CORPORATE LAW & ECONOMICS OF LIMITED LIABILITY: A PERSPECTIVE OVERVIEW AND SOME OPEN QUESTIONS!

- *Lucas Fulanete Gonçalves Bento*[*]

I. INTRODUCTION

Limited liability is considered to be "the feature" of corporate law. From a Corporate Law & Economics perspective, for very broad and different economic stimuli and reasons, it is supposed that limited liability provides gains from improving liquidity and diversification.

Although, it is knowledge that in some cases where there is much less separation between management and risk bearing, those gains are minimal while creating a high probability that a firm will engage in a socially excessive level of risk taking. When such cases happen and are studied in closed corporations, they are obviated by the piercing the corporate veil.

Here, we are proposing an overview of the economic and legal reasons of the creation of limited liability rule. We will review in a structured and organized manner as to how such topic has been studied by the mainstream scholars of the area, adding some personal analysis to the topic under combination of more recent studies of behavior law & economics and social development economics.

Also, in this essay, we bring as first publication of our current topic of research at the University of Hamburg, in which we propose that the even in publicly listed corporations, when the major active controlling shareholder figure is known and indentified, the lack of well defined separation of management and risk bearing has very close effects to the closed corporation cases; excepting that piercing the corporate veil in such situations may have potentially even more harmful effects.

[*]Lawyer, LL.B. at the University of São Paulo with sandwich period as Visiting Scholar in Law & Economics at the University of Illinois at Urbana-Champaign UIUC and IV SILE of Economic Analysis of Corporate Law and Commercial Contracts in the Coase-Sandor Institute for Law & Economics at The University of Chicago. PhD Candidate in Corporate Law, Commercial Contracts and Capital Market at the Universität Hamburg.

ISSN 2582-2667

II. LAW & ECONOMICS OF LIMITED LIABILITY

Bainbridge and Henderson (2016, p.1) says that the production in other forms of organizations that not such in limited liability corporations is known for thousands of years, however, the result of using such forms were widespread poverty as well as low levels of productivity and innovation.[126] For them, the central problem was that risk taking and collaboration were inhibited using other forms of organizing activities, as all the investors of such previous forms of business endeavors were carrying unlimited risky for each of its investment.

In that sense, focusing in the importance of legal tools designed for social development, Cooter and Schäffer (2011) has explained that the growth of the economy happens when companies develop innovations and those innovations depend on the combination of new ideas and capital.[127] Although, to combine these two it is necessary to face the mutual trust dilemma; meaning that to develop one innovation, idealizer shall trust that the investor do not steal its new idea and the investor shall trust that the idealizer to not divert the capital invested.

Frank Easterbrook and Daniel Fischel (1991, p. 41/44), summarizing the studies in the economics stimuli brought by limited liability as a corporate law rule, come onto five aspects of it:[128]

- **i.** Limited liability makes diversification and passivity a more rational strategy and so potentially reduces the costs of operating the corporation.
- **ii.** Limited liability decreases the costs of monitoring the agents behavior in managing the company.

---

[126] STEPHEN M. BAINBRIDGE & M. TODD HENDERSON, LIMITED LIABILITY: A LEGAL AND ECONOMIC ANALYSIS 1 (Edward Elga 2016).
[127] HAND-BERND SCHÄFER& ROBERT D COOTER, SOLOMON'S KNOT: HOW LAW CAN END THE POVERTY OF NATIONS (Princeton University Press 2011).
[128] FRANK H. EASTERBROOK & DANIEL R FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW41-44 (Harvard University Press, Cambridge, Mass 1991).

ISSN 2582-2667

iii. Limited liability makes identity of others shareholders irrelevant in the valuation of the company's and insolvency risk of it. Thus limited liability avoids the costs of monitoring all the shareholders.

iv. Limited liability permits easier transfer of blocks of shares, which facilitates a new shareholder who buys a block of shares and acquire the power to change the managers of the company. This potential for displacement gives the existing managers incentives to operate efficiently in order to keep share prices high.

v. Limited liability permits that shares are fungible. With limited liability the value of a share is a function of the income stream generated by the firm's assets, what permits that every share has a price to be negotiated, otherwise, the value of share would be a function of the present value of the future cash flow and the wealth of the shareholders, becoming not fungible.

