Legal personality of Corporation and limited liability

Description

Companies or corporations (in this text, a company is the same as a corporation unless otherwise indicated in the context) are so ubiquitous in our life and yet at law, companies are so elusive to define.

I am reading the book “Business Persons-A legal theory of the Firm” by Eric W. Orts, a law and economic professor at Wharton School, a nice piece of work reviving the legal analysis of companies, distinct from dominant analysis of companies from economic perspective. Another great book “The Anatomy of Corporate Law” (second edition) is also in my hand.

But apparently I don’t and cannot agree with all ideas in the books.

I. Historical Analysis

To clearly tell what a company or corporation is, one cannot dispense with a search and review from historical perspective to understand how the companies were brought into life.

In the most primitive eras when our ancestors fed themselves by shooting animals and picking wild fruits, there was no sophisticated social production, nor was there in the early feudal societies when people relied on family-based agricultural production.

Then when the mankind came to a stage where social production appeared, the grouping of many people and the combinations of properties (means of production) were required. There, whatever names you call, partnerships, regulated company, joint stock company, chartered company, new business forms were developed and brought into life over time.

The privately grown business form posed challenges to the rulers then back in 16 and 17 centuries in UK. As a representation of intervention of “public power” (if not exactly law) toward the new business form, the early chartered company was created by the government then. A charter was granted to a specific company other than to all entities meeting certain qualifications. Later on well into 19 century, UK adopted its 1844 company act, marking the start of modern company or corporation.

So from the historical perspective, a company, in the ontological sense, is the product of natural development human economic activities, but in its conceptual sense, a company is also the product of law in mirroring and reflecting social realities.

After the economic reality was captured by law, then the law has further developed additional theories and rules in defining and regulating the same.

II. Legal Analysis

(i) Legal Person/Legal Personality

From its debut in the world, a company with its capacity and power to wield multi-fold wealth and

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influence as compared to an individual, is acting on the society rather than being acted upon by society (at large). In other words, a company, being able to act, is the subject to certain legal relationship other than object. Thus, the law should accord to a company a similar legal status as a natural person/individual, recognizing it as a new type of subject at law. Catering to that demand, the legal entity or legal person theory was invented, a legal technology by legal scientist whereby the association or grouping of individual natural persons acting for the same purpose is abstracted as one legal person. This one legal person can enter into contracts, assume obligations, sue and be sued in its own name. In other words, the company is said to have its own personality or identity separate from those who set it up.

Naturally, here comes the question “what is legal personality”. [*I realize that by bringing up this question, I am risking losing myself in phylosophical discussion which I may not be able to manage even in Chinese language.*]

From a functional point of view, as described above, legal personality is simply the legal technology invented to make it possible for a group of individuals to hold themselves out as one person that is able to enter into legal relationships while disregarding or absorbing the individual personality of members of the group. Strictly speaking, the concept of legal personality in this case has nothing to do with the way or the form of legal liability (unlimited or limited) of the group members, as that is an issue to be addressed by agency theory.

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The legal personality is the abstraction instrumentality employed by law for certain subjects to have rights and bear duties and to have standing in legal proceedings. In such a sense, human individuals and registered partnership and companies are all conferred legal personality by law. In other words, registered companies, corporations and partnerships are all legal persons. This is true in quite a few important jurisdictions in the world, including Italy and UK. Here the importance and significance of business registration in history is often neglected or not fully appreciated. It is the registration of the business name, address, investors/partners/shareholders and the like that makes it possible for the law to recognize such business organizations as independent and separate from their investors.

However, in China, the legal person is provided in China General Civil Principles as having, *inter alia*, limited liability as one of fundamental attributes. This is a mistake made at an understandable time when China just enacted its very first civil code. The problem is that the mistake has been so entrenched in Chinese civil law discourse now that people seem to forget this is indeed a mistake. Instead, the mainstream view in China is that a legal person must assume liabilities independently and its members shall enjoy the limited liability protection.

(ii) Corporate Will

However the above is not adequate to fully understand the concept of legal personality. One must read into legal personality the indispensable element of “will” or “volition”, though many scholars are averse to this understanding. It is a must because the law after all works through regulating conducts or acts taken by “persons” (natural or legal). A conduct or act in the eye of the law always involves a “will”. Here the will takes two forms: the physical will in any human individual, and the artificial/fictional collective will attributed to a group of individual persons (not the simple aggregate of multiple wills, but one derived from the group of persons). Further, as a conceptual element for legal personality, the “will” here does not have regard to the actual functionality of the will as in the case of a specific person.

