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The Legal and Economic Boundaries of Corporate Group Structures - The UK Company Law Debacle of the Corporate Form

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Abstract

This thesis critically examines the interplay between shareholder incentives, powers, and the externalisation of risk in the framework of UK company law, with a focus on corporate groups. It tackles fundamental questions surrounding the legal structure of companies and its ramifications for third-party interests. The questions explored include the mechanisms through which shareholder incentives intersect with company law, the impact of corporate group structures on risk externalisation, and the effectiveness of existing legal frameworks in addressing these issues. By highlighting the disconnect between theoretical premises and real outcomes within company structures, this thesis seeks to examine the real-world consequences of shareholder-driven risk externalisation by the use of the corporate form. While many have researched corporate groups from a doctrinal perspective to highlight gaps in group regulation, this thesis uniquely addresses these gaps through theoretical lenses.

Chapter 1 lays the groundwork by considering the inherent incentives for externality within company structures and the development of shareholder privileges. Chapter 2 evaluates the mechanisms through which shareholders use the corporate form to transfer risk onto external parties, particularly unsecured tort creditors. Chapter 1 and 2 highlight the disconnect between theoretical concepts and business realities, revealing how legal doctrines inadvertently facilitate risk externalisation.

Chapter 3 explores the role of corporate group structures in exacerbating this issue. By dissecting the complexities of corporate groups, this thesis reveals how their structure(s) enables parent companies to exploit legal and economic principles by controlling the group, receiving its benefit, and shielding its assets from liabilities, leaving the subsidiaries' unsecured creditors vulnerable. In corporate groups, shareholder incentives generated by the corporate form are significantly amplified, potentially increasing at an exponential rate. This escalation of incentives can lead to a higher risk of externalisation due to the compounded effect of using multiple corporate forms.

In chapter 4, various legal mechanisms, which could have the effect of mitigating externalities, are scrutinised yet found inadequate. Both internal solutions to company law and external solutions found in other areas of law are not effective in resolving the issue. Ultimately, the issue lies in the use of the corporate form, which, due to its conceptual underpinnings, inadvertently incentivises risk externalisation. Therefore, a more comprehensive exploration of its theoretical foundations is imperative to understand and address these systemic challenges.

Chapter 5 critically evaluates prevailing theories of corporate personality, revealing also their limitations in addressing risk externalisation. The fine points of chapter 5 emphasise the need to reassess theoretical company law to provide solutions to the externalisation of risk stemming from the corporate form. The analysis of theories, such as the concession theory, aggregate theory, and real entity theory, reveals their limitations in adequately recognising the complexities of corporate groups and the consequences of their actions. By showing how these theories fail to account for the economic and social impacts of corporate activities and their interconnectedness within groups, this chapter advances the importance of reorienting company law towards a deeper understanding of corporate functions and their implications. By advocating a broader consideration of economic and social consequences, it calls for a reconceptualisation of company law beyond the narrow confines of legal boundaries.

In exploring alternative regulatory approaches, in chapter 6, this thesis proposes the adoption of the enterprise theory as a supplement to traditional legal entity theories. By emphasising the economic realities of corporate structures and advocating in favour of collective accountability, it bridges the gap between corporate legal theory and practical implications. Ultimately, this thesis advances a holistic understanding of corporate groups that transcends traditional boundaries; by aligning the corporate and organisational forms, it aims to foster a more heightened accountability of corporate groups.

Lay summary

This thesis explores the relationship between UK company law and corporate structures, particularly concerning the externalisation of risks. At its core, it investigates how the legal framework governing companies influences the distribution of risks among corporate stakeholders, such as shareholders and creditors. It analyses how certain legal principles inadvertently incentivise shareholders to transfer risks onto external parties, potentially leaving creditors in a vulnerable position.

In this examination, this thesis evaluates the complexities of corporate group structures, where a parent company controls subsidiaries in order to carry out a business. Through this evaluation, it uncovers how hierarchical shareholding dynamics, and the exponential use of the corporate form, can exacerbate the issue of risk externalisation through the exploitation of legal and economic principles, posing fairness concerns for third parties that come into contact with the corporate form used in the group's operations.

In addition to scrutinising existing legal doctrines, this thesis critically analyses prevailing theories of corporate personality. While influential, these theories often overlook the consequences of corporate actions through a corporate form, highlighting a gap between legal theory and real-world outcomes. To address these shortcomings, this thesis proposes the adoption of an enterprise approach as a supplementary framework to the traditional conceptions. This approach emphasises the economic realities of corporate groups, aiming to hold them collectively accountable for their activities. By integrating economic insights into legal discourse, this thesis seeks to contribute to a more nuanced understanding of corporate structures and their implications for society.

Ultimately, this research stresses the importance of re-evaluating traditional legal frameworks to ensure they align with contemporary economic and social realities. By shedding light on these complex dynamics, this thesis aims to inform UK company law about the need for a reform in legal thinking to promote more accountability among corporate entities.

Declaration

I certify that the thesis presented here for examination for a PhD degree of the University of Edinburgh is solely my own work, other than where I have clearly indicated that it is the work of others. The thesis has not been edited by a third party beyond what is permitted by the University's PGR Code of Practice.

I declare that the thesis does not include work forming part of a thesis presented successfully for another degree. The copyright of this thesis rests with the author. No quotation from it is permitted without full acknowledgement.

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Chapter 1- Background of The Study

1. Introduction

In the analysis of UK company law, the issue of risk externalisation onto third parties has emerged as a critical concern, particularly within corporate group structures. This thesis explores the issue of risk externalisation triggered by the distinction between a legal entity and an organisational form performing an economic activity, allowing shareholders to use the corporate form for their own benefit at the expense of third parties. The literature extensively discusses the clash between shareholder limited liability and tortious involuntary creditors.[1] Building on this discourse, this thesis focuses on how limited liability in corporate groups adversely affects unsecured tort creditors and how traditional company law principles contribute to increased risk externalisation.[2] Considering this context, and the growing influence and incorporation of corporate groups,[3] it is imperative to review the legal framework governing their operations.

This thesis argues that UK company law incentivises risk externalisation by combining the legal features of the corporate form, namely separate legal personality, limited liability, and economic and control rights, leaving tort victims uncompensated. Additionally, companies can own shares of other companies and use all the advantages provided by the corporate form for

[1] See Phillip I. Blumberg, 'Limited Liability and Corporate Groups' (1986) 11(4) Journal of Corporation Law 573; David W. Leebron, 'Limited Liability, Tort Victims, and Creditors' (1991) 91(7) Columbia Law Review 1565; Stephen M. Bainbridge, 'Abolishing Veil Piercing' (2001) 26 Journal of Corporation Law 479; Peter Muchlinski, 'Limited Liability and Multinational Enterprises: A Case for Reform?' (2010) 34 Cambridge Journal of Economics 915.

[2] See Adolf A. Berle, 'The Theory of Enterprise Entity' (1947) 47 Columbia Law Review 343; Henry Hansmann and Reinier Kraakman, 'Toward Unlimited Shareholder Liability for Corporate Torts' (1991) 100 Yale Law Journal 1879; Nina A. Mendelson, 'A Control-Based Approach to Shareholder Liability for Corporate Torts' (2002) 102 Columbia Law Review 1203; Kurt A. Strasser, 'Piercing the Veil in Corporate Groups' (2005) 37(3) Connecticut Law Review 637.

[3] Holding companies constitute a substantial portion of private companies globally. Private and holding companies represent 18% of market capitalisation, in the UK alone they represent 9% of owners of public companies. See Adriana De La Cruz, Alejandra Medina and Yun Tang, 'Owners of the World's Listed Companies' (2019) OECD Capital Market Series, 6, 37 <https://www.oecd.org/corporate/Owners-of-the-Worlds-Listed-Companies.htm> accessed 7 May 2024. Multinational corporate groups coordinate international trade and have a significant impact on countries and communities. For instance, the UN has stated that three quarters of total international trade is driven by multinational enterprises. See United Nations Department of Economic and Social Affairs, 'Accounting for Global Value Chains: GVC Satellite Accounts and Integrated Business Statistics' (2021), 147 <https://unstats.un.org/unsd/business-stat/GVC/Accounting_for_GVC_web.pdf> accessed 7 May 2024. In addition, the number of global corporate groups has grown dramatically over the past 100 years. If we consider only the estimated data between 1970 and 2014, the number of corporate groups grew from 7,000 in 1970 to more than 230,000 in 2014. See OECD, 'Multinational enterprises in the global economy Heavily debated but hardly measured' (2018), 2 <https://www.oecd.org/industry/ind/MNEs-in-the-global-economy-policy-note.pdf> accessed 7 May 2024.

each incorporated company, exponentially increasing the risk of externalisation. As such, parent companies make use of company law rules regarding the corporate form to compartmentalise liabilities and externalise the risk of operations, leaving unsecured tort creditors uncompensated. The combined[4] principles of the corporate form have created through time a corporate shield that renders parent companies not liable for the unpaid debts of their subsidiaries.[5]

The group structure allows them directly or indirectly to control group operations and receive dividends, with limited circumstances in which they are exposed to liability.[6] Dividends can only be paid out of distributable profits, which are defined as accumulated realised profits, less accumulated, realised losses.[7] Although shareholders' dividends are considered in the literature as a right,[8] they do not constitute a legal entitlement to the company's profits.[9] Instead, they are a mechanism used to justify shareholders' influence on corporate decisions, which either through dividends or capital gains[10] will ultimately return the company's profits to shareholders. Nevertheless, once approved, they become a debt payable to shareholders.[11]

Distributable assets can be distributed to shareholders up to the vicinity of insolvency.[12] UK accounting standards protect parent companies and their profits insofar as creditors' interests have to be considered only when the entity is balance sheet or cash flow insolvent.[13] This means that as long as the company is solvent, directors will act in the best interests of the

[4] As ch 2 will explain, it is the combination of companies' and shareholders' rights that causes risk externalisation. By itself, separate legal personality is not a problem.
[5] Limited liability towards involuntary creditors has been regarded as highly problematic, especially in corporate groups. See Phillip Lipton, 'The Mythology of Salomon's Case and the Law Dealing with the Tort Liabilities of Corporate Groups: An Historical Perspective' (2014) 40 Monash University Law Review 452, 479. Blumberg stated that limited liability should not apply to corporate groups because its main economic justifications do not apply to them: see Blumberg, 'Limited Liability and Corporate Groups' (n1) 623-626. Corporate structures can result in thinly capitalised subsidiaries with severe consequences for tort creditors: see Lynn M. LoPucki, 'The Essential Structure of Judgment Proofing' (1998) 51 Stanford Law Review 147.
[6] The connection between these two incentives is often under-researched. For instance, Blumberg identifies control as the central tenet to understand corporate groups and extend liability: see Phillip I. Blumberg, *The Multinational Challenge to Corporation Law* (Oxford University Press 1993), 116. Nina Mendelson mentions the two but focuses on the issues of control and the moral hazard of limited liability: see Mendelson (n2).
[7] Companies Act 2006 (CA 2006), s.830(2). The two tests applicable to calculate distributable profits (CA 2006, ss.830 and 831) will be analysed in section 4.1.3.
[8] See Reinier Kraakman and others, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (3rd edition, Oxford University Press 2017) 13.
[9] Distribution of dividends is discretionary: Paul L. Davies and Sarah Worthington, *Gower: Principles of Modern Company Law* (11th edition, Sweet & Maxwell 2021) 689.
[10] Directors can decide to either distribute profits in the form of dividends or retain earnings to invest in other projects. With the former, shareholders will receive their share of profits. With the latter, if the project is successful, the value of the company will grow, and shareholders will profit in terms of market capitalisation.
[11] *Potel v CIR* [1971] 2 All ER 504 (Ch).
[12] *BTI 2014 LLC v Sequana SA and others* [2022] UKSC 25, [2022] 3 WLR 709 [161].
[13] ibid [12] (Lord Reed SCJ).

company, which are treated as the interests of shareholders as a whole,[14] and often at the expense of creditors. Thus, parent companies will receive their shares of distributable profits more often and before certain liabilities will manifest in the company's financial statements.

Environmental and toxic torts illustrate the issue. These torts have a long latency period and possess uncertainties regarding both their causality and the magnitude of harm generated.[15] Their characteristics fit the description of future contingent liabilities, which, being remote or difficult to measure, can be omitted from the entity's balance sheet.[16] Ultimately, if enough value is diverted from the company, there will be insufficient funds to satisfy all future liabilities, and unsecured tort creditors will be the ones to lose out in the insolvency proceedings.[17] Accordingly, they represent a legally recognised harm that can remain unremedied.

Control-enhancing mechanisms enable parent companies to control their subsidiaries both in their role as shareholders and in their role as parent company, through formal and informal means.[18] Control in groups is formed by the shareholding structure[19] and an intra-group decision-making mechanism,[20] which corresponds to a series of control relations among the entities in the group used to coordinate a single economic activity.[21] Effectively, UK company law allows units within a group to collectively act as a single (economic) enterprise when it is beneficial to shareholders, operating in coordination with a unified purpose and strategy, while each company remains legally separate and independent for the purpose of ascribing liabilities.

This thesis presents two innovative insights. First, it questions the foundational theories upon which modern company law is built. It considers the use of the corporate form within corporate group structures to maximise its exploitation from a theoretical perspective. The existing body

[14] See CA 2006, s 172(1): *'A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole* […]'; *BTI v Sequana* (n12) [47].
[15] See 1.2.2.
[16] The surplus of assets can be distributed because the entity's balance sheet will not take into account future contingent liabilities, which are omitted because they are uncertain (not probable) obligations - i.e., they depend on uncertain future events or their amount cannot be measured reliably: see Financial Reporting Council, *FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland* (2022) para 2.40.
[17] If the company does not have sufficient funds to satisfy all liabilities, some creditors will remain unsatisfied. The position of unsecured tort creditors will make them the most likely creditor to lose. See 2.2.1.
[18] Formal means correspond to control through equity-based links or operational control, while informal means are strategic management and culture-based links. See 3.5. and 4.2.
[19] See 3.5., percentage of ownership is irrelevant when coupled with other control-enhancing mechanisms.
[20] Linn Anker-Sørensen, *Corporate Groups and Shadow Business Practices* (Cambridge University Press 2022) 39.
[21] Geoffrey Jones, *Multinationals and Global Capitalism: From the Nineteenth to the Twenty First Century* (Oxford University Press 2005) 172.

of literature surrounding corporate groups identifies the issues generated by group structures, whereby a parent company profits from and controls a subsidiary's management of operations without having to bear its liabilities.[22] However, this thesis goes beyond well-established legal rules and black-letter law. It questions the dominant theories regarding the corporate form and shows the role and importance of reforming company law to solve the issue of companies' externalisation of risk.

UK company law not only provides parent company shareholders with the incentives to externalise risks onto third parties, but it also promulgates a strict traditional entity view of the corporate group, aligning each company with its corresponding rights and responsibilities. This results in a theoretical misalignment between the legal entity[23] and the enterprise.[24] Hence, the source of the issue is a theoretical deficiency of the corporate group. The role of company law in redressing its own mistakes is key, and some scholars have realised its potential,[25] although using a different approach to the one that this thesis will present. This thesis will present a re-evaluation of the importance of conventional theories of the corporate form by questioning and supplementing them, which is an original contribution to corporate law scholarship.

The UK legalistic entity approach creates a strict framework where in a single group it is possible for each member to bear independent liabilities.[26] However, this approach creates an undesirable and increased risk of externalisation towards tort victims. It must be noted that all shareholders' "rights" incentivise risk externalisation and taking away all or any of these incentives could potentially provide a solution to the issue of externalisation. Nevertheless,

[22] Witting has argued that '*limited liability in the corporate group context has been positively harmful in permitting over-investment in various risky business activities'*: see Christian A. Witting, *Liability of Corporate Groups and Networks* (Cambridge University Press 2018) 78. Blumberg reflected on the fact that Anglo-American legislation introduced limited liability without imagining its application to corporate shareholders and as a result the extension of limited liability to parent companies was an accident. See Blumberg, 'Limited Liability and Corporate Groups' (n1) 605. Muchlinski noted that externalisation of risk lets the poorer risk taker assume the burden of risky operations: Muchlinski, 'Limited Liability and Multinational Enterprises' (n1) 923.

[23] Seen as separate legal personality or legal mechanism used by an enterprise to conduct its business.

[24] Seen as a form of collective economic activity, which uses legal entities, but the legal entity does not determine its boundaries.

[25] See, for instance, Jonathan Hardman, 'Fixing the misalignment of the concession of corporate legal personality' (2023) 43(3) Legal Studies 443. Hardman' s work clearly shows the misalignment between a separate legal entity and an organisational form and company law increasingly withdrawing in its role in mitigating the issue. However, he uses traditional corporate theories to explain the *phenomenon* (ch 5). See also Beate Sjåfjell, 'How Company Law has Failed Human Rights – and What to Do About It' (2020) 5(2) Business and Human Rights Journal 179, 189-198, addressing human rights issues resulting from company law principles. She then argues that company law reform is key being at the heart of the problem.

[26] Unless the group will adopt a system of intra-group guarantees to borrow funds externally, which however creates other issues of shareholder opportunism by the overuse of the corporate form: Richard Squire, 'Strategic Liability in the Corporate Group' (2011) 78(2) The University of Chicago Law Review 605, 619, 644.

shareholders' rights are embedded in UK company law,[27] and addressing only limited liability - instead of other shareholders' rights - is the most theoretically justified solution.

It is important to conduct a review of company law principles because the conception of the corporate form with all its modern characteristics took centuries to develop and its meaning evolved over time. In the seventeenth century, companies were an artificial legal creation of the state with certain corporate features that did not entail shareholder's rights or limited liability.[28] With subsequent legislative limitations to the creation of incorporated companies,[29] the corporate form shifted to that of a contractual creature with several advantages similar to the incorporated company, albeit less efficient.[30] Afterwards, an increase in the number of private investors pushed economic and political change in the form of free incorporation in the mid-nineteenth century and the development of statutory limited liability.[31] This wave of legislative changes brought the courts to form the view of complete separation between the legal entity and shareholders.[32] Together with the courts, scholars looked at the significance of the changing perception of the corporate form through theoretical lenses by setting out its key characteristics as a source of value for the company. However, traditional legal thinking is inadequate in addressing the complexities of modern business practices.

Corporate legal theories present two main claims. First, there is a descriptive claim regarding the best way of understanding what the company is, and secondly, a normative claim arguing the position of company law and its potential changes as a result of its understanding.[33] Addressing the theories of legal personality brings forward the notion that up to this point all the theories have focused on what a company can and cannot do, namely they have focused on companies' rights, and not on its potential to create harms.[34] They have concentrated on the nature of the corporate form rather than the consequences of its use on society. Furthermore, the rhetoric used by scholars promulgating traditional theories has led to an interpretation of the company that would fit any normative belief held by its proponent. Therefore, it has led to a circular debate, which to date remains unresolved. Central to the re-

[27] See 2.1.3.
[28] Shareholders could be made liable for the company's losses in certain occasions: John Bruce, *Annals of the Honourable East India Company from 1600 to 17 vol I* (Black, Parry, and Kingsbury 1810) 145. Moreover, limited liability did not exist as a *de jure* principle: Ron Harris, *Industrializing English Law: Entrepreneurship and Business Organization, 1720-1844* (Cambridge University Press 2000) 143.
[29] i.e., the Bubble Act 1720.
[30] Under the law they were considered partnerships, and its members were liable for the partnership's debts: see *R v Dodd* (1808) 9 East 516, 103 ER 670 (KB).
[31] The Companies Act of 1844, the Limited Liability Act of 1855 and the Joint Stock Companies Act of 1856.
[32] *Salomon v A Salomon and Co Ltd* [1897] AC 22 (HL).
[33] See the distinction between 'ontological' (which this thesis calls positive) and normative question in Rutger Claassen, 'Political theories of the business corporation' (2023) 18(1) Philosophy Compass 1.
[34] Addressed in ch 5.

evaluation of traditional theories is the adoption of a separate framework that would supplement the original debate and offer a holistic perspective on companies, filling the gap perpetuated by corporate theories. The supplementary concept of enterprise[35] can be used to develop a theory that focuses on the consequences of using the corporate form and develops a more nuanced understanding of corporate groups and their liabilities.

Corporate groups are identified in this thesis as legal-economic *phenomena*. In more detail, the economic entity - the enterprise - does not always match the legal entity - the company - and when this happens it creates a misalignment that hurts third parties.[36] While the boundaries of the two may not be aligned, namely the corporate group formed by separate legal entities exploits economic and legal principles to act as a unified enterprise for a common purpose, UK company law compels us to create a symmetrical relationship between the rights of each legal entity with its own liabilities and lets companies choose when this rule will not apply.[37]

This thesis argues that the best way to understand corporate groups is through the lens of the enterprise concept, which involves looking at the relationship between company-investors and a separate legal entity from a unified perspective. This would provide a supplement to the absent line of inquiry in corporate theories because it places more relevance on the company's potential to cause harm and the incentives provided by company law to move business activities outside the company's boundaries. The concept of enterprise focuses on the consequences of having a misalignment between the organisational and the corporate forms.

Stone crafted a fitting illustration of how to describe an organisational form conducting a business activity. He stated that an enterprise can be compared to an equilibrium of several closely related clusters of relationships among investors, agents - i.e., the management - and the company seen as the juridical entity; using the enterprise theory would mean intervening in the relationship between investors and the juridical entity by altering the rules of limited liability.[38] The enterprise corresponding to the entirety of a corporate group is also an equilibrium of relationship clusters and the focus of intervention is on the relationship between parent companies *qua* investors and their subsidiaries in the form of juridical entities. The proposal is, therefore, to disregard the concept of limited liability in isolated circumstances, or in other words to realign the company asymmetrically with the enterprise. This re-evaluation

[35] See ch 6.
[36] See Berle, 'The Theory of Enterprise Entity' (n2), Hardman, 'Fixing the misalignment' (n25).
[37] See the use of intra-group guarantees or other financial arrangements, which are permitted to facilitate intra-group transfers: CA 2006, s 208.
[38] Christopher D. Stone, 'The Place of Enterprise Liability in the Control of Corporate Conduct' (1980) 90(1) The Yale Law Journal 1, 9-11.

of the corporate form will happen in limited circumstances and will be based on a principled test of the "enterprise".[39]

The contribution of this thesis can be summarised in a number of important points[40]: 1) the current theoretical framework of company law is flawed, albeit still relevant to the discussion; 2) because traditional theories have some merit, it is not necessary to dismiss completely the current theoretical framework, but it can be supplemented; 3) the thesis will combine the literature on theoretical lines of inquiry going beyond the corporate form; 4) this line of inquiry will constitute the "enterprise theory", which will be refined and evaluated for the purpose of applying it to corporate groups; 5) the enterprise theory, based on normative principles, will correspond to the idea of attributing liability to the organisational form rather than the individual legal entity, and 6) the qualifying conditions that will make the enterprise theory a principled solution will be dependent on three factors proposed in this thesis, namely the concept of the enterprise, a legally recognised harm, and the characteristic risk of the enterprise.

Chapter 1 begins by defining externalities and their relevance to company operations, highlighting the need for legal normative attention to address externalities affecting third parties' legitimate interests. Chapter 2 explores the incentives embedded within UK company law that drive risk externalisation. This chapter scrutinises the corporate form and its characteristics, revealing how the legal presumption of shareholder rights, which are not theoretically an immutable part of the corporate form, leads to increased risk externalisation onto third parties, notably tort creditors.

Chapter 3 investigates whether and how corporate group structures intensify the issue of risk externalisation. Through a detailed examination of hierarchy-type corporate groups, the chapter justifies how hierarchical arrangements and structures exponentially increase the risk. It stresses the importance of addressing the use of the corporate form by shareholders at the expense of third parties to bridge the gap between the legal and business realities.

Chapter 4 further explores existing legal mechanisms designed to mitigate externalities produced using corporate forms and finds them wanting. By examining the veil-piercing doctrines, tort law principles, and other company law tools, the chapter assesses the efficacy of various remedies - both internal and external to company law. However, it concludes that relying solely on these remedies is insufficient, highlighting the need for a paradigm shift in company law to address the broader societal and economic consequences of corporate activities as a result of the use of the corporate form.

[39] See ch 6.
[40] Which are discussed respectively in ch 5 and 6.

Continuing the inquiry, chapter 5 critically examines prevailing theories of corporate personality and their implications for risk externalisation. It emphasises the limitations of existing theories in addressing contemporary challenges posed by corporate groups, advocating for a more comprehensive examination of the economic and social consequences associated with the corporate form. Finally, chapter 6 addresses the complexities of aligning the corporate form with the organisational form, focusing on conceptualising corporate groups as enterprises. It proposes an enterprise approach as a theoretical supplement to traditional legal entity theories, giving the theoretical basis for acknowledging and understanding corporate groups. Once corporate groups are conceptualised as enterprises, it is possible to establish an enterprise liability. This approach offers a more refined understanding of UK company law, calling for a reconsideration of corporate boundaries to ensure adequate protection for external parties and prevent unwarranted forms of risk externalisation.

1. Aims and Research Objects

This thesis analyses UK company law with academic literature, judicial decisions, legislation, and corporate law theories. The research aims to critically evaluate whether UK company law and its principles still achieve their purposes in today's economic landscape, where controlling corporate shareholders have all the power with no responsibility, and their negative externalities leave unsecured creditors uncompensated. The research objects are as follows:

1) To examine whether UK company law provides companies with incentives to externalise risk by considering and analysing in detail the corporate form and its characteristics.
2) To explore the intersection between UK company law incentives to externalise risk and shareholders.
3) To investigate how complex corporate structures exacerbate the issue.
4) To provide a critique of the current legal framework within which the corporate form is used in the UK.
5) To question the dominant theories advanced in UK company law and develop a framework capable of resolving these theoretical errors.
6) To give academic recommendations by identifying the legal tools that would solve the inherent issue created using the corporate form in group structures.