In the next section of this essay, we will explore these five aspects as considered by the use of simple examples and bringing some extra thoughts on its effects in the mutual trust dilemma.

2.1. MODELING THE ASPECTS OF LIMITED LIABILITY

Imagine a person holding $ 100.000 patrimony and he wishes to invest the available half of it in a company. From this, let's compare two situations; with and without corporate shareholder's limited liability. In the first the limit of his losses is $ 50.000, since if the company fails the worst scenario is that he never gets dividends and also loses the amount invested. In the second there is no limit, since if the company fails the creditors will pursue their credits against the shareholders and it can lose its whole $100.000 patrimony.

It is not hard to figure that the first situation is better off to the investor than the second, once the risk of personal liability for the investor lowers the cost of his investment. To understand even better why the first option is more attractive and fundamental to allow

ISSN 2582-2667

the investments in companies' equity, we will describe 5 economic stimuli associated to corporate shareholder's limited liability: 2.1 investment diversification, 2.2 risk aversion compensation, 2.3 reduction of monitoring costs, 2.4 fungible shares, and 2.5 efficient control transfers.

2.1.1. Investment Diversification

Let's imagine again a person holding $ 100.000 patrimony and he wishes to invest the available half of it. But now it has other two options: invest $ 10.000 in 5 different companies or invest $ 50.000 in only one company.

In the first situation his investment is very diversified, so, just to facilitate the calculations, assuming each company has a chance of 50% total failure, he multiplies this chance by the number of investments (50% * 5 = 25%) obtaining a very strong reduction of the total chances of losses, and, indirectly, his cost of investment (25% * $50.000 = $12.500). If one compares this situation with that of only one investment, then all the $50.000 is exposed to only one time of the 50% fail rate (50% * $50.000 = $25.000), what using our number for example given, makes this situation an investment twice more risk costly.

However, everything we have described above is only being worse of because of in a no corporate shareholder's limited liability investment. In the first situation, the person would not rely in the diversification as a strategy of investment cost reduction, because he knows that each of those 5 investments can consume the whole $100.000 patrimony (which includes the amounts allocated in other investments) in case of a total fail.

The non stimulus for the diversification has a potential strong effect in economy as well.

By that what concerns here is that new ideas usually are initially funded by more relational investors (famously famous in finance as 3 Fs, family, friends and fools) or professional high risk-taking investors (private equity and venture capital - whom are

ISSN 2582-2667

also very relational addressed), and in either situations a relational investor has interest of funding the idea it is not willing to expose its whole patrimony by doing it; same to a professional high risk-taking investor that really works with business where the rate of total fails is way higher. This business only exists because the investor will have losses limited to the amount invested in each company, and the one company that goes well will compensate the ones that went fail.

So, as elaborated above, without the corporate shareholder's limited liability, the dilemma of mutual trust would set its point for the investors, that would not feel comfortable in funding new ideas instead of allocating their capital in more trustworthy investments (such as consolidated business or financial system). This situation not only hampers the development of economy's growth but also makes the concentration of capital and income (inequality) even more probable.

2.1.2. Risk Aversion Compensation

Kahneman &Tversky (1979) have proved that besides, from the mathematical finance perspective for investments, damage losses and profit losses are equivalent, the psychological effect of them in the investors are not the same.[129]The behavioral consequence of this difference is that risk-averse investors will not invest in situations where there is a posited expects monetary value just for the fear of suffering a damage loss.

Taking once again the example of our investor holding $100.000 patrimony willing to invest the available half of it; let's imagine that he has two investment proposals with and expected positive value in both; to invest in company or to buy some kind of debt bonds. In the first investment, if the business plan of the company works, by the end of the first year, the investor gets an increase in his equity participation of 50%, however, there is also a 50% chance that the company fails and he loses everything invested and also he

[129] Daniel Kahneman& Amos Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 47 ECONOMETRICA 263, 263 (1979).

ISSN 2582-2667

has to cover extra $1.000 in discovered liabilities of the company. In the second investment, he will be paid a 15% of interest rate and the risk of default is 5%.

