LAW AND ECONOMICS

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Week 11

Company law
Limited liability

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Company law: main issues

Hansmann–Kraakman:

1. legal personality;
2. limited liability;
3. transferable shares;
4. separation of ownership and control;
5. ownership by contributors of capital
   - All aspects: public shareholding company

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Structure of the week

I. What is a company? – economic models
II. Basic logic of limited liability
III. Incentive effects of limited liability (veil-piercing)
    I. Risk-taking
    II. Diversification
    III. Control
IV. Limited liability and economic models of the company
V. Administration problems
VI. Limited liability and distribution
VII. Misuse – Empty shell

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I. What is a company?

Property and contractual model

Property model: company serves investors, shareholders

- Really? Agency problem: private interests of management?
- C.f. owner of the company in the economic sense?
- Problems of shared ownership – divided ownership: how to persuade and control management. Collective action necessary
- Problem of collective ownership – divided ownership: control and information are public goods.

Basic assumption in most (European) legal systems.

Contractual model: *nexus of contracts*

- Organized relations between company and *stakeholders* (input owners, contractors, employees, buyers, local community, etc.).
- Organized relationship = (implicit or explicit) contracts
- Implicit contracts: e.g. based on market-based expectations (expected return to shareholder)
- „Company” = management (contracting in the name of company).
- *Shareholder* is one of the stakeholders.

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II. Limited liability: Basic issues

- Economic debate: is it necessary?
  - Dilemma:
  - If revenue < debt, all revenue goes to creditor.
    - No (weak) interest of shareholders to increase revenue.
  - Above this level: profit to shareholders.
  - If profit goes fully to shareholders – why should loss not be financed by them?
- Legal solution: veil-piercing – limited liability, but shareholder assets can be reached in some cases.

  In some legal systems: veil-piercing if

  1. Assets of company and assets of shareholders are not separated clearly.
  2. Decisions by shareholders are dangerous for the company – and are known to be so.

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II. Limited liability: Basic issues

- *Almost* consensus: contractual creditor does not need to be saved through veil-piercing.
  - Contractual creditors = contract with the company.
  - Institutional creditors: banks, financial institutions
  - Market creditors = unpaid contracts
- Contractual relationship: opportunity for ex ante compensation (if not, their risk) – incentives for ex ante risk-assessment
  - E.g. extra security (or shareholder guarantee) in contract

  BUT:
    - Bounded rationality – why consider it? Learn!
    - Information asymmetry – why veil piercing rather than disclosure? (e.g. invalid contract)

  BUT: if small probability of small asset => high (transaction) cost of ex ante risk assessment.

  Institutional creditor (bank, security): no need for veil piercing
    - Better risk-assessment techniques (lower transaction cost than for market creditor or small shareholder)
    - Less risk-averse (than market creditor or small shareholder)
    - Strong solutions (covenants in credit contract against future debt, secured credit, etc.)

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II. Limited liability: Basic issues

The effects of limited liability (veil-piercing) depend on the basic structure of tort law

Suppose:

1. Negligence (vs. strict liability);
2. Unforeseeability test in tort law;
3. Better risk-bearer test;
4. Joint and several liability of shareholders – risk of others' judgment-proofness borne by first payers);
5. Biased against company;
6. Judgment-proofness (i.e. limited liability) in tort law as well.

Incentives:

1. Externalities.
2. Diversification of investments.
3. Shareholders effort to control

III. Incentives

Externality, risk-taking

- *Risk-averse investor:*

	Project A Social benefits	*Project B* Social benefits	Limited liability: Private gains from both
A (Pr=0.25)	11	11	11
B (Pr=0.25)	1	1	1
C (Pr=0.25)	–1	– 1	– 1
D (Pr=0.25)	– 10	– 12	– 7

- Risk-averse investor:
  - If unlimited liability (full social benefit) – neither Project A, nor project B: high risk of loss vs. small expected profit
  - Project A: positive social gain – if limited liability, investment.
  - BUT Project B – social loss – if limited liability, investment as well.
- Is the investor risk-averse?
  - General assumption: he is not (diversified investment) – no need for limited liability.
- BUT: small and medium companies, family companies? Limited liability as incentive of risk-taking
  - Excessive risk-taking, too.