1.1. Research Questions

With regard to the research objects, this thesis addresses the following questions:

1) Does UK company law generate incentives for shareholders to externalise risk?
2) What specific incentives exist within UK company law that relate to shareholders externalising risk?
3) Do corporate group structures intensify the risk of externalisation? If yes, how?
4) To what extent is UK company law effective in addressing the issues it creates?
5) Can theoretical company law provide a viable solution to the problem of risk externalisation?
6) How can the law understand corporate groups to provide a more effective regulatory framework?

1.2. The Issue of Externalities

"*Legal reality no longer coincides with company law as enacted*."[41]

Since the seventeenth century and more prominently in the modern history of UK companies,[42] UK company law has provided the legal means to investors to conduct business purposes by forming a business association via a separate legal entity.[43] It has also attached certain characteristics to the legal entity, thereby endowing the legal entity *and* investors with certain features.[44] Company law, with the development of the "freely incorporated" company, promotes a system of privatised gains and socialised losses, where companies' earnings are

[41] Commission, 'Draft Proposal for a Ninth Council Directive pursuant to Article 54(3)(g) of the EEC Treaty relating to links between undertakings and in particular to groups' (unpublished), 2.
[42] With the first emergence of the corporate form in colonial companies: Giuseppe Dari-Mattiacci and others, 'The Emergence of the Corporate Form' (2017) 33(2) The Journal of Law, Economics, and Organization 193; and freedom of incorporation first granted in 1844: Michael Lobban, 'Corporate Identity and Limited Liability in France and England 1825-67' (1996) 25(4) Anglo-American Law Review 397.
[43] The modern company as a creation of the law is a separate person from its shareholders: *Salomon* (n32).
[44] See generally Paddy Ireland, 'Finance and the Origins of Modern Company Law' in Grietje Baars and Andre Spicer (eds), *The Corporation A Critical, Multi-Disciplinary Handbook* (Cambridge University Press 2017) 238-245. In sum, companies have perpetual succession. Shareholders cannot withdraw their capital at will but have the option to sell their shares or receive a reward in the form of dividends. Shareholders also possess limited liability - company's creditors cannot claim against their personal wealth - and companies have entity shielding - shareholders' creditors cannot claim against the company's assets. Shareholders have the right to elect a board of directors.

treated as an inherent right of shareholders[45] with society and the economy left to bear the responsibility of companies' losses. As such, shareholders obtain advantages from the use of the corporate form at the expense of third parties. UK company law should be concerned with this because not only is it company law itself that provides the incentives to shareholders to let other parties bear the responsibilities arising from the company's business operations, but it also retracts from its role in regulating the corporate form and abdicates what are really its own responsibilities by farming them out to other branches of the law to try and resolve.

Incorporation of a company is simply an administrative formality involving form-filling and low fees; in the UK, it is possible to set up a limited company for as little as £12.[46] Once incorporated, companies are separate legal entities with their own rights, obligations, and liabilities.[47] Its significance is that the liabilities arising from business operations are attributed to the legal entity and not its members, and the company's assets are separated in a different pool from those of the shareholders, which designation has been described as "affirmative asset partitioning".[48] The latter involves the company owning its assets, which can be levied by the company's creditors but cannot be used by shareholders or levied by shareholders' creditors. Limited liability companies entail the shareholders having their liability limited to the minimum amount of assets they have to contribute, which is generally the nominal value of the shares they hold in the company.[49] As long as the company remains solvent, shareholders can expect open-ended profits from the company's business. In company law analysis,

[45] The literature based on the principal-agent model, namely that the company is a bundle of assets owned by shareholders (the principal) who delegates the management of the assets to directors (the agent), sees the option to receive dividends as rightful ownership of shareholders and is substantiated by the practice of shareholder primacy. See: '*there are two key elements in the ownership of a firm, as we use the term "ownership" here: the right to control the firm, and the right to receive the firm's net earnings'* in Kraakman and others (n8) 13; '*as a consequence of both logic and experience, there is convergence on a consensus that the best means to* (…) *the pursuit of aggregate social welfare is to make corporate managers strongly accountable to shareholder interests and, at least in direct terms, only to those interests*' in Henry Hansmann and Reinier Kraakman, 'The end of history for corporate law' in Jeffrey N. Gordon and Mark J. Roe (eds), *Convergence and Persistence in Corporate Governance* (Cambridge University Press 2004) 42-43.

[46] Companies House, 'Guidance Incorporation and names', (updated 2024) <https://www.gov.uk/government/publications/incorporation-and-names/incorporation-and-names> accessed 16 April 2024.

[47] *Salomon* (n32) 51: '*The company is at law a different person altogether from the subscribers to the memorandum; and, though it may be that after incorporation the business is precisely the same as it was before, and the same persons are managers, and the same hands receive the profits, the company is not in law the agent of the subscribers or trustee for them. Nor are the subscribers as members liable, in any shape or form, except to the extent and in the manner provided by the Act.*'

[48] Henry Hansmann and Reinier Kraakman, 'The Essential Role of Organizational Law' (2000) 110(3) The Yale Law Journal 387, 393.

[49] CA 2006, s 542. When applicable, the minimum amount of assets will be the par value of each share plus a premium: CA 2006, s 582.

shareholders are referred to as the residual claimants and they have the right to receive the residual company's profits once all other liabilities have been satisfied.[50]

The internal governance structure of "modern companies",[51] characterised by a separation of ownership and control and dispersed shareholders, results in the decision-making power being vested in directors, albeit subject to the influential position of shareholders.[52] Shareholders do not *directly* control the company's decisions; instead, management is delegated to directors, but they control them *indirectly* by way of appointment and decision rights.[53] Shareholders can appoint and remove directors, as well as make certain corporate decisions.[54] Shareholders have the right to receive dividends, attend meetings, and cast their votes thereat.[55] Consequently, the corporate form becomes controversial when shareholders possess the means and opportunities to influence corporate decisions and gain profits from them with few or no repercussions.

This thesis argues that, over time, the corporate form has transformed into a shield protecting investors, incentivising them to take more risk and externalising it onto third parties, particularly unsecured tort creditors. When a company becomes insolvent, the risks are borne by creditors because shareholders, although last in line to recover their investments under insolvency law,[56] do not have to financially contribute to the company's liabilities and have potentially little to lose. The distinct positions of shareholders and creditors create conflicting incentives. When a legal entity is in the vicinity of insolvency, shareholders are incentivised to take actions that will benefit them at the expense of the company's creditors. The company's assets can be reduced by making excessive dividend payments, new debts can be raised by exercising riskier borrowing, or assets can be taken outside of the company and out of the reach of creditors.[57] In a corporate insolvency, the total losses are fixed, and *some* creditors will inevitably face significant losses due to the competitive nature of loss distribution among creditors. This creates a scenario where more informed and powerful creditors can employ strategies to secure their debts, often at the expense of less informed and weaker creditors.[58]

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[50] Frank H. Easterbrook and Daniel R. Fischel, 'Voting in Corporate Law' (1983) 26(2) Journal of Law and Economics 395, 403-406; Frank H. Easterbrook and Daniel R. Fischel, *The Economic Structure of Corporate Law* (Harvard University Press 1991), 63, 69; Stephen M. Bainbridge, 'Director Primacy: The Means and Ends of Corporate Governance' (2003) 97 Northwestern University Law Review 547, 565.
[51] i.e., large public limited companies.
[52] William W. Bratton, 'The New Economic Theory of the Firm: Critical Perspectives from History' (1989) 41(6) Stanford Law Review 1471, 1476.
[53] Kraakman and others (n8) 51-58.
[54] John Armour, 'Shareholder rights' (2020) 36(2) Oxford Review of Economic Policy 314, 316.
[55] *Birch v Cropper* (1889) 14 App Cas 525 (HL).
[56] *Re Nortel Companies and others* [2013] UKSC 52, [2014] AC 209 [39].
[57] See Vanessa Finch, *Corporate Insolvency Law Perspectives and Principles* (2nd edition, Cambridge University Press 2009) 76-77; Kraakman and others (n8) 111-114.
[58] Lynn M. LoPucki, 'The Unsecured Creditor's Bargain' (1994) 80(8) Virginia Law Review 1887, 1916.

This competitive environment shifts the adverse effects of externalisation onto unsecured creditors, who are least equipped to protect their interests. UK company law has created an environment where vulnerable third parties can be harmed by the use of the corporate form, and such harm goes unnoticed and unremedied.

1.2.1. The Meaning of Externalities

This section refrains from delving into the broader theoretical debate surrounding the nature and regulation of externalities as interpreted by the law and economics analysis.[59] Instead, it aims to delineate the specific types of externalities that are addressed within the scope of this thesis. When business activities have a negative effect on society, externalities are termed negative "social costs",[60] namely the costs of an initiator's actions imposed on others.[61] Externalities are used mainly as an economic concept. In economics, externalities *per se* do not possess any moral connotation; they are simply a form of rational behaviour of companies and utility maximising individuals that are expected to externalise harms in the absence of legal rules.[62] In its most basic form, an externality is also called a *third-party effect* insofar as an action between *A* and *B* creates a *non-consensual* relationship between *A* and a third-party *C*, where the activity of one externally affects, in a positive or negative way, the utility of another.[63]

The concept of externality is broad and has a long history; it is not a novel approach to observe surrounding economic activities and notice the negative spill-over effects generated by them.[64] While there is a debate amongst economists that some externalities are irrelevant,[65] there is a consensus within the literature that externalities are indeed present. Therefore, the debate primarily revolves around "normative" judgments rather than the existence of externalities *per*

[59] Ronald H. Coase, 'The Problem of Social Cost' (1960) 3 Journal of Law and Economics 1; Arthur Pigou, *The Economics of Welfare* (4th edition, Palgrave Macmillan 1960).
[60] Costs are negative externalities, while social benefits are positive externalities. Here we are concerned only with negative externalities.
[61] Johannes de V. Graaff, 'Social Cost', *The New Palgrave Dictionary of Economics* (3rd edition, 2018) 12516–12520.
[62] Michael Faure, 'Environmental Liability of Companies in Europe' (2022) 39(1) Arizona Journal of International and Comparative Law 1, 9.
[63] James Buchanan and William Stubblebine, 'Externality' (1962) 29(116) Economica, New Series 371, 372.
[64] Steven G. Medema, *The Hesitant Hand Taming Self-Interest in the History of Economic Ideas* (Princeton University Press 2009) ch 1. Medema produces a discussion on negative effects of self-interested behaviour in the market from the Ancient Greeks and the mercantile period to Adam Smith.
[65] One-on-one cases are relatively unimportant: William J. Baumol, 'On Taxation and the Control of Externalities' (1972) 62(3) The American Economic Review 307, 308. If there is no influence on the party affected to modify the action of the party generating the externality, such externality is irrelevant: Buchanan and Stubblebine (n63) 373-374.

se.[66] As previously stated, externalities in economics do not cause any moral concern.[67] However, the economic analysis frames externalities in terms of market failures and efficiency outcomes, which do involve the normative task of assigning a value to the "harm" or "benefit" generated by an action.[68]

Economists seem to use normative principles in an ambiguous way. While they claim to be unconcerned with normative judgments, the act of assigning value inherently involves normative judgments.[69] And any externality would count in their analysis regardless of how morally abhorrent it might be.[70] This is partly because, in the economic literature, legal principles are also used in an ambiguous way. There, the meaning of exercising a "legal right" is often confused with simply the doing of something[71] or the ability to choose the use of something.[72] For instance, if a murderer values causing harm more than a victim values her life, economists might view the state's prohibition of murder as imposing an externality on the murderer. In this scenario, harming others is not a legal right;[73] it is merely a voluntarily chosen course of action. The state's enforcement of laws is a deliberate effort to uphold social norms and protect citizens, rather than creating a true externality for the murderer. Thus, it seems less questionable to adopt a view of externalities mainly from a normative legal perspective rather than from one that is purely economic.

Company law is traditionally based on the maximisation of the company's value, which, regardless of the definition taken,[74] assumes that events unfolded at the micro level (i.e., within the company) do not have macro consequences outside of the company.[75] Although it is

[66] Carl J. Dahlman, 'The Problem of Externality' (1979) 22(1) Journal of Law and Economics 141.
[67] Faure (n62) 9.
[68] See Rutger Claassen, 'Externalities as a basis for regulation: a philosophical view' (2016) 12(3) Journal of Institutional Economics 541, 548.
[69] ibid.
[70] See the analogy of the murder victim as accessory to the crime: Baumol (n65) 308.
[71] Daniel H. Cole and Peter Z. Grossman, 'The Meaning of Property Rights: Law versus Economics?' (2002) 78(3) Land Economics 317, 322-323.
[72] The economic literature is not concerned with the role of law, but the ability to exercise a choice. See Geoffrey M. Hodgson, 'Much of the 'economics of property rights' devalues property and legal rights' (2015) 11(4) Journal of Institutional Economics 683, 691-694.
[73] E.g. self-defence does not give you a legal right to do harm, it allows you to use *reasonable* force to respond to harm towards you. See Criminal Justice and Immigration Act 2008, s 76.
[74] In the literature, it is possible to find the view of profit maximisation to benefit shareholders' interests, see D. Gordon Smith, 'The Shareholder Primacy Norm' (1998) 23 Journal of Corporation Law 277, 282; or the idea of "shareholder welfare", which differs from maximisation of profits insofar as it includes ethical issues that shareholders are concerned about and can be implemented through corporate policies: Oliver Hart and Luigi Zingales, 'Companies Should Maximize Shareholder Welfare Not Market Value' (2017) 2 Journal of Law, Finance, and Accounting 247, 249; or more generally shareholder wealth maximisation based on shareholders' interests that can be both financial and non-financial: Paul Weitzel and Zachariah Rodgers, 'Broad Shareholder Value and the Inevitable Role of Conscience' (2015) 12 New York University Journal of Law & Business 35, 41–42.
[75] Kraakman and others (n8) 23, focusing on the fact that maximising the company's value leads to higher overall social welfare; Vasco M. Carvalho, 'From Micro to Macro via Production Networks' (2014) 28(4) Journal of Economic Perspectives 23, 25, who summarises the argument that shocks hitting a

acknowledged that companies produce externalities while pursuing their business, those externalities are perceived as able to be either confined inside the corporate structure or internalised through other areas of law rather than company law.[76] While damages are often inseparable from the company's activities and externalities do become visible outside of the company,[77] the norm is looking at company law through the lens of advancing shareholder value, which is believed to be congruent with social wealth, hence leading to overall aggregate good.[78]

The assumption that company law's purpose is to focus exclusively on the company's (and shareholders') interests without needing to address its potential harms is based on the false premise that the boundaries of a legal entity coincide with the boundaries of the economic activity carried out by an organisational form.[79] Shareholders and directors, the key constituents in the company,[80] have the means to use the corporate form to their advantage[81] and are incentivised to do so. Externalities cannot be confined to the company's legal boundaries because company law incentivises and enables the externalisation of business risks, creating a misalignment. For example, a single firm can develop into a group of several

company at the micro-level will not affect the economy on a macro-level as these "local" disturbances will be diversified and averaged out in the bigger picture.

[76] Stephen M. Bainbridge, 'In Defense of The Shareholder Wealth Maximization Norm: A Reply to Professor Green' (1993) 50(4) Washington and Lee Law Review 1423, 1431.

[77] Such as incomplete markets, whereby maximising the company's value would not reach efficiency, or global externalities - i.e., climate change - which require global coordination to reach optimality. See Oliver Hart and Luigi Zingales, 'The New Corporate Governance' (2022) 1(1) University of Chicago Business Law Review 195, 199-203.

[78] The UK promotes the principle of enlightened shareholder value. Directors must have regards of broader societal issues to the extent that they affect the overall interests of shareholders: CA 2006, s 172(1). This principle maximises shareholder value by leaving great discretion to directors to evaluate what is relevant to consider for corporate decisions because the ultimate goal is to ensure the long-term success of the company. See generally Andrew Keay, 'Having regard for stakeholders in practising enlightened shareholder value' (2019) 19(1) Oxford University Commonwealth Law Journal 118.

[79] Companies can be interconnected. This interconnectedness creates significant consequences outside of the company. See Luca Enriques and Alessandro Romano, 'Rewiring Corporate Law for an Interconnected World' (2022) 64(1) Arizona Law Review 51, arguing that the COVID-19 pandemic, climate change, and financial crises are all instances in which the interconnection among actors has created systemic macroeconomic shocks. Similarly, the interconnectedness of several legal entities within a group structure creates consequences outside the singular corporate form.

[80] Shareholders and directors are the key constituents because they are the ones initiating the process of the corporate form. They will register a company by submitting a memorandum of association indicating that its subscribers want to form a company and agree to become its members. The subscribers will then become the holders of the specified shares, and the directors named in the statement will be appointed. See CA 2006, ss 7(1), 8, 16(2), 16(5)-(6).

[81] The classic example is shareholders maximising their profits at the expense of unsecured tort creditors via the rule of limited liability: Hansmann and Kraakman, 'Toward Unlimited Shareholder Liability for Corporate Torts' (n2). Directors also have incentives to maximise their profits owing to the idea of the principal-agent relationship arising from the separation of ownership and control in companies. In other words, directors are the agents of shareholders, but they have differences in interests and objectives, leading directors to pursue self-interest. See generally Eugene F. Fama, 'Agency Problems and the Theory of the Firm' (1980) 88(2) The Journal of Political Economy 288; Michael C. Jensen and William H. Meckling, 'Theory of the firm: Managerial behavior, agency costs and ownership structure' (1976) 3(4) Journal of Financial Economics 305.

legal entities, with each company representing only a portion of the entire business. While the legal structuring of the firm may disrupt its internal environment to some extent,[82] as will be discussed later,[83] it will undoubtedly affect its external environment by compartmentalising each company's liabilities and externalising risks onto third parties.[84] According to Deakin and others, '*a corporation is a kind of firm; it has a structure as designated under corporate law. All corporations are firms, but not all firms are corporations*.'[85] In this sense, the boundaries of a legal entity will dictate the structure of the firm. Although they are correct in stating the relevance of the corporate form, we cannot possibly equate the two in all circumstances. There will be times in which a firm conducting a business will misalign the boundaries of the legal entity with its business activities for its own benefit. And the result that shareholders will pursue the maximisation of their value at the expense of third parties is exacerbated.

When an organisational form decides to split its business into separate legal vehicles used for several purposes in which the parent company owns shares, it can also decide to have one of these vehicles enter into contracts with external parties, such as suppliers, to increase the surplus of the investment. If the contracts are wrongfully ended, the fault and consequential remedies will be against the vehicle itself, not the organisational form.[86] Theoretically, the parent company shareholder will then be shielded from the liabilities arising from the wrongful termination. The inner operations will hardly be disturbed, the liabilities arising in one vehicle will not contaminate the whole structure, and business will continue as usual.[87] The external environment, in contrast, may be highly affected since the contracting party, in this case, will be harmed and may remain uncompensated. This situation is exacerbated when the external

[82] For example, if two individuals incorporate a company to produce a product, but then the demand for the product increases and the company decides to incorporate two subsidiaries to meet the demand, the internal environment will not drastically change. It will still be one single firm, albeit with a different corporate structure in the form of a corporate group. The same individuals will still make the key decisions, and although at the subsidiary level there will be autonomous directors and management, they will all be part of the governance structure of the single firm. This example is taken from Jean-Philippe Robé, 'The Legal Structure of the Firm' (2011) 1(1) Accounting, Economics, and Law, article 5, 48-49. Explained in more detail in ch 3.

[83] See ch 3.

[84] Asset partitions allow the separation of risks. However, in complex corporate group structures, shareholders can tailor the amount of risks and liabilities they are willing to take. They can implement cross-liability provisions that will make contractual creditors have more enforcement options compared to the remedies available to other types of creditors - i.e., non-contractual. For an overview on tailored partitions: Anthony J. Casey, 'The New Corporate Web: Tailored Entity Partitions and Creditors' Selective Enforcement' (2015) 124 Yale Law Journal 2680.

[85] Simon Deakin and others, 'Legal institutionalism: Capitalism and the constitutive role of law' (2017) 45 Journal of Comparative Economics 188, 194.

[86] Unless there is a system of cross-liabilities in place: see Casey (n84).

[87] Ch 3 will further delineate that corporate groups not only can decide to be insulated from liabilities but receive several advantages from the group structure because they can – within the confines of the law - choose when and how to pool the assets and liabilities of the group.

party will not voluntarily enter into a transaction with the legal entity and be as informed as a contractual party.[88]

Company law fails to address the repercussions of its actions, and other legal areas are ill-equipped to rectify these failures. Attempting to resolve issues stemming from company law through other legal avenues is merely a stopgap measure, as it does not address the underlying problem of company law incentivising corporate constituents to exploit the corporate form for personal gain. Thus, while it may resolve some issues, it aggravates others.[89] It will always present an incidental solution, because it will not fix the root cause of the problem, consequentially providing an intellectually and doctrinally lax approach to the externalities of company law principles. It is illogical to assume that the role of company law is simply to set up the corporate form, and other areas of law should mitigate the issues arising from it.[90]

It is the role of company law to regulate the corporate form and its consequences. The social norm that company law's purpose is only to protect shareholders' interests is a legal and dangerous myth.[91] The Companies Act 2006 does not stipulate that the corporate form can be used for the benefit of shareholders by causing negative externalities to third parties.[92] However, company law inadvertently creates incentives that can lead to harmful exploitation of the corporate form in certain scenarios. Furthermore, other areas of law are not the best option to address the externalities of the corporate form because remedies are linked to a loss caused by actionable wrongs that cannot be remedied due to company law principles. In the case of using the corporate form at the expense of third parties, the losses can be remedied only when the use is illegitimate or the action constitutes an identifiable wrong, which is confined within the legal boundaries of the corporate form.[93] This system will result in only the most egregious cases being resolved, and all the other present losses will be overlooked insofar as the corporate form was used in a way that is in accordance with the law.[94] This thesis contends that the unresolved issues surrounding legally relevant externalities persist within company law. While other legal frameworks may have made strides in addressing

[88] See 2.2.3.
[89] See for example tort law solution in 1.2.2. and 4.2.
[90] See 4.3.
[91] Beate Sjåfjell, 'Beyond Climate Risk: Integrating Sustainability into the Duties of the Corporate Board' (2018) 23 Deakin Law Review 41, 51.
[92] Directors need to act in the best interests of the company after having regard of broad societal concerns: CA 2006, s 172. While there are issues with s 172 and its interpretation has been applied as considering stakeholders only for the purpose of maximising shareholder value (see Andrew Keay and Hao Zhang, 'An Analysis of Enlightened Shareholder Value in Light of Ex Post Opportunism and Incomplete Law' (2011) 8 European Company and Financial Law Review 445, 457), the section does not declare unquestionable shareholder superiority over stakeholders.
[93] See 4.2.
[94] See the analysis of *Adams v Cape Industries PLC* [1990] 1 Ch 433 (CA) in 4.1.1.

similar issues,[95] the stagnation of UK company law in this regard raises normative concerns, highlighting the need for a clearer framework addressing companies' externalities.

Company Law Externalities

Companies are assumed to be vehicles used by shareholders and directors for the benefit of shareholders.[96] The corporate form has been the method deployed for centuries by investors to organise business activities.[97] Because incorporation is a choice made and initiated by shareholders and directors,[98] they will choose to incorporate in the specific jurisdiction they favour based on the rules the jurisdiction offers in terms of members' rights, prices charged for incorporating and ongoing administrative and filling requirements, and any other relevant consideration.[99] Consequentially, a framework of supply and demand is created, where company law within the jurisdictional boundaries serves as supply and shareholders and directors form the demand.[100] By retaining control of the incorporation process, shareholders use the company as a vehicle and ultimately control it.[101]

In the company law sphere, the mounting pressure and demands of individuals wishing to organise their economic activities using a corporate entity to transact easily in market economies has led to several core features attributed to companies.[102] First, companies are separate legal entities. It means that as soon as the entity is incorporated under the law, it is recognised as capable of carrying out certain activities as a person; specifically, it can enter into contracts, own property, sue and be sued, and have a centralised management structure

[95] For instance, competition law, tax law, or labour law. See, in this regard, 6.3. However, these legal frameworks do not address the root cause of the issue in company law.
[96] Margaret M. Blair and Lynn A. Stout, 'A Team Production Theory of Corporate Law' (1999) 85 Virginia Law Review 248, 248, footnote 1; Jensen and Meckling (n81) 309.
[97] Historically, investors have used several means to organise their investments. Since the seventeenth centuries, with the development of colonial companies, the corporate form started to emerge, and in the nineteenth and twentieth centuries became the main form of organisation. See Dari-Mattiacci and others, 'The Emergence of the Corporate Form' (n42); Colin Mackie, 'From Privilege to Right: Themes in the Emergence of Limited Liability' (2011) 4 Judicial Review 293.
[98] See (n80) regarding the importance of shareholders and directors.
[99] This has been described as a "market" for incorporations. Shareholders and directors will incorporate the company in the jurisdiction which most suits their needs. Similarly, they will "purchase" a product - the act of incorporating - in that jurisdiction, creating a market where jurisdictions compete with each other. See Roberta Romano, 'Law as a Product: Some Pieces of the Incorporation Puzzle' (1985) 1(2) Journal of Law, Economics, and Organization 225; Oren Bar-Gill, Michal Barzuza and Lucian A. Bebchuk, 'The Market for Corporate Law' (2006) 162(1) Journal of Institutional and Theoretical Economics 134.
[100] See, in relation to the UK, Jonathan Hardman, 'Further Legal Determinants of External Finance in Scotland: An Intra-UK Market for Incorporation?' (2021) 25(2) Edinburgh Law Review 192.
[101] Jonathan Hardman, 'The nexus of contracts revisited: Delineating the business, the firm, and the legal entity' (2022) 34(2) Bond Law Review 1, 9.
[102] Kraakman and others (n8) 2.

acting on its behalf.[103] Furthermore, companies have four other core characteristics, which are considered to flow from the company's separate legal personality: transferable shares, investor ownership, entity shielding, and limited liability.[104] While each is a stand-alone feature, they all work together to increase the attractiveness of the corporate form.

