very little cost, purporting to have the capacity to bestow limited liability, conveys quite the opposite signals.

The second problem is whether, the required minimum capital could be ring-fenced so as to provide protection. Easterbrook and Fischel point out that if firms had to hold or ring fence funds to be held in a risk-free way, there would be a large amount of capital tied up in a form that would not yield the return it could do if free for investment in the business. This measure, therefore, would result in a social cost. If the capital were not protected in this way, however, they consider that the minimum capital requirement would not be effective. This reflects the concerns of the Jenkins Committee regarding evasion. The problems described here are real ones, although they have not prevented the introduction of a minimum capital requirement for public companies in the UK, accompanied by various safeguards to preserve capital reserves.[129]

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126 Hansmann and Kraakman, n 72 above: see, however, Grundfest's response, n 81 above, 421 where minimum capitalization is seen as having some virtues, despite the difficulties in its application.

127 This has been proposed by J. Hudson, n 116 above, 37 and see the responses referred to in n 125 above, especially that of the Association of Chartered Certified Accountants.

128 It would reduce, to some extent, what presently seems to be an official endorsement of limited liability for undercapitalised firms even if only symbolically: see Gabaldon, n 16 above, 1432.

129 Companies Act 1985, s 118 imposes a minimum capital requirement on public companies as defined. The UK capital maintenance provisions were tightened by the EC Second Directive on Company Law. Not all these provisions have been applied to private companies and they seem likely to be relaxed: see Davies, n 105 above, chapter 11; The Company Law Review Steering Group, *Company Formation and Capital Maintenance* URN 99/1145 (London: DTI, 1999).

Again, though, these anxieties are only significant if the initial objective is to provide funds for creditors. If the objective is, rather, to signal that limited liability does not come without some responsibility and to prevent frivolous incorporations, this aim might be met without tying up large amounts of capital. It would be the initial outlay required which would be important, whilst recognising that it would not necessarily provide a fund for creditors. A minimum capital requirement of this type would not achieve the end of making limited liability accessible only to those firms where there was a solid economic justification for this regime, but it would be a formal reminder that incorporation with limited liability was not always appropriate. In this way it would be an indirect, rather than a direct, creditor protection method. It would also act as a warning to business owners that they should consider the suitability of their chosen legal regime carefully rather than treating it as a mere formality.

Another objection to a minimum capital requirement for limited liability companies is that unlimited liability businesses may, in fact, reduce their liability by ensuring that family assets are not held by the business owner. Equally, unincorporated businesses may themselves be undercapitalised, as pointed out by Easterbrook and Fischel.[130] On this argument it is illogical to require a minimum capital under a limited liability regime only: a similar requirement should be imposed on all businesses. There are two responses to this. First, in practice, owners of businesses without limited liability do tend to consider their assets to be at risk and act accordingly.[131] Secondly, if the objective of the minimum capital requirement is to give a signal about the suitability of incorporation as a limited liability company, the parity argument does not apply.

There are arguments, then, for a minimum capital requirement, but only at a fairly low level as a barrier to formation of companies for those cases where limited liability is unhelpful for the owners as well as for creditors. Beyond this, it does not seem that a minimum capital requirement would be a practical or effective mechanism for drawing the line between firms where limited liability would achieve optimal risk allocation and those where it would not. In any event current enthusiasm for an 'enterprise culture' and the association of this with limited liability make it unlikely that any such barriers will be erected. To the extent that the downside of encouraging risk-taking is recognised, the solution seems to be seen in terms of tightening up legislation on insolvency and taking other action after the event, rather than reducing access to limited liability or issuing warnings about its use.[132]

Contracting around limited liability

As discussed in general terms above, on one argument there is no need to reduce access to limited liability, since contractual waiver is possible.[133] The reasoning is that, since most creditors can contract around limited liability by imposing

130 Easterbrook and Fischel, n 77 above, 50.

131 Freedman and Godwin 1994, n 1 above, 259 (survey showed that over 70 per cent of unincorporated firms considered that capital contributed by owners was an important source of finance at foundation) and see n 190 and text thereto, below.

132 See, for example, the approach to risk in DTI, *Our Competitive Future: Building the Knowledge Driven Economy*, n 17 at para 2.12 'We are too afraid of failure. People worry that business failure will create a lasting stigma. Investors are too rarely willing to back those who have failed and want to try again'. See also DTI Press Release, n 38 above, 'For too many people the fear of failure stifles innovation and enterprise'.

133 See n 78 above and text thereto.

personal guarantees on the owners, the problem of moral hazard is reduced. This method of limiting access to limited liability, which is in effect at present, essentially leaves it to the parties to decide which regime is appropriate.

On this basis, it might seem that the liability regime imposed by law is inconsequential. In widely held companies, however, it would be very costly for the owners to contract for limited liability in every case, so a limited liability regime is generally preferred in order to cut transaction costs. Halpern et al argue that it is less costly for contractual waiver to take place in the case of close companies, where fewer parties are involved. Thus the case for an unlimited liability regime for close companies is not as compelling as the case for limited liability for large, widely held companies.[134]

There are many problems with this analysis, as referred to already in the general discussion of limited liability. Leaving the question of liability regime to the parties assumes they are all equally equipped to decide an efficient position and negotiate to achieve this. This self-help approach does not deal with involuntary creditors and those too small, ill-advised, or lacking in the necessary bargaining power to enter into such contractual waiver.[135] The type of administrative cost involved in contractual waiver is regressive: it weighs most heavily on the smallest players. Where the trade creditor is small, the cost of contracting around limited liability in the case of an every-day transaction would be likely to be in excess of his resources. He does not have the facilities to monitor all potential clients, and yet cannot afford to turn them away if he wishes to continue in business. What seems a small sum to a banker or other large concern can be enough to cause real difficulties to a very small trader.

Hansmann and Kraakman[136] consider that their arguments against limited liability in tort do not extend to contract. Their reasoning is also largely based on the supposed ability of voluntary creditors to waive limited liability. They consider that shareholders do, in practice, waive limited liability toward contract creditors 'where this is most efficient (that is, where waiver will reduce the total cost of contracting)'. They do not go into the details of how this efficient balance is measured by the participating parties. Nor do they deal with the problem of the small trade creditor raised above.[137] They conclude that limited liability toward contract creditors makes sense even for corporations with a single shareholder because of this ability to contract around the rule. On this basis, they are content that it makes sense to allow incorporation by a single shareholder, 'something that might otherwise seem pointless'. This seems a thin rationale for the existence of one person limited liability companies, but may be better understood in the light of these authors' view that the case for limited liability for corporate tort is not made out either for close or public companies.