For the investment in the company the expected monetary value (MVc) can be expressed as MVc = (0.5)*($50.000+$25.000) + (0.5)*(-$50.000-$1.000) = $63.000. And, for the investment I bonds the expected monetary value (MVb) would be EVb = (0,95)*($50.000 + $7.500) + (0,05)*(-$50.000) = $57.125.

In this situation the expected monetary value of the investment in the company is ($63.000-$57.125=$5.875) is more than 10% higher than the expected monetary value of the investment in bonds, however, the idea of extra damage loss (the $1.000 extra that the investor can be called to cover) makes him avoid this kind of investment.

Once again we have the shareholder's corporate limited liability working as a tool to deal with the mutual trust dilemma and facilitate that more investors, even with higher levels of risk-aversion, makes the decision of funding companies and business ideas instead of going for less social desirable investments; as explained above companies and new business ideas are the most important ground for economy growth and development.

2.1.3. Reduction of Monitoring Costs

Now we come to the point that shareholder's corporate limited liability deals with the mutual trust dilemma in its most evident way. The point here is that, because of shareholder's corporate limited liability, the identity of the other shareholders of a company are almost irrelevant. In a company with no corporate shareholder's limited liability, the wealth of each shareholder to cover the potential discovered liabilities of the company, in case it fails, matters for the valuation of the company itself and for the valuation of each shareholders share in the company.

When an investor is going to make an investment in a company with no corporate shareholder's limited liability it would have to verify the wealth of each of the other

ISSN 2582-2667

shareholders, in order to attest they are wealthy enough to cover their part of the discovered liabilities if the company fails, otherwise, it will pay more discovered liabilities that the others shareholders couldn't cover. Also, besides the preliminary verification, the investor would have to monitor it, meanwhile, he keeps his investment because the wealth of the other shareholders can (and most probably will) change and it will change the risk and value of its own investment.

The costs to make this kind of verification and monitoring would be very high and inefficient, especially when it comes to large companies with thousands of shareholders. Also, it would bring up two very well known costly market failures: information asymmetry and quality uncertainty.

First, it is not necessary much more arguments to assume that the information that each of the shareholders would have about the other would not be homogeneous. This asymmetry would creates all kind of the different valuations for the company. Each shareholder would have its own valuation of the company, once they have different information of the financial asset of the other shareholders.

For the second, we would have a quite close situation of quality uncertainty as showed by Georg Akerloff in "Martket for Lemons". The patrimony and wealth of each shareholder would always be uncertain for the others, even because of the changes it can suffer constantly. This uncertainty, caused by a sort of obstacles (and costs of information) to have a trustworthy quality of the other shareholders, would make each of them take it as a factor to undervalue the other's wealth.

Both cases lead us to a conclusion that without the corporate shareholder's limited liability, the monitoring costs of making an investment in a company would be way higher and would end in a general tendency of less investment of this kind.

As said before, this point is most evident when it comes to see from the mutual trust dilemma perspective, because once there is no stimulus for the shareholder to trust in the

quality of the information it get about the valuation of the company it is considering to invest in; corporate shareholder's limited liability makes the information about of other shareholders almost irrelevant as considerable risk of the investment, and, as consequence, for the valuation the company.

2.1.4. Fungible Shares

One way of companies to look for funding on their business ideas is the development of Capital Market. Public offering shares of the company for any interested investors, the company can fund their ideas without taking current liabilities, and on the other hand the investors can allocated their available money in investments that are supposed to bring higher expected monetary values and have also liquidity enough in case the money is needed by them.

However, the possibility of a Capital Market is based on the idea that it does not matter who the people are holding the shares of the company, just if they have paid their subscription money.

III. WHY PIERCING THE CORPORATE VEIL?

As shown, the body corporate not only protects firm assets from shareholder's debts, but also protects shareholders from liabilities arising from the corporate activities. For both sides limited liability has been the tool to provide the proper development of companies and business activities in the way it is known nowadays and for such it is not a rule that can be set aside easily given its individual and collective importance.

However, in certain situations, courts are likely to allow creditors to absorb the assets of the shareholders. Those decisions are based in cases where limited liability provides minimal gains from improve liquidity and diversification, while creating a high probability that a firm will engage in a socially excessive level of risk taking.[130]

[130] EASTERBROOK & FISCHEL, *supra* note 128, at 55.