The transferability of shares is a consequence of the capital lock-in mechanism[105] necessary for the perpetual existence of a legal entity.[106] Companies can conduct their activities in perpetuity because investors cannot withdraw their capital at will; instead, they receive shares that can be sold.[107] The corporate form rendered large-scale operations easier by widening the body of investors, which also caused business operations to become more "impersonal"[108] with numerous and constantly changing shareholders. Accordingly, corporate decisions are delegated to the board of directors. Yet, the board, representing the legal entity, is ultimately controlled by shareholders.[109] Indeed, the feature of investor ownership includes two key components, two fundamental "rights"[110] falling under economic and control rights, such as the entitlement to a share of the company's profits[111] and the entitlement to vote on important matters relating to the business.[112] Moreover, entity shielding and limited liability are often paired together, as they are believed to be functionally complementary and the inverse of each other. In other words, limited liability denies claims of companies' creditors against shareholders' assets, and entity shielding prevents shareholders' creditors from claiming the

[103] Kraakman and others (n8) 8. Management as we know it today, namely being involved in the day-to-day running of the company, did not have, originally, the same meaning. When the corporate form emerged in England with the English East India Company, management had a broader meaning of directing and supervising the members rather than "managing" a business. See Susan Watson, *The Making of the Modern Company* (Bloomsbury 2022) 53-55.
[104] Kraakman and others (n8) 5-16.
[105] In contrast to a partnership, investors in a company cannot withdraw their capital at will. The assets belong to the company and there is the full separation between the company's and shareholders' assets and liabilities: Henry Hansmann, Reinier Kraakman and Richard Squire, 'Law and the Rise of the Firm' (2006) 119(5) Harvard Law Review 1333, 1338. This means that shareholders' capital is locked-in and the only way to exit is to sell shares to another investor.
[106] The company can exist in perpetuity and its assets can be accumulated over time without being subject to division and distribution at the death or departure of its members. The commitment of locked-in capital in a separate legal person allowed this development. See Margaret M. Blair, 'Corporate Personhood and the Corporate Persona' (2013) 3 University of Illinois Law Review 785, 794.
[107] This is another feature that started with colonial companies: Margaret M. Blair, 'Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century' (2003) 51 UCLA Law Review 387, 414.
[108] Ron Harris, 'Trading with strangers: the corporate form in the move from municipal governance to overseas trade' in Harwell Wells (ed), *Research Handbook on the History of Corporate and Company Law* (Edward Elgar 2018) 88.
[109] Who collectively have the power to appoint and remove directors by way of an ordinary resolution: CA 2006, ss 160(1) and 168(1).
[110] Julian Velasco, 'The Fundamental Rights of the Shareholder' (2006) 40 University of California Davis Law Review 407, 409.
[111] If dividends are declared by the board: Companies (Model Articles) Regulations 2008 (SI 2008/3229) art 70(4).
[112] Among others, voting in the election of the board: Paul L. Davies, *Introduction to Company Law* (3rd edition, Oxford University Press 2020) 58.

assets of the company. The two create a wall between the company's and shareholders' assets by delineating a separate pool of wealth for both.[113]

Although the significance of separate legal personality has been downplayed by many,[114] the company is a legal tool made available under state law to organise economic activities. The corporate form is a legal vehicle that can be misused when the boundaries of the latter do not align with the former.[115] Under UK company law, the corporate form is made available for corporate group structures, where each member is recognised as having separate legal personality with its own rights and liabilities.[116] This is known as the legal entity approach.[117] When a single organisational form is divided into multiple separate legal entities, parent companies *qua* shareholders will be incentivised to externalise more risk onto third parties by having the legal means to compartmentalise liabilities within the structure and divert value from one entity to the other. Not only will they be insulated from the harms of liability when it is in their interest, but UK company law also provides them the means to voluntarily decide when to function as a single organisational form for their benefit. Therefore, corporate shareholders will take advantage of using the corporate form at the expense of others.

This thesis argues[118] that there is a wrongly assumed conception in company law that binds together separate legal personality and limited liability. Once the two are separated, it appears clearly that UK company law promotes the use of the corporate form generating undesirable consequences at the hands of shareholders and directors.[119] Limited liability is advantageous for several economic reasons.[120] An increase in individual private investors served as a drive for political and economic forces to recognise the corporate form to include limited liability and normalise detached profit-seeking investors.[121]

However, when limited liability is awarded automatically to parent companies, which feature concentrated corporate ownership in the form of controlling shareholders, it will result in an

[113] See Hansmann and Kraakman, 'The Essential Role of Organizational Law' (n48) 393.
[114] For instance, it has been described as a '*legal fiction'*: Jensen and Meckling (n81) 310; or a '*heuristic formula'*: Kraakman and others (n8) 8.
[115] Hardman, 'Fixing the misalignment' (n25).
[116] *The Albazero* [1977] AC 774 (HL), 807 (Roskill LJ).
[117] The term is used in the legal scholarship to describe the approach of looking at the company as a stand-alone entity: see Witting, *Liability of Corporate Groups and Networks* (n22) 174. Using this approach/view is simply to put emphasis on the legal form of the company. The legal form dictates how we look at the company and the principles of the corporate form (i.e., separate legal personality and limited liability) are sacrosanct: Blumberg, *The Multinational Challenge to Corporation Law* (n6) 21-45.
[118] In ch 2, where the principles of company law are discussed.
[119] This is because it is difficult to challenge the corporate form. Limited liability, for example, has become a legal norm so entrenched in the legal minds that any theory going against it is regarded as a too profound shift in company law to work: see Witting, *Liability of Corporate Groups and Networks* (n22) 182-183.
[120] See 2.1.4.
[121] Ireland, 'Finance and the Origins of Modern Company Law' (n44) 238-246.

incentive to take risks and use the corporate form of subsidiary companies at the expense of creditors. This is because the shareholders of parent companies will have the same fundamental rights, but with the additional choice of resorting to control-enhancing mechanisms.[122] This elevates their risk-taking activities as their financial exposure is limited twice by the principle of limited liability[123] and their control can be disproportionately related to the entire cash flow "rights"[124] of any unit of the group. It follows that parent companies are incentivised to externalise more risk and divert the value of a company for their own advantage. For instance, they can transfer value from one entity to another in which they, i.e., the controlling shareholder, hold all or the majority of economic rights.[125] Excessive risk-taking is incentivised because negative results can be shifted to "outsiders" - third parties outside of the corporate form. Although taking risks is not in itself illegal, it raises normative concerns about the incentives that are provided by the domestic company law framework and when they arise.[126]

The corporate form with all its characteristics would not be the source of the issue of externalisation if UK company law differentiated the incentives it provides[127] and remedied its mistake of enabling the boundaries of a legal entity to diverge from the boundaries of the organisational form. To that extent, it is the selective difference between the legal conception of a company and the economic activity of the organisational form that causes the fundamental issue of externalisation in corporate groups and leaves harms unrepaired. The harms that are relevant to this consideration are legal harms that cannot be remedied and tacitly benefit parent company shareholders; in other words, legally recognised harms that lead to unsecured tort creditors of subsidiary companies remaining unsatisfied because parent companies can exercise shareholder rights, control the economic activity, and have their liability limited.[128]

1.2.2. An Illustration of the Problem

Environmental and toxic torts are an illustration of a legally recognised harm that is externalised through company law principles without being adequately addressed. Risky operations are generally carried out by group structures, given the economic and legal benefits

[122] See 3.5 and 4.2.
[123] One level protecting the individual shareholders of the parent company and one protecting the parent company *qua* shareholder.
[124] Economic rights.
[125] Davies, *Introduction to Company Law* (n112) 121.
[126] Goodhart and Lastra, for instance, link excessive risk-taking to limited liability and propose a reform to limited liability for "insiders", i.e., those with inside information, control, and influence on corporate decision-making: see Charles A. E. Goodhart and Rosa M. Lastra, 'Equity Finance: Matching Liability to Power' (2020) 6(1) Journal of Financial Regulation 1.
[127] For instance, by separating the concepts of limited liability and separate legal personality.
[128] This idea of harms will be expanded in ch 6.

that such structures provide.[129] Notable examples include: the Nigerian Federal Government agency reported 998 oil spills in 2023, of which 399 were caused by Shell's subsidiary, "The Shell Petroleum Development Company of Nigeria";[130] Union Carbide Corporation's subsidiary managed a pesticide plant near Bhopal, India, which leaked chemicals into the city, injuring two hundred thousand and killing between three and twenty thousand individuals;[131] and Trafigura offloaded toxic waste in the Ivory Coast, killing seventeen and injuring more than one hundred thousand.[132] Large-scale industries carry, as a consequence of their operations, negative environmental effects on both the geographical area where the operations of the group are conducted and on individuals and communities.

These incidents, while seemingly isolated, represent the stark reality of business operations with inherent risks. Data from the Environmental Justice Atlas,[133] an online database documenting environmental injustices caused by economic activities, further highlights the prevalence of such issues. Its list is not exhaustive as it grows continuously with more research and when more collaborators join the project; still, the contributors are both activists and academics, and the production of data is a responsibility shared with the communities themselves.[134] As of 2024, the Atlas has recorded 3988 cases of businesses - including a majority of corporate groups - negatively impacting communities.

The environmental externalities generated by corporate groups are not adequately addressed by UK company law. Company law has retreated from regulating business activities, leaving other branches of the law to manage the issues generated by using its principles. The common perception of companies' environmental impacts on communities, for instance, is that they are

[129] Sharon Belenzon, Niron Hashai and Andrea Patacconi, 'The Architecture of Attention: Group Structure and Subsidiary Autonomy' (2019) 40 Strategic Management Journal 1610, 1614. Ch 3 will discuss in more detail the dynamics of corporate groups.
[130] Nigerian Oil Spill Monitor <https://nosdra.oilspillmonitor.ng/> accessed 20 March 2024. This company is a subsidiary in the Shell group, although Shell decided to sell its ownership percentage from January 2024: Shell, 'Shell agrees to sell Nigerian onshore subsidiary, SPDC' (16 January 2024) <https://www.shell.com/news-and-insights/newsroom/news-and-media-releases/2024/shell-agrees-to-sell-nigerian-onshore-subsidiary-spdc.html> accessed 20 March 2024. Over time, the oil spills caused the communities at the Niger Delta to have health issues, lose access to food, drinking water, and their ability to work: see *Okpabi v Royal Dutch Shell Plc* [2021] UKSC 3, [2021] 1 WLR 1294 [4].
[131] There is no consensus on the actual number of victims: see John Curtis and Julie Gill, 'Potential UK support for investigations into the Bhopal gas explosion' (2022) <https://commonslibrary.parliament.uk/research-briefings/cdp-2022-0202/> accessed 20 March 2024.
[132] See Rebecca Bratspies, 'Corrupt at Its Core: How Law Failed the Victims of Waste Dumping in Côte d' Ivoire' (2019) 43(2) Columbia Journal of Environmental Law 417, 447.
[133] The Environmental Justice Atlas is a project documenting environmental conflicts. It catalogues issues logged against companies with heavy environmental impacts on communities, such as mining, drilling, and waste management amongst others.
[134] Leah Temper, Daniela del Bene and Joan Martinez-Alier, 'Mapping the frontiers and front lines of global environmental justice: the EJAtlas' (2015) 22(1) Journal of Political Ecology 255, 263.

not a concern for company law.[135] This is reflected in the fact that relevant provisions can be found in several areas of law that fall outside the direct regulation of the corporate form. There are provisions in environmental law, tort law principles of direct liability, or along more general lines in reporting requirements, broad creditors' protection rules, and company directors' duties.[136] While UK company law is the source of an externalisation of risk by parent company shareholders via the corporate form, it does not play a part in remedying this externalisation. Truly, it creates the atmosphere for a "perfect storm". It is possible to witness and appreciate the risks of business activities when manifested in environmental and toxic torts, which affect third parties who are not only put in a disadvantaged position by the legal system,[137] but whose compensation will also be dependent on legal principles not connected to the cause of the externalisation, i.e., the principles of the corporate form, and compensation is frequently denied.[138] The result is that tort victims will be systemically harmed, while parent company shareholders will benefit from the use of the corporate form in group structures.

Since the 1970s, with a shift in the scientific and societal perception of environmental risks for individuals, a new class of torts has emerged and has provided a vehicle for victims of environmental harms to litigate previously unknown hazards.[139] Environmental and toxic torts are different from traditional torts due to the fact that they intersect environmental and tort considerations,[140] therefore creating a new set of factors that courts will need to take into account, and challenges that claimants/plaintiffs will need to overcome to recover any damages. Damages from both toxic and environmental torts require scientific evidence showing that the defendant *caused* the harm.[141] Therefore, establishing the damage involves difficult questions regarding the factual or technical link between the toxic substance or environmental damage and the plaintiff's claim. For example, a failure to exercise due care is not regarded as a sufficient basis for the establishment of liability when the harm was not a reasonably foreseeable consequence of the spillage of hazardous substances at the time the

[135] Corporate impacts on the environment and communities are framed within the interests of a company as a whole, which means that directors have a degree of flexibility to take into account the environment only when it poses a significant risk to the company and its shareholders: see CA 2006, s 172; Financial Reporting Council, *UK Corporate Governance Code 2024* (January 2024) 6: '*A successful company is led by an effective and entrepreneurial board, whose role is to promote the long-term sustainable success of the company, generating value for shareholders and contributing to wider society*'.
[136] Lisa Benjamin, *Companies and Climate Change Theory and Law in the United Kingdom* (Cambridge University Press 2021) 47.
[137] See 2.2.3.
[138] ibid.
[139] Andreas Philippopoulos-Mihalopoulos, *Law and Ecology: New Environmental Foundations* (Taylor & Francis Group 2011) 68.
[140] Troyen Brennan, 'Environmental Torts' (1993) 46(1) Vanderbilt Law Review 1, 2.
[141] Carl F. Cranor, *Toxic Torts Science, Law and the Possibility of Justice* (Cambridge University Press 2006) 7.

negligence occurred.[142] Moreover, when the plaintiff claims personal injuries, there are further complexities that reside in the difficulty of measuring and assessing the victims' harm. For the most part, those harms are intangible; they also require scientific determinations of causation, and the long latency of the harm itself raises issues both with the determination of the defendant[143] and with the recognition of the harm by the victim.[144]

These issues create a layer of complexities for the courts to establish corporate liability and then to extend liability within the corporate group structure. The complexity is, however, the result of company law retreating from any role in the mitigation of the issues generated by the corporate form. In contrast, the main approaches applicable to (environmental and toxic) tort victims[145] wishing to recover damages in respect of losses they have sustained involve a judicial analysis of:

1) the direct relationship between a parent company and its subsidiary,[146]
2) the direct or indirect control or supervision exercised by the parent company over the activities of the subsidiary,[147]
3) the exercise of control over the subsidiary's board of directors.[148]

Liabilities arising from environmental and toxic products are even more difficult to manage compared to other torts because environmental and toxic tort claims do not correspond exactly to traditional torts. There are three factors rendering environmental and toxic torts different from traditional torts, adding to the complexities of remedying the externalisation of risk. They can be categorised as: (a) magnitude of the harm, (b) latency, and (c) causal uncertainty.[149]

[142] *Cambridge Water Co. v Eastern Counties Leather Plc.* [1994] 2 AC 264 (HL).
[143] See below "latency".
[144] Robert L. Rabin, 'Continuing Tensions in the Resolution of Mass Toxic Harm Cases: A Comment' (1995) 80(4) Cornell Law Review 1037, 1038.
[145] These are general approaches available to all tort victims.
[146] This means that the corporate group structure was deliberately created to evade liabilities and therefore the courts are justified in piercing the corporate veil, see 4.1.1.
[147] Here the issue is whether the parent company can be said to have caused the damage by examining the nature and degree of control that the parent company exercises over its subsidiary. The focus on control has led the courts to impose a duty of care on the parent company directly towards a stakeholder. The application of this is still contested and subject to criticisms because of the questions left unresolved by the courts, such as the relevance of mandatory group policies and what level of control is necessary to satisfy the test: see 4.2.
[148] Although parent companies will not be regarded as shadow director of their *solvent* subsidiaries only because the latter's directors are accustomed to act in accordance with parent companies' instructions (Companies Act 2006, s 251(3)), when a subsidiary is *insolvent*, the definition of shadow director may also catch parent companies (Insolvency Act 1986, s 251). See 4.1.4.
[149] Kathryn R. Heidt, 'The Changing Paradigm of Debt' (1994) 72 Washington University Law Quarterly 1055, 1068-1069.

(a) Magnitude of the harm

The first issue to confront is that a single toxic product or a single instance of misconduct can cause substantial harm. For instance, in the UK, between 1981 and 2020, there were 11,109 registered deaths related to asbestosis.[150] The multinational corporate group Turner & Newall was the main producer of asbestos in the UK, and although the dangers of developing asbestosis have been known since 1906, their production of asbestos increased dramatically from the 1930s to 1980.[151] Asbestosis is generated by exposure to asbestos dust, and in the UK, although the use of asbestos has been banned since 1999, it is still found in buildings built before the year 2000.[152] Therefore, even when the danger is removed, i.e., by banning the use of asbestos, the continuing contamination and presence of hazardous substances cause the spread of future injuries, which are difficult to estimate in numbers.

In addition, when the widespread damage is minor, it may remain uncompensated due to the victim's rational apathy towards claiming compensation.[153] This happens when the tortfeasor damages multiple individuals, yet each individual sustains only a small fraction of the harm, leading to a disincentive to bring legal proceedings due, for example, to the high cost of litigation.[154] Thus, without a clear legal framework in which corporate groups can be liable, thereby incentivising environmental and toxic tort victims to bring claims, such claims may not even reach the court stage. This could explain the lack of statistical evidence and data regarding insolvency and environmental claims in the UK.[155]

This issue of the magnitude of harm raises normative concerns. We know that the corporate form is beneficial to shareholders, as they typically do not incur losses exceeding their initial investment when risks materialise within the business. Nevertheless, it is morally intuitive to

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[150] HSE, 'Asbestos-related disease statistics, Great Britain 2022' (2022) <https://www.hse.gov.uk/statistics/causdis/asbestos-related-disease.pdf> accessed 12 June 2024, 15.

[151] T&N in the 1970s had a market capitalisation of £65 million, and they also used the corporate veil to protect the group from liabilities as a matter of routine in this kind of corporate structure. For instance, the American factories were originally wholly owned by the holding company in Montreal, which however was subject to complex restructuring in the 1970s by setting up "buffer" companies in-between the structure to separate the assets from the claimants. See Geoffrey Tweedale and Laurie Flynn, 'Piercing the Corporate Veil: Cape Industries and Multinational Corporate Liability for a Toxic Hazard, 1950—2004' (2007) 8(2) Special Issue: Business and Nature 268, 289. For a thorough summary of Turner & Newall's activities, see Witting, *Liability of Corporate Groups and Networks* (n22) 105-112.

[152] Public Health England, 'Guidance Asbestos: general information' (2024) <https://www.gov.uk/government/publications/asbestos-properties-incident-management-and-toxicology/asbestos-general-information > accessed 21 August 2024.

[153] Hans-Bernd Schaefer, 'The Bundling of Similar Interests in Litigation. The Incentives for Class Action and Legal Actions taken by Associations' (2000) 9(3) European Journal of Law and Economics 183, 185.

[154] ibid.

[155] Blanca Mamutse, 'Environmental liabilities in insolvency – an area ripe for reform?' (2016) 8(3) International Journal of Law in the Built Environment 243, 253.

restrict the corporate form when used at the expense of third parties. If we take into consideration environmental and toxic torts, thousands of individuals could be negatively affected without access to a proper remedy in law or incentives to pursue a case. All these cases are likely to remain uncompensated if UK company law does not provide means for tort victims to pursue their cases within a framework in which the corporate form is not an absolute concept that cannot be displaced in corporate groups.

(b) Latency

There is a higher probability of these kinds of claim arising in the future. The long time-lapse between the action causing an injury and when the injury manifests is referred to as latency. For instance, asbestos was used in the market during the late nineteenth century; however, it took decades for the harm of being exposed to asbestos to reveal itself. In fact, it has a latency period of between 10 and 40 years.[156] Latency provides a challenge to the compensation of tort victims. First of all, the long-developing health risks suggest that there are many more victims anticipated in the future, and the technological growth in synthetic products will create new pressures on the traditional tort system.[157] Secondly, the latency period also causes evidence to be unavailable or unusable at the time when the proceedings are brought to court.[158] Finally, where the action causing the injury took place at a point in time when the conduct would not have been considered wrongful, it would raise issues of retroactive liability, which provides a disincentive to prevention and would most likely be uninsurable.[159] Therefore, this kind of claim is not suitable to be solved via tort liability rules.

When applied to company law principles, the main point of reflection about the latency issue is that while environmental and toxic torts will most likely manifest in the future, the incentives of the corporate form will perpetuate irresponsible behaviour. Parent company shareholders may frequently receive dividends before such liabilities manifest. Although there are restrictions on distributions under company law,[160] UK accounting standards allow corporate groups to omit future environmental tort litigation from their balance sheets. These future liabilities can be classified as contingent liabilities, i.e., possible but uncertain obligations that are not recognised as liabilities that need to be taken into account for the purpose of

[156] Christopher F. Edley and Paul C. Weiler, 'Asbestos: A Multi-Billion-Dollar Crisis' (1993) 30 Harvard Journal on Legislation 383, 388.
[157] Robert L. Rabin, 'Tort Law in Transition: Tracing the Patterns of Sociolegal Change' (1988) 23(1) Valparaiso University Law Review 1, 22.
[158] Brennan (n140) 58.
[159] Faure (n62) 114.
[160] See 4.1.3.

distributing the assets of the company.[161] Even though liabilities can arise from '*past events'*, they need to be probable, i.e., it must be more likely than not that a present obligation exists.[162] These standards, compared to how environmental and toxic torts develop, seem unlikely to apply to UK accounting standards, considering the issues in timing and causality that this category of torts faces. It follows that latency allows parent company shareholders to receive all the benefits of the corporate form at the expense of third parties.

(c) Causal uncertainty

Finally, there are uncertainties for both debtors and creditors. Generally, the same concepts pertaining to traditional torts are applicable to environmental and toxic torts. For instance, the victims will not be aware of the identity of the tortfeasor in advance, which company within a corporate group caused the damage, etc. However, a specific issue with environmental and toxic torts is that, at times, the identity of the victims will be uncertain. If a community is exposed to a pollutant causing cancer some time after exposure, it could be difficult to ascertain who was damaged by the exposure to the pollutant and who was harmed by some other background risk other than a toxic tort.[163] Concurrent to this issue of identification, there is the issue of causation. If there is no obvious evidence that a specific product or action caused the harm there will be no certainty on causation, which will consequentially be an obstacle to compensation, as the judge needs to be convinced that the tortious conduct caused the harm on the balance of probabilities.[164]

Thus, for tort creditors to rely on tort law to remedy the externalisation of risk of the corporate form, it would often mean that the externalisation is left unremedied. The illustration provided in this chapter should only make the case stronger for UK company law to re-think the theory of the corporate form and its role in it. Leaving externalisations without a remedy only reinforces the presumption that the corporate form can be used as a vehicle to pursue self-interest without any restrictions; whereas if UK company law were to take a leading role in remedying the externalisation of risk caused using the corporate form, legal rules would serve their original purpose, and company law would also serve its purpose of regulating corporate activities.

[161] Financial Reporting Council, *FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland* (2022) para 2.40.
[162] ibid para 21.4.
[163] Albert C. Lin, 'Beyond Tort: Compensating Victims of Environmental Toxic Injury' (1983) 7(2) Harvard Environmental Law Review 1439, 1447.
[164] The ordinary civil standard of proof is on the balance of probabilities: *Brendon International Ltd v Water Plus Ltd and another* [2024] EWCA Civ 220, [2024] WLR 2434 [50].

1.3. Methodology

The issue of externalisation of risk generated by the shareholders' use of the corporate form at the expense of third parties is demonstrated by deploying a doctrinal analysis. This supports the identification of the key issue in UK company law for ongoing discussion. The second part of this thesis will use a theoretical framework regarding company law theories to provide a solution to risk externalisation. Case law, legislation, and other legal provisions will be considered to describe the past and present legal status and definition of the corporate form in the UK. Moreover, this thesis will use the body of knowledge built up in previous studies to show the gaps in the existing scholarship that has examined the failures of company law to address the self-serving behaviour of shareholders, and the development of corporate legal theories applicable to the use of the corporate entity as a vehicle for commercial operations.

The thesis will also adopt economic principles when applicable. Economic principles are fundamental to the analysis of both the discrepancy between the legal entity and the organisation conducting economic activities, as well as to how this discrepancy can be addressed in the context of corporate group structures. The externalisation of risk caused by the differing boundaries between the two is accentuated in the case of corporate groups, where all the units in the groups act in the form of an economically integrated unit, while internal decisions are *manoeuvred* by the parent company "behind the scenes", and legally substantial independence is given to the singular legal entities within the group.[165]

However, this study presents some limitations and points of reflection useful for future research. In more detail, this thesis has four important limitations:

1) International Law

More difficulties regarding risk externalisation, which are not dealt with in this thesis, arise in the context of corporate groups. This is attributable to the fact that the latter are jurisdictionally complex structures. For instance, in cases involving the liability of multinational corporate groups in tort law there are two issues: the first is of a procedural nature, namely whether a UK court would have jurisdiction over the case, and the second concerns the substantive laws adopted to establish liability. This thesis will engage with the law and legal literature on the latter point, without addressing conflict of law issues.