Contracting around the limited liability of small firms is an incomplete approach to the moral hazard problem and, worse, creates distortions of its own. The business owner under such a regime has every incentive to pass on risk wherever he can to compensate for the fact that he cannot always do so. He is encouraged to keep his large creditors with personal guarantees happy at the expense of the others.[138] Though he may not have shifted sufficient risk away from himself to

134 Halpern et al, n 70 above, 148.
135 Hamilton and Ribstein, n 45 above, 697.
136 Hansmann and Kraakman, n 72 above.
137 That is the problems of unequal bargaining power, lack of information and expertise and transaction costs.
138 Leebron, n 81 above, agrees that personal guarantees, far from correcting the balance of liability, are a distortion and an argument for lifting the veil in favour of involuntary creditors.

survive financially in the long run, he may well take other small businesses down with him. Whether this is efficient in any sense is questionable.[139] Far from shifting the risk to superior risk bearers (the large specialist creditors), it transfers it to those small trade and involuntary creditors least able to assess and bear it, without necessarily protecting the business owners.

Unlimited liability in respect of tort victims

The contractual waiver arguments are clearly of no help in relation to tort creditors, for whom contracting out of limited liability is not an option. The views of Hansmann and Kraakman in favour of an unlimited shareholder liability regime for tort have been referred to above. Halpern et al propose that directors, rather than shareholders, should be personally liable to involuntary creditors in large, widely held companies in certain circumstances where the use of limited liability might be considered unmeritorious.[140]

As noted above, there would be major practical problems with the introduction of an unlimited shareholder liability regime in the case of widely held, public, quoted companies. These difficulties relate mainly to the costs of administering such a regime in terms of enforcement against a number of parties, additional monitoring costs and the reduction of efficiency in the capital markets. These problems would not exist to such an extent in the case of the very smallest close companies.[141] As close companies grew, however, so would these practical difficulties. Once again we meet the problem of the appropriate boundary for accessibility to limited liability. Although the argument for an unlimited shareholder liability regime is more practically defensible in the case of the smallest, private firms, this distinction does not assist us in drawing a practical line between the different types of company.[142]

The proposal of Halpern et al for directors' personal liability is more limited and more practical in some senses. The circumstances in which this exception to the general rule on limited liability would apply would need to be defined, however, and this would be difficult since so much depends on the facts of the individual case in deciding whether the use of limited liability is justified or not.

Mandatory insurance

Another approach found in the general literature on limited liability is that the adverse effects of risk shifting might be mitigated by mandatory insurance. Again, though, this could create barriers, particularly for new, small businesses, since the cost of insurance may be greater where there is no past record.[143] Conversely, if effective monitoring by insurers was not possible, so that insurance was made available for a risky enterprise at a price not reflecting the full risk, owners might be encouraged to undertake risky activities which they would not have attempted without the insurance.[144] Such a development would increase moral hazard rather than decreasing it. Whilst some firms would be encouraged to take risks which were not beneficial to society, ultimately the existence of insurance for certain

139 As to whether it passes other tests, see part five of this article, below.
140 n 70 above, 149 and see Hansmann and Kraakman, n 72 above.
141 Bratton and McCahery, n 45 above, 639.
142 D. Goddard, 'Corporate Personality Limited Recourse and its Limits' in R. Grantham & C. Rickett (eds) *Corporate Personality in the 20th Century* (Oxford: Hart Publishing, 1998).
143 Easterbrook and Fischel, n 77 above, 61.
144 V. Finch, 'Personal Accountability and Corporate Control: The Role of Directors' and Officers' Liability Insurance' (1994) 57 MLR 880.

whole classes of company could be threatened.[145] Thus, mandatory insurance would not necessarily create the optimal level of incentive to enter into business ventures.

If insurance was always available in the market, there would be less need for limited liability, but there will be risks which insurance companies will not cover. In a perfect world, these would be only the risks that would not benefit society, but market failure can occur.[146] It will be costly for insurers to gather information about large numbers of firms: creditors might be in a better position to evaluate risk as they may well deal with fewer firms and have a closer relationship with them. Halpern et al conclude that, in the type of case where creditors currently contract out of limited liability – that is, small, high risk firms – insurance would be unlikely to be available. If insurance were mandatory, the inability of such firms to obtain insurance would indeed have the effect of reducing their access to limited liability, which is the outcome we seek in some circumstances, but would the line be drawn in the optimal place?

Since a level of insurance cover would have to be fixed upon if the mandatory requirement was to be meaningful,[147] the insurance solution has all the difficulties of a minimum capital requirement in terms of fixing this level.[148] It would also be difficult to police; possibly more so than a minimum capital requirement, which could more easily be linked with the registration process. In addition, the argument for mandatory insurance assumes that insurance will be available where appropriate and that effective monitoring can and will take place. In essence, the mandatory insurance route substitutes the judgement of the insurance market (which may be non-specialist and not particularly well positioned to monitor risks) for that of the legislator or the creditor about the acceptable level of risk.[149]

Another modification of the insurance argument is put forward by Leebron.[150] He argues that shareholder/managers in close corporations[151] should have an obligation to provide adequate insurance to meet the claims of foreseeable tort victims. Such an obligation would have the advantage of flexibility. It would be up to the shareholder/managers to decide on adequacy of insurance levels, and they

145 Halpern et al, n 70 above, 140.

146 See K. Arrow, *Essays in the Theory of Risk-Bearing* (1971), 140 cited in Halpern et al, *ibid* 125. The current auditor liability debate is in part premised on the notion that auditors cannot always obtain insurance to cover their risks: see Freedman and Finch, n 3 above.

147 Pettet, n 73 above, 157 suggests that the requirement could be ‘to purchase liability insurance against tort claims to the extent that the claims overtop their assets’ but recognises that such insurance might not be available in some cases. Insurance companies seem unlikely to be keen to provide open-ended cover.

148 Gabaldon, n 16 above suggests that a panel of community volunteers might make periodic recommendations about adequate insurance levels but admits that this proposal raises ‘a few practical issues’.

149 These arguments against mandatory insurance in general terms may be less strong in relation to insurance for specific risks such as, for example, injury to employees, which are more easily quantifiable than general risks and where more obvious policing mechanisms are available. In the UK, for example, employees who are tort victims are protected by the Employers’ Liability (Compulsory Insurance) Act 1969. Employees may be in a better position than creditors to monitor compliance with this requirement. This solution also enables employees to claim against the employer’s insurance policy to take priority over other creditors in the event of insolvency. It remains possible that an employer could have difficulty in obtaining the required cover: see Cheffins, n 11 above, 508 citing ‘Insuring the Uninsurable’, *Financial Times*, 2 December 1994.