III. Incentives

Diversification

- Unlimited liability: control needed.
  - I.e. joint and several liability = extra risk of others' judgment-proofness.
- Consequences
  - Undiversified investment
    - If diversified – control over many companies
  - Concentrated ownership within a company.
    - Not interest in buying small shares – Joint and several liability: potential suit against small investors as well, but weak control over management.
  - Need for information about other shareholders' wealth to avoid others' judgement-proofness.
    - Information problem
    - Investment not through equity but loans

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III. Incentives
Control

- Expectation: concentrated ownership => stronger control over management
- BUT
  - Possibility to reduce the agency problem (at what cost)?
  - If not…
  - …public good – free riding:
    - Unlimited liability (easy veil-piercing) is worse: concentrated ownership without extra control
  - Implicit assumption: management takes too much risk (i.e. shareholder should control)
    - Really?
    - Economic models: management takes too little risk (compared to shareholders' interests): management is risk-averse.
    - Why? Company specific capital (information) + reputation
      - In case of bankruptcy: both lost.
    - But near to bankruptcy: excessive risk-taking (for the sake of resurrection) – if it fails: bankruptcy like without risk-taking, if success: large gain.

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IV. Limited liability and models of the company

Property vs. contractual model: different answers

- Property model: agency model
  - Profit to shareholders – loss to creditors?
  - Model of vicarious liability: control over company.
  - BUT: vicarious? – Not every principal (contract: no; employment: yes)!
    - If no control, it is worse : management could shift the cost to shareholders.
  - Negligence? – Suboptimal (limited) damages have no effect (only if damages are very small)
- Contractual model: nexus of contracts
  - Shareholder is one of the stakeholders (capital is one of the inputs): why make him liable?
  - Unlimited liability / veil-piercing: shift from investment (shareholder position) to credit, high leverage.
  - Selection of shareholders: small asset owners (judgment proof) and risk-averse.

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V. Administrative problems

Which shareholders should pay?

- Shareholders at what time? (time of contracting, the activity, the failure or loss, the beginning of the suit, the judicial decision or bankruptcy)?
  - How does it affect share trade? Capitalization?

- Administration: who is (was) a shareholder? From where do we have information? Shareholder registry: not all shareholders (only those who want to participate and vote at shareholders' meetings)

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VI. Fairness, distribution
Incidence

Fairness, distribution: who pays for the loss – shareholders, not the victim…

Two basic situations:

1. With liability insurance

- Increased price – paid by the buyer.
- If victim is a contractual creditor? Ex ante defense? (asymmetric information?)
- If he is not a contractual creditor (e.g. victim of an accident) – distributive question: victim or buyer? Better risk-bearer… no a-priori answer (unlimited liability assumes it is always the shareholder)

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VI. Fairness, distribution?
Incidence

2. Without liability insurance

Model:

- X: Limited liability investment
- Y: other investments
- Decreasing marginal return in both
- Equilibrium (equal marginal return) at point 1