[165] Kurt A. Strasser and Phillip I. Blumberg, 'Legal Form and Economic Substance of Enterprise Groups: Implications for Legal Policy' (2011) 1(1) Accounting, Economics, and Law 1, 6.

2) Focus on Incorporated Companies

In UK company law, corporate groups not only include legal entities such as incorporated companies, but also unincorporated entities.[166] While there can be different kinds of entities in play in the case of groups, the research in this thesis will focus on the relationship between the parent and subsidiary in the form of separate companies with limited liability.

3) One Type of Corporate Group

The thesis will examine the corporate group defined as a hierarchical group of separate legal entities organised by authority and power relations, where the parent company is the controlling shareholder of the other entities.[167] In contrast, the discussion will not consider network groups, which use contracts instead of shareholdings as the key links among the units.[168] To differentiate the two, this thesis will refer to hierarchy-type corporate groups as "traditional corporate groups".[169] The scope is restricted in this way because traditional groups adopt a different behavioural principle compared to network groups and, therefore, the two require different forms of analyses. First, networks have at their core different internal power relations. In network groups the units within do not hold any controlling interest in each other. As such, they are simply a coalition of separate entities cooperating for a common purpose. In this kind of "alliance", it is easier for the entities to maintain their own autonomy, and although opportunistic behaviour and exploitation of other network participants is more concentrated,[170] the companies forming the network will have more freedom in terms of corporate strategies and budgetary decisions. In traditional corporate groups, power dynamics differ. Control-enhancing mechanisms allow parent companies to influence subsidiary decisions through formal and informal means, thereby consolidating control over financial and operational strategies within the group.[171] By concentrating decision-making power and influence, and limiting liability exposure through legal entities, traditional corporate groups can take advantage of the gaps in UK company law.

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[166] CA 2006, s 1161.
[167] For a more detailed definition of traditional corporate groups, see 3.1.
[168] Gunther Teubner, *Networks As Connected Contracts* (Michelle Everson tr, Bloomsbury 2011) 241-243.
[169] This approach was also used in Barnali Choudhury and Martin Petrin, *Corporate Duties to the Public* (Cambridge University Press 2018) ch 5.
[170] They are more cooperative in nature and have a more fluid and flexible business form: see Witting, *Liability of Corporate Groups and Networks* (n22) 39-41.
[171] See 3.5.

4) Listed Parent or Subsidiary Company Within the Structure

This thesis will focus on the traditional corporate group structure with the characteristic of having at least one listed entity in the group, i.e., either the parent or subsidiary company. The scope of this thesis enables us to gain a better understanding of the current provisions implemented in the UK to protect third parties from the abuse of the corporate form. The UK uses the same Act - the Companies Act 2006 - to govern public and private companies. While the regulatory approach adopted does not excessively control companies - and affords them a large degree of flexibility and discretion in terms of their internal governance arrangements,[172] there is a distinction between how the two are treated under the Act and the law. For example, veil-piercing rarely occurs in the case of public companies or within corporate groups;[173] the minimum capital requirements prescribed by the legislation extend only to public companies,[174] and the most noteworthy tort cases to date have involved corporate groups with a parent company that is a public limited company.[175] Because of the reach of the operations conducted by public companies, businesses operating through public legal entities have the means to injure society at large.[176] Moreover, the scope is limited to intra-group dynamics. This means that the focus is on the relationship between the parent (i.e., corporate shareholders) and subsidiary companies rather than the parent and its ultimate (individual) shareholders.

1.4. Concluding Remarks

In examining the dynamics of corporate groups within the framework of UK company law, this thesis will focus on the crucial legal discourse surrounding the externalisation of risk, particularly as it pertains to the exploitation of the corporate form by shareholders to the detriment of third parties. This thesis will explain the multifaceted nature of corporate group structures and their legal, economic, and societal implications. Shareholders use the legal attributes of the corporate form to shield themselves from liabilities, leaving involuntary creditors uncompensated. By dissecting the incentives at play within corporate groups and

[172] Davies and Worthington, *Gower: Principles of Modern Company Law* (n9) 250.
[173] See 4.1.1.
[174] CA 2006, s 761.
[175] *Vedanta Resources Plc v Lungowe* [2019] UKSC 20, [2020] AC 1045 and *Okpabi* (n130). In *Vedanta*, the damages claim had a long history dating back to 2005, Vedanta was delisted in 2018. Information can be found on the Government website filing history: Companies House, 'Vedanta Resources Limited, Company number 04740415: Re-registration from a public company to a private limited company' (29 October 2018)<https://find-and-update.company-information.service.gov.uk/company/04740415/filing-history?page=3> accessed 12 June 2024.
[176] See 1.2.2.

unveiling the systemic factors driving risk externalisation, the chapter highlighted the fundamental disconnect between corporate legal theory and economic reality within contemporary corporate structures.

Building upon this foundation, the thesis will undertake a theoretical analysis of company law theories, challenging the conventional paradigms that underpin modern company law. By interrogating the foundational principles of the corporate form, this thesis will call into question the normative and descriptive claims of traditional theories and propose a paradigm shift towards a more holistic understanding of corporate entities and their societal implications. This thesis will not only identify the shortcomings of existing legal frameworks but also propose innovative solutions to address the systemic failures that perpetuate risk externalisation. Nevertheless, this chapter also acknowledges certain limitations in its frame of analysis. These limitations offer a valuable opportunity for future research to explore the complexities of different corporate groups and their regulatory frameworks.

Chapter 2- The Corporate Form, Its Advantages and The Incentives to Externalise Risk

2. The Corporate Form

This chapter will answer the first two research questions of this thesis, namely whether UK company law generates incentives to shareholders to externalise risk and what these incentives are. In the UK, since the nineteenth century, the incorporation of companies has become an administrative and bureaucratic formality.[177] With a series of legislative acts starting with the Companies Act of 1844 and culminating in the Companies Act of 1856, any company that met certain registration requirements could benefit from the corporate form with investors' limited liability.[178] This rendered the doctrine of limited liability a right that is intrinsic to incorporation.[179] The combination of the characteristics of the corporate form and the treatment of looking at the company as a stand-alone body[180] is what is called the "legal entity" view.[181] The corporate form is readily available to investors[182] and among the several advantages it provides, there is the "shielding effect" that protects the company's internal members from personal financial exposure.

The combination of the corporate form and all its characteristics, namely having a separate legal entity in which shareholders can influence the company's decisions (control rights), claim its profits (economic rights), and have limited liability, gives investors the leeway to pursue excessive risk-taking at the expense of the company's creditors. In exploring the corporate form, it is crucial to distinguish between its immutable and mutable characteristics. Immutable components constitute the foundational elements necessary for the existence and recognition of the corporate form itself. Among these, separate legal personality and entity shielding stand out prominently, especially when connected to specific corporate structures - i.e., groups.[183] This chapter argues that separate legal personality is the cornerstone upon which the entire concept of the corporate entity rests. It embodies the notion that a company is recognised as a legal person distinct from its individual members. This principle has deep historical roots and

[177] The corporate form with all its characteristics is granted upon satisfaction of certain conditions. These conditions are only formalities; hence, freedom of incorporation rendered the incorporation process a formality in its entirety. For instance, the Companies Act of 1856 had the only requirement of having seven or more subscribers. See Mackie (n97) 295-296.
[178] Louis De Koker, 'The Limited Liability Act of 1855' (2005) 26(5) Company Lawyer 130.
[179] Mackie (n97).
[180] See ch 1.
[181] See (n117).
[182] The formal requirements (i.e., the ease) of incorporation facilitates the use of corporate entities for the benefit of their internal members but at the expense of outsiders. For example, the use of shelf companies facilitates illicit behaviours at the expense of defrauded victims: Masarah Paquet-Clouston and others, 'Incorporating the Illicit: Assessing the Market Supply of Shelf Companies' (2024) European Journal on Criminal Policy and Research (forthcoming).
[183] See 2.1.1. and 2.1.2.

is fundamental for delineating the legal boundaries between companies and their members. Similarly, entity shielding ensures that the assets and liabilities of the company are distinct from those of its shareholders.

In contrast, shareholders' rights represent a mutable aspect of the corporate form. While shareholders undoubtedly hold certain rights and privileges within the UK company law framework, such as voting rights, dividend entitlements, and limited liability, these rights are not inherently linked to the foundational principles of the corporate form. Instead, they are legal constructs established through statutory provisions and judicial interpretations. The evolution of shareholders' rights has been influenced by various factors, including changes in company law, economic and political expectations.[184]

Therefore, it is important to separate the theoretical conceptions of separate legal personality and limited liability, together with the other characteristics that are linked either with the legal entity or the company's members. They serve distinct roles within company law and have different implications. Separate legal personality delineates the legal boundaries between companies and their members, establishing the company as an independent legal entity capable of owning property, entering into contracts, and being liable for its own debts.[185] This principle is fundamental to the corporate form, as it ensures that the company is treated as a separate person under the law. In contrast, limited liability shields shareholders from personal liability for corporate debts.

Historically, limited liability was formally recognised by statute with the Limited Liability Act of 1855, a decade after the Companies Act 1844 established freedom of incorporation. This sequence suggests that the primary aim of incorporation was to confer separate legal personality upon companies, with limited liability emerging as a subsequent development rather than a logical extension of this principle.[186] Shareholders' "rights" are not inherently linked to separate legal personality. They are specific privileges granted to shareholders that can encourage risk-taking behaviour by having a say in the business, gaining profits from it, while being insulated from the consequences of corporate actions. Therefore, the issue of risk externalisation is created by the intersection of mutable and immutable components of the corporate form, which are both wrongly considered essential for the corporate form. It is also critical to recognise that while the combination of all shareholders' rights in the corporate form creates externalisation, they are embedded everywhere in UK company law, and hence limited

[184] See 2.1.3. and 2.1.4.
[185] Kraakman and others (n8) 8.
[186] See Jonathan Hardman, 'Reconceptualising Scottish Limited Partnership Law' (2021) 21 Journal of Corporate Law Studies 179.

liability is the easiest and most theoretically justifiable "right" to tackle in the examination of the externalisation of risk.[187]

Limited liability has several advantages.[188] By enabling a wider base of investors to participate in company ownership without fear of disastrous loss, limited liability facilitates capital formation and liquidity in the market. Moreover, it fosters a passive investment culture, allowing shareholders to diversify their portfolios and engage in capital markets with reduced monitoring obligations. Thus, limited liability is considered the cornerstone of modern company law because of its economic importance. However, this principle harbours a duality that warrants careful examination, as it simultaneously incentivises greater risk-taking while redistributing risks onto third parties. It follows that limited liability provides several *private* advantages at the expense of third parties.

Ultimately, the use of the corporate form has a significant impact on creditors. The intersection between the corporate form and insolvency principles should also be considered, as it affects how the burden of externalisation is shifted onto certain categories of creditors. Secured creditors, provided by law with priority claims, fortify their positions at the expense of unsecured creditors, particularly tort victims. The inability of tort creditors to adjust their claims or secure adequate insurance coverage leaves them vulnerable to the externalisation of risk by shareholders. They are identified as the "third parties" deserving more attention in the legal discourse.

2.1. Use of the Corporate Form

2.1.1. Separate Legal Personality

UK company law provides the incentives to investors to use the characteristics of the corporate form for their benefit and at the expense of third parties. However, by clarifying the distinction between separate legal personality and shareholders' rights, we can better understand how to mitigate the negative consequences of these features. This section argues that separate legal personality is essential for the corporate form, representing an immutable component of it, and hence by itself it does not create the issue of risk externalisation. Separate legal personality corresponds to the idea of the company being a separate and distinct legal person from its members. The concept has ancient roots, and although it is debated whether it originated in classical Roman law, it is possible to find the notion of separateness in the writings of the classical jurist Ulpian. He stated that a representative appointed for legal

[187] See 1: introduction.
[188] See 2.1.4.

business acts for the corporate body[189] itself and not on behalf of its individuals.[190] Even the word "company" and its derivative of "corporation" have roots in the Latin language from "*corpus*" meaning body, or "*corporare*" meaning to "form a body".[191]

Separate legal personality is a fundamental feature of companies.[192] While the Companies Act of 1844 created a right to incorporate under UK law and established companies as distinct legal persons, historically incorporation alone did not entail a complete separation between a company and its shareholders as recognised today.[193] A complete separation involves a clear demarcation of the boundaries between the company and its shareholders, meaning that theoretically the latter cannot be made liable for the company's debts due to the company being a separate person.

Professor Ireland argued that today's concept of "separation" was not even present in the Joint Stock Companies Act of 1856, which reflected the original perception that companies were an aggregation of shareholders. As such, the prevalent view was that they could '*form themselves'* into a company as a result of the company's evolution from partnerships.[194] Ireland has claimed that only the subsequent Companies Act of 1862 recognised companies as formed by shareholders and not made of them.[195] His argument concludes that the separateness given to companies is not the result of the legal act of incorporation, but instead, that it was granted to accommodate the *economic* separation between joint stock companies and their shareholders.[196]

Although Talbot points out that in the first half of the nineteenth century there was no general principle of company law applicable to all companies and therefore corporate separation depended on a case-by-case basis, she does agree with Ireland about the relevance of

[189] In this context, the institution referred to is the *universitas*, which is a Roman institutional form of autonomous entity. See Henry Hansmann, Reinier Kraakman and Richard Squire, 'Incomplete Organizations: Legal Entities and Asset Partitioning in Roman Commerce' in Giuseppe Dari-Mattiacci and D. Kehoe (eds), *Roman Law and Economics: Institutions and Organizations Volume I* (Oxford University Press 2020) 215.
[190] Reuven Avi-Yonah, 'The Cyclical Transformations of the Corporate Form: A Historical Perspective on Corporate Social Responsibility' (2005) 30 Delaware Journal of Corporate Law 767, 775, discussing various interpretations of Ulpian's writings where both the aggregate and entity views of the corporate form are present.
[191] Allan C. Hutchinson and Ian Langlois, 'Salmon Redux: The Moralities of Business' (2012) 35(4) Seattle University Law Review 1109, 1109.
[192] Easterbrook and Fischel, *The Economic Structure of Corporate Law* (n50) 11.
[193] Paddy Ireland and others, 'The Conceptual Foundations of Modern Company Law' (1987) 14 Journal of Law and Society 149, 150.
[194] Paddy Ireland, 'Company Law and the Myth of Shareholder Ownership' (1999) 62(1) The Modern Law Review 32, 39.
[195] Paddy Ireland, 'Limited liability, shareholder rights and the problem of corporate irresponsibility' (2010) 34 Cambridge Journal of Economics 837, 846.
[196] Ireland (n194) 43.

economic reasons in the development of separate legal personality and limited liability.[197] Moreover, she argues that limited liability and the more permissive Acts that followed helped to establish the legal boundaries between the company and its shareholders.[198] This thesis also takes the position that the concept of separate legal personality has been influenced greatly during the nineteenth century by an increase in private investments and the government's laissez-faire attitude towards the organisation of business activities. Mixing these two concepts renders the characteristics of the corporate form blurred, when each corresponds to a distinct feature. Separate legal personality and limited liability serve two different purposes and satisfy two different tasks: one pertains to the company itself, vesting powers in a separate legal entity and based on a long-standing theoretical framework; while the other pertains to its shareholders, protecting investors and being grounded mainly in economic reasoning.[199]

The corporate form and its legal capacity under the common law's interpretation of its incidents are legal creations, and companies have a more limited range of powers compared to natural persons.[200] Generally, courts reject the idea that companies can have physical attributes, a mind, or conscience similar to natural persons.[201] However, as soon as a company is formed, the law does recognise its existence as capable of carrying out activities as a "person". Hence, the capacity of the company enables it to (a) enter into contracts, (b) possess property rights, (c) sue and be sued in its own name, and (d) delegate authority to natural persons called agents.[202] This corresponds to the distinctive feature of separate legal personality.

From the nineteenth century onwards, the law has been peppered with metaphors to justify the assumption that certain rights and attributes of shareholders are a logical necessity of incorporation.[203] In particular, limited liability is perceived under the common law as the logical consequence of separate legal personality. For instance, as expressed in *Salomon*,[204] the metaphor of personality separating the company and its shareholders led to the belief that once incorporated, a company has its own rights and liabilities and therefore its shareholders are legitimately allowed to limit their liability.[205] The law since *Salomon*[206] has been applied consistently; at the time of incorporation the company and its members are legally separated.

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[197] Lorraine Talbot, *Critical Company Law* (Routledge 2007) 51-60.
[198] ibid.
[199] See 2.1.4.
[200] *Ashbury Railway Carriage & Iron Co Ltd v Riche* (1874-75) LR 7 HL 653, 694 (Lord Selborne).
[201] *Daimler Co Ltd v Continental Tyre & Rubber Co (Great Britain) Ltd* [1916] 2 AC 307 (HL), 345.
[202] Kraakman and others (n8) 8.
[203] Nicholas James, 'Separate Legal Personality: Legal Reality and Metaphor' (1993) 5(2) Bond Law Review 217, 217.
[204] *Salomon* (n32).
[205] ibid 30-31.
[206] ibid.

In effect, it can be said that the *Salomon* decision[207] marked the final stage of the "complete separation" currently present.[208] This complete separation under the law, formed by the combination of the entity and shareholder rights, creates the issue of risk externalisation; whereas, they represent respectively immutable and mutable components of the corporate form.

Understanding these distinctions is crucial for addressing the issue of risk externalisation posed by the corporate form. The distinction between the two concepts has been evidenced in Scots law with reference to Scottish partnerships, which are business entities possessing separate legal personality but not always limited liability.[209] What does follow logically from separate legal personality is the company's independent existence, its property rights and liabilities involved in running a business, and a designated pool of assets that belongs exclusively to the company. The last point describes the feature of affirmative asset partitioning or entity shielding, which is the other immutable part of the corporate form. This can be contrasted with limited liability (also referred to as "defensive asset partitioning"), which is not a logical consequence of the corporate form and represents one of its mutable components.

2.1.2. Entity Shielding

Entity shielding is the protection of a company's assets from the claims of its shareholders' creditors, which ensures that the assets of the company are distinct from the personal assets of shareholders. Hansmann and Kraakman have been the key contributors in the academic literature on entity shielding and the broader conception of asset partitioning in organisational law. They have argued that the essential role of organisational law is to provide a pattern of creditors' rights, or more simply put, to delimit the boundaries between the shareholders' assets and liabilities and the company's own.[210] To better understand this concept, let us imagine two pools of assets. On the one hand, there are the company's assets that belong to the company and can be sold, used, and are available for attachment by the entity's creditors.[211] The company's assets cannot be used by the shareholders and are unavailable for attachment by shareholders' creditors as a result of the company being a juridical person

[207] *Salomon* (n32).
[208] Watson, *The Making of the Modern Company* (n103) 221.
[209] Members will not be liable for the debts of a partnership in the case of limited liability partnerships: Laura Macgregor, 'Partnerships and Legal Personality: Cautionary Tales from Scotland' (2020) 20 Journal of Corporate Law Studies 237, 246-247.
[210] Hansmann and Kraakman, 'The Essential Role of Organizational Law' (n48).
[211] ibid 393.

and being able to hold title and rights in its own assets.[212] On the other hand, there are shareholders' private assets, which cannot be used or levied by the company's creditors, generating the concept of limited liability. The first pool of assets corresponds to the reverse of limited liability or "owner shielding" - this is labelled as "entity shielding".

Entity shielding is the '*sine qua non of the legal entity'*,[213] and hence it is a central feature of the corporate form for the purpose of legal personality. Although there are examples of corporate organisations that do not need separate legal personality for the entity shielding feature to arise,[214] the two can become interconnected when the boundaries of a legal entity are not aligned with the boundaries of a business activity. In corporate groups, parent companies often opt to establish subsidiaries tasked with handling risky operations. As a result, they can effectively compartmentalise risks within each subsidiary, thereby "shielding" the assets of each individual subsidiary from the claims of the creditors of other companies in the group. In this context, companies do have legal personality and will need *affirmative* asset partitioning to conduct the group businesses.[215] As will be explained later in greater detail,[216] hierarchical corporate groups can have subsidiaries owning shares of other subsidiaries to keep the parent company in indirect control of each entity. Owing to the fact that each subsidiary may be in charge of different operations, the creditors of each subsidiary by default will be incapable of attaching the assets of another subsidiary, except in the case of binding agreements with contractual creditors and corporate group guarantees.[217] While entity shielding aids in the structuring and compartmentalisation of risk and makes it more difficult for creditors to claim assets across the group, it is an immutable component of the corporate form, tied to the legal entity rather than shareholder behaviour. Consequently, it plays a protective role within the corporate structure, but it does not *directly* incentivise shareholders to externalise risk.

[212] Henry Hansmann and Reinier Kraakman, 'Organizational law as asset partitioning' (2000) 44 European Economic Review 807, 812.
[213] Hansmann, Kraakman and Squire, 'Law and the Rise of the Firm' (n105) 1338.
[214] For instance, English partnerships may display both weak and strong entity shielding without being separate legal entities. Based on the existence of Scots and English partnerships, Cabrelli has argued that separate legal personality, limited liability, and entity shielding are mutually exclusive, and each can arise and function in isolation. See David Cabrelli, 'The Case Against 'Outsider Reverse' Veil Piercing in Company Law' (2010) 10 Journal of Corporate Law Studies 343, 348.
[215] Whether the economic activity is structured in such a way that a single company is responsible for all operations, affirmative asset partitioning will render the sole company responsible for all the claims that arise out of the business. Instead, by organising businesses in group structures, the compartmentalisation will influence the choice of structure adopted insofar as parent companies can be less engaged in daily operations and less in "control", giving space for more investments, different operations, etc.
[216] See 3.1. and 3.5.
[217] Squire, 'Strategic Liability in the Corporate Group' (n26) 643-644.

Entity shielding takes three forms: “weak”, “strong”, and “complete”. Each form provides a different level of protection for the company’s assets. In the weak form, a priority rule of law applies, whereby the company’s creditors have a priority claim over the personal creditors in the company’s debts, hence deferring the rights of shareholders’ creditors after the first are paid in full.[218] Every type of business organisation, including partnerships, exhibits this priority rule.[219] A strong form of entity shielding combines the weak form with an additional rule of law, known as liquidation protection. Not all entities exhibit this form. The liquidation rule forbids shareholders from withdrawing the company’s assets at will, as well as prohibiting their creditors from liquidating those assets.[220] A practical example of the liquidation rule in company law can be found in the law requiring a 75% majority to wind up and dissolve a company.[221]

Nonetheless, this thesis is concerned with the complete form of entity shielding,[222] in which any non-company creditors are denied any claim to the company’s assets. All incorporated companies in the UK possess complete entity shielding.[223] And therefore it is possible to observe a rigid compartmentalisation between the company’s and shareholders’ assets and consequential liabilities attached to them.[224] Complete asset partitioning, incorporating both entity *and* owner shielding, fosters externalisation incentives. To understand how asset partitioning encourages the use of the corporate form for the externalisation of risk, it is essential to recognise the interplay between the characteristics of the company *and* those of the shareholders. Entity shielding protects the assets of the company from the personal creditors of its shareholders, ensuring that the company’s assets are available exclusively for the company’s creditors. This protection is necessary for the company to perform its function as a legal entity conducting business. However, when combined with shareholder rights, such as limited liability, this complete separation can lead to the externalisation of risk. Limited liability shields shareholders from personal liability for corporate debts, meaning they can invest in and benefit from the company’s operations without being held accountable for its obligations. This creates a scenario where shareholders are incentivised to pursue riskier business strategies, as their potential losses are capped at their investment, while any

[218] Hansmann and Kraakman, ‘The Essential Role of Organizational Law’ (n48) 394-395.
[219] Kraakman and others (n8) 6.
[220] Hansmann, Kraakman and Squire, ‘Law and the Rise of the Firm’ (n105) 1338.
[221] Insolvency Act 1986 (IA 1986), s 84(1)(b).
[222] Because it is concerned with incorporated companies under UK law, see methodology 1.3.
[223] Susan Watson argues that, although Hansmaan and Kraakman categorise incorporated companies as an example of strong entity shielding, they are in fact an example of complete entity shielding. She attributes this to the artificial legal personality of the company. Only during liquidation when the artificial legal personality of the company comes to an end do the creditors have a claim on the companies’ assets because the assets will not be covered by the ‘cloak’ of the legal entity any more: Watson, *The Making of the Modern Compan*y (n103) 223-224.
[224] Cabrelli (n214) 346-347.

additional liabilities fall onto the company and its creditors. Clarifying the distinction and interaction between separate legal personality, entity shielding, and shareholder rights is crucial for understanding the mechanism of risk externalisation. The following section focuses on the theoretical framework of limited liability and shareholders' "rights", which represent the mutable components of the corporate form and, therefore, are potentially displaceable.