150 Leebron, n 81 above, 1636.

151 Leebron, *ibid* argues that in the case of publicly held companies, officers have sufficient incentive to insure in any event. They get little benefit from failing to do so unlike owner managers who thereby save costs of greater significance to themselves. In any event, officers of publicly held companies usually will have few assets compared with the assets of the company and likely claims.

could be subject to penalty or personal liability if they did not provide a proper level of cover. Whilst superficially attractive, this proposal contains the seeds of many difficulties. The duty would have to be enforced through judicial decision on what was an adequate level of insurance to meet foreseeable tort victims. Such court decisions would normally be taken with the benefit of hindsight, but the officers would not have had that advantage. The result would be considerable uncertainty about proper levels of insurance, which might result in over-insurance by the cautious, with the reckless continuing to under-insure or ignore the requirement entirely, especially if they were unable to obtain cover at what they considered to be an acceptable cost. The problems of the insurance market discussed above would continue to apply.

Thus, mandatory insurance may have a role to play in specific circumstances in reducing the extent to which certain groups of tort creditors are forced to bear the risks created by business owners. In relation to risk-taking by those with limited liability more generally, its effectiveness would depend on the insurers' ability to monitor and assess risk accurately, which could be difficult and costly in the case of closely held companies. If monitoring was not accurate, insurance could increase, rather than decrease, moral hazard.

Imposing liability on managers or shareholders: piercing the corporate veil and other devices

In practice, the law sometimes deals with the problem of drawing the line between firms that should and those that should not have the benefits of limited liability by the device of piercing the corporate veil. This is used at times to hold shareholders liable and at others to impose liability on managers. The difficulty is that this strategy is used only after a wrong has been committed and usually only in extreme cases. There is uncertainty about the circumstances in which it will be used because cases are dealt with on a fact basis, case by case. This approach may blunt the deterrent effect of this strategy and prevents it from drawing a clear dividing line between types of company.

Judicial veil-piercing is present in both the USA and the UK, but is more developed in the former jurisdiction. Easterbrook and Fischel analyse the USA veil-piercing cases as an attempt by the courts 'to balance the benefits of limited liability against its costs'.[152] They see this as a means of controlling 'socially excessive levels of risk taking'. Indeed it has been argued that the conceptual 'distinction between "liberalized veil-piercing" and "unlimited liability" is largely rhetorical.'[153] In some states of the USA, the courts do indeed lift the corporate veil explicitly on the basis of undercapitalisation of close corporations, so that this view has some credibility.[154] The position of the courts on lifting the corporate veil in the UK is much less straightforward and more uncertain.[155] They are generally reluctant to look through the corporate veil other than in the most

152 Easterbrook and Fischel, n 77 above, 55.

153 Hansmann and Kraakman, n 72 above, 1932.

154 R. Thompson, 'Piercing the Corporate Veil: An Empirical Study' (1991) 76 Cornell L Rev 1036; Larry E. Ribstein, *Business Associations*, (New York: Matthew Bender, 1990), 69. See especially *Minton* v *Cavaney* 56 Cal.2d.576 (1961).

155 Whincup 'Inequitable Incorporation' (1981) 2 Co Law 158; Davies, n 105 above, chapter 8; S. Wheeler (ed), *A Reader on The Law of the Business Enterprise* (Oxford: OUP, 1994) 13; C. Mitchell, 'Lifting the Corporate Veil in the English Courts: An Empirical Study' [1999] CfiLR 15. The rationale for lifting the veil in Australia seems similarly unclear although, as in the USA and UK, the veil is lifted most often in relation to small proprietary companies – see I. Ramsay, 'Models of Corporate Regulation: the Mandatory/Enabling Debate' in Grantham and Rickett (eds), n 142 above.

extreme circumstances. A recent empirical study has come to the conclusion that the UK courts are *less* likely to lift the veil where the claim is in tort than when it is in contract.[156] Judicial statements voice strong support for the sanctity of limited liability, which is seen as a tenet of legal policy that the courts should support wherever possible.[157] A similar line of judicial reasoning can be seen in the reluctance of the UK courts to breach the principle of limited liability by making managers personally liable through the application of general principles of tort law.[158] The value of judicial mechanisms for looking through limited liability should not be overestimated, especially if the legislature is giving the signal that wide access to limited liability is desirable.

In addition to attempts to make directors personally liable through tort law and judicial piercing of the veil, there are now relevant statutory provisions in the UK. Directors can be ordered to contribute to the assets of an insolvent company where they can be shown to have been trading wrongfully or fraudulently,[159] although actions under these provisions must be brought by the liquidator.[160] Further, directors of insolvent companies may be disqualified for a period in the future, if they are found to have traded wrongfully or fraudulently, or if the court finds that their conduct as director of the insolvent company makes them unfit to be concerned in management of a company.[161]

Helpful though these provisions might be when they can be enforced,[162] they come into operation to restrict limited liability after the damage has been done. The risk may have been shifted and it may be too late to restore the parties to their original positions. The directors may by this time have no assets. This can of course occur also with an unlimited liability enterprise. If the business owner has been given access to limited liability and allowed to act on that basis, however, this apparent protection may have affected his behaviour prior to the insolvency. Removing limited liability after insolvency may be better than nothing, but may well be too late. The fraudulent and wrongful trading provisions and disqualification rules do not control initial access, but act against those who have abused this access. These provisions may have some general deterrent effect,[163] if those setting up companies are well advised, but equally they may act as a trap for the unwary without necessarily giving the necessary advance signals about the limitations of limited liability.[164]

156 Mitchell, *ibid*. Mitchell does not seek to explain this odd result but notes that Thompson's USA findings were similar, n 154 above, 1058, although Ramsay, *ibid* found a higher lifting rate in tort claims in Australia than in any other context. The Australian study was of a very small number of cases.

157 *Adams* v *Cape Industries plc* [1990] Ch 433; *Yukong Lines Ltd of Korea* v *Rendsburg Investments Corporation and Ors* [1998] BCC 870.

158 *Williams and another* v *Natural Life Health Foods Ltd and another* [1998] 2 All ER 577 (HL); R. Grantham and C. Rickett, 'Directors' "Tortious" Liability: Contract, Tort or Company Law?' [1999] 62 MLR 133.