The existence of Will is critical in understanding the concept of legal personality. Why does the law not confer legal personality to a pile of stones or logs or other inanimate objects

Obviously, unlike the biological nature of the Will of an individual, a corporate will is artificial in nature for the reason that it is derived or generated by rules or mechanism, a process in which the collective will of a group of people (generally the board of directors) is personified as the will the organizational company.

My argument for recognizing corporate will is that this will allow the setup or creation of consistent legal framework applicable to all persons at law (either individual or corporate). After all, there should be common attributes of “subjects” at law.

Further issue shall be given particular attention when we discuss corporate will, i.e., where the corporate will is derived from.

Corporate actions are undertaken by its participants (the company itself as a conceptual entity cannot really act without its participants), and thus corporate will shall be derived from or based on the collective will of its participants (or a group of such participants).

Next question is which group of participants is relevant: shareholders, board of directors, or employees (general manager and other officers are employees). Again, if we look back to early history of legal persons when the members/partners run business by themselves, the collective will of members and partners matter and dictate. Over time, investors retreated from active management in companies they invest but shifted the managerial functions to a team of professional directors and managers who are supposed to do a better job due to their expertise and understanding of corporate businesses, a process that is characterized as fragmentation of ownership and control. So, looking from history, the proper answer to the question at the beginning of this paragraph is: people, either shareholders or not, who manage the company are relevant in determining where the corporate will is derived. So in a partnership enterprise, it is the partners (general partners, not limited partners), and in a company, it is the board of directors as well as general managers (based on the corporate pattern laid out in China Company Law).

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In contemporary corporate practice, with a typical company being managed by a board of directors, it is clear that the corporate will is derived from the collective will of the board of directors. In other words, the collective will generated as per rules set out in company law and the articles of association of the company is the will of the said company.

In some peculiar situation such as in the course of liquidation, the corporate will is then derived from the (collective) will of the liquidator or liquidation committee.

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Now comes another question: is the corporate will the same as the will of a natural person? Does a legal person have an incapacity status during its life time?

Many scholars say “no”. Indeed, as early as back in the famous British case Salomon V A Salomon Co. Ltd., one of the lords, Lord Macnaghten, opined that “the company attains maturity on its birth.

There is no period of minority – no interval of incapacity." But I disagree with idea in this statement. We need to look at the issue from two perspectives: on books and in reality.

On the books, any body corporate does attain its maturity upon its birth and maintains its maturity all the way because the law attributes artificial will to it, and this artificial will has "no interval of incapacity". However, a company does not exist on the books, and it has a real life in practice. If we look at a company in reality, its actual will come from the collective will of the board of directors (in some cases the sole executive director) which run in accordance with the rules set out in the articles of association. The derivation of corporate will from its board of directors is not always smooth and may have lethal hiccup which can give rise to the incapacity of the corporate will, namely, the corporate deadlock phenomena.

I have not noticed any legal theory in corporate law that can well explain the deadlock issue. To me, when the deadlock is caused by the impasse of board which cannot be cured by the shareholders, we can well decide that the corporate will cannot function well or simply the corporation is now incapacitated.

Of course, corporate deadlock is more often caused by shareholder conflicts which has not much to do with corporate will, and shall be addressed by the agency doctrine.

(iii) corporation in relation to property or asset

From its initial birth to the world, a corporation (even in its primitive form) has some sort of properties or assets to run, and by today, most jurisdictions have come to recognize the ownership by corporations over their assets. Thus, in legal theory, asset is claimed to be the basis for creating separate legal personality for entities. At its extreme in that direction, it is said that "no asset, no personality".

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Is it true? If untrue, what is, and how can we rightly describe the correlation between legal personality and assets?

Again if we look at the history, it is true that assets or some sort of property is in accompany with the birth of the association and organization of individual persons. After all, historical partnership enterprise and corporations were invented for purpose of pursuing commercial activities in which capital in various forms is indispensable. Even today, most corporations are born with capital contributed at the time of incorporation or over some time following the incorporation of the corporations.