2.1.3. Shareholders' "Rights"

The law endowed investors with specific privileges to incentivise economic activities and enable a wider class of people to hold shares in companies.[225] As a result, expanding firms, moved by business forces, sought limited liability for their investors.[226] It is crucial to discuss shareholder's "rights" to show that, albeit important for economic reasons, they are not linked or necessary to the legal capacity of the separate legal entity to function. Limited liability is not actually connected to separate legal personality; in fact, there is no evidence that in the UK the term "limited liability" was linked to companies' shareholders before the nineteenth century.[227] The literature suggests that companies did not always need limited liability, particularly in order to utilise the key features of the corporate form. Instead, the introduction of limited liability within the modern corporate form is considered to have been driven by the rise of rentier investors and the increased demand for financial assets.[228] In the nineteenth and twentieth century, a booming economy required the English corporate form to reflect the economic realities of the country, leading to the development of limited liability.[229]

As previously mentioned,[230] shareholders, as residual claimants, are treated as having certain fundamental rights: the right to receive residual earnings of the company's cash flow,[231] the residual claim on the company's assets in insolvency after all other claims are satisfied,[232] and the right to control the company.[233] Their status as sole and absolute residual claimants has

[225] Frank H. Easterbrook and Daniel R. Fischel, 'Limited Liability and the Corporation' (1985) 52(1) The University of Chicago Law Review 89, 95.
[226] Strasser and Blumberg (n165) 5.
[227] Ron Harris, 'A new understanding of the history of limited liability: an invitation for theoretical reframing' (2020) 16(5) Journal of Institutional Economics 643, 649.
[228] Ireland, 'Limited liability, shareholder rights and the problem of corporate irresponsibility' (n195) 841; Guillaume Vuillemey, 'The Origins of Limited Liability: Catering to Safety Demand with Investors' Irresponsibility' (2023) CEPR Press Discussion Paper No. 17910 <https://cepr.org/publications/dp17910> accessed 20 April 2024.
[229] Max Gillman and Tim Eade, 'The development of the corporation in England, with emphasis on limited liability' (1995) 22(4) International Journal of Social Economics 20, 29-30.
[230] See ch 1.
[231] Which is recognised as a "right": see Kraakman and others (n8) 13, but is more of an economic than a legal right.
[232] Easterbrook and Fischel, 'Voting in Corporate Law' (n50) 403-06.
[233] Henry Hansmann, *The Ownership of Enterprise* (Harvard University Press 1996) 11.

been disputed;[234] but the right itself has not. Because shareholders are the only constituents with a residual, unfixed, *ex post* claim on the assets of the company, they are vested with voting rights - exercising the "ultimate" control of the company.[235] Shareholder's control in public companies has been labelled as a '*myth*'.[236] However, nowadays shareholders have the ability to exert greater influence on corporate decisions than before,[237] and they effectively have the means to voice their opinions and guide corporate decision-making in both private and public companies.

Shareholders' rights are embedded in UK company law. There are instances where the general meeting functions as the decision-making body. While management is generally delegated to directors who can make binding decisions for the company,[238] when a decision will have an impact on shareholders' rights, shareholders are empowered by the law to either approve it or initiate it. Shareholders can appoint and remove directors, and make certain decisions.[239] Examples include[240] alterations of the company's articles,[241] the choice of type of company,[242] share issuance[243] and pre-emption rights,[244] the reduction of share capital,[245] the re-purchase or redemption of shares,[246] alterations to class rights,[247] and decisions concerning winding up.[248] Shareholders can propose resolutions[249] that are passed with either 50%[250] or 75%[251] of acceptance. This implies that shareholders holding 25% or higher of the

[234] Blair and Stout (n96).
[235] See the theory behind it and its restrictions in Stephen M. Bainbridge, *The New Corporate Governance in Theory and Practice* (Oxford University Press 2008) ch 1.
[236] Lucian A. Bebchuk, 'The Myth of the Shareholder Franchise' (2007) 93(3) Virginia Law Review 675.
[237] Lynn A. Stout, 'The Mythical Benefits of Shareholder Control' (2007) 93(3) Virginia Law Review 789, 807. See also the increasing engagement of shareholder activists: Andrew C. Baker and others, 'The Evolving Battlefronts of Shareholder Activism' (2023) Stanford Closer Look Series Corporate Governance Research Initiative 1.
[238] Kraakman and others (n8) 11.
[239] Armour, 'Shareholder rights' (n54) 316.
[240] For more detail, see Davies and Worthington, *Gower: Principles of Modern Company Law* (n9) 505-506.
[241] CA 2006, s 21.
[242] CA 2006, ss 7-9.
[243] In private companies with only one class of shares, directors can issue shares of that class, but shareholders can remove this power in the company's articles: CA 2006, s 550(b). For all other companies, shareholders can authorise this power: CA 2006, s 551(1)(b), (4)(b), however subject to some restrictions: CA 2006, s 551(3)(b), (4)(a).
[244] CA 2006, ss 567-568.
[245] CA 2006, s 641.
[246] CA 2006, s 690.
[247] CA 2006, s 630.
[248] IA 1986, s 122(1)(a).
[249] When they hold 5% (or lower if specified in the company's articles) of the total voting rights: CA 2006, s 292(4)-(5).
[250] CA 2006, s 282.
[251] CA 2006, s 283.

voting rights will be able to exert a substantial influence over the company's direction. They can also decide on matters within their competence with unanimous consent.[252]

If, during the time of Berle and Means[253] it was the case that the body of shareholders was generally dispersed and comprised small outside investors incapable of acting in concert, today share ownership is much more "concentrated". The main investors of modern business structures are institutional investors, the public sector, and corporate groups.[254] These new forms of ownership entail holding shares in bulk and confer a prevalent position in the company; whereas not all these categories of shareholders will indeed exert an influence,[255] they have the potential to exercise it if they so choose.

The entrenched rights of shareholders enable them to have a right to profit from and control the company, in the sense of voting and appointment powers. Shareholders also enjoy the legal "privilege" of limited liability, which augmented the legal debate on corporate irresponsibility - i.e., receiving all the benefits with no repercussions.[256] As mentioned before,[257] all the incentives together lead to the risk of externalisation and removing any of them would potentially provide a solution to risk externalisation. However, this thesis focuses on limited liability because altering or removing other shareholders' rights would entail reshaping UK company law completely anew.[258] Moreover, limited liability is easier to tackle as it is conceptually misinterpreted in the current legal framework. As a result, the next step is to analyse the shareholder's incentive of limited liability to externalise risks onto third parties.

2.1.4. Limited Liability

Limited liability is regarded as one of the core characteristics of the corporate form. Its purpose is to limit the claims of the company's creditors against the company's assets, thereby limiting shareholders' losses to the nominal value of their shares.[259] It is such a benefit for

[252] CA 2006, s 281(4)(a).
[253] Adolf A. Berle and Gardiner C. Means, *Modern Corporation and Private Property* (Palgrave Macmillan 1933).
[254] Institutional investors hold 41% of global market capitalisation, the public sector holds 14%, and corporate groups (private companies and holding companies) together with strategic individuals hold 18%. See De La Cruz, Medina and Tang (n3) 6.
[255] See the modest outcomes of hedge fund activism and the approach adopted by institutional investors in Brian R. Cheffins, 'The Rise and Fall (?) of the Berle–Means Corporation' (2019) 42 Seattle University Law Review 445.
[256] Ireland, 'Limited liability, shareholder rights and the problem of corporate irresponsibility' (n195) 844-846, 852-854.
[257] See ch 1.
[258] When it comes to rights, UK company law is '*shareholder-centric*' and empowers shareholders as a class. Some examples are appointment and removal rights, and certain decision rights: see Kraakman and others (n8) ch 3.
[259] ibid 8-9.

shareholders to incorporate a company with limited liability that this principle was deemed as '*the most important discovery of the modern world'*.[260] Limited liability exists because it reflects the desire of the public interest in developing the economy and commerce.[261] Lord Sumption in *Prest*[262] noted the relevance of limited companies when he said that they '*have been the principal unit of commercial life for more than a century'*.[263] He also referred to the company as a tool used by parties to conduct business, implying that interfering with its fundamental characteristics will lead to uncertainty in the economic life of a country.[264]

When discussing limited liability, many commentators have focused on its upsides and the benefits it provides.[265] Limited liability, while beneficial, also creates incentives for shareholders to externalise risk. It promotes an increase of *private* advantages at the expense of the public. The compartmentalisation of assets and liabilities allows shareholders to pursue riskier business strategies, as they stand to gain the upside of successful ventures while knowing their personal assets are protected. This leads to the externalisation of risk to third parties, particularly creditors who bear the financial consequences of corporate failure.

The traditional view is that limited liability derives from the company's personality as a "logical" connection given by the separateness of the corporate person from its shareholders.[266] It is then considered a standard feature of the corporate form. For occasions when the principle of separateness is abused, the law has created "safety nets", namely exceptions to the default rule of limited liability[267] allowing the courts to disregard the separation between shareholders and the legal entity. Yet, as will be debated later,[268] the exceptions are not effective in their purpose. The precise evolution of and interrelation between limited liability and separate legal personality remain contentious and convoluted topics in the literature. Compounding this complexity, the courts have failed to consistently delineate a clear theoretical distinction between them. For instance, on the one hand in *Standard Chartered Bank v Pakistan National*

[260] Jose E. Antunes, *Liability of Corporate Groups: Autonomy and Control in Parent-Subsidiary Relationships in US, German and EU Law An International and Comparative Perspective* (Kluwer Law and Taxation Publishers 1994) 64.
[261] William Hackney and Tracey Benson, 'Shareholder Liability for Inadequate Capital' (1982) 43(4) University of Pittsburgh Law Review 837, 841.
[262] *Prest v Petrodel Resources Ltd* [2013] UKSC 34, [2013] 2 AC 415.
[263] ibid [8].
[264] ibid. See also Witting, *Liability of Corporate Groups and Networks* (n22) 65.
[265] See 2.1.4.
[266] Morton J. Horwitz, 'Santa Clara Revisited: The Development of Corporate Theory' (1986) 88(2) West Virginia Law Review 173, 205; Mariana Pargendler, 'The Fallacy of Complete Corporate Separateness' (2024) 14 Harvard Business Law Review Online 1, 3.
[267] These exceptions are not always clear. For example, there is judicial confusion on what veil-piercing does and its purpose - i.e., whether it removes separate legal personality or limited liability. See 4.1.1.
[268] See ch 4.

Shipping,[269] Lord Rodger stated that limited liability is not a necessary characteristic for the corporate form to exist, but it is a necessary condition for companies to raise capital; hence, only in exceptional circumstances will shareholders be held liable for its debts.[270] On the other hand, there are court judgments relying on the idea that the liability of the company's controllers originates from an abuse of the separate legal personality of the corporate entity.[271]

Compared to separate legal personality, limited liability as a standard feature of the corporate form is a distinct[272] and more "modern" idea. From an historical perspective, in Britain, limited liability became available as a common principle with the Limited Liability Act 1855 and Joint Stock Companies Act 1856.[273] Nonetheless, the concept has been regarded more as evolutionary rather than revolutionary, considering that the pursuit of limited liability in some shape or form is an ancient activity.[274] Some scholars identify the beginning of limited liability with the development of the Dutch and English East India Companies in the seventeenth century.[275] This thesis does not dispute the origins of limited liability, but it criticises the theoretical underpinnings of considering limited liability as a standard and necessary feature of the corporate form.

The corporate form managed to exist with different types of liability for centuries, i.e. with unlimited liability. The earlier forms of companies did not possess limited liability and even after the introduction of the Limited Liability Act 1855 and the Joint Stock Companies Act 1856, there was no single liability model adopted in the UK. One notable example was the UK banking sector, where between the eighteenth and nineteenth centuries, several liability regimes were implemented.[276] Only in the twentieth century is it possible to witness a convergence of the concept of limited liability to its modern and uniform sense.[277]

Limited liability was established to protect investors, who were members of the public, and incentivise commercial activities.[278] Therefore, limited liability was a means of attaining safe

[269] *Standard Chartered Bank v Pakistan National Shipping Corpn and Others* [2002] UKHL 43, [2003] 1 AC 959.
[270] *Standard Chartered Bank* (n269) [37] (Lord Rodger).
[271] *Hurstwood Properties (A) Ltd & Ors v Rossendale Borough Council* [2021] UKSC 16, [2022] AC 690 [65], reaffirming *Prest* (n262).
[272] See also Blumberg, 'Limited Liability and Corporate Groups' (n1) 604.
[273] Witting, *Liability of Corporate Groups and Networks* (n22) 71.
[274] See Robert W. Hillman, 'Limited Liability In Historical Perspective' (1997) 54 Washington and Lee Law Review 615, 615.
[275] Dari-Mattiacci and others, 'The Emergence of the Corporate Form' (n42).
[276] Before 1858, banks could not be incorporated with limited liability. In such banks, shareholders were liable jointly and severally. Some banks possessed also reserve liability, where, to protect creditors, a sum of capital could be called upon on the insolvency or liquidation of the company. See Graeme G. Acheson and John D. Turner, 'The death blow to unlimited liability in Victorian Britain: The City of Glasgow failure' (2008) 45(3) Explorations in Economic History 235, 239-240.
[277] Harris, 'A new understanding of the history of limited liability' (n227) 657-658.
[278] Easterbrook and Fischel, 'Limited Liability and the Corporation' (n225) 95.

investments that would store value,[279] since investors are mainly interested in the risk and return of their investment.[280] The economic literature started to flood with arguments supporting the role of limited liability for the efficient functioning of the economy, which was composed of large companies with a multitude of investors holding transferable shares.[281] While the original intent behind limited liability was to safeguard *individual* investors, particularly those who were not professional investors, today's landscape reflects a significant departure from this vision. Individual investors, members of the public, nowadays correspond only to a tiny fraction of investors that dominate the ownership of global public companies.[282] As such, they are no longer the main category of shareholders invested in large listed public companies.

Limited liability leads to positive consequences for shareholders and promotes economic growth. These advantages that are used in the literature to justify limited liability will be discussed in the following section.[283] However, limited liability also encourages greater risk-taking. This "shielding" effect incentivises shareholders to take more risks because it pushes negative externalities away from the actor generating them, who decides the amount of risk to take and can effectively transfer or "shift" the risks onto the company's creditors.[284] When limited liability is the norm, shareholders face unlimited upside potential and limited downside risk, and the extent of both the former and latter are unknown at the outset and can be substantial,[285] posing a normative legal challenge to the current regulatory framework. Considering this, the economic advantages should be balanced with the potential negative effects, i.e., the externalisation of risk that is largely imposed on the company's creditors. Therefore, after discussing the advantages of limited liability, the remaining part of this chapter will examine the effects that the use of the corporate form has on different types of creditors.

[279] Vuillemey (n228).
[280] Leebron (n1) 1570.
[281] For a discussion of the advantages of limited liability in context: see Easterbrook and Fischel, 'Limited Liability and the Corporation' (n225) 98-101.
[282] Institutional investors hold 41% of global market capitalisation, the public sector holds 14%, and corporate groups (private companies and holding companies) together with strategic individuals hold 18%. See De La Cruz, Medina and Tang (n3) 6.
[283] For a summary of all the benefits: Jonathan R. Macey, 'The Limited Liability Company: Lessons for Corporate Law' (1995) 73(2) Washington University Law Review 433, 450-452.
[284] In the case of tort victims, Hansmann and Kraakman stated that limited liability encourages excessive risk-taking since the company can engage in hazardous industries and consider them an attractive investment, even though the net present value to society would be negative: Hansmann and Kraakman, 'Toward Unlimited Shareholder Liability for Corporate Torts' (n2) 1883.
[285] Although the extent of risk is unknown, based on the discussion of ch 1, we know that it has substantial consequences for third parties. For example, see the implications of environmental and toxic torts in 1.2.2.

The Advantages of Limited Liability

The traditional legal entity view, which considers the company to be completely separate from its shareholders, led the insertion of limited liability as a fundamental feature of the corporate form. However, this has been a double-edged sword. Limited liability does not eliminate risk, but simply externalises it by shifting it from investors onto third parties other than shareholders.[286] This section will investigate the economic benefits of limited liability. The investigation will be based on the role and effect of limited liability in publicly held companies[287] whose shares are quoted on a stock market.[288] The main effects of limited liability can be summarised as follows: (i) it allows capital to be raised by widening the shareholder base and hence alleviating shareholders' risk; (ii) it reduces the need for shareholders to monitor both the company and each other by facilitating the separation of ownership and control and shifting the monitoring costs to creditors; and (iii) it enables shareholders to become passive investors and diversify their portfolio by holding shares in a much larger number of companies. In contrast to the law and economic debate on limited liability, this section does not wish to add to the discourse regarding the efficiency of limited liability.[289] It provides a critical analysis of limited liability's justifications in terms of *private* benefits. These benefits, simultaneously, cause harms and a balance must be struck with limited liability's capacity to create externalities. In this way, the discussion lays the foundation for a subsequent evaluation of whether limited liability is justified in corporate groups.[290]

(i) Capital Raising and Dispersion of Risk

Limited liability encourages the flow of capital in companies, and the original argument behind its development was that, by facilitating capital formation, small entrepreneurs could grow new businesses and the overall economy.[291] This feature allows individuals to use only a small portion of their savings to invest in companies, without the risk of losing more in the event that

[286] When the company reaches insolvency, shareholders are liable to contribute an amount to companies' assets representing the unpaid value of their shares: see IA 1986, s 74. Shareholders also come last in the line of creditors. But because of limited liability, their liability is capped and that is why risk can be shifted towards other parties.
[287] See 1.3.: methodology and limitations of the study.
[288] The arguments in favour of limited liability for small non-listed companies may have different results than the ones analysed here. See Judith Freedman, 'Limited Liability: Large Company Theory and Small Firms' (2000) 63(3) Modern Law Review 317.
[289] See William W. Bratton and Joseph A. 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.
[290] See 3.3. and Blumberg, 'Limited Liability and Corporate Groups' (n1).
[291] Stephen M. Bainbridge and M. Todd Henderson, *Limited Liability A Legal and Economic Analysis* (Edward Elgar 2016) 52-53.

the latter becomes insolvent.[292] There are a series of consequences flowing from reducing the risk of investors losing more than the amount they invest in the company. First, companies' cost of capital will also be reduced, compared to a system of unlimited liability.[293] If investors were forced to bear the risk of unknown liability, it would be difficult to value the price of their shares; thus, it would shrink the amount of funds available for investing in those projects that subject investors to more risk.[294] It follows that a system of limited liability is beneficial for: investors willing to capitalise on better risk-return combinations of assets, companies wanting to increase the available funds for their business, and society - to a certain extent - because it encourages capital flows by shifting the risk of investments.

Secondly, under a limited liability system the shares of all investors are valued equally and because there is no difference in risk between a wealthy and a small investor, there is increased liquidity in the market, promoted by the free transferability of shares.[295] Halpern, Trebilcock and Turnbull explained this benefit in relation to what would happen under an unlimited liability regime with no transaction costs.[296] In this scenario, each investor would know the wealth of other investors and the price of the shares would reflect the risk of exposure to liability. When both a small investor and a wealthy investor buy shares in the same company, the former will need to pay more because the presence of the latter reduces his risk of liability. In contrast, the price of the shares for the latter will be negative; by "insuring" that the small investor's chance of liability is reduced, he will be compensated in the form of an insurance premium paid by the small investor. The presence of different share prices and risks will then discourage investments, especially for small investors, and reduce the liquidity in the market.

Limited liability ensures that shares are fungible, meaning they are interchangeable and can be bought and sold at the same price because the prices are not influenced by the identity and wealth of other investors. This uniform valuation occurs due to limited liability, eliminating the need for price differentiation based on individual wealth or risk exposure. Thus, limited liability makes shares also reflect information about the value of companies. When shares are traded at one market price in a liquid market, share prices reflect available information regarding a company, meaning that the company's prospect will be accounted for in the

[292] Henry G. Manne, 'Our Two Corporation Systems: Law and Economics' (1967) 53(2) Virginia Law Review 259, 262.
[293] Easterbrook and Fischel, 'Limited Liability and the Corporation' (n225) 97.
[294] ibid.
[295] ibid 95.
[296] Paul Halpern, Michael Trebilcock and Stuart Turnbull, 'An Economic Analysis of Limited Liability in Corporation Law' (1980) 30(2) The University of Toronto Law Journal 117, 130-131.

market price of its shares.[297] Limited liability assures investors that they are buying shares at a "fair" price, or more generally it assists shareholders to discover whether they are buying shares at the right price.[298]

(ii) Monitoring Incentives

The extent of monitoring incentives contains a dual perspective, the shareholder's and the creditor's. From the shareholder's perspective, limited liability reduces the need to monitor managers.[299] Since shareholders would not suffer critical financial consequences from managers' actions, shareholders started to take a passive role in the management of the company, which led to what Berle and Means labelled as the "modern company", a legal entity with a clear separation between ownership and control.[300] Thus, if the risk of the investment is limited, there is less need for shareholders to monitor managers.[301]

In comparison, without limited liability, shareholders will need to monitor managers more closely as their actions increase the riskiness of shareholders' investments.[302] Under this system of unlimited liability, shareholders will also need to keep track of other shareholders' wealth.[303] As aforementioned, wealthier shareholders will be the most likely target for liability claims. Therefore, all investors will be interested in knowing the wealth level of their fellow investors to evaluate the likelihood of their own liability. This enhanced monitoring will also lead to shareholders demanding control over the transferability of shares or, in other words, who can be accepted as a shareholder,[304] thereby terminating the advantage of transferability of shares and a constant flow of investments in the capital market.

From a creditor's perspective, limited liability shifts the monitoring costs from shareholders to creditors, who, having claims only in the company's assets, are more likely to monitor the company's finances and its management.[305] Generally, creditors are more incentivised to monitor closely what happens in a limited liability company. However, not all creditors are the

[297] See Ronald Gilson and Reinier Kraakman, 'The Mechanisms of Market Efficiency' (1984) 70 Virginia Law Review 549, 552.
[298] Bainbridge and Henderson (n291) 65.
[299] Easterbrook and Fischel, 'Limited Liability and the Corporation' (n225) 94.
[300] Berle and Means (n253).
[301] Larry E. Ribstein, 'Limited Liability and Theories of the Corporation' (1991) 50(1) Maryland Law Review 80, 102-103.
[302] Halpern, Trebilcock and Turnbull (n296) 126.
[303] Jensen and Meckling (n81) 331.
[304] Timo H. Kaisanlahti, 'Extended liability of shareholders' (2006) 6(1) Journal of Corporate Law Studies 139, 143.
[305] Hansmann and Kraakman, 'The Essential Role of Organizational Law' (n48) 425.

same. Limited liability affects only voluntary contractual creditors'[306] information monitoring. This category of creditors can negotiate with the company and be compensated for the enhanced risk by adding contractual provisions in their own interests. To avoid the company having insufficient assets to compensate the claims, they can protect themselves *ex ante*. In this case, limited liability is said to be beneficial for society since the risk of investments is shifted to a party who is considered a '*better risk bearer*'.[307] Although creditors will still have incentives to monitor the company, with limited liability the costs of monitoring are reduced insofar as the creditworthiness of individual shareholders, which changes over time, will not need to be under constant surveillance.[308]

(iii) Diversification and Shareholder Passivity

Limited liability has helped shareholders to become passive "owners" of the company.[309] Passive investors do not take active actions in the management of the company; shareholders have no right to *directly* control the company.[310] Regardless of the negative effects of shareholder passivity,[311] shareholders today are rationally apathetic;[312] hence, it is desirable to provide them with limited liability as a means to refrain from actively monitoring their investments.[313] Needless to say, limited liability is desirable in this scenario only for individual investors, who are ordinary people with jobs whose main income is unrelated to their investments, meaning that they will not have the means, time or drive to be actively engaged in the companies' affairs.

Shareholder passivity as a consequence of the limitation of personal liability allows investors to hold a diversified portfolio of companies' shares because there would be no additional risk for each holding.[314] In other words, investors are able to hold shares in various companies, and in the event that one investment is not fruitful, they will still profit from the other companies

[306] Contractual creditors, i.e., secured creditors, enter voluntarily into contracts with a company, which gives them the possibility to secure their debts through legal arrangements. See 2.2.2.
[307] Janet Cooper Alexander, 'Unlimited Shareholder Liability through a Procedural Lens' (1992) 106(2) Harvard Law Review 387, 390.
[308] Halpern, Trebilcock and Turnbull (n296) 134.
[309] Ribstein (n301) 102.
[310] The governance structure of public companies leaves the decision-making power to the board of directors: see Kraakman and others (n8) 50.
[311] Shareholders could have a greater role in monitoring the board's decisions, and it is suggested that if shareholders had greater engagement with the board, several financial scandals would have been prevented. See Gabriel A. Huppé and Priya Bala-Miller, 'Shareholder passivity: a viable explanation for corporate governance failures at NewsCorp?' (2012) 1(3-4) Journal of Sustainable Finance & Investment 180 for a theoretical context.
[312] Stephen M. Bainbridge, 'Redirecting State Takeover Laws at Proxy Contests' (1992) 4 Wisconsin Law Review 1071, 1080.
[313] Bainbridge, 'Abolishing Veil Piercing' (n1) 490-491.
[314] Ribstein (n301) 101.

in their investment portfolios. Diversification, in turn, allows shareholders to manage the risk of investments better and seek a level of risk they are comfortable with by eliminating company-specific risks associated with holding shares in individual companies.[315] Without limited liability, individual shareholders will need to monitor each investment because, as stated above, each company comes with its own risks related to the decisions taken by the management, and the identity and creditworthiness of other investors.

Most scholars in the literature argue that there are tangible advantages to a system of limited liability. While limited liability can certainly be advantageous for several reasons, the focus of academic debate should be not on what positive consequences limited liability has, but the latter should be balanced with the negative effects it generates.[316] Limited liability does not eliminate the risks of doing business; it simply shifts the risks away from the parties who can decide how much risk to take, namely investors and, as shown below,[317] contractual creditors. When it is a standard and absolute feature of the corporate form, it leads to great normative concerns.[318] Limited liability is a symptom of an inauspiciously structured legal framework, where UK company law joins all the incentives to externalise risk in a simple and convenient form, the separate legal entity, which generates *private* benefits at the expense of vulnerable parties.

2.2. The Effects on Creditors

The characteristics of the corporate form, as reviewed above, incentivise shareholders to take on more risk and push it onto third parties. Shareholders stand to profit from risky ventures as residual claimants, exert indirect control over company direction through their control rights, and enjoy insulation from company liabilities due to limited liability. Consequently, shareholders are not personally responsible for the company's debts, while asserting influence on its decisions. So far, this thesis has argued how the use of the corporate form can negatively affect third parties in the normal course of business. More challenges emerge when the company is insolvent and fails to meet its obligations, raising questions about how various categories of creditors will recover their claims in such scenarios. This section explores how shareholders' rights affect different creditors in insolvency. Understanding these effects is crucial because it highlights the externalisation of risk and the unfair treatment of tort victims,

[315] Macey, 'The Limited Liability Company: Lessons for Corporate Law' (n283) 450.
[316] See for instance the critique of limited liability in Hansmann and Kraakman, 'Toward Unlimited Shareholder Liability for Corporate Torts' (n2); and in relation to small firms in Freedman (n288).
[317] See 2.2.2.
[318] Especially when it is attributed to corporate shareholders. This is expanded in ch 3.

who have been regarded as a category of creditors deserving more favourable laws.[319] The subsequent sections will assess insolvency rules and creditors' rights, which exacerbate the externalisation of risk, stemming from the incentives of the corporate form, towards unsuspecting third parties.