159 Within the definitions in Insolvency Act 1986, ss 213 and 214.

160 See also n 106 above and text thereto.

161 Company Directors Disqualification Act 1986 ss 4 and 6.

162 See ns 105 and 106 above.

163 The deterrent effect of the disqualification provisions has been argued to be weak due to the small number of directors affected and lack of awareness of the provisions: see A. Hicks, *Disqualification of Directors: No Hiding Place for the Unfit?* ACCA Research Report 59 (London: Certified Accountants Educational Trust, London 1998). Professor Sealy has argued, however, that the law on wrongful trading has had an effect on business, especially as banks may be implicated and so may exert pressure on companies: L. S. Sealy, 'Directors' Personal Liability: English Perspective' in J. Ziegel (ed) *Current Developments in International and Comparative Insolvency Law* (Oxford: Clarendon Press, 1994) 498.

164 Clearly there will be ex ante regulation in individual cases since disqualified directors will not be able to manage new companies for a specified period or may be given leave to act in relation to a specified company, subject to conditions to protect the public: *Re Gibson Davies Ltd.* [1995] BCC 11.

The attitude of the judiciary is also important: the courts remain wary of undermining the principle of limited liability too far through this legislation,[165] although they are prepared to make directors personally liable in circumstances where they have not been dishonest but have been unreasonable. Thus in *Re DKG Contractors Ltd*[166] the judge stated that neither of the directors had any knowledge of company law or the concept of limited liability. He went on:

> I do not think that they deliberately traded in the manner in which they did in order to avoid personal liability. However, I do not think they acted reasonably. Before trading in the manner in which they did, they ought to have sought some advice at least.

These directors were made personally liable for the company's debts. The procedures surrounding incorporation had been insufficient to alert them to their responsibilities or to mark out the company to creditors as particularly risky. There is a very real practical distinction between preventing access to limited liability and veil-piercing in this situation.

One more arbitrary but certain method of achieving partial veil-lifting has been suggested recently in the UK.[167] This is a proposal to cap the limited liability of 'micro' companies at £50,000. Above this, shareholders would have unlimited liability. Naturally, though, this requires a definition of micro company with all the problems that would entail. A minimum capital requirement or other barrier would be needed for companies that were to have full limited liability, otherwise no-one would entertain use of this new regime. This, then, would encounter the definitional difficulties discussed above.

Reliance on *ex post* court decisions seems a haphazard and costly way of dealing with the problem that making limited liability available has created. If lifting the veil is justified in certain circumstances, arguably limited liability should never have been available in these circumstances, and an *ex ante* barrier would be preferable. In practical terms, though, lifting the veil or making directors personally liable after the event has the advantage of not imposing arbitrary barriers and not requiring the legislature or others to decide *ex ante* on an appropriate size or other classification for access to limited liability. If these devices are to be relied upon, it may seem important for a clear and reasonably consistent body of case law to be built up in order to provide guidance and for principles drawn from this case law to be communicated to business owners prior to incorporation. Such reliance, however, presupposes a highly rational system of deterrence in which directors show a high level of understanding of detailed legal information. In practice, general deterrence effects will be cruder than this model suggests. *Ex ante* monitoring does not need to rely upon high levels of information and rational response in the same way.

Theory and practicality

It has been shown that strict economic theory points in the direction of making limited liability more difficult to attain for very small firms. Most law and

165 See, for example, Harman J in *Re Douglas Construction Services Ltd* v *Anor* [1988] 4 BCC 553, 'It is of vital importance that the court, in operating this very important jurisdiction created by Parliament for the protection of the public should be careful that it does not so act as to stultify all enterprise. The purpose and the great value of the invention in 1862 of the limited liability company was to enable entrepreneurs to take risks without bankrupting themselves'.

166 [1990] BCC 903.

167 See Recommendations of a Joint Institute of Chartered Accountants of Scotland (ICAS) and Institute of Chartered Accountants in England and Wales (ICAEW) Small Companies Working Party, *Getting Into Shape* (London: ICAS/ICAEW, 1999).

economics writers, however, recognise the difficulties of drawing boundaries between those for whom this regime is efficient, or might become so as they grow, and those for whom it is not. Therefore, most do not advocate restricting access to limited liability, preferring to concentrate on protection of creditors who might suffer from incorporation by undercapitalised firms. As a result of accepting that very small firms should have limited liability, these writers often consider the need for a suitable governance regime for small or close corporations that would differ from that for public companies.[168] This approach might justify a separate legal vehicle, analogous with partnerships in terms of rights to engage in management, restrictions on share transfers and protections for minority shareholders for whom there is no escape via the market. Those writers who discuss such a regime or less radical deviations from standard corporation law do not, however, link this discussion on internal governance with the question of restricting access to limited liability.[169] Since they are seeking to replicate some of the conditions of partnership within a limited liability form, they are by definition accepting the reality that closely held firms will continue to use limited liability forms if they are freely available to them. They do not discuss any *ab initio* restriction on limited liability as part of this more suitable regime. It does not follow logically, however, that because it is difficult to restrict access to limited liability, it should be made more attractive by creating special limited liability vehicles for small firms or by relieving small firms within a general limited liability regime from regulation which applies to others. It may be preferable to accompany any limited liability regime with certain requirements and characteristics designed to signal the implications of that regime and the responsibilities it brings to the prospective owners.

The LLC: proof of the efficiency of limited liability in close corporations?

Despite the arguments against limited liability for small firms, as we have seen in the second part of this article, developments in the UK have been moving in the direction of making limited liability regimes more attractive for small firms. In the USA also, as seen in relation to LLCs, limited liability is becoming more, rather than less, attractive for small firms.[170] In the USA the creation of the LLC has given rise to a renewed debate on limited liability for small firms. This section examines these arguments.

Applying the limited liability efficiency arguments to LLCs

In the context of advocating the LLC regime, Ribstein, its foremost proponent, attempts to argue that limited liability is the most efficient regime for close corporations by an application of the reasoning found in the writing on public

168 For example, Manne, n 76 above, Posner, n 10 above, 399. See however, Easterbrook and Fischel, n 77 above, 237 who argue that the importance of special close corporation statutes has been exaggerated since the same result can be achieved by contract.

169 Contrast Hicks n 1 above, who proposes a new *unlimited* liability regime for small firms, akin to a reformed partnership – see Freedman (1999), n 18 above and Freedman (1994), n 5 above for further discussion of internal governance issues.