ISSN 2582-2667

The principle of the correspondence between management of business power and risk taking liability plays a relevant role in economic life. It sanctions the irresponsibility in the conduct of the company. Faced with the possibility of suffering the consequences for irresponsible managing, the holder of business power naturally tends to exercise his activity with diligence and care.[131]

Most of the cases on disregarding the corporation's legal entity, allowing the creditors to reach shareholders assets, happen in closed corporations.[132]

Some explanations for that theory is that there is much less separation between management and risk bearing, because those who supply capital in a closed corporation typically are also involved in decision making.[133] In those cases limited liability does not reduce monitoring costs, at the same time the diversification are much less important in closed corporations.

3.1. CORPORATE CONTROL

For majority of the scholars veil piercing should be rare, as per as they are intend to understand that such doctrine are still unprincipled and arbitrary.[134]

However, a comparative study on the empirical studies of veil piercing in a variety of countries, even between different legal systems, has shown a very common sense between all of such decisions, they identify an "owner" of the corporation that dispose of its assets as off him/her/itself.[135]

---

[131] EDUARDO SECCHI MUNHOZ, DESCONSIDERAÇÃO DA PERSONALIDADEJURÍDICA 213 (2002).
[132] ROBERT B. THOMPSON, PIERCING THE CORPORATE VEIL: AN EMPIRICAL STUDY 1039 (1991); EASTERBROOK & FISCHEL, *supra* note 128, at 55; CHARLES MITCHELL, LIFTING THE CORPORATE VEIL IN THE ENGLISH COURTS: AN EMPIRICAL STUDY 17 (1999).
[133] CLARK, ROBERT C. CORPORATE LAW. BOSTON: LITTLE BROWN & COMPANY, 1986.
[134] BAINBRIDGE & HENDERSON, *supra* note 126, at 19.
[135] THOMPSON, *supra* note 132, at 1039;EASTERBROOK & FISCHEL, *supra* note 128,at 55; MITCHELL, *supra* note 132, at 17.

The dynamics of power in corporations was the object of several legal attempts to understand reality by categories suitable to frame business power, but the mutability of these relations of power has always exceeded the scope of such understandings.[136] When we talk about the control over a corporation, some different understandings through comparative law can be found.

In the German stock law of 1965 which defines control from a broad notion of dominant influence (§ 17 et seq.), as well as the Italian civil code, amended by Law no. 216 of 1974, which defines controlled companies as companies that are under the dominant influence of another company because of the shares or quotas held by it, or of particular contractual links with it (article 2.359).

Even in South America, we have the Argentine law of 1972 that defines as controlled companies those in which another company directly or through another company, in turn controlled, has participation, for any title, which grants the necessary votes to form the social will (article 33).

The Brazilian Corporate Law, dealing with the figure of the Controlling Shareholder, defines it as the natural person or legal entity, or group of persons bound by a voting agreement, or under common control that, having the rights of a member that the majority of votes in the deliberations of the general meeting and the power to elect a majority of the company's directors, and effectively uses that power to direct social activities and guide the functioning of the company's organs (article 116).

In order to explain the legal qualification of the power of control, it is helpful to understand some concepts from the German doctrine on the gender of the powers of action on others legal sphere.

From that we can see that the power of control is not a formant right (*Gestaltungsrechte* - which is exercised in the benefit of its own, eg the right to vote), or a management or

[136] PATELLA, Laura Amaral, Controle Conjuntonas Companhias Brasileiras: disciplinanormativa e

ISSN 2582-2667

administrative right (*Verwaltungsrechte* - exercised in the benefit of the subjects whose legal sphere produces effect, by means of a derived prerogative, eg trustee). It is a power properly (*Macht-befugnisse*), which involves exercise in the benefit of the subject on whose legal sphere produces effect, however, by exercising its own prerogative.[137]

For that reason, the behavior of those who holds and use power of control closely approximates that of an individual entrepreneur. The concentration of capital permits that the controlling shareholder uses the benefits of the corporation form, without losing its prerogatives to control the business itself.

The controller essentially has the power to dispose of these goods, to sell them, to mortgage them or to engage them, to exchange them, or to consume them. Such power, well known to lawyers, is the classic *iusabutendi*, an essential element of property. Control is therefore the right to dispose of the property of others as an owner. Controlling a business means being able to dispose of the goods that are destined for it, of such art that the controller becomes master of its economic activity.