2.2.1. Principles of Insolvency

The issue of risk externalisation becomes acute in insolvency because if shareholders cannot be held accountable for the company's obligations, and the company fails to fulfil all creditors' claims, *some* creditors remain unsatisfied. Insolvency means that a company is currently unable to pay its debts or is deemed unable to pay its debts when they fall due.[320] In such cases, the shareholders' incentives to pursue greater risk-taking also encourage them to display opportunistic behaviour at the expense of creditors, since corporate insiders will likely know about the financial decline of the company before outside creditors.[321] They can dilute assets i.e., pooling assets in their favour; substitute assets, i.e., shifting the risk of projects by selling assets in low-risk activities to pay for assets of high-risk activities; or dilute claims, i.e., issuing new debt.[322] While there are rules aimed at mitigating opportunistic behaviours;[323] ultimately, because shareholders face minimal financial consequences, they are incentivised to pursue these behaviours, and the insolvency law framework places the burden of business risks specifically on unsecured tort creditors.

Insolvency rules deal with the inability to pay on the distribution of assets. In practice, this legal framework has been regarded as a distribution of losses, or more specifically which creditors will bear the loss.[324] Not all creditors' interests will be protected if the company can be used to externalise risks for the benefit of shareholders. While creditors' claims rank ahead of shareholders', and creditors' interests become paramount in insolvency,[325] certain creditors (secured creditors) can also pursue opportunistic behaviour over other creditors.

Once a company reaches insolvency, issues of priority will arise. In this situation, a creditor would wish to be in the best place in line when the assets of the company are distributed amongst all the creditors. While priority does not guarantee a recovery of the debt, being in a

[319] See Leebron (n1); Hansmann and Kraakman, 'Toward Unlimited Shareholder Liability for Corporate Torts' (n2).
[320] IA 1986, s 123.
[321] Davies, *Introduction to Company Law* (n112) 225.
[322] Kraakman and others (n8) 111-112.
[323] See 4.1.2.
[324] Elizabeth Warren, 'Bankruptcy Policy' (1987) 54(3) University of Chicago Law Review 775, 785.
[325] *Liquidator of West Mercia Safetywear Ltd. v Dodd* (1988) 4 BCC 30 (CA); *BTI v Sequana* (n12).

good position amongst all the creditors of the legal entity gives a better chance of recovery.[326] Although the Insolvency Act 1986 provides a *pari passu* rule,[327] which states that all competing creditors are treated equally in proportion to their debt,[328] the existence of security interests that prioritise certain creditors endangers the recovery of unsecured creditors.

It has been established in the early history of UK insolvency law that company's assets subject to security interests would take priority over other types of creditors without property rights in the assets in question.[329] Therefore, security interests are recognised by the law[330] and rank higher up in the priority list of companies' creditors. To formulate a priority list of creditors it would be necessary to consider several provisions of the 1986 Act.[331] Lord Neuberger summarised the '*effect of insolvency legislation'* in *Re Nortel Companies and others*[332] as follows:

'(1) Fixed charge creditors;

(2) Expenses of the insolvency proceedings;

(3) Preferential creditors;

(4) Floating charge creditors;

(5) Unsecured provable debts;

(6) Statutory interest;

(7) Non-provable liabilities; and

(8) Shareholders.'[333]

In order of priority, we find first fixed charge creditors. They are also called secured creditors. They have security interests on the assets of the company. Not only do they have priority, but they are generally able to recover the whole debt by virtue of a proprietary title that allows them to stand apart from the collective distribution process in insolvency.[334] The second category in the priority list refers to the appointed liquidator, who, after fixed charge creditors, has priority over any other claim in property, and the payment order is prescribed by the

[326] Kayode Akintola, *Creditor Treatment in Corporate Insolvency Law* (Edward Elgar 2020) 29.
[327] IA 1986, s 107.
[328] Vanessa Finch, *Corporate Insolvency Law* (Cambridge University Press 2002) 599.
[329] *Re David Lloyd & Co* (1877) 6 Ch 339, 344.
[330] IA 1986, s 248.
[331] See for instance, IA 1986, s 115 ('*all expenses properly incurred in the winding up (…) are payable out of the company's assets in priority to all other claims*.') and s 175 ('*In a winding up the company's preferential debts (…) shall be paid in priority to all other debts*.').
[332] *Re Nortel* (n56).
[333] ibid [39].
[334] Ian Fletcher, *The Law of Insolvency* (5th edition, Sweet & Maxwell 2017) para 24-018.

Insolvency Rules.[335] In third position there are preferential creditors, who are given a statutory special priority. Following the abolition of the Crown's preferential status in the Enterprise Act 2002,[336] the remaining preferential debts are enumerated in Schedule 6 of the Insolvency Act 1986.[337] Today, preferential creditors are mainly employees and their pension schemes. Fourth, floating charge holders have priority over the legal expenses incurred by the liquidator.[338] Any charge created after 2003 is subject to a "prescribed part", namely a portion of the assets included in the floating charges issued by the company can be made available for satisfying unsecured debts,[339] if it is not disapplied by the court.[340] Unsecured tort creditors come in fifth in the ranking of priority. One class of unsecured creditors is tort creditors.[341] Sixth, if the assets are sufficient, interest accruing during the insolvency period is payable on provable debts.[342] Then, non-provable debts may participate in the insolvency process, but they have only been considered judicially in the context of statutory liabilities.[343] Finally, at the bottom of the list, shareholders have the chance - although unlikely - to recover their investment. Nevertheless, it must be remembered that they benefit from limited liability, which means that in insolvency they will not have to contribute to the company's shortfall of assets.

The effect of the insolvency system under UK law has a substantial impact on unsecured tort creditors because the order of priorities will leave little to no assets available to distribute to them,[344] considering that the rights in *rem* conferred to fixed charge creditors result in a substantial reduction of the company's assets available for distribution. The remaining free assets will have to meet first the ranking in priority, and after all the prior creditors are satisfied, what is left is *'often pitifully small'*.[345] The Insolvency Act 1986 empowers, in certain occasions, creditors who are left unsatisfied to recover from other creditors,[346] or they could impose responsibility on directors.[347] However, the order of priority, combined with the competitive nature of secured creditors who routinely inflict harms on other creditors, places tort victims in a precarious position while shareholders walk away with no repercussions.

[335] Insolvency (England and Wales) Rules 2016 (SI 2016/1024) rr 6.42 and 7.108.
[336] Enterprise Act 2002, s 251.
[337] Amended by Bank Recovery and Resolution Order (SI 2014/3329) and Deposit Guarantee Scheme Regulations 2015 (SI 2015/486).
[338] Insolvency (England and Wales) Rules 2016 (SI 2016/1024) r 7.112.
[339] IA 1986, s 176A.
[340] IA 1986, s 176A(5).
[341] Insolvency (England and Wales) Rules 2016 (SI 2016/1024) r 13.12(2).
[342] IA 1986, s 189.
[343] *Re Nortel* (n56) [111].
[344] Kristin van Zwieten, *Goode on Principles of Corporate Insolvency Law* (5th edition, Sweet & Maxwell 2011) para 8-03.
[345] ibid para 8-04.
[346] See IA 1986, ss 127, 238, 239, 245, and 423.
[347] See IA 1986, ss 213 and 214.

2.2.2. Secured Creditors

Although the use of the corporate form for the benefit of shareholders externalises risks onto third parties, secured creditors do not experience the same negative effects as unsecured tort creditors. Secured creditors voluntarily contract with the company and consequentially they are also called voluntary (or adjusting)[348] creditors. Security status provides them with several advantages compared to unsecured creditors, and while these advantages benefit them, simultaneously they render tort creditors worse off. This is because risks begin to reveal themselves only to those who are familiar with the economic activity at hand, and the externalisation can manifest in unpredictable ways, rendering the external parties unaware of the risk until it affects them.[349] Therefore, secured creditors, who have better information on the company's business, contribute to the company's externalisation of risk onto creditors who are less knowledgeable - i.e., unsecured creditors.

Voluntary creditors can protect themselves *ex ante* from the externalisation of risk when contracting with a limited liability company. Bebchuk and Fried explained this in relation to security interests reducing other creditors' share of the '*bankruptcy pie'*.[350] This category of creditors then raises concerns not only on how the bankruptcy pie is divided, but also on the size of the pie itself. First, regarding how the pie is divided, we can refer to the order of priority in insolvency proceedings. Secured creditors have priority in distribution over unsecured creditors, a direct consequence of the nature of the secured creditors' interest, namely it confers rights i*n rem*. This advantage also worsens tort victims in their recovery because unsecured tort creditors do not willingly subordinate their claim,[351] and the order of priority leaves few assets available for distribution to them.

Secondly, when it comes to the size of the pie, secured creditors have proprietary rights exercisable against the debtor's assets to secure payment of the debt, and those assets that are secured property, on the debtor's insolvency, are removed from any insolvency proceedings,[352] thereby recovering their debt in full and reducing the size of the bankruptcy

[348] Not all voluntary creditors can adjust. For example, some voluntary creditors with small claims cannot adjust due to the impracticability of doing so. For this section, it is not relevant to investigate further into the different categories of non-adjusting creditors. For more information see Lucian A. Bebchuk and Jesse M. Fried, 'The Uneasy Case for the Priority of Secured Claims in Bankruptcy' (1996) 105(4) The Yale Law Journal 857, 885.
[349] This concept has been explained regarding financial regulation and why regulators have failed to successfully tackle systemic risk: see Roberta Romano, 'Regulating in the Dark' in Cary Coglianese (ed), *Regulatory Breakdown: The Crisis of Confidence in U.S. Regulation* (University of Pennsylvania Press 2012) 93.
[350] Lucian A. Bebchuk and Jesse M. Fried, 'The Uneasy Case for the Priority of Secured Claims in Bankruptcy: Further Thoughts and a Reply to Critics' (1997) 82 Cornell Law Review 1279, 1306.
[351] LoPucki, 'The Unsecured Creditor's Bargain' (n58) 1893.
[352] Davies and Worthington, *Gower: Principles of Modern Company Law* (n9) 1019.

pie. Prior to insolvency, voluntary creditors can also adjust their arrangements by taking security interests into account.[353] By contracting with the relevant company, they can employ further protection strategies by adding security interests in the agreement, which gives them a legal right in particular assets in the event of default, and acceleration clauses, whereby in case of the debtor's breach the payment becomes due and payable.[354] It is possible to conclude that secured creditors are the "better off" parties when dealing with the issue of risk externalisation of the corporate form, thus making tort creditors worse off.

2.2.3. Position of Tort Creditors

Company law facilitates the use of the corporate form at the expense of third parties. However, in insolvency, unsecured creditors are put in a disadvantaged position compared to secured creditors.[355] This thesis will focus on the risk externalisation of the corporate form towards tort creditors. Since the characteristics of the corporate form help shareholders externalise the cost of their investments, the legal entity is led to underinvest in precautions and overinvest in risky activities - because the costs can be externalised onto involuntary (tort) creditors.[356] What differentiates voluntary from involuntary creditors is then visible when the entity reaches insolvency, namely voluntary creditors possess *ex ante* protection by adjusting their claims and involuntary creditors will most likely bear the losses *ex post*.

Involuntary creditors are also referred to as non-adjusting,[357] and following Bebchuk and Fried's categorisation, the tort creditor is a type of private involuntary creditor.[358] The latter cannot adjust their claims against a company by considering other security interests in existence against the entity.[359] The classical example is a tort claimant who is injured by the company and has an unsecured claim exceeding its insurance coverage when the company becomes insolvent. Insurance is an auxiliary device to tort law used to provide compensation to victims;[360] however, it is problematic.[361]

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[353] Bebchuk and Fried, 'The Uneasy Case for the Priority of Secured Claims in Bankruptcy' (n348) 882.
[354] Kraakman and others (n8) 119.
[355] See *Re Nortel* (n56).
[356] See Bebchuk and Fried, 'The Uneasy Case for the Priority of Secured Claims in Bankruptcy' (n348); Hansmann and Kraakman, 'Toward Unlimited Shareholder Liability for Corporate Torts' (n2).
[357] Non-adjusting creditors can also be voluntary creditors, such as employees: Bebchuk and Fried, 'The Uneasy Case for the Priority of Secured Claims in Bankruptcy' (n348) 885. However, here we are concerned only with involuntary tort creditors.
[358] Bebchuk and Fried, 'The Uneasy Case for the Priority of Secured Claims in Bankruptcy' (n348) 883.
[359] ibid 887.
[360] Insurance is a related topic to the issue of involuntary creditors; hence, it will be briefly discussed here for the purpose of discussing its effect on tort claims.
[361] Gerhard Wagner, 'Tort Law and Liability Insurance' (2006) 31(2) The Geneva Papers on Risk and Insurance - Issues and Practice 277, 284.

Involuntary tort creditors would not be put at a disadvantage inflicted by risk externalisation if they met the business operation's insurance cover. Most business structures purchase liability insurance, oftentimes because they are required to. In the UK, the only mandatory insurance for companies comes under the Employers' Liability (Compulsory Insurance) Act 1969. The Act, however, covers only the liability to *employees* for bodily injury and disease.[362] Thus, there is no compulsory requirement for companies to purchase an insurance that would cover third parties' damages. There are other types of non-mandatory insurance that protect third-party damages, the public liability and environmental insurance. Nonetheless, insurance is generally not adequate, even when voluntarily purchased by companies.[363] This is because insurers are not willing to provide high limits on their cover,[364] and because cover is capped, not all tort victims can receive full compensation for their damages.[365]

Therefore, adequate insurance as a form of protection for involuntary creditors is difficult to obtain and insurers do not wish to cover excessive risks. Those in favour of providing adequate insurance for torts argue that companies should be required to carry insurance for the purpose of satisfying tort claims.[366] Albeit insurance and its regulation is socially desirable,[367] the above proposition would not be suitable or realistically provide a solution to tort claimants. The reason is that non-limited covers are unavailable when not imposed by law because they are not cost-effective; therefore, it would be exceedingly difficult to find them in the market and for smaller companies it would not be feasible to purchase them.[368]

Insurance is also not available for unknown risks. In contrast, it covers specific and clearly defined risks up to a limit, which makes it ineffective in a system of limited liability where the risks are visible only once realised.[369] It follows that, as Professor LoPucki stated, there is a vast domain of uninsurable liabilities[370] and insurance could complement a sound liability system but could '*neither save nor replace an unsound one*'.[371] As it is shown in *Cape plc*,[372] insurance companies do not wish to cover excessive risks, such as asbestosis. Asbestos-related claims are a significant example of mass-torts; in the United States alone there were

[362] Employers' Liability (Compulsory Insurance) Act 1969, s 1.
[363] Hansmann and Kraakman, 'Toward Unlimited Shareholder Liability for Corporate Torts' (n2) 1890.
[364] Fred Collins, *Public Liability Insurance* (Thorogood Publishing 1999) 37.
[365] Vanessa Finch, 'Security, Insolvency and Risk: Who Pays the Price?' (1999) 62 Modern Law Review 633, 655.
[366] Ben Pettet, 'Limited Liability: A Principle for the 21st Century?' (1995) 48(2) Current Legal Problems 125, 157.
[367] Steven Shavell, 'On the Social Function and the Regulation of Liability Insurance' (2000) 25(2) The Geneva Papers on Risk and Insurance 166, 170.
[368] Kaisanlahti (n304) 154.
[369] Michael Simkovic, 'Limited Liability and the Known Unknown' (2018) 68 Duke Law Journal 275, 310.
[370] Lynn M. LoPucki, 'The Death of Liability' (1996) 106 Yale Law Journal 1, 75.
[371] ibid 72.
[372] *Cape Plc v Iron Trades Employers Insurance Association Ltd* [1999] PIQR Q212 (QB), Q213.

approximately one million claims for personal injury related to exposure to asbestos.[373] This shows why insurance companies would avoid having policies covering for such substantial risk of compensation. Therefore, relying on insurance alone is insufficient to protect tort creditors.

The fundamental problem of externalisation stems from shareholders being incentivised by UK company law to use the corporate form for their benefit. The impact of this exploitation varies among creditors. Tort victims face significant challenges because secured creditors and shareholders can siphon valuable assets from the company; the insurance system has deficiencies, and their position is inherently vulnerable. In fact, their claims are further limited by:

(a) The impossibility of choosing the tortfeasor

Involuntary tort creditors cannot foresee the injury or the likelihood of injury. Therefore, they cannot secure or adjust their claims by assessing the solvency of a company, nor can they identify their tortfeasor beforehand and pick a legal entity that will have the funds to compensate a tort claim.[374]

(b) Fewer protections are available to tort creditors

Contractual creditors can remedy negative externalities through bargaining. For tort creditors, there are some circumstances that render bargaining unfeasible, such as in the case of mass tort claims where a large number of parties involved or the lack of knowledge in relation to the externality has an impractical effect on bargaining.[375] While contractual creditors employ different strategies as highlighted above, tort creditors, whose claims are not covered by the business' insurance, do not as a consequence of their involuntary nature.

2.3. Conclusion

This chapter answered the first two research questions as to whether UK company law generates incentives for shareholders to externalise risk and secondly, what these incentives are and how they relate to shareholders. Building on chapter 1, which concluded that companies' externalities affecting a third party's interest, generating a legally recognised harm, deserve attention in company law, chapter 2 explored the corporate form and its characteristics. It gathered that having separate legal personality with a separate pool of assets creates a legal presumption that shareholders have certain rights and privileges in the

[373] Witting, *Liability of Corporate Groups and Networks* (n22) 103.
[374] See Lipton 'The Mythology of Salomon's Case' (n5) 481.
[375] Steven Shavell, *Foundations of Economic Analysis of Law* (Harvard University Press 2004) 88.

entity. With the development of UK company law, the law conferred to shareholders the right to control the direction of the company, a residual claim on the company's assets, and limited liability. However, this is based on a flawed assumption of the theoretical underpinnings of company law – i.e., shareholder rights are essential to the corporate form. While theoretically unsound, the use of the corporate form and all its characteristics has a tangible effect. It promotes an increased externalisation of risk onto third parties and a shift in risk from shareholders to creditors. However, the protection of shareholder interests, alongside the legal privileges of secured creditors, leads to the marginalisation of unsecured tort creditors.

Chapter 3- Exacerbated Incentives in Group Structures

The corporate form is regarded as the instrument that shapes the foundations of business structures.[376] This chapter aims to address the third research question as to whether and how corporate groups exacerbate the issue of externalisation. It explores traditional corporate groups, highlighting the legal implications of hierarchical shareholding and emphasising the disconnect between the legal entity and economic activity inherent in these structures. Corporate groups represent a significant topic in the literature, as companies expand their operations through subsidiaries, leading to legal normative complexities.

This thesis examines the incentives embedded in UK company law that, regardless of motive,[377] encourage risk externalisation and create negative effects to third parties in complex corporate structures. This chapter starts with a definition of corporate groups, which will be beneficial for subsequent analysis regarding the concept of enterprise.[378] Then, it discusses respectively corporate ownership, the applicability of limited liability in the corporate group context, the economic dynamics of groups, and control.

Corporate ownership involves intricate shareholding arrangements and control mechanisms that dilute direct accountability and facilitate risk-shifting. The applicability of limited liability in the corporate group context further exacerbates risk externalisation. Furthermore, in groups, the justifications of limited liability decrease while the harms accumulate. The economic dynamics of corporate groups allow for internal resource allocation and risk transfer, leading to the externalising of the costs of high-risk activities to creditors and third parties. Corporate groups are legal-economic structures and should be treated as such in the legal discourse. They can employ legal and economic principles to behave both as a unified enterprise and as a group of legally separate entities when it serves their interests. Finally, methods of control, both formal and informal, enable parent companies to influence subsidiary operations and pursue risk-taking behaviours without direct legal repercussions.

[376] According to Deakin and others, the corporate form resolves the uncertainties generated by the academic debate on the "firm". Having a corporate form means that the state recognises the entity as a single person with rights and duties, which can own assets, enter into contracts, be sued, and exist independently of the legal lives of its members: see Deakin and others (n85) 194-198.
[377] We are not concerned about whether company members are inherently "good" or "bad". Jennifer G. Hill, 'Good Activist/Bad Activist: The Rise of International Stewardship Codes' (2018) 41 Seattle University Law Review 497, 498.
[378] See ch 6.

3. Corporate Form in Groups

The previous chapters argued that shareholders are incentivised to externalise risk through the corporate form. Not only can shareholders incorporate a company with ease, but they can divide an economic activity into several "parts" by incorporating multiple legal entities and enjoy the advantages of the corporate form as many times as companies that are incorporated. Legal entities can own the shares of other companies, meaning that they will also be regarded as shareholders with economic and control rights and limited liability, and form structures referred to as corporate groups. Corporate groups thus externalise risk through the lawful application of the corporate form, with consequences borne by third parties. And because of the deployment of several legal entities, this risk can grow exponentially. This section provides an overview of the issues and incentives for corporate groups to externalise risk.

The corporate form is applied as a universal rule,[379] and '*a shareholder is a shareholder*',[380] meaning that a single body of rules will apply to shareholders irrespective of whether the shareholder is an individual or a legal entity. This rests on the notion of the traditional legal entity view,[381] based on the jurisprudential conceptions of separate legal personality and limited liability, which sees each company as a separate single unit providing shareholders with limited liability, even when these single units are part of larger and interrelated structures.[382] Corporate groups are the modern reality of how a business is organised,[383] and their organisation allows investors to pursue growth by exploiting *economic* principles, which contribute to risk externalisation, through expansion strategies and transaction cost economics.[384] Parent companies can also exploit the *legal* principles of separateness in the corporate form. Dividing a business into separate incorporated entities allows parent companies *qua* investors to decide the level of risk they are willing to take in each unit based on their percentage of shareholding.

[379] Except in limited situations, such as when the courts decide to pierce the corporate veil, which will be evaluated in 4.1.1.
[380] Phillip I. Blumberg, 'The Corporate Entity in an Era of Multi-National Corporations' (1990) 15(2) Delaware Journal of Corporate Law 283, 288.
[381] See (n117).
[382] The UK has the strictest legal entity view, in which entities within a group have strong limited liability protections: see Sharon Belenzon, Honggi Lee and Andrea Patacconi, 'Managing risk in corporate groups: Limited liability, asset partitioning, and risk compartmentalization' (2023) 44(12) Strategic Management Journal 2888, 2891.
[383] Witting, *Liability of Corporate Groups and Networks* (n22) 37.
[384] Christian A. Witting, 'The Corporate Group: System, Design and Responsibility' (2021) 80(3) Cambridge Law Journal 581, 583-584. Explained also in 3.4.

Traditional groups rely heavily on the legal independence of the companies within them. Groups can compartmentalise liabilities by dividing the assets and liabilities among legally independent entities, avoiding the risk of spreading across other units within the group and shielding the entities from losses incurred in one single unit.[385] This risk can be subsequently externalised onto third parties. The parent company benefits from limited liability, except in limited circumstances,[386] for damages caused by subsidiaries' operations, and it can influence the direction and outcome of such operations. With the use of corporate ownership and control-enhancing mechanisms,[387] parent companies have additional means to assert influence on their subsidiaries, differentiating them from individual investors. Studies have shown that risky operations that are susceptible to large-scale injuries adopt corporate group structures for this reason.[388] For instance, in large-scale industries where mass injuries appear frequently and toxic products can be latently dangerous - such as pharmaceutical, oil, or asbestos-related -[389] subsidiaries are strategically incorporated to segregate hazardous activities and limit the amount of liability of parent company shareholders.[390]

Hansmann and Squire call the separation between a parent company and its individual shareholders an *external* partition; while the separation between two companies within the group, for instance the separation between the parent and the subsidiary company, is called an *internal* partition.[391] The former and its benefits are evident and pertinent to the analysis of limited liability, as expressed in chapter 2.[392] Internal partitioning, in contrast, is more controversial. The latter renders parent companies *qua* shareholders of their subsidiaries able to exploit both entity shielding and owner shielding at the expense of third parties.[393] Hansmann and Squire stated that this type of internal corporate partitioning either cannot generate the same economic benefits of external partitioning, or if it can, it rarely does so in practice.[394] For example, the benefit of correcting debt overhang by isolating risks and rewards for different projects in subsidiaries is rare in corporate groups. The parent company usually

[385] Hansmann and Kraakman, 'The Essential Role of Organizational Law' (n48) 400.
[386] For example, liability may be extended through veil-piercing, the notion of shadow or *de facto* director, and tort law. See ch 4.
[387] See 3.5.
[388] Belenzon, Hashai and Patacconi (n129) 1614. Dearborn provides the examples of asbestos, chemicals, and tobacco industries which resort to subsidiarisation as a strategy of limiting liability: Meredith Dearborn, 'Enterprise Liability: Reviewing and Revitalizing Liability for Corporate Groups' (2009) 97 California Law Review 195, 198.
[389] Witting, *Liability of Corporate Groups and Networks* (n22) 6. See also 1.2.2.
[390] Muchlinski, 'Limited Liability and Multinational Enterprises' (n1) 923.
[391] Henry Hansmann and Richard Squire, 'External and Internal Asset Partitioning: Corporations and their Subsidiaries' in Jeffrey N. Gordon and Wolf-Georg Ringe (eds), *The Oxford Handbook of Corporate Law and Governance* (Oxford University Press 2015) 253.
[392] See 2.1.4.
[393] From the discussion in ch 2, 2.2.3., tort victims will be the parties with the most worrying loss.
[394] Hansmann and Squire (n391) 259.

does most of the borrowing and then distributes funds to the subsidiaries, and a system of intra-group guarantees is common.[395] Thus, internal asset partitioning not only rarely generates benefits, but it produces costs to individuals external to the corporate structure, rendering it unfavourable from a normative perspective. It can induce asset shifting amongst the group, where the most valuable assets are separated from the risk of liability.[396] While there are other economic reasons why businesses are structured in groups,[397] internal partitioning creates the perverse incentive to externalise risk onto tort creditors.