170 And see Grundfest, n 81 above, 420 who points out the general pressure for limited liability from Lloyd's names, accountants and lawyers as well as trading firms.

companies. He agrees that his theories lack empirical support, but states that the burden of proof is on those who argue that limited liability is not the superior regime. In this, he goes further than the writers discussed above who argue that limited liability cannot be denied to small, closely held firms for practical reasons. He positively espouses the benefits of limited liability for close corporations.[171]

One problem with Ribstein's analysis is that he does not define clearly the characteristics of the type of firm to which he is referring.[172] Many of his points might apply to closely held corporations of the larger kind but, in practice, the majority of firms are very small.[173] In respect of the smallest firms, Ribstein's arguments are less than convincing, and yet it is for these very small firms that the justification for limited liability is needed. The larger close corporation would have chosen full incorporation if the LLC had not been available. The question is whether the LLC is efficient for the type of firm that might otherwise choose to trade as a sole trader or general partnership, because, for example, there is total identity between owners and managers (described as a micro-firm in the following discussion). Even if we accept the efficiency arguments in favour of limited liability for public quoted corporations, simply applying them to closely held firms with adaptations, rather than starting afresh, stretches these justifications to breaking point.[174]

Diversification, ownership and control and monitoring costs

Ribstein and Macey argue that, even in close corporations, limited liability may reduce owners' monitoring costs and facilitate diversification and separation of ownership and control.[175] Ribstein himself admits, however, that diversification is not usually an important consideration for closely held firms because most owner managers invest their assets in a single firm.[176] Diversification will only be a major factor where there are passive investors, so this argument has little application to micro-firms, as defined above.

Since the LLC regime is specifically designed for firms in which ownership and control are in the same hands, facilitation of separation of ownership and control also has, by definition, no relevance.[177] Of course, if the firm is to grow (which may be a desirable economic objective) it will need to address these issues, but its governance regime will then need to be reviewed anyway. At this stage of the firm's life cycle there might be a good argument for limited liability, so that we might think limited liability is justifiable from the outset to allow for this expansion without a barrier. This is convincing, but is not proof of the efficacy of limited liability for micro-firms, only a reminder that it may be difficult to separate out those which will remain micro and those that will grow.

The role of limited liability in reducing monitoring costs is also substantially less important where owners and managers are a unified group. They will all have access to information if they are all managers. They will wish to monitor each other's activities in any event. There is some strength in the argument that in an

171 Ribstein (1991), n 39 above; Ribstein (1992), n 37 above, Ribstein (1995), n 26 above.
172 See Hillman n 39 above, 479. This takes us back to the problem of describing closely held firms as if they were a homogeneous grouping; see Freedman (1994), n 5 above and O'Neill, n 99 above.
173 For the UK figures see n 19 above and see n 21 above – Gabaldon suggests the position is similar in the USA. The LLC tax regime is most suitable for firms with small numbers.
174 See Bratton and McCahery, n 45 above, 639.
175 Ribstein (1991), n 39 above, 101 *et seq*; Macey, n 39 above, 451.
176 See n 101 above.
177 Hillman, n 39 above, 484.

unlimited liability regime each partner will need to monitor the wealth of the other partners because potentially each will be liable for the total torts and debts of the firm. This may be a reason for choosing limited liability even though there are few partners and all are engaged in management.[178] In micro-firms there will be few persons involved, however, and they may well be spouses or other close relations. Such monitoring normally will not be costly. The comparison must be with the cost that would be imposed on creditors if the firm had limited liability when either the creditors might bear the cost of excessive risk taking or they would all have to monitor the firm closely to avoid this.[179]

Creditors, insurance and capitalisation

Ribstein attempts to demonstrate that, even if the advantages of limited liability in closely held firms are small, its costs to closely held firms in terms of the cost of credit may be even smaller.[180] He picks up the familiar argument that creditors will protect themselves by contracting around limited liability if they feel that they are very much prejudiced by it. The firm can choose this approach if it wishes to reduce its cost of credit, where the amounts concerned justify the transaction costs. He then takes this further by suggesting that large creditors may even prefer defined personal guarantees to general partnership liability.[181] Other creditors will consider the risk of dealing with the limited liability firm to be acceptable, perhaps because it has sufficient assets. Yet other creditors will not charge differential credit charges under limited and unlimited liability regimes because the debts are too small to incur the investigation and collection costs that would justify lower credit charges for unlimited liability. Also the chance of recovering from the owners under an unlimited regime might not be much greater than under a limited liability regime, for example if all the owners' wealth is tied up in the firm. In such a case the partners of the unlimited liability firm would have to bear the risk of unlimited liability to all creditors without benefiting from compensating lower credit charges. In sum, Ribstein contends that limited liability coupled with guarantees offers a better opportunity for firms to differentiate among creditors than does unlimited liability, so benefiting from lower credit costs in the case of large debts without any great cost in the case of smaller debts. Thus, he argues, limited liability is a superior default rule for small firms.

There are potential losers here, of course. The ability to differentiate between creditors is not necessarily desirable. Personal guarantees are popular with lenders precisely because they give the secured creditor an advantage over the unsecured. For the reasons described above, the small trade creditor may not be in a position to assess the risk being passed to him and to amend his costs accordingly. The sum concerned may be small in each case, but in total a risk is being passed to those who can least afford it. As Hillman asks,[182] 'Who speaks

178 66.4 per cent of limited liability company owner respondents to the author's empirical survey thought limited liability was an important reason for incorporation. 16.8 per cent thought that limited liability to other shareholders was important as compared with around 46 per cent who thought that limited liability to suppliers banks and financiers was important: Freedman and Godwin (1994), n 1 above, 245.

179 Macey, n 39 above, 449.

180 Ribstein (1992), n 37 above, 428.

181 This may well be the case as the former gives them priority, which the latter does not.

182 Hillman, n 39 above, 487. His question is posed mainly in respect of limited liability partnerships, although these arguments apply equally to LLCs. See the similar sentiments of McCahery and Bratton, n 45 above, 686.

on the issue of limited liability for claimants of the firm such as trade creditors, employees, and the like?'

Ribstein does not believe that concerns about trade and involuntary creditors justify restricting the development of LLCs.[183] He argues that owners of closely controlled companies have an incentive to capitalise adequately and insure under a limited liability regime. In his view, they will wish to insure against personal liability and also will want to protect their own investment in their firm through insurance. In addition, Ribstein contends that certain creditors will be likely to provide pressure on small firms to capitalise adequately and to insure. The consequence of all these likely actions will be to extend protection to those creditors not in a position to contract around limited liability.