Suppose: fixed quantity of capital

Unlimited liability (shift of return in X): new equilibrium

- lower return in BOTH sectors

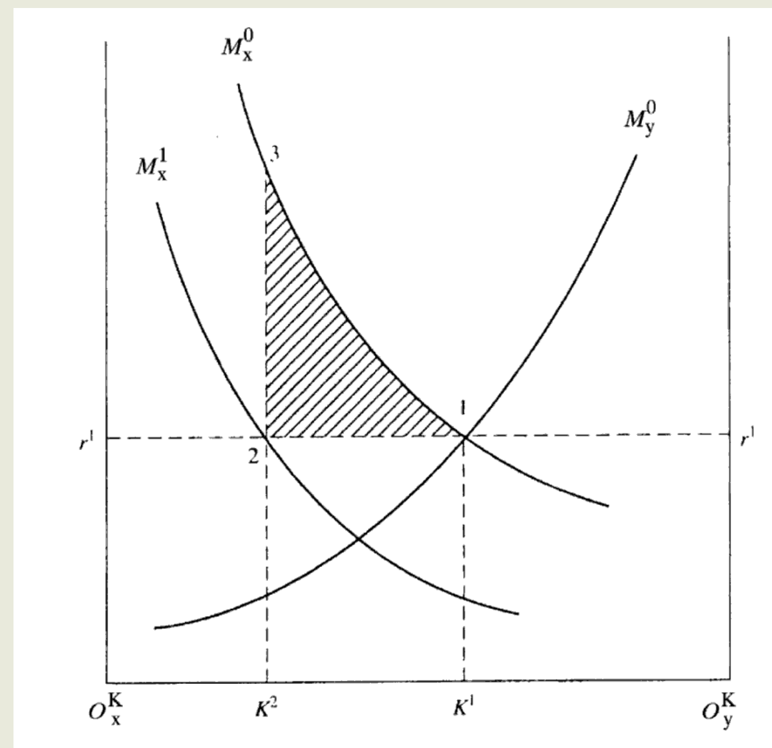
BURDEN NOT ONLY ON SHAREHOLDER – on all forms of investment

Trade off: victim or all investors?

- Better risk-bearer test: none of them had better information or could prevent risk

Simplicity?:

- Where it falls – no suits, no administrative costs => loss borne by victim.
- Loss borne by group with more assets (wealthier)… => are these always really the investors?



VII. Misuse – empty shell

Example: owner of ship vs. shipping company

- Shipping company's profile: oil transport. No tankers – the tankers are leased from other companies.
- Tankers owned by a different company of the same owners (shareholders).
- Accident – water pollution, large amount of damages. Tort against the shipping company with no assets. Asset of the other company (tankers) available only through veil-piercing.

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VII. Misuse – empty shell

Problem: intentionally small asset => goal: avoiding high damages…

Government regulation

- High capital requirement
  - When? Entry, Founding? Future withdrawal?
  - How large? Lobby: entry constraint, limiting competition.
- Deposit? Give it back upon exit.
  - Similar effects on competition
- Mandatory liability insurance…

Private enforcement – civil (common) law: good faith, honesty – assessed in all cases: intentionally small asset?

- When is it ‘small’? If foreseeability test…
  - Practically: negligence rule on assessing capitalization: is the capital of company enough to finance expected damages?
  - BUT: decisions made by management (not by shareholders)
- If company has a daughter? If two companies are owned by the same owners? Higher standard for corporate owners?
  - Manipulation of shareholder structure – e.g. small share for employees?
  - Daughter not only for reducing liability – e.g. on different market: more information for investors if separated asset (balance)

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Practice

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Company law: main issues

Hansmann–Kraakman:

1. legal personality;
2. limited liability;
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5. ownership by contributor of capital
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- What is a company? Property vs. contractual models

Problem

In several countries, it is hotly debated how creditors should be satisfied when a company has become insolvent and is being liquidated. In what sequence should the creditors be paid from the company's remaining assets?

Most criticism targets the rule which states that those creditors should be satisfied first who have a contract with the firm and has secured their loans by various means (e.g. mortgage).

Critics of this rule demand that creditors should be paid in the reversed order: first should come those who suffered harm while they had no contractual relationship with the firm (e.g. they were victims of an accident).

How do you evaluate this criticism?

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Solution

- Contractual vs. non-contractual creditors (e.g. tort victims)
  - Contractual = better control?
  - Transaction costs: ex ante defense exists?
  - Smaller return on loans – how would it affect financing, the capital market?