3.2. NOT A CONCLUSION

After reading the above it may seem that we are arguing at the corporate control shall be the key factor of the veil piercing or either the fundamental reason for it, but as the subtitle of this section shows, that is not a conclusion we are seeking or even agree.

In seminal text Berle & Means (1993) has understood the corporate control in multiple categories depending on the factual reasons of such control.[138] As showed by them it is possible to control a company since from the obvious aspect of majority shares to the aspect of excessive diversification in shareholder's ownership structure, permitting that any minimal amount of concentrated capital controls the company.

pressupostosteóricos, 11, (2015)(Unpublished PhD thesis Faculty of Law, University of Sao Paulo, São Paulo).

[137] FÁBIO KONDER COMPARATO & CALIXTO SALOMÃO FILHO, O PODER DE CONTROLE NA SOCIEDADE ANÔNIMA139 (4th ed. 2005).

ISSN 2582-2667

However, for the sense of proprietorship behavior for the power of control, as we have shown above, does not seem to be applicable to every category, especially if we are talking on categories that do rely on the passivity of other stakeholders.

In that sense, it is important first of all to be sure that we are talking as fundamental factual "box check" in veil piercing, the possibility of indentifying a major controlling shareholder, whom its majority is in such level that factually nullifies the opposition of minority shareholders by ordinary means.

Even though, it is not our intention to advocate that the control in such a sense should be the reason of piercing the corporate veil. We understand it just as a factual circumstance which has been verified in the decisions of those cases. In economic terms, we can say that control is correlated to the possibility of piercing of the corporate veil, but not the cause of it, especially it cannot be in the case of publicly listed companies, as exposed.

IV. WHAT REMAINS FROM THE ABOVE?

As said from the introduction, this essay aims to a brief review on the economic and legal reasons for the limited liability rules and its abuse and remedies. We also pointed out that piercing of the corporate veil, it's the known remedy but mostly it is somehow feared by majority of the scholars, even though we do believe, under the analysis of empirical studies, that there is a common ground, even just from a factual perspective, to sustain such a doctrine.

From that, and as brief as the text is proposed to be what really remains is the non answered question by empirical studies. By that we mean, we showed that piercing the veil has been used as the remedy for abuse of corporate limited liability, however such solution as almost exclusively applicable to closed corporations with low number of shareholders.

[138] ADOLF A. BERLE & GARDINER C MEANS, THE MODERN CORPORATION & PRIVATE PROPERTY (Legal Classics

ISSN 2582-2667

In concentrated markets, although, the existence of an effective controlling major shareholder is not uncommon even in publicly listed corporations.

As showed by La Porta *et all* (1998), in 1996, besides USA and UK, all the countries with established stock exchange organizations for equity capital market has more than 50% of 20 largest publicly listed companies with strong block holders. As well as, if we talk about Brazil, in 2014, from the largest 225 publicly listed companies 90% has a defined controlling shareholder that holds in average 76% of voting capital and/or 54% total capital.

The existence of a figure such as controlling shareholder seems to not be very suitable for the economic reasons that supports the benefits of limited liability, however, it does not also seems to be possible to establish a equity exchange market without this feature.

In such context, comes the research questions to be answered here proposed: does such control in publicly listed corporations affect the benefits of the limited liability as a corporate feature that allows investment? If so, is the veil piercing the proper solution for freshen the necessary economic backgrounds needed for corporation investments development?

As our preliminary view, we understand that in concentrated markets the confusion between corporate control and business control is so intensive that the limited liability is not a sufficient feature to guarantee the economic stimuli that it provides for the development of equity capital markets in non-concentrated corporate ownership environment.

However, the solution of disregarding the limited liability, as provided by the courts especially in closed corporations, has no better economic consequences. So that, we aim that if confirmed our proposition, it is our current topic of research, and for which we

Library New York N.Y. (1993).

ISSN 2582-2667

once again open the invitation for inputs of all readers, how to construct different legal features for business controlling liability to provide economics stimuli, that aligned with the limited liability, could avoid the confusion between majority shareholder and business control on corporations or at least the non-contributively effects it can have in the development of an equity capital market.

ISSN 2582-2667