This reasoning is less than convincing in a micro-firm context. As discussed above, personal liability for torts is imposed only in rare cases, where owner-managers can be shown to have assumed personal responsibility. Although assumption of personal liability will be found to have occurred more often in micro-companies than others, it will still not be frequent. A primary objective of incorporation for many of these owners will be to try to avoid just such liability and the UK courts consider this to be an important point of principle, which will be breached only in exceptional circumstances.[184] Empirical evidence shows that company owners will often have some types of insurance cover, but it may be quite limited in scope: very wide cover is likely to be too expensive for such firms.[185] The micro-firms which give greatest cause for concern in moral hazard terms are those that are undercapitalised. The owners of such firms will have little incentive to protect their investment in the firm through insurance, since such firms will have few assets.[186] They may have insurance in relation to their personal liability as directors,[187] but since the circumstances in which they will be held personally liable as having breached their duty as directors, or having assumed personal liability, will be rare, this insurance may offer little solace to creditors of the firm.

If pressure to capitalise and insure were to come from creditors, as Ribstein argues, this would be from banks or other major creditors: trade creditors and employees are unlikely to have the resources, expertise or bargaining power to exert such pressure. But these large and sophisticated creditors, being mainly concerned about their own risk and not that of other creditors, may be more inclined to take personal guarantees or security over existing assets of the firm.[188] Such measures will reduce rather than increase the capital available for other creditors.

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183 Ribstein (1992), n 37 above, 439.

184 Hillman, n 39 above, 479 notes that USA litigation suggests that 'owners can and do isolate themselves from the tort liabilities of their employees and firms'. On the UK, see n 158 above.

185 60 per cent of the limited liability respondents to the author's questionnaire had product liability insurance for goods or services provided. This compared with 64 per cent of the unincorporated respondents. The difference is not statistically significant and so suggests that limited liability is not being used widely used as an insurance substitute, providing some support for Ribstein, but the extent of insurance cover available to and taken out by these firms is not known (Freedman and Godwin, *Legal Form, Tax and the Micro Business* (London: Institute of Advanced Legal Studies, Working Paper, 1991) 1991). The ACCA Research Report, n 5 above, 19 also found high levels of insurance cover in some areas but only 38 per cent of their respondent companies had product liability cover.

186 Hillman, n 39 above, 482.

187 Finch, n 144 above.

188 Empirical evidence suggests a high degree of dependence on collateral (a capital gearing approach) rather than an income gearing or prospects based approach in UK bank lending to small businesses see, for example, M. Binks and C. Ennew, 'The Relationship Between UK Banks and their Small Business Customers' (1997) 9 *Small Business Economics* 167.

A further argument of Ribstein's in favour of limited liability in the LLC context is that unlimited liability firm owners can seek methods of limiting their liability, such as transferring funds to other family members. Thus, risk shifting to creditors is not unique to those using limited liability regimes. Such risk shifting is possible, of course, if the business owner is sufficiently far-sighted, though it will be subject to legislative restrictions.[189] The author's empirical evidence suggests, though, that unlimited liability owners of small trading firms in the UK view themselves at having more at stake than their limited liability counterparts,[190] and this perception will give them a greater incentive to take care and to insure. A high proportion of small partnerships will consist of arrangements between spouses, which suggests that it will not be practical to transfer property as a means of protection in many cases. Concern about the matrimonial home is often what persuades such owners to incorporate their business in order, as they see it, to protect this asset.[191] They would be most unlikely to want to transfer their home to third parties, even if they were sophisticated enough to be aware of this possibility. If a limited liability regime was not so readily accessible, this concern about the matrimonial home could be reflected in aversion to risky ventures for which insurance could not be obtained and thus protect society from projects that are suboptimally risky and from undue risk-shifting.[192]

Positive benefit or controllable inevitability?

To the extent that the creation and development of LLCs has attracted firms which otherwise would have organised as general partnerships, it will have expanded the opportunities for business owners to externalise the risks of the business.[193] To support this as a positive development on the grounds of efficiency involves an uneasy application to small, closely held firms of reasoning which is more suited to larger, and in particular public, firms. Positive support for limited liability for non-quoted firms, and particularly micro-firms, on efficiency grounds assumes that those firms will grow and that the owners will wish to diversify their shareholdings and transfer shares as well as separating ownership and control. In other words, it assumes that micro-firms will cease to be micro-firms. Proponents of limited liability in these firms must also consider that risk shifting on to, or sharing with, creditors is an effective way of increasing general wealth by ensuring that capital is available for ventures within those micro-firms. This view relies upon the ability of

189 For example, in the UK, certain transactions are vulnerable to challenge by liquidators and administrators under Insolvency Act 1986 ss 238, 239, 244 and 245: Farrar and Hannigan, n 105 above, 728–735.

190 See Freedman and Godwin (1994), n 1 above, 259. 70.5 per cent of unincorporated respondents stated that owner's capital was an important source of finance at start up and 15.8 per cent that long-term loans were important. Of incorporated firms, 21.6 per cent stated that share capital was an important source of finance on incorporation, 19.2 per cent stated that long term loans were important and 10.4 per cent that debentures were important (these were overlapping groups). There was little difference in the importance of bank borrowing between the incorporated and unincorporated firms.

191 In fact they will often lose that protection through personal guarantees, Freedman and Godwin (1994), n 1 above.

192 It might also dry up funds for business enterprise. If the aim is to protect the home it might be best to do this through homesteading legislation to provide specific protection up to a limit rather than through general limited liability: this is discussed further in J. Freedman and M. Godwin, 'Legal Form, Tax and the Micro-Business' in K. Caley et al (eds), *Small Enterprise Development* (London: Paul Chapman Publishing Ltd, 1992) 127. See also DTI Press Release, n 38 above for some tentative suggestions for a provision in the UK to protect a limited amount of a bankrupt's assets to cover the deposit for a new home. This is currently being considered as part of an ongoing review of barriers to enterprise.

193 Macey, n 39 above, 449.

the creditors to monitor to ensure that these ventures are socially worthwhile. It assumes that there is little or no excessive moral hazard, since some of the risk is borne by the shareholders in one of the ways described above, or at least no more of the risk is shifted than would be under an unlimited liability regime. Such an approach seems to take insufficient account of the fate of the creditor not in a position to monitor and of employees and involuntary creditors. Such creditors may well include other small businesses, so the availability of limited liability to small businesses is not necessarily helpful to the small business sector as a whole. This approach overestimates the extent to which the micro-business owner with little capital invested in the firm, who is unlikely to be held personally liable for the acts of the firm, will have an incentive to insure for risks. It also overestimates the extent to which creditors will take actions to protect those dealing with the firm other than themselves.

