EDITORIAL ASTREA

# *Some thoughts about the limited liability from a law & economics perspective**

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## 1. Introduction

By means of this short paper, our proposal is to find out if corporations have limited liability in all situations or if some exceptions should be made in any given cases or situations.

First of all, we are going to describe the general concepts applicable to limited liability and its rationale. Then we will explain the grounds under the piercing of the corporate veil doctrine. We will also make a brief reference to the liability from a civil law point of view. Finally, we are going to describe some problems that we think that limited liability faces and will make some proposals in order to try to solve them.

## 2. The rationale of limited liability

The majority of the authors say that limited liability is the distinguishing aspect of corporate law.

Corporations do not have limited liability. They must comply with all of their obligations. Limited liability means that shareholders of a corporation are not personally liable for debts incurred or torts committed by the firm. This means that if the company fails, shareholders' losses will be limited to the amount that they invested in the company[1].

In that sense, article 163 of the Argentine Companies Law 19.550 (hereinafter the "ACL"), provides for corporations ("*Sociedad anónima*") that "The corporate capital shall be evidenced by shares of stock and *the liabilities of the shareholders shall be limited to the payment of the shares subscribed by them*".

Please note that under Argentine Law, a foreign corporation may carry out its business on an on-going basis in Argentina either through a subsidiary or a branch.

Pursuant to the ACL, a corporation is formed by at least two shareholders (either individuals or companies). Said minimum must be maintained during the life of the company.

The legal capacity of a corporation is limited to the fulfillment of its corporate purpose, therefore, the purpose of a corporation must be concise and determined.

There is a minimum amount of capital required (AR$ 12,000 approximately equivalent to US$ 4,000). Under the ACL, when referring to capital, the concept of corporate capital is the same as the concept of subscribed capital. Notwithstanding

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* Recommended bibliography.

[1] Bainbridge, Stephen M., *Corporation law and economics*, chapter 4, "Limited liability".

the provisions about minimum capital, this minimum must be in accordance with the corporate purpose.

As we stated, shareholders' liability is *in principle*, under the ACL, limited to their subscribed investment in capital stock of the corporation. Nevertheless, if the corporation performs any act while in formation, prior to receiving all final incorporation approvals and registrations, its founding shareholders and the members of the board of directors shall have unlimited, joint and several liability, except for those transactions which are specifically authorized in the by-laws. Such liability can be assumed by the corporation if, within three months after its registration, the board of directors assumes the liability and notifies the shareholders' meeting.

### 3. The piercing of the corporate veil

Personal liability may be involuntarily thrust upon a shareholder under the equitable remedy known as "piercing the corporate veil"[2].

Courts sometimes allow creditors to reach the assets of shareholders[3]. The legal basis for this is not clear. In the US, State's laws typically say that limited liability is absolute. Moreover, the nominal tests used by courts are singularly unhelpful. Easterbrook and Fischel[4] say that the doctrine of piercing the corporate veil, and the distinction drawn by courts, make more economic sense than at first appears. The cases may be understood as attempts to balance the benefits of limited liability against its costs. Courts are more likely to allow creditors to reach the assets of the shareholders 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.

In Argentina, article 54 of the ACL provides, under the title of "*Fraud or negligence of the partner*" that: "*Damages incurred by the company through fraud or negligence of the partners or of those who, not being partners, control it, make such persons jointly and severally committed to indemnify it, without being able to allege a compensating gain from actions in other activities. A partner or controller who uses resources or assets of the company for its own advantage or for a third-party, is obliged to return to the company the resulting profits, but the losses are for its exclusive account*".

Some argentine authors[5] interpret that this article refers to a firm not acting in accordance with its corporate purpose. Also, argentine case law declared the application of the lifting of the corporate veil when the company "*careciera de toda actividad destinada a la producción o intercambio de bienes o servicios, que sus únicos bienes sólo se usaban para el provecho personal del controlante y que las únicas operaciones*

[2] Bainbridge, *Corporation law and economics*, chapter 4, "Limited liability".

[3] The classic case is "Walkovsvy vs. Carlton" (NY, 1966). Also see "Brunswick Corp. vs. Waxman" (EDNY, 1978) and "Bank Saderat Iran vs. Amin Beydoun, Inc." (SDNY, 1983).

[4] Easterbrook, Frank - Fischel, Daniel, *The economic structure of corporate law*, chapter 2, "Limited liability", 1991.

[5] Foglia, Ricardo A., *La responsabilidad de los socios y controlantes por las deudas laborales de la sociedad frente a los trabajadores en negro*, "Revista Derecho del Trabajo", January 2002, p. 917.

*de la sociedad eran las referidas al pago de expensas comunes y otros servicios y gastos del controlante*"[6].

Other argentine authors[7] consider that the application of article 54 of the ACL also requires the existence of actual damage.

## 4. The argentine civil law point of view

The argentine civil liability system is divided in contractual and non-contractual liability.

*a*) *Non-contractual liability*. The basic rule is that whoever causes damages intentionally or due to his negligence, is liable to the victim. These rules, then, require a show of willful intent (*dolus*) or negligence on the part of the party charged with the liability ("defendant") and they impose a system of "subjective" liability.