But how did property/asset/capital contribute, if any at all, to the being of legal personality?

In the eyes of law, properties and persons are objects and subjects, two distinct worlds. For an individual as a person, the subject at law, properties are of no relevance to the being of personality for the individual. You cannot say a bankrupt person does not have legal personality at law. Why is it a different case when it comes to the personality of corporation or other form of association of persons?

The no-asset-no-personality doctrine cannot explain some of the common questions in practice:

(1) does a financially better company have a more sound personality than other companies?

(2) does a bankrupt company have personality?

(3) for a new duly registered company, does it have personality before its shareholders pay in the subscribed capital?

(4) for those companies that have stopped business for long with no assets left but not duly wound up and deregisterred, do they have personality?

I believe there won't be satisfactory answers that can be provided under the no-asset-no-personality doctrine to those questions.

Again in my opinion, the personality of corporations in nature has nothing different than that of a natural person. The key lies with the Will. A person, either natural or legal, has its own will that allows it to be recognized as subjects of rights and obligations at law.

(iv) Limited Liability

As the most conspicuous feature of modern company, limited liability is something any corporate authors cannot miss in their works.

Many scholars and some country's legislation have taken the entrenched view that when an entity is said to have legal personality, that entity shall have the attribute of limited liability for sure. The Japanese law professor, Katsuhito Iwai, claimed in its essay "Persons, Things and Corporations: the corporate personality controversy and comparative corporate governance" that "*the shareholder's limited liability and the corporation's legal personality are merely the difference sides of the same coin*." As mentioned above, in my country China, the limited liability is said to be one of the inherent attributes of a legal person as prescribed in General Principles of Civil Code.

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So what is the limited liability? What does it have to do with legal personality?

My personal research into past UK laws convinced me that limited liability is not twinborn with the concept of legal personality. Indeed, in UK history, limited liability is a concept that was coined probably centuries later than the emergence of phenomenon of legal personality which should start from the official registration of partnerships.

In the UK history, for centuries, unlimited liability attached to partnership and later to joint stock company all the way down till the company act in 1855. Before the enactment of company act in 1855, investors in joint stock company have sought to limit their unlimited liability by inserting clauses to that effect in their memorandum or articles which were generally struck out by courts. It is of particular interest to know that before the 1855 company act, fragmentation of ownership and management in respect of joint stock company had sprouted then with some investors taking passive role in managing the company they invested. This was probably one of the key reasons contributing to the passing of the company act in 1855 that formally availed the limited liability protection to most joint stock company shareholders/members, marking the beginning of new era of modern company law.

While the development of unlimited liability to limited liability in UK history prompted increased regulation on companies in terms of both internal governance and the externality on third parties, what effect did it have on the legal person or legal personality theory, if any at all? I don't see any at all.

One must bear in mind that unlimited or limited liability is more a feature of corporate shareholders or

members other than the feature of the companies themselves. In other words, the company, as a legal person capable to enter into contracts and to sue or be sued in court, did not change at all. If we take limited liability as the basis for a company or an entity to obtain legal personality, are we saying the unlimited liability joint stock companies before UK 1855 company act are not legal persons?

Limited or unlimited, the liability is assumed in both cases by the shareholders/members of companies. Here many may object to this point on the ground that the companies as legal persons are assuming liabilities by themselves, not shareholders, as companies own assets. Such objections will be stronger in civil law system countries such as China, but I believe my idea may be easier to accept in common law system countries. My answer to the objection is that the ownership enjoyed by companies over their assets are not the true ownership as enjoyed by individual natural persons over their properties. The corporate ownership can be said to be “legal ownership” as in the case of trust with the beneficial ownership retained by shareholders/members of the companies. However to explicate this point in full, it will take a separate lengthy article. I would leave it to a later time in future.

So what is the underlying rationale for legislature to recognize limited liability in preference to unlimited liability?