Like Ribstein, Macey[194] believes that the arguments in favour of the social benefits of limited liability are stronger than the arguments against it, even for closely held companies. He is, however, less certain of this view than Ribstein and explicitly acknowledges that the interests of potential tort victims were not taken into account at all in the process of developing the LLC. His response to this is that the necessary balance should be achieved by 'common law judicial craftsmanship'; that is, by lifting the corporate veil. The problems with this 'solution' have been discussed above. It is both uncertain and cumbersome, and operates only in extreme cases. It remains to be seen how far the courts will be prepared to apply it in the case of LLCs.[195]

If the efficiency arguments for complete freedom of access to limited liability are unconvincing, it does not follow that access should, or can, be restricted. Pragmatism may be necessary. As discussed above, the difficulties of differentiating satisfactorily between firms for which a limited liability regime is desirable and those for which it is not, may prevent the development of a realistic scheme for achieving a sensible division. Macey states that 'once it is acknowledged that limited liability is necessary for the pooling of capital, then it is impossible to refrain from extending the benefits of limited liability to smaller firms such as [LLCs] without creating serious economic distortions'.[196] This logic seems to miss a step. If limited liability is not efficient for small firms per se and can cause both inefficiencies and injustice when applied to them, as argued above, then ideally it will be curbed. Even if we accept the proposition that it is not practical to restrict access to limited liability, this is not an argument for *extending* it and actually facilitating and encouraging use of a limited liability legal form by small firms.

Other explanations for the LLC's popularity

Ribstein has been correct in predicting the spread of the LLC.[197] This outcome could be seen as supporting the limited liability efficiency hypothesis on the basis that interstate competition is a 'race to the top' which has produced an efficient

194 *ibid.*

195 CCH Guide, n 23 above, 44; Ribstein and Sargent, n 35 above, 645; Karjala (1995), n 42 above, 463. The ULLCA 1995 δ303 provides that failure to observe the usual corporate formalities is not a ground for imposing personal liability. Thompson at n 30 above concludes that liability protection in LLCs will not be markedly different than that under the corporate form, but some uncertainty remains.

196 Macey, n 39 above, 449.

197 Ribstein (1992), n 37 above and Ribstein (1995), n 26 above.

legal form through competition.[198] Bratton and McCahery,[199] however, argue that the spread of the LLC is not the result of a 'classic race to the top story in which fifty states compete to supply cost-saving business forms', although neither does it amount to a 'race to the bottom'. Instead the story is based on locally based supply and demand and interest group causation and, as such, provides no basis for an efficiency or inefficiency pronouncement in favour of the LLC. It seems to be agreed that the LLC is the result of pressure group activity. This has produced a legal form demanded by some business owners and their professional advisers, initially primarily for tax reasons, but has not taken into account the needs of the losers from this change: involuntary creditors and others not capable of forming a powerful lobby group.[200] Ribstein agrees that Bar groups supported LLCs in order to retain business in their states.[201] He believes that the rapid evolution of the LLC supports the hypothesis that it is efficient, but is forced to give weight to other factors also.[202] The spread of the LLC in the USA is not itself proof of its efficiency.[203] It has occurred for reasons specific to the USA and is not necessarily a good model for export.

Alternative tests of limited liability

Incorporation with limited liability achieves a degree of risk-shifting which cannot be so easily attained in an unlimited liability regime. To the extent that it makes the risk-shifting more automatic and cost free for the business owner, it increases the chances that risk will be shifted to the creditors. How far this is acceptable is partly a question about efficiency, as discussed above, but also partly a question of public policy. What signals should the law be sending out about risk-taking and personal responsibility? Does sensible encouragement of entrepreneurship demand the subordination of personal responsibility?

We have seen that the efficiency arguments for limited liability for the smallest firms are questionable. Even if we were to accept, contrary to this view, that the current regime was efficient overall because of the support it gives to enterprise, we would need to go further. Is society prepared to sacrifice small creditors? Should losers actually be compensated and how? What costs should society be prepared to bear to devise a system that secures the advantages of limited liability and avoids the disadvantages, perhaps by setting up barriers to access to limited liability for certain firms? Leaving these issues to the market arguably has an 'unjust' distributive effect within the business community and outside it, due to inequalities of information and resources. So, for example, contractual waiver of limited liability may achieve an efficient result for the large creditor, but encourage the business owner to lay off still more of his risk on to those less able to insist on

198 Roberta Romano, 'Law as a Product: Some Pieces of the Incorporation Puzzle' (1985) 1 *Journal of Law, Economics, and Organisation,* 225; Easterbrook and Fischel, n 77 above, 18; Ralph K Winter Jr 'State Law, Shareholder Protection, and the Theory of the Corporation' (1977) 6 J. Legal Studies 251; Ralph K Winter Jr, 'The ''Race for the Top'' Revisited' (1989) 89 Colum L Rev 1526.

199 Bratton and McCahery, n 45 above, 633 and 667 *et seq.*

200 Macey, n 39 above, 452; Levmore, n 45 above, 492. Creation of the LLC might have meant a loss of tax revenue initially since some firms would move from corporate form to the lower taxed LLC, but at least they would be kept within the state and so pay some tax, and create other business there.

201 Ribstein 1992, n 37 above 474.

202 Ribstein 1995, n 26 above 406–411.

203 And see Deakin and Hughes, n 7 above, citing Roe, n 45 above and arguing that 'there is no automatic process of adjustment between the legal system and the external economic environment through which inefficient rules are 'weeded out'.

such a contractual waiver. The ability to do this under the current system signals to the business owner that such actions are reasonable. Only once he gets into difficulty may he find that he has to pay up on personal guarantees to the larger creditors, so that he may not have preserved his personal assets. He may also be made personally liable to general creditors under insolvency legislation, but the signals this offers in terms of guiding business behaviour may come too late to be of strong direct value. They are certainly less direct than would be, for example, requiring a capital contribution from business owners. As Hall argues,

> The law, in allowing limited liability, not only has the real effect of reallocating risks by reducing shareholder liability... but it encourages individuals and society as a whole to think this sort of risk shifting is desirable. It stimulates a mentality that legitimises individuals artificially distancing themselves from the real life effects of their involvement in activities and, in the process, it decreases society's perception of personal responsibility.[204]