The Argentine Civil Code does not provide for different levels of negligence (slight, gross, etc.), but establishes a general standard defining negligence as "*the omission of the diligence required by the nature of the obligation and which was due given persons, time and place involved*". It also provided that the greater the duty to act prudently and in full knowledge of the situation, the greater the responsibility resulting from the possible consequences of the conduct. A technician acting in his profession is thus held to higher standards of care than a layman.

In the event of joint tortfeasors, their liability to the victim is joint and several. Among them, the liability is then shared according to their different degrees of responsibility or otherwise equally. Thus, a person who participates slightly in the cause of the accident may be forced to pay all the damages to the victim but may subsequently recover, say, 90% of the amount paid from the person who was the main tortfeasor.

It is also possible that two or more parties (of which only one was negligent but all are made liable by law) be held fully liable *vis a vis* the victim. In that case the court may then allow total recovery from the negligent party of the amount paid to the victim by the non negligent parties. Such may be the case when the owner of the building pays damages caused by the building to third parties due to negligence of the constructor.

*b*) *Contractual liability*. Liability arising from contractual default does not require a demonstration of the negligence or *dolus* of the defaulting party. The mere lack of performance of the contractual obligation is enough to generate the liability, subject also to the defenses based on lack of causation explained below (e.g., *force majeure*).

Both non-contractual and contractual liability depend on the existence of an "adequate" causal connection between the damage and the person or thing which caused it.

[6] Argentine CNCom, Sala C, 10/9/95.
[7] Carlos San Millán, Roberto A. Muguillo and Julio C. Otaegui, among others.

## 5. Problems. Possible solutions and proposals. Conclusions

The institution of limited liability may result in abuse. It may be used as a shield to stop corporate creditors from doing anything effective about corporate transactions that were fraudulent or unfair as to them. It may seem to operate unfairly against certain classes of creditors, such as small trade creditors and tort victims. It may be used in ways that do not seem to further its basic purposes or functions, as when the parts of a single business enterprise are put into numerous separate corporate entities solely for the propose of shielding enterprise assets, rather than the investors' personal assets, from liability.

The advantages of limited liability suggests that, if it did not exist, firms would attempt to invent it.

One close substitute is insurance (i.e., failure insurance). The problem is that, in companies with a lot of shareholders, their transaction costs in purchasing insurance would be very high.

Another problem of limited liability is that, if we analyze the issue from the creditors' point of view, they would probably like to have a liability system more closely to the civil law liability system. The fact is that this may probably destroy the distinguishing aspect of corporate law.

In Argentina, the system adopted by article 54 of the ACL seems to be working well. The problem is that we face high transaction cost because the application of such provisions depends, in the majority of the cases, on a judge.

The other problem is that, since there are no limits to the participation of shareholders or partners, you can have an operative company with, for example, two shareholders, but these shareholders may also be companies with shareholders that may be companies with shareholders and so on. In these cases (which are very common) it is very difficult to "find an individual person", and the application of the theories about piercing the corporate veil becomes very difficult. Once again, high transaction costs are involved.

In Argentina, some resolutions issued by the Inspección General de Justicia[8] (hereinafter the "IGJ") since 2003, tried to limit the participation of foreign shareholders in local companies. The main problem was that it is quite easy to have a company set up in a tax heaven with, for example, bearer shares, and have this foreign company as a shareholder or partner in a local company. It was very difficult to discover who are the shareholders or partners in case of a problem of fraud. Now, the participation of foreign companies in local companies is limited to genuine foreign inversions. The main obstacle in order to apply these resolutions is, again, the transaction costs that the IGJ should face to control the effective application of these resolutions.

But, from my point of view[9], the main problem that the corporations are facing is the problem of undercapitalization. In this case, we proposed that both shareholders

[8] Public body that controls companies in the Republic of Argentina.

[9] Triolo, Ignacio L., *Responsabilidad de los administradores y socios controlantes por infracapitalización ante la insolvencia de la sociedad*, paper presented in "IX Congreso Argentino de Derecho

and directors should be liable in case of breaching their duties under articles 54 and 59[10] of the ACL.

As we explained, limited liability faces many problems nowadays, principally caused by the way in which the companies do business in a highly developed economy. We can not eliminate limited liability because this will be translated into the death of the corporations. What we can do is to try that, in a future amendment to the ACL, these issues be taken into consideration (i.e., limit the number of companies in which a person may be a shareholder or partner).

Finally, we do not have to forget that, despite the problems explained, from an economic point of view, limited liability produces benefits because: *a*) it often shifts risks to a better risk bearer, and this produces gains for trade; *b*) it reduces transaction costs, and *c*) permits the avoiding of tort liabilities[11].



Societario y V Congreso Iberoamericano de Derecho Societario y de la Empresa", and Rovira, Alfredo L. (dir.), *Empresa en crisis*, Bs. As., Astrea, 2005, chapter "Infracapitalización e insolvencia".

[10] Article 59 of the ACL provides that "*The administrators and representatives of a company shall perform their duties with loyalty and diligence as a good businessman would do. Those who do not comply with their obligations shall be unlimitedly and jointly and severally responsible for any damage or loss arising from their action or failure to take action*".

[11] See Clark, Robert C., *Corporate law*, Aspen Law & Business, 1986, p. 6 to 8.