The typical unlimited liability doctrine probably applies universally to partnerships. In China, the partners of the duly registered partnership enterprise are subject to unlimited liability. So why does the law require partners to assume unlimited liability? I believe we can find its root in the primitive legal principle that one should be responsible for his or her own acts. Unlike a limited liability company, normally in a general partnership (with no limited liability partner), all partners are directly involved in the management of their common cause and each has the power to represent and bind the partnership as a whole, and additionally, as a primitive business organization, partnerships are closed organizations with outsiders having no access to its financial health or internal governance (delegation among partners etc.), from either inside perspective or outside one, partners who conduct themselves in the name of partnership (enterprise) shall be held accountable for their own acts. It would be too much for the law to shift partners’ liability to outside third parties when the latter have no way to gauge the risks of dealing with such a closed entity.

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However, when it came to joint stock companies in which part of the members or shareholders were very often passive investors subjecting their fate in the company to a group of directors or managers, there were good reasons for those passive investors to demand protection against unlimited liability toward the debts of the company they invested but managed by others.

We can also analyze unlimited liability and limited liability from the perspective of agency law.

Once duly registered, a general partnership in my logic is also a legal person separate from its partners and as a legal person, the partnership is created by all partners who want to employ an agent to facilitate interaction with third parties and represent and pursue their ends and purposes. In this sense, the partnership as a legal person is the agent of and for all individual partners. But the agency at this level is very often neglected. Instead courts readily find the agency relationship between the partnership and the individual partner who acts on behalf of the partnership. Indeed, the dual agency can be illustrated as: all partners as a whole as principal—-> partnership as a legal person as agent——> individual partner as sub-agent.

A partnership as a legal person shall have its own will as well just like the corporation. Unlike the

corporation whose will is generally deprived from a collective will of a board, a partnership has its view deprived from the will of any individual acting partner. After all, each partner can legally bind the partnership toward third parties. By this analysis, we can see that in a general partnership, its structural agency can be simplified as follows: a group of persons as a whole as one principal appoints each of the partners as its agent. Due to the close connection and easy communication and control between and among partners who are often natural persons engaged in relatively simple businesses, this agency is very much the typical agency between two individuals and therefore the principal shall assume unlimited liability.

So how does it lead to or foster the limited liability doctrine?

With the development of economy, business activities were getting more and more sophisticated, and very often, investors who contributed money, were not directly involved in managing their own money and business simply because they don't know much about the business operation, so they have to reply on a group of talented team for their commercial endeavors. In response to that development, joint stock company made its debut in history and then the limited liability company. Due to the lack of knowledge about businesses, investors/shareholders can not issue detailed instructions to their agents as in the case of typical civil agency situations. Instead, as principals, shareholders can only set the business goals and objectives and then leave broader and broader powers and authorities to the company or corporation who is in the capacity of agent. In other words, in this agency relationship, principals wield less and weak control over the conducts of their agents and cannot really decide or even predict the consequences of their agents' conducts. That said, it will be too much or too demanding to ask those principals to bear unlimited liability for the conducts of their agents. In fact, as seen in UK joint stock company history before introduction of 1855 limited liability company act, shareholders had sought relentlessly to restrict their liabilities. With the passing of the 1855 limited liability act, we can equally say that the agency law has developed into a variant form whereby the principals can now limit their liability to certain amount without pledging everything for the conducts of their agents.

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Unfortunately, most people were overwhelmed by the new development of corporate law, but not many people notice or recognize this special variant form of agency. Thus, while in economic arena, people discuss agency issue all the time, legal theorists rarely discourse on the agency relationship between shareholders and their companies.

Lastly, not the least, we may have to adjust our understanding of agency law by taking out the unlimited liability element in the definition of agency. At the heart of agency are the following elements: calculation of interests by agent for principal, certain degree of control by principal over agent and liability (here not necessarily unlimited) by principal for agent's acts. Of course, this will again take a separate article to make this point clear.

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Economic and legal reality has raised serious challenges to the idea that limited liability is the indispensable attribute of the legal personality or legal person. For example, many states, such as China, have adopted the limited partnership law where a partnership enterprise is allowed to have one or more limited partner whose liability toward the partnership is limited to the contribution to the partnership provided that the limited partner is not directly involved in the management of the partnership business. In China, a partnership is always regarded as non-legal-person organization

even after the introduction of limited partnership in legislation. Now with the traditional legal person and limited liability theories, the contradiction arises here in the case limited partnership enterprise: why does a non-legal-person organization carry with it the limited liability feature if the limited liability is an essential attribute of a legal person? I don’t see any possible sound explanation, but a need for change of our legal theories.

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