The response to this from an economic analysis perspective is that the social benefits of encouraging risk-taking outweigh the costs of risk-shifting. This still leaves the question of deciding how to achieve optimal levels of risk taking. If we *begin* from a principle of personal responsibility, whilst this might not override efficiency in all cases, it does alter the burden of proof. From this perspective we might argue that the onus is on those who argue in favour of risk-shifting to show that its advantages apply in the case of small, closely held corporations, not on those who doubt its advantages to show why it should not apply to these firms. On this view, efficiency would not be ignored, but weighed in the balance with the values to be fostered in the business community, such as the concept of personal responsibility.[205] The practical difficulties in the way of excluding small firms from limited liability regimes would remain. The arguments in favour of encouraging such access and making it simpler, however, would be seen to be weak, and would be countered by the need to underline business owner's responsibilities from the outset in order to protect them and others in the long term. The company law reform process in the UK is very different from that in the USA. Theoretically there is an opportunity for all groups to comment on proposals, but, as in the USA, those groups most in need of protection are the least able to lobby and respond to consultative documents, so their needs must not be forgotten by the policy makers.[206]

Conclusion

It has been shown that the arguments for the efficiency of limited liability are widely, although not universally, accepted for public corporations in respect of contractual creditors (though in the case of tort creditors there is some disagreement). For small, owner-managed or micro-firms, the efficiency arguments are much less clear. Returning to the economics based questions posed in the first part of this article, first, within very small firms limited liability does not seem to allocate risk to those most capable of bearing it, but rather favours sophisticated contractual creditors over smaller and involuntary ones. In the long run this must weaken the small business sector as well as others, since other small businesses frequently lose when one of their number fails.

204 Hall, n 16 above, 168.
205 For a similar argument see Vestal, n 52 above, 523.
206 J. Freedman, 'Reforming Company Law' in Patfield, n 72 above, 217–219.

Secondly, limited liability for micro-firms does not necessarily achieve optimal levels of risk-taking. In some cases, easy availability of this regime provides an incentive for small firm owners to try to undertake unduly risky ventures in the belief that they are protected and can shift the risk to others at no or little cost to themselves. In fact they may subsequently discover that this has not been entirely possible and that they will have some measure of personal liability, but nevertheless others may lose where they have been successful in shifting the risk. The signals sent out by the law are confused and it does not obviously achieve optimal levels of risk-taking.

Finally, the role of limited liability in reducing transaction and monitoring costs is much reduced in micro-firms. In some respects, the apparent existence of limited liability adds a layer of costs, such as disclosure costs. There is then pressure to reduce these regulatory burdens[207] for firms where limited liability does not accompany separation of ownership and control. To provide special, lightly regulated, vehicles in such cases, however, encourages those for whom limited liability is not efficient for the first two reasons to enter into such a regime.

So, the application of the economic efficiency arguments devised for public companies to micro-firms is not convincing. It is justified only as the micro-company begins to grow and acquire some of the characteristics of the public company. It is, however, very difficult to find methods of differentiating between those firms where limited liability might be efficient and those where it will not: firms that might grow and those that will not. It is argued in the literature, therefore, that it is impossible to refrain from extending the benefits of limited liability to smaller firms on grounds of practicality and avoidance of economic distortion.[208]

It might seem to follow that if micro-firms cannot be excluded from limited liability regimes, it should be made easier and more efficient for them to use them, on grounds of consistency and competition. This does not follow logically. The fact that it is hard to restrict access to limited liability does not mean that it should be encouraged if that will result in yet more inefficiency. In addition, as argued above, other questions of social policy, such as the signals given by the law on personal responsibility, must be considered. Limited liability for small firms is often argued to be essential for the encouragement of entrepreneurship but the level of risk-taking which is to be encouraged, and at whose expense, must come into this equation to avoid an 'unjust' distributive effect due to inequalities of information and resources.

There are real difficulties encountered in, and objections to, making access to limited liability more difficult for micro-firms. These problems should not prevent the use of signalling devices, such as a minimum capital requirement set at a low but not insignificant level, combined with information about the implications of limited liability. These devices would not set up barriers to genuine enterprise, but would prevent some incorporation with limited liability that had not been properly considered. A minimum capital would not stop rogues from attempting to abuse limited liability. Other measures would still be needed for that. A significant minimum capital requirement might, however, encourage business owners to take proper advice on set up. Obtaining such advice would have its own cost but could also have many beneficial effects, including awareness of statutory measures that might result in personal liability. Ideally, these developments should be combined

207 Often hand in hand with pressure for internal governance reforms, not discussed here.
208 Macey, n 39 above.

with a more principled and cogently expressed approach from the courts, recognising the dangers as well as the advantages of limited liability. Taken together, this group of measures could result in much stronger signals being given to business owners about the balance between risk-taking and personal responsibility.

Creating a specialist limited liability form for small firms, or a less regulated version of incorporation, might encourage inappropriate use of the limited liability regime that could otherwise have been avoided. If such a regime is to be provided, therefore, it is most important to be aware of the disadvantages of limited liability in micro-firms so that an attempt can be made to counter them by protecting or compensating those who must bear the resulting costs. If anything, LLCs and similar specialist limited liability regimes for micro-firms need to be more, not less, heavily regulated in relation to third parties than larger corporations since the potential to exploit moral hazard is greater. The fact that the overall sums involved are smaller may not prevent losses to small creditors that are of a significant level for them. If the business owners object to these regulatory protections, they should be encouraged to adopt unlimited liability legal forms. Appropriate unlimited liability regimes need to be available, therefore, and prospective business owners need access to good information about the choices available to them.[209]

Limited liability is not universally beneficial, either for business owners, or those who deal with them. The current enthusiasm for limited liability both in the UK and in the USA and amongst lawyers as well as politicians needs to be considered carefully both in terms of economic efficiency and from other perspectives. In the USA the LLC has emerged as a product of a combination of factors rather than being the result of a clearly articulated consensus of all groups concerned that limited liability should be extended and made more accessible.[210] The UK should not be persuaded that it needs to make opting for limited liability even easier and more attractive than it already is for small firms merely because of developments emerging in other jurisdictions. Limited liability has its limits.

209 The Law Commission recommended to the DTI, in 1994, that education and reform of general partnership law was the way forward: DTI, *Company Law Review: The Law Applicable to Private Companies*, n 5 above. See also Freedman (1994), n 5 above, 583–584. A Law Commission report on partnership law is now awaited.

210 Vestal, n 72 above.