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Assumptions about tort law

1. Negligence (vs. strict liability) – effect of too small damages
2. Unforeseeability test in tort law – no damages if very low probability
3. Better risk-bearer test;
4. Joint and several liability of shareholders – risk of others' judgement-proofness borne by the first payers) – effects on diversification and control
5. Courts are biased against companies;
6. Judgment-proofness (i.e. limited liability) in tort law as well.

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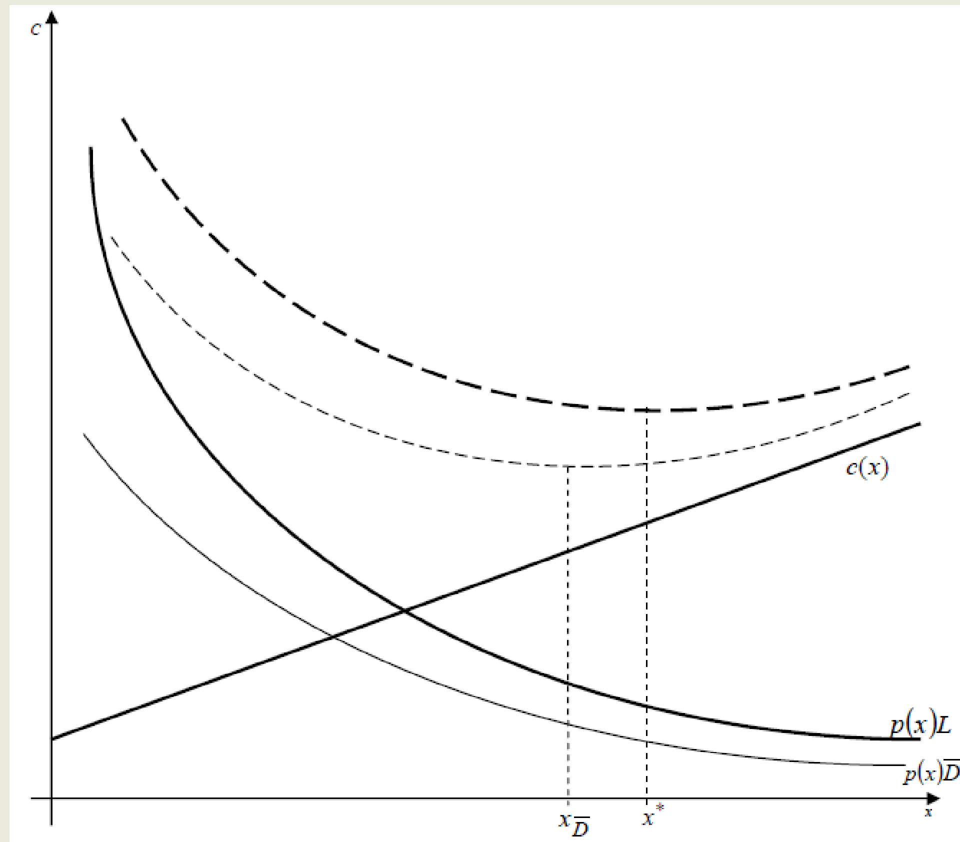
Revision

Disappearing defendant vs. small asset?



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Limited liability

Incentives?

1. Externality, risk-taking
2. Diversification
3. Control

Administrative problem?

Distribution, fairness?

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Problem

A taxi company functions as a 'cooperative', i.e. each car is owned by a driver. Each driver is a separate firm.

One car causes an accident and the firm's assets (basically the car) do not cover the damages that should be paid.

Would it be an efficient rule if the victim of the accident could demand the missing amount from other members of the taxi company?

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Solution

- Basic problem: empty shell.
- How do we know? Asset vs. expected damages?
- Solutions?
  - Government regulation – pros and cons?
  - Private enforcement – civil (common) law solution?

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Revision

Disgorgement – effects?

- Prevents efficient breach as well
- When:
  - Fiduciary contract, fiduciary relationship
    - Tasks that are difficult to define.
  - Intentional (opportunistic) breach
    - Utility, gain from the loss (suffering) of the victim

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