When the complete separation of liabilities between the company and its shareholders crystallised in UK company law,[398] corporate groups were not taken into account and the extension of limited liability to parent companies appeared as an '*historical accident'*.[399] Parent companies *qua* shareholders are positioned in more advantageous ways both economically and in their respective role of controllers compared to individuals.[400] Therefore, questions arise regarding the use of the corporate form in the internal partition of the corporate group to the extent that parent companies receive all the benefits attributed to the corporate form *and* two layers of protection with the incorporation of subsidiaries. Individual investors of the parent company possess limited liability regarding the parent company's obligations, and simultaneously the parent company's liability is also limited regarding subsidiaries' losses, thus, adding the second layer of protection and effectively treating parent companies as individual investors.[401]

The issue of externalisation in corporate groups relies on the differing boundaries between the corporate and the organisational form. While the traditional legal entity view observes that an incorporated company is separate and independent, the reality of the traditional corporate group can be one of an integrated economic entity divided into several legally independent entities. Although both parent and subsidiary company can be part of the same and singular

[395] Hansmann and Squire (n391) 262.
[396] When the corporate group itself does not respect the boundaries of the corporate form, assets can be moved within the structure through legal mechanisms, such as transfer pricing and licensing agreements, and there can be confusion about the ownership of the assets at the level of its corporate members: see Jay L. Westbrook, 'Transparency in Corporate Groups' (2018) 13 Brooklyn Journal of Corporate, Finance and Commercial Law 33, 37-38.
[397] See 3.4.
[398] As discussed above in 2.1.1., this occurred after the ruling in *Salomon* (n32).
[399] Blumberg, 'Limited Liability and Corporate Groups' (n1) 605.
[400] Certainly, there are other corporate shareholders - as mentioned above institutional investors for example - that play a significant role in today's global shareholding of listed companies. The same considerations could be applied to any category of "insider" corporate shareholder having additional information about managerial decisions and power to influence them. Institutional investors as large shareholders might also decide to be actively involved in their role and therefore will be in the same position. However, this is beyond the scope of this thesis. For more information see Goodhart and Lastra (n126).
[401] Strasser (n2).

economic enterprise, UK law will hold liable only the one conducting the activity generating harms.

It is important to note that UK insolvency law also follows a legal entity perspective, not business lines, which means that insolvency operates along single entities and there are no rules applying specifically to corporate groups.[402] This legal entity perspective means that when a subsidiary becomes insolvent, only the subsidiary's assets are available to satisfy its creditors, and the parent company is under no obligation to contribute to the assets of the insolvent company. Contractual creditors will still possess their advantages, discussed in chapter 2,[403] at the expense of unsecured creditors. For example, when a group is divided into separate lines of business, each entity will have its own types of assets that can be made available to the contractual creditors of the specific entity.[404] Moreover, because secured creditors can choose the terms of their relationship with the debtor, legal partitions - i.e., the structure of the group - will have little to no impact on the secured creditors' risk allocation, monitoring, and enforcement rights.[405]

Albeit the position of voluntary creditors might be undermined by the practice of corporate groups to shift assets amongst all their entities within the group, they are able to gain protection through other provisions, such as intra-group guarantees.[406] In fact, contractual creditors are expected to protect themselves from the known risks of non-payment by the company through bargaining around the default rules of entity law with the controlling shareholder.[407] Nonetheless, when it comes to unsecured creditors, as Templeman J stated, parent companies prosper while they are unaccountable for the liabilities of an insolvent subsidiary that turned out to be the '*runt of the litter'*.[408]

Involuntary tort creditors cannot adjust their claims based on the subsidiary's financial structure, which means that they will be '*hurt*' by the existence of secured creditors having priority in the subsidiaries' assets.[409] Therefore, when the tort claim is realised and the

[402] This is because each company within the group is a separate legal entity, and when a subsidiary becomes insolvent the parent company will not be liable for its debts: see *Re Southard Ltd* [1979] 1 WLR 1198 (CA), 1208 (Templeman J). To resolve the issue of parental liability in insolvency, the IA 1986 provides a statutory veil-piercing solution under ss 213 and 214, namely fraudulent and wrongful trading.
[403] See 2.2.2.
[404] Kraakman and others (n8) 110.
[405] Lenders can tailor the group's partition. If lenders have the expertise to monitor different projects, it would be favourable for them to have a system of cross-liability provisions in place. In this way, lenders can choose their preferred enforcement mechanism after the relevant circumstances have materialised. They can decide to enforce against a specific entity or firm-wide, on which, see Casey (n84) 2718.
[406] Hansmann and Squire (n391) 268; Ilya Kokorin, 'Promotion of group restructuring and cross-entity liability arrangements' (2021) 21(2) Journal of Corporate Law Studies 557, 562.
[407] Bainbridge, 'Abolishing Veil Piercing' (n1) 501-502.
[408] *Re Southard* (n402) 1208.
[409] Bebchuk and Fried, 'The Uneasy Case for the Priority of Secured Claims in Bankruptcy' (n348) 894.

subsidiary holds only nominal or inadequate assets to fully satisfy all claims, the parent-subsidiary structure leaves individuals being exposed to business risks without adequate redress.[410] Tort victims find themselves in a vulnerable position within any corporate structure, whether it is an individual company or a corporate group. However, the vulnerability is particularly acute in corporate groups. In such cases, tort victims, who are often unaware of the group structure, are at a disadvantage, especially when dealing with insolvent or thinly capitalised subsidiaries. The traditional legal entity approach assigns rights and liabilities to each unit separately; nevertheless, the actual boundaries between them may not be aligned. Shareholders can exploit this misalignment to gain enhanced benefits at the expense of third parties by either segmenting their economic activity into separate legal entities or conducting their economic activities outside the legal entity but within the organisational structure. This chapter will show that UK company law allows parent companies both to benefit from the unity of the group structure when it is beneficial for them, and to rely on the legal separation of companies when business risks are manifested.

In sum, the incentives provided by UK company law to shareholders,[411] and the corporate group structure, facilitate and exacerbate risk externalisation, whereas parent companies gain (enhanced) economic and control rights in other companies with limited liability, protecting them from losing more than their original investment. Company law incentivises risk compartmentalisation as it applies the same rules to individual and corporate shareholders, rendering the latter able to enjoy the advantages of the corporate form multiple times in group structures while upholding a legal entity approach. It follows that parent companies will find themselves in a better position than other investors, by having potentially unlimited upsides for any corporate form used and their financial risks capped, with any amount exceeding this cap being externalised onto unsecured tort creditors.[412]

3.1. What Is a Traditional Corporate Group?

Corporate groups started to emerge only after the jurisdictions allowed the existence of corporate shareholders, namely companies owning shares of other companies.[413] Although it is generally believed that the modern corporate group structure emerged first in the United

[410] See Hansmann and Squire (n391) 264-265.
[411] As analysed in ch 2.
[412] Simkovic (n369) 290.
[413] Before companies were granted this power, owning shares in other companies was considered improper. Therefore, only at this point in the nineteenth century does Blumberg refer to the '*emergence of corporate groups*': see Blumberg, *The Multinational Challenge to Corporation Law* (n6) 52-53.

States around the end of the nineteenth century,[414] it might not be the case.[415] In the U.S., the power to own shares in other companies was first specified by statute in New Jersey in 1888.[416] In contrast, the UK permitted company powers to be authorised in its Articles of Association through the Companies Act 1862;[417] therefore, it effectively granted companies the power to own other companies' shares before it was acknowledged in the United States.[418]

To date there is no *consensus* amongst scholars and lawyers on what a corporate group is. The complexity of its definition is bound up with the various academic disciplines' approach to the topic and the fact that a group itself may assume various forms. Indeed, '*complexity*' is said to be the most common characteristic of corporate groups.[419] It is worth noting that despite the concept of "business group" emerging in the late nineteenth century, academic interest in the topic was not sparked until the late 1990s,[420] and without a theoretical basis for legal development, arguably the law on corporate groups has not yet been fully developed.[421]

This section will adopt the definition of traditional corporate group to advance this thesis' discussion.[422] The legal definition of the (traditional) corporate group provided by UK common law might appear quite simple; it is a group of separate legal entities, each possessing separate legal rights and liabilities,[423] each having '*theoretical independent existence*'.[424] The idea of legal segregation refers to the long-standing decision of *Salomon*,[425] which confirmed the principle of company law that a company is separate from its members and its liabilities are separate from shareholders' liabilities, which are limited to the amount of capital invested in the company.[426]

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[414] Irit Mevorach, *Insolvency within Multinational Enterprise Groups* (Oxford University Press 2009) 10-11.
[415] Historically, although not bearing the same structural form, it is possible to witness an early conception of the "group" in the British East India Company chartered by Queen Elizabeth I in 1600, which was granted a monopoly on the trade in spices: see Jones (n21) 17.
[416] New Jersey Session Laws 1888, ch 295, 445.
[417] Companies Act 1862, s 12. This Act did not explicitly make corporate shareholders lawful. However, judicial interpretations of the Act stated that it was possible for a shareholder to be a corporate body. See *In Re Barned's Banking Company* (1867-68) LR 3 Ch App 105,112-114.
[418] Blumberg, 'Limited Liability and Corporate Groups' (n1) 605.
[419] Anker-Sørensen (n20) 27.
[420] Asli M. Colpan, Takashi Hikino, James R. Lincoln, 'Introduction' in Asli M. Colpan, Takashi Hikino, James R. Lincoln (eds), *The Oxford Handbook of Business Groups* (Oxford University Press 2010) 2. See also 1.3.
[421] Theoretical and legal developments are interconnected. See David Millon, 'Theories of the Corporation' (1990) 39 Duke Law Journal 201.
[422] The definition of "corporate group" will be essential for ch 6, which will delimit the boundaries of the enterprise subject to regulation.
[423] *The Albazero* (n116) 807.
[424] *Reed v Nova Securities Ltd* [1985] 1 WLR 193 (HL), 201 (Lord Templeman).
[425] *Salomon* (n32) 30-31.
[426] Confirmed by the IA 1986, s 74(2)(d).

However, legal definitions vary amongst jurisdictions,[427] statutory definitions may even be absent,[428] and the relationship between companies within the group is most often defined in terms of "control", which in itself it is an inconsistent denomination.[429] The common approach is to neglect the fact that the legal and economic boundaries of the corporate group are not congruous with each other.[430] UK statutory law does not provide a definition for corporate groups, but it defines what parent and subsidiary companies or "undertakings" are.[431] This approach is not sufficient because the definitions of parent and subsidiary companies embrace an outdated principle of control, relying on majority shareholding or the right to remove or appoint a majority of the board of directors.[432] By looking closely at the corporate group, it can be seen that whilst there are separate entities from a legal perspective, they are all linked by common ownership or "control" and the factual economic reality is one of '*unified direction* or *common management'*.[433]

Traditional corporate groups are conceptually separate from network-type groups based on alliance principles. A traditional group is defined as an association of separate legal entities related hierarchically, organised by the principle of authority,[434] i.e., where one unit, the parent or holding company, is the *controlling* member[435] of the others. In this context, hierarchies are organisational structures composed of layers of companies in succession that correspond to the level of subordination of one entity to the other. For example, as depicted in Figure One, there is *A* the parent company, which is the ultimate controller, and companies *B* and *C* as subsidiaries, which are controlled - i.e., subordinate to the company above, which in this example is the parent company - and can be wholly or partially owned by the latter.

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[427] Antunes (n260) 314.

[428] For instance, the UK does not define what a group is, and simply provides a definition of the key players, i.e., the parent company and subsidiary: see CA 2006, s 1159.

[429] See, for instance, the definition of control in the US, where various Acts define control in numerical percentages. The Public Utility Holding Company Act of 2005 § 366.1 uses 10% of voting ownership, and the Bank Holding Company Act of 1956 §§ 1841-1850 has 25% ownership to create a presumption of control.

[430] See Edward M. Iacobucci and George G. Triantis, 'Economic and Legal Boundaries of Firms' (2007) 93 Virginia Law Review 515, 520.

[431] CA 2006, ss 1159 and 1162.

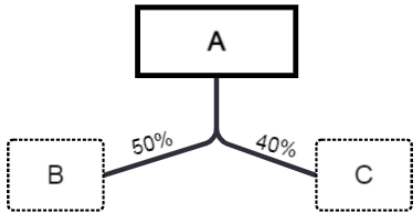
[432] CA 2006, ss 1162(2) and 1159(1); and a person with significant control is a person owning more than 25% of the shares in a company, or more than 25% of the voting rights, or the right to appoint or remove members of the board, on which see Companies Act 2006 sch 1A.

[433] Rafael M. Manovil, *Groups of Companies: A Comparative Law Overview* (Springer 2020) 6.

[434] See A. Colpan and T. Hikino, 'Foundations of Business Groups: Towards an Integrated Framework' in Colpan, Hikino and Lincoln, *The Oxford Handbook of Business Groups* (n420) ch 2.

[435] The definition of control that this thesis promotes will not follow the legal definition of control stipulated in UK statutory law based *solely* on a majority shareholding or appointment and removal rights. As explained in 3.5., the means of control in corporate groups are various and are not only connected to parent companies *qua* shareholders, but also to the other role of the parent company as *the* parent company, namely the strategic centre of the group.

Figure 1. Ownership Structure



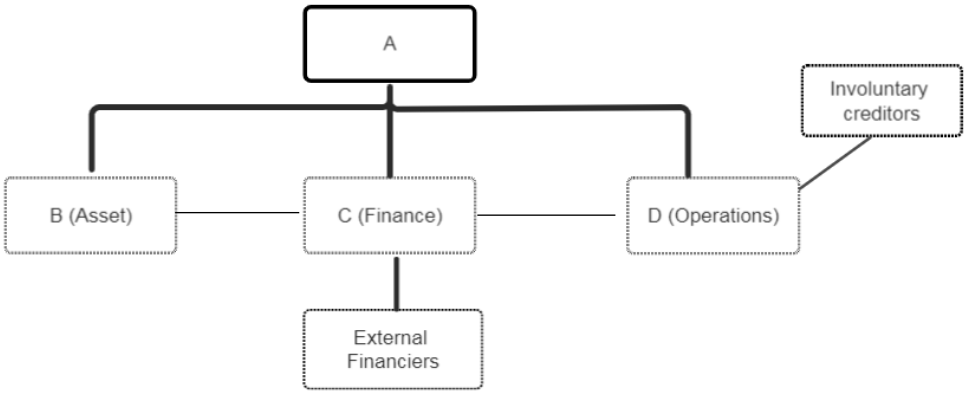
It is important to note in Figure One the presence of company *A*'s 40% ownership of shares in company *C*; this number is intentional. Even if *A* does not own a majority shareholding in *C*, it does not mean that *A* will not be effectively in control. Having majority ownership is not the only requirement of being a controlling shareholder in a corporate group context[436] and, due to the group relationship, control can be asserted indirectly as well as directly through the majority of shareholding.[437] Indirect control can arise in instances where there is no majority of shares, yet the parent company owns a strategic position in the subsidiary's decision-making capacity, rendering the subsidiary not fully autonomous.[438] Most importantly, while equity linkages among the units in the group are the building blocks creating the corporate group structure, share ownership is only a formalistic perception of groups. The interior design that holds together the units as glue, even without the formal majority ownership percentage, is formed by group strategies and coordinative means.[439] These two ways of "control" are the essential characteristics of traditional corporate groups, namely equity linkages and internal mechanisms,[440] with the latter being taken into consideration only to a limited extent by the law.[441]

The definition provided above embraces several types of groups found in the market. It encompasses multinational enterprises with foreign subsidiaries, multidivisional structures with independent legal entities, conglomerates, and vertically integrated companies.[442] At the same time this definition excludes other types of groups, i.e., networks, such as franchises, where there is no equity-based control, and the group relationship is created through operating

[436] CA 2006, s 1159 (1).
[437] Witting, *Liability of Corporate Groups and Networks* (n22) 36-39.
[438] Antunes (n260) 116–121.
[439] Influence is also achieved through common strategies and the coordination of activities or production within the group, such as aligning actions and incentives to generate common group goals: see generally Anker-Sørensen (n20) ch 5.
[440] For a more detailed discussion of the two, see 3.5.
[441] This is relevant for corporate group liability in torts, where courts give relevance to informal means of control (although in a limited way). See 4.2.
[442] Maria I. Sáez Lacave and Maria Gutiérrez Urtiaga, 'Corporate Groups: Corporate Law, Private Contracting and Equal Ownership' (2021) European Corporate Governance Institute - Law Working Paper No. 581/2021, 7 < https://ssrn.com/abstract=3826510> accessed 22 August 2024.

agreements.[443] Albeit hierarchical shareholding distinguishes more clearly the legal boundaries in a corporate group, it does not delimit the boundaries of the economic activity conducted in the group by several entities.[444] Parent companies can divide a unified business into multiple parts and enjoy the benefits of the corporate form for as many companies as they decide to incorporate. UK company law renders the extension of liabilities within this structure rare, perpetuating the issue of risk externalisation. In fact, each unit within a group will have its own rights and liabilities; consequentially, liabilities and risks will be compartmentalised. Figure Two illustrates the basic assumption underlying the issue at hand. There is *A*, the parent company, that is the controlling shareholder of companies *B*, *C*, and *D*. Companies *B* and *C* are special purpose subsidiaries created to mitigate the risks and costs of financing the operations of the group.[445] Company *B* is a holding entity; it holds the assets which are then transferred to company *C*, a service entity,[446] in order to raise external finance that in turn is transferred to company *D*. In the figure below, the external financiers are contractual creditors and, although not relevant to this hypothetical example, it is important to distinguish them from involuntary creditors due to their position in insolvency.[447]

Figure 2. Compartmentalisation of Liabilities



Company *D* is the only subsidiary conducting operations. Hypothesising that this fictional corporate group is engaging in risky activities in the UK that can injure a large number of victims, such as mining asbestos or producing pesticides, legally company *D* will only harm those victims, i.e., tort creditors could seek recourse against company *D only*. When the latter is insolvent or for other reasons unable to satisfy their claims, the victims would have no other

[443] Richard Whittington and Michael Mayer, *The European Corporation: Strategy, Structure, and Social Science* (Oxford University Press 2000) 9.
[444] This will be the concept of the "enterprise", which will be defined in ch 6.
[445] See Steven L. Schwarcz, 'The Alchemy of Asset Securitization' (1994) 1 Stanford Journal of Law 133, 135.
[446] Anker-Sørensen (n20) 74-75.
[447] See 2.2.1.

remedy against any of the other companies in the group according to the current company liability rules.[448]

The result is that *A*, the parent company, will own shares and enjoy the benefits of the corporate form in respect of companies *B*, *C*, and *D*. Due to the fact that there is a clear demarcation of the assets, corporate groups *qua* debtors can – within the bounds of law -[449] opportunistically exploit asset partitioning by moving assets around the corporate structure, such as moving parent companies' assets into subsidiaries in order to appropriate parent companies' creditors or *vice versa*, removing assets from subsidiaries to the parent company in order to appropriate subsidiaries' creditors.[450] In one individual company all the assets would remain within the boundaries of one corporate form, whereas a corporate group structure, such as the one presented above, would facilitate the presence of fewer assets in the operating entity, relying on the other units to hold the assets and raise external finance. This will be decided in accordance with the parent company *qua* shareholders' control rights. In this scenario, *A* has secluded the assets in *B* - far away from the group's operations in *D*. Additionally, by being a shareholder in *D*, it may receive the profits of *D*'s operations in the form of dividends, hence diverting further the assets of *D*. Thus, *A* has abused the legal use of the corporate form insofar as it will control and profit from *D*'s operations. Nonetheless, *D* will have few or no assets available to satisfy the injured involuntary creditors, and *A* as a shareholder of *D* will be under no obligation to contribute to the shortfall of *D*'s assets.

3.2. Corporate Ownership

As mentioned in the previous section, corporate groups emerged only after companies were given the right to own shares of other companies. In the early history of share ownership by companies, any company incorporated under the Companies Act of 1862 had the power to purchase shares of other companies if expressly stated or there was an implied authorisation in its memorandum of association.[451] It follows that, without the power to own other companies' shares, corporate groups would not have existed; hence, corporate ownership is a fundamental feature determining the corporate architecture of groups.[452] This ability sits on the notion of shareholders' rights and it is used in corporate groups as a mechanism through which parent companies can achieve exponential benefits with few repercussions.

[448] Choudhury and Petrin, *Corporate Duties to the Public* (n169) 109.
[449] See, for example, potential limitations in 4.1.2.
[450] Oscar Couwenberg, 'Corporate Architecture and Limited Liability' (2008) 4(2) Review of Law & Economics 621, 628.
[451] *In Re William Thomas & Co., Limited* [1915] 1 Ch 325, 330.
[452] Namely the organisational instruments that groups use to organise themselves into a coordinating and hierarchical model. See Couwenberg (n450).

The notion of corporate ownership can be reconciled with the change in legal view of the "share" that was embarked on during the time that corporate groups started to emerge. Following an economic development in the market of joint stock companies in the early to mid-nineteenth century, given by a rapid growth in the number and size of companies, UK common law interpreted the nature of the "share" as a form of property in itself and shareholders' interest was regarded as an interest only in the profits of a company.[453] Thereafter, courts held similar views and shares slowly transformed from an equitable interest in the property of a company to a mere instrument of investment.[454] The significance of corporate ownership lies in the enhanced incentives provided to parent companies to externalise risk. Unlike individual shareholders, parent companies enjoy *multiple* layers of advantages and protection due to their structure. This structure allows them to benefit from share ownership of each individual subsidiary, including financial benefits, control rights, and limited liability, within a highly controlled environment[455] where subsidiary companies act under the parent company's direction. Parent companies are incentivised to pursue risky business strategies with minimal fear of repercussions because their liability is limited to their investment in the subsidiary. And while the structure can allow the group to work in unity as an enterprise, the legal independence of each entity coupled with all the benefits of the corporate form is upheld. Therefore, as the use of the corporate form in corporate groups can increase exponentially so does the externalisation of risk.

Shareholders possess a set of economic and legal entitlements that this thesis has referred in chapter 1 and 2 to as "rights". First, the economic right to receive dividends when distributed and be entitled to the residual claim on the company's cash flow if the company is liquidated, and second, the legal control right referring to the ability of shareholders to make certain corporate decisions, appoint and remove directors.[456] In corporate groups, parent companies can have a great influence in subsidiaries' operations, with limited repercussions, based on three principles[457]: (i) as shareholders they can indirectly influence the strategic direction of the group and profit from the group's operations, (ii) as parent companies they can decide group strategies, purposes and set financial and operational targets, and (iii) due to

[453] *Ex parte the Lancaster Canal Company* (1 D & C 420; Mont & Bligh, 113).
[454] *Bligh v Brent* (1837) 160 ER 397, 408-409; *Bradley v Holdsworth* (1838) 150 ER 1210. At that time, there were differing opinions, but the matter was settled during the second half of the nineteenth century: see Paddy Ireland, 'Capitalism without the capitalist: The joint stock company share and the emergence of the modern doctrine of separate corporate personality' (1996) 17(1) The Journal of Legal History 41, 46-48.
[455] This will be explained in more detail in 3.5 and 4.2. Parent companies can achieve a unique highly controlled environment given their position as the parent of the group and their influence as shareholders in their subsidiary companies.
[456] Armour, 'Shareholder rights' (n54) 316.
[457] Discussed in more detail in 3.5.

shareholder limited liability, the liability flowing from a decision will lie at the management level of the subsidiary.

In regard to (i) and (ii), the effect of parent companies owning shares in their subsidiaries is that the profits made by a subsidiary return to the parent company in the form of intercorporate dividends proportional to its percentage of ownership.[458] Moreover, parent companies, in their roles as both shareholders of the subsidiaries and parent companies of the group, can not only have a say in the subsidiary decision-making process but they can also control the general directions, goals, purposes and outcomes of all the units in the group.[459] Parent companies can act through subsidiaries, benefiting from their profits and being more incentivised to pursue risky business strategies due to little fear of repercussions resulting from shareholder limited liability. UK company law is the source of the externalisation of risk at the expense of third parties, which is exacerbated in groups compared to individual companies.

As established in *Salomon*,[460] incorporation completely separates the company and its shareholders, by placing a "veil" between them.[461] The implications of such decision significantly shaped the course of company law,[462] and the principles of the corporate form gradually entered the corporate group context. Each member of the group has separate legal personality upon registration under the Companies Act 2006.[463] Each subsidiary of the parent company will then have its own assets, management capability, rights, and liabilities. Likewise, subsidiaries' assets will belong to the legal entity and not to the parent company *qua* shareholder, and their liabilities will be their own and the parent company's. An empirical study conducted by Dignam and Oh on UK cases between 1885 and 2014 shows that courts tend to uphold the principles expressed in *Salomon*,[464] and they are averse in disregarding the corporate personality as depicted by a mere 35% of successful disregard outcomes throughout the 1885-2014 period.[465]

[458] Independent from the class of shares, shareholders are entitled to receive a share of the company's profits, on which, see the Companies (Model Articles) Regulations 2008 (SI 2008/3229) sch 1 reg 30(4), and sch 3 reg 70(4).
[459] Discussed at 3.5.
[460] *Salomon* (n32).
[461] Davies and Worthington, *Gower: Principles of Modern Company Law* (n9) 339.
[462] Lipton, 'The Mythology of Salomon's Case' (n5) 453.
[463] CA 2006, s 16(2).
[464] *Salomon* (n32).
[465] Alan Dignam and Peter B. Oh, 'Disregarding the *Salomon* Principle: An Empirical Analysis, 1885-2014' (2019) 39(1) Oxford Journal of Legal Studies 16, 27.

The courts have continued to apply the corporate form principles as absolutes in corporate groups, where it is also possible to witness a reluctance to disregard the corporate veil.[466] Limited liability is not only strictly enforced by UK courts, but it is also safeguarded by statutory law.[467] Therefore, in the corporate group context when a subsidiary company acts negligently and commits a tort,[468] it is the subsidiary that will be liable for the damage and not its shareholders, i.e., the parent company. However, there can be a significant difference between the boundaries of the corporate form and those of the economic activity. Subsidiaries can be used for specific activities of the corporate group, while the general business activity is organised outside that legal entity through all the other units forming the group. The subsidiary entities are then convenient vehicles exploited by the group as a whole to enable the use of the incentives provided by UK company law for the benefit of parent company shareholders.

Corporate ownership will be even more controversial when there are variations in the standardised instrument of shares, such as when they deviate from the one share-one vote principle.[469] Parent companies can achieve additional control in subsidiaries with the issuance of specific classes of shares, such as non-voting shares or shares with multiple voting rights. Therefore, ownership can become a control-enhancing mechanism, leaving the parent company as the only shareholder with an influential position in the subsidiary company. This mechanism creates a discrepancy between shareholders' economic and control rights. Ultimately, parent companies will benefit from the profits of each unit of the group, but in certain subsidiaries, for instance the ones in charge of operations, their control rights can exponentially exceed their financial exposure.[470] Accordingly, based on the "corporate ownership test",[471] it might appear that certain subsidiaries receive less influence from the parent company when in reality the structure presents forms of "hidden" control. The additional layer of limited liability provided to parent companies thus renders corporate investors unaccountable for the risks they create by holding control rights and shifting profits from the subsidiary's business to other entities in the group. The following section will discuss the controversial use of limited liability in corporate groups and whether it is justified to apply the concept in these corporate structures.

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[466] See *Adams v Cape* (n94); *Re Polly Peck International PLC* (in admin) [1996] 2 All ER 433 (Ch); *Hurstwood* (n271). This also corresponds to the findings in Dignam and Oh, 'Disregarding the *Salomon* Principle: An Empirical Analysis, 1885–2014' (465) 31.
[467] IA 1986, s 74.
[468] Except when there is clear operational control or *de facto* management of the subsidiary by the parent company: see *Okpabi* (n130), examined in 4.2.
[469] See CA 2006, s 284.
[470] See Rafael La Porta, Florencio Lopez-De-Silanes and Andrei Shleifer, 'Corporate Ownership Around the World' (1999) 54(2) Journal of Finance 471, 473.
[471] See also 3.5.

3.3. The Application of Limited Liability in Corporate Groups

In chapter 2, the traditional justifications for limited liability were discussed. The majority of scholars hold the view that, by protecting shareholders, the economy and society will similarly benefit from the rule of limited liability.[472] Indeed, it is true that limited liability provides some advantages.[473] However, for the most part, limited liability provides *private* advantages at the expense of third parties. We know that the limited liability rule for parent companies, interlinked with the other features of the corporate form, increases the incentives for negative externalities. The risk of externalisation and its consequences are, however, considered to be outside the scope of company law.[474] Yet, company law provides for the use of the corporate form and its features. This section will, therefore, evaluate the premises of limited liability and the necessity of maintaining it in corporate groups under UK company law. It will conclude that the advantages of limited liability are either not present or not as relevant in group structures, undermining its justifications and leading to the argument that it is possible to re-evaluate it.

(i) Capital Raising and Dispersion of Risk

Limited liability for individual investors is said to promote liquidity in the market by allowing shareholders to freely transfer their shares and disperse their risk of investments because no conflicts would arise from the disparities in shareholders' wealth.[475] Starting from the first advantage, namely the promotion of liquidity in the market, from a more general perspective, according to Blumberg, it can be refuted on a historical basis. English commercial life flourished and functioned for a long time without the need for limited liability to encourage the flow of capital.[476] Moreover, within the legal entities of corporate groups specifically, what Hansmann and Squire define as "internal partitioning",[477] the promotion of liquidity through limited liability is not as straightforward. Liquidity is promoted by limited liability since first, shareholders will not be concerned about the identity of other shareholders, and second,

[472] This is asserted based on the presumption that companies do not have macro consequences outside of their corporate boundaries. However, this is not the case. Recent events of climate change and economic crises are some examples: see Enriques and Romano (n79).
[473] See 2.1.4.
[474] See ch 1.
[475] See 2.1.4.
[476] Blumberg has claimed that companies had widespread share ownership, even without limited liability. For instance, the Birmingham Flour and Bread Company counted 8,000 shareholders in 1808 (47 years before the Limited Liability Act 1855), on which, see Blumberg, 'Limited Liability and Corporate Groups' (n1) 581.
[477] See 3.

consequent to this assertion, shares will have informational value that ensures shareholders will buy at a "fair" price.

While individual investors benefit from the liquidity of shares due to limited liability mitigating conflicts arising from wealth disparities among shareholders, this advantage is not as evident in corporate groups. On the one hand, shareholder conflicts in group structures where the parent company wholly-owns its subsidiary do not arise *a priori* insofar as the parent company will be the only shareholder in this scenario.[478] On the other hand, while studies have shown that the presence of controlling shareholders coupled with a discrepancy between voting and economic rights reduces liquidity,[479] evidence on this is limited, and the control device chosen will have important consequences for whether liquidity is increased or decreased.[480] This means that in corporate group structures where there are minority shareholders, there will be shareholder conflicts between the controlling and noncontrolling owners,[481] but there is no conclusive argument on their effect on liquidity.

Second, the argument that limited liability favours the free transferability of shares is only partially applicable to corporate groups. With free transferability of shares, investors can easily sell their shares in the market and exit the investment whenever they wish. Without limited liability, shares would not be fungible due to their price being dependent on the wealth of the owner. In corporate group structures, there is not always a need for this benefit because the investors within subsidiary companies will not reach the same numbers as those in other listed companies. When subsidiaries are wholly owned, there will not be thousands of shareholders with various levels of wealth; there will merely be a single shareholder, i.e., the parent company. The argument is more plausible for corporate groups with minority shareholders present in the structure, i.e., when the subsidiary owned partly by minority shareholders will invest in a risky project. Nevertheless, this argument reinforces the need for limited liability of individual investors, namely *bona fide* entrepreneurs who enter the market to finance commercial projects, not corporate shareholders in the role of parent companies.

Finally, parent companies do not derive the benefit of dispersing the risk of investment from limited liability. Parent companies are not *absentee* investors; they actively control their subsidiaries either through formal (equity) links or informal (other control-enhancing

[478] Hansmann and Squire (n391) 260.
[479] See Marco Becht, 'European corporate governance: Trading off liquidity against control' (1999) 43 European Economic Review 1071, 1073.
[480] Double voting rights for example are found to enhance liquidity: see Edith Ginglinger and Jacques Hamon, 'Ownership, control and market liquidity' (2012) 33 Finance 61.
[481] This is identified as an agency problem where the minority shareholders are seen as the principals and the majority shareholders as agents: see Kraakman and others (n8) 30.

mechanisms) means.[482] Hence, dispersion of risk is not a relevant factor to justify limited liability in corporate groups.

(ii) Monitoring Incentives

Limited liability procures monitoring advantages for both individual shareholders and secured creditors.[483] Individual shareholders will face fewer costs in monitoring as their investment liability will not be dependent on other shareholders' wealth, consequently reducing the costs of monitoring other shareholders, and they will also have fewer incentives to monitor managers. Likewise, secured creditors will not need to monitor the creditworthiness of shareholders when giving credit to a company. Therefore, re-evaluating limited liability for individual shareholders in quoted companies with dispersed share ownership will raise uncertainties in everyday commercial life. Monitoring requires the acquisition of information, and individual shareholders, who hold only a fraction of the equity shares of a company, would encounter significant information costs.[484] Nevertheless, in corporate groups, the advantage of lower monitoring costs does not apply.

From a shareholder's perspective, parent companies are better suited to acquire information because they have the incentive and the means to take on a monitoring role. In either case of the parent being the only shareholder or the controlling shareholder in a subsidiary company, the incentive comes from the fact that its financial performance will depend on the subsidiary's performance, implying that parent companies are more incentivised to monitor or, with a lesser degree of control, set strategic directions for their subsidiaries.[485] They are also in a better position to monitor the subsidiaries' management since, depending on the structure adopted, parent companies will either be involved in daily operations or set strategic, operational, and financial targets for subsidiaries.[486] On a broader level, the monitoring mechanism is provided by the vertical equity ties of the parent company in the subsidiary[487] and the horizontal ties that can be created by board interlocks and cross-shareholdings.[488] Parent companies *qua*

[482] See 3.5.
[483] See 2.1.4.
[484] Mendelson (n2) 1222.
[485] Witting, *Liability of Corporate Groups and Networks* (n22) 74.
[486] This means that the parent company will be ultimately and indirectly involved in the decision-making of each subsidiary. See Asli Colpan and Takashi Hikino, 'Foundations of Business Groups: Towards an Integrated Framework' in Colpan, Hikino and Lincoln (n420) 27.
[487] Allowing for the selection and appointment of, and the power to, fire managers.
[488] Board interlocks is the practice of having directors sitting on more than one subsidiary's board, increasing the monitoring of the entity's management. Cross-shareholdings arise when the entities within the group own a percentage of each other's shares, creating the incentive to cross-monitor each other. See Brian K. Boyd and Robert E. Hoskisson, 'Corporate Governance of Business Groups' in Colpan, Hikino and Lincoln (n420) 678-681. However, there are some limitations. For instance, subsidiary companies cannot own any shares in the parent company: see CA 2006, s 136.

shareholders do not need limited liability to reduce monitoring because they have the drive and means to play an active role by internalising the benefits of monitoring. Moreover, reduced inter-shareholder monitoring costs cannot arise in corporate groups where the subsidiary has only one shareholder, namely the parent company. In the case where minority shareholders are present, when subsidiaries are listed companies with a percentage of public ownership, limited liability for individual investors should remain untouched and justified as per the previous discussion.[489]

From a secured creditor's perspective, limited liability in the internal partition of the group could theoretically provide lower information costs. As shown by Posner,[490] limited liability allows the creditor to monitor only the entity he is transacting with; while without limited liability, he will need to investigate the creditworthiness of the parent company as well as the entity in the transaction.[491] Thus, limited liability would be beneficial *if* the creditor could focus specifically on the creditworthiness of the legal entity he is transacting with. In reality, corporate groups do not maintain clear financial boundaries. Limited liability incentivises asset shifting; intra-group assets can be taken from one entity to the other to the detriment of creditors.[492] To limit this kind of misbehaviour, the creditors will then incur more costs of monitoring.[493]

A frequent practice within corporate groups is to arrange intra-group guarantees,[494] which should reduce the uncertainty of asset shifting and, simultaneously, the information costs of creditors. However, intra-group guarantees can be problematic and enhance the downsides promoted by limited liability. First, guarantees can dilute the recovery of involuntary tort creditors because they cannot adjust their claim against the security interests encumbering the subsidiaries' assets or other contractual creditors who are unaware of the arrangements the group is involved in.[495] Second, Squire argues that with intra-group guarantees, the financial boundaries of the separate legal entities are irrelevant as the secured creditor's pay-out will depend on the assets of the entity involved and the entity guaranteeing the credit, leading to the creditor having to monitor each member involved in the guarantee.[496] Therefore, the practice ultimately defeats the purpose of limited liability in corporate groups.

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[489] See 2.1.4.
[490] Richard A. Posner, 'The Rights of Creditors of Affiliated Corporations' (1975) 43 University of Chicago Law Review 499, 516-517.
[491] ibid.
[492] Westbrook (n396).
[493] Known as agency cost of debt: see Jensen and Meckling (n81) 333.
[494] Squire, 'Strategic Liability in the Corporate Group' (n26) 615; Richard Squire, 'Shareholder Opportunism in a World of Risky Debt' (2010) 123 Harvard Law Review 1151, 1213, Kokorin (n406) 558.
[495] Kokorin (n406) 563.
[496] Squire, 'Strategic Liability in the Corporate Group' (n26) 643-644.

(iii) Diversification and Shareholder Passivity

Limited liability enables investors to manage their risk by reducing exposure to company-specific risks through the diversification of their shareholdings. As aforementioned,[497] following the separation of ownership and control within a company, limited liability benefits shareholders that have become passive investors or '*absentee*', i.e., risk-averse individuals who do not take part in the management of the company they invest in.[498] This argument assumes less importance in corporate groups. Leebron argues this objection by examining two types of corporate groups: subsidiaries in the form of integrated companies where they will have functions related to an integral part of the business of the group, and subsidiaries that are fully independent businesses with no commercial relationship among the other units.[499]

When considering these two categories, subsidiaries with integrated functions are not financially and commercially independent because the business investment will depend on all the units in the group working together; they do not provide a form of diversification of risk for parent companies.[500] Subsidiaries that are commercially independent entities could potentially provide shareholder diversification since having distinct businesses in a group could resemble a diversified investment portfolio. Yet, there are two problems with the claim. First, shareholder diversification through independent subsidiaries does not provide any superior performance on investment returns,[501] which indicates that shareholders can diversify better with other types of investments rather than investing in subsidiary companies. Second, shareholder diversification in the context of corporate groups is provided by the fact that the internal partitioning of the group reduces the investment's volatility by making the risks of one subsidiary's business have no effect on the others. [502] This can only happen if groups do not engage in practices that link together the activities of the group, such as resource sharing, intra-group lending, and guarantees, which is unusual.[503]

Moreover, limited liability is needed for passive investors who are risk-averse. Parent companies are not passive investors in their subsidiaries. In corporate groups, there is no clear separation between ownership and control; parent companies will always control their

[497] See 2.1.4.
[498] Blumberg, 'Limited Liability and Corporate Groups' (n1) 612.
[499] Leebron (n1).
[500] ibid 1617.
[501] R. Hal Mason and Maurice B. Goudzwaard, 'Performance of Conglomerate Firms: A Portfolio Approach' (1976) 31(1) The Journal of Finance 39, 45-46.
[502] Hansmann and Squire (n391) 262.
[503] ibid.

subsidiaries, either through ownership linkages or other control-enhancing mechanisms.[504] Whether they are also risk-averse investors or not is subject to academic debate. Hansmann and Kraakman argue that the parent company *qua* shareholder is neither risk-averse nor a passive shareholder.[505] It is more likely to be risk-neutral[506] and able to diversify the risk of investment without the need for limited liability as a result of three conditions: (i) parent companies may hold more total assets compared to the subsidiary company exposed to a liability; (ii) they diversify by having several subsidiaries with uncorrelated risks, thereby reducing the aggregate risk of the group; and (iii) when they are publicly traded companies, their own diversified shareholders will reduce investment risks.[507] Empirical studies show that there is a positive correlation between ownership and risk-taking,[508] meaning that larger shareholders take more risks, which is consistent with the argument above that parent companies are more risk-neutral. However, other studies have presented evidence that groups with subsidiary structures are more risk-averse.[509]

Regardless of whether the parent company is more risk-averse or risk-neutral, this section thus far has proven that limited liability for corporate shareholders in business groups has no real conceptual justification, and hence it is not always needed. From a broader perspective, limited liability in this context is not socially desirable due to its incentive to externalise costs, leading to an over-investment in risky activities.[510] This premise adds additional weight to the argument that there is a need to revisit the corporate form to address the potential for harm being incentivised by UK company law. The use of the corporate form in corporate groups is controversial because it allows parent companies to benefit from the unity of the group structure when advantageous yet rely on the legal separation of entities to shield themselves from liabilities when risks manifest. This exacerbation of externalities particularly harms unsecured tort creditors. Therefore, the findings in this section support the claim that company law should remedy the issues it creates and recognise the unique dynamics of corporate

[504] See 3.5.
[505] Hansmann and Kraakman, 'Toward Unlimited Shareholder Liability for Corporate Torts' (n2) 1882.
[506] Although they are actually risk averse, by limiting their liabilities via the use of multiple legal entities, limited liability and its advantage of diversification make them act as if they were risk neutral because uncorrelated volatility within the businesses owned will not relate to a general high volatility of their overall investment - which will boost their private returns and limit their financial losses/ risks.
[507] Hansmann and Kraakman, 'Toward Unlimited Shareholder Liability for Corporate Torts' (n2) footnote 6.
[508] This study claimed that diversified owners in the banking sector take more risks: see Luc Laeven and Ross Levine, 'Bank governance, regulation and risk taking' (2009) 93(2) Journal of Financial Economics 259.
[509] Teodora Paligorova, 'Corporate Risk Taking and Ownership Structure' (2010) Bank of Canada Working Paper 2010-3, 3 <https://www.econstor.eu/bitstream/10419/53851/1/618958037.pdf> accessed 11 May 2024.
[510] See Bebchuk and Fried, 'The Uneasy Case for the Priority of Secured Claims in Bankruptcy' (n348) 900; Hansmann and Kraakman, 'Toward Unlimited Shareholder Liability for Corporate Torts' (n2) 1883.

groups. This thesis argues the need to understand corporate groups as legal-economic *phenomena*. To do so, it is necessary to understand the economic dynamics working within corporate groups, how they relate to the legal principles, and what scholars can do with this knowledge.

3.4. The Economic Dynamics

To fully understand corporate groups, it is essential to explore their economic dynamics for two reasons. First, economic theories offer an insight into why corporate groups exist and how they pursue expansion in the market. This perspective is expanded with the use of the legal principles detailed in chapter 2. Both economic and legal principles help us identify the reasons why a business is structured into separate legal entities within a co-ordinated structure. Secondly, once it is clear how the economic theories relate to corporate groups, it will be more straightforward to integrate an economic outlook into the re-evaluation of the conception of the corporate form.[511] The legal corporate group structure escalates the incentives to externalise risk due to the compounded effect of using multiple corporate forms, protecting the parent company's investment and granting them exponential benefits. The economic dynamics of corporate groups also contribute significantly to this risk of externalisation. Corporate groups exploit both legal and economic principles to expand and gain more benefits with fewer repercussions. By leveraging economic principles, corporate groups can optimise their operations and reduce costs. However, these strategies, combined with legal principles, enable parent companies to compartmentalise and isolate risks within specific subsidiaries, externalising liabilities onto third parties by diverging economic and legal boundaries. This structural advantage allows parent companies to direct and benefit from the group's operations while limiting their liability and minimising their exposure to the negative consequences of their subsidiaries' actions. Understanding these dynamics is essential for a comprehensive legal analysis of corporate groups. It reveals how the interplay between legal and economic principles facilitates the externalisation of risk. And by recognising corporate groups as legal-economic *phenomena*, we can better limit their impact on third parties and develop more effective regulatory frameworks.

This section will rely heavily on the writings of Alfred Chandler and Ronald Coase. The reason for it is that these two writers dominated, respectively, the fields of business history and economics.[512] Their insights, although subject to modern academic debate, are still widely

[511] See ch 6.
[512] See Witting, *Liability of Corporate Groups and Networks* (n22) 23: '*their views* (…) *have attracted widespread acceptance*.'

adopted and used as the basis for corporate group research.[513] Generally, corporate groups achieved both organic and inorganic growth[514] by adding new operating units to their structure, each with its own legal form but with different economic functions, located in several geographic areas, and in charge of different lines of business.[515] From an economic perspective, growth results from economising on transaction costs.[516] During both the second and third industrial revolutions, from the onset of capitalism and globalisation to today's economy, the pursuit of growth strategies has remained the same.[517] Notwithstanding technological advancements and changes in the market, the presence and permanence of corporate group structures stem from their ability to adapt to changing external circumstances.[518]

Corporate groups organise economic activities at a mesoeconomic level, which means that they exist between microeconomics and macroeconomics. They operate more collectively than individual companies, but on a smaller scale than economies.[519] The implication of mesoeconomics is that corporate groups can avoid transaction costs of the market that microeconomic firms experience, which means that costs are prevented by internalising market imperfections related to intermediate outputs in the market.[520] Moreover, corporate groups can achieve further savings and pursue growth by exploiting economies of scale and scope, internalisation, and diversification strategies.[521] Therefore, these strategies will be discussed to understand the economic dynamics present in corporate group structures. They expand the idea of legal boundaries as the overall economic activity can extend beyond and diverge from individual entities, exacerbating risk externalisation.

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[513] Whittington and Mayer (n443) 23-46; Oliver E. Williamson, 'The Modern Corporation: Origins, Evolution, and Attributes' (1981) 19 Journal of Economic Literature 1537; Geoffrey Jones and Jonathan Zeitlin, *The Oxford Handbook of Business History* (Oxford University Press 2008) 171-193; Luis Dau, Randall Morck and Bernand Yeung, 'Business groups and the study of international business: A Coasean synthesis and extension' (2021) 52 Journal of International Business Studies 161, 174.

[514] Inorganic growth is achieved through mergers and acquisitions, alliances, and partnership, thus creating a subsidiary: see Angel G. Basteiro, *Strategy in Action A Holistic Management Strategy Framework to Navigate Businesses and Multinational Organizations* (Springer 2022) 79. Organic growth is achieved by setting up new companies as subsidiaries. See Karsten Sørensen, 'The governance of company groups' (2021) OECD Corporate Governance Working Papers No. 22, 5 <https://doi.org/10.1787/6302f79a-en> accessed 11 May 2024.

[515] Alfred D. Chandler, *Scale and Scope: Dynamics of Industrial Capitalism* (Harvard University Press 1994) 15.

[516] Williamson, 'The Modern Corporation: Origins, Evolution, and Attributes' (n513) 1540.

[517] Anker-Sørensen (n20) 48, 58.

[518] Jones and Zeitlin (n513) 183.

[519] Dau, Morck and Yeung (n513) 174.

[520] C. Paul Hallwood, *Transaction Costs & Trade Between Multinational Corporations* (Routledge 1990) 68-69.

[521] Chandler (n515) 17.

Economies of scale and scope

The organisational capability of companies, which transforms the use of their facilities and skills - for instance, internal knowledge and technology - into large quantities of products with lower costs,[522] is the main advantage generated by the economies of scale adopted by companies expanding in the market.[523] Corporate groups often operate globally or on a large scale, due to the fact that producing significant outputs generates economies of scale and consequently lowers the cost of production or distribution.[524] In hierarchical or vertically integrated groups, economies of scale are achieved through the control of inputs, which in most cases are financial capital.[525] Parent companies may act as a key party in financing the operations of their subsidiaries,[526] and commonly, the group will adopt a system of intra-group guarantees to borrow funds externally that is simultaneously able to reduce the costs of raising finance when the guarantee comes from the parent company.[527]

The theory of "scale" generated big businesses and groups of companies, insofar as it dictates that cost reductions will depend on the capacity of production and the intensity of the capacity utilised.[528] In other words, smaller companies or companies that do not produce at large volumes cannot reach lower costs through expansion. Therefore, it follows that exploiting scale will also vary from industry to industry. For instance, historically, it is possible to witness certain industries that have been able to grow extensively because of "scale", such as chemicals, automobiles, or telecommunications.[529]

Corporate groups adopt both economies of scale and scope, as the two are equally related to the efficient use of facilities and skills within a company.[530] Whereas scale is achieved by producing more of the same output, scope reduces costs by producing different outputs in the same firm - or in the same group - by having several companies carry out distinct operations.[531] This means that a company (or group) can use its production capability for more than one

[522] See Jones and Zeitlin (n513) 78-79.
[523] Chandler (n515) 18.
[524] Knut Blind and Jo-Ann Muller, 'Why corporate groups care about company standards' (2020) 58(11) International Journal of Production Research 3399, 3399.
[525] Ingo Pies and Peter Koslowski, *Corporate Citizenship and New Governance* (Springer 2011) 139.
[526] Witting, *Liability of Corporate Groups and Networks* (n22) 32.
[527] Intragroup guarantees lower the interest rates on the companies' loans and therefore increase shareholder opportunism. In addition, they result also in overusing the corporate form and consequentially creating new subsidiaries because it is required to have an entity with limited liability to partition assets whose shifts in value are linked: see Squire, 'Strategic Liability in the Corporate Group' (n26) 619, 644.
[528] Chandler (n515) 24.
[529] Whittington and Mayer (n443) 51.
[530] Chandler (n515) 18.
[531] Williamson, 'The Modern Corporation: Origins, Evolution, and Attributes' (n513) 1547.

product. Corporate groups use "scope" as strategic planning; by deciding the size and jurisdiction of the different units within the group, they will achieve a specific and unified corporate purpose and will use as a platform the organisational links available.[532] Therefore, scope ultimately has an effect on the direction and internal control relationships of the group.

While the economies of scale and scope can lead to overall growth for the group, combined with legal principles, they also contribute significantly to the externalisation of risk. Corporate groups can decide to maintain their (legal) boundaries when beneficial, i.e., isolate risks in single legal entities, and converge their economic boundaries, by leveraging economic dynamics, when they need it, e.g., intra-group guarantees and alignment of group objectives. This flexible use of economic advantages and legal principles allows parent companies to externalise the potential risks to third parties and decide when they will remain shielded from the liabilities.[533] By adopting economies of scale and scope, corporate groups decide how and where to draw their operational boundaries. When particularly risky activities can be assigned to specific companies within the group, the potential liabilities under the law are then confined to that subsidiary. Moreover, economies of scope encourage diversification, using existing production, facilities, and personnel to enter new markets or develop new products[534] - another tactic that reinforces risk externalisation. This strategy, along with its implications, will be explored below.

Diversification

From an economy-of-scope perspective, diversification is resource-based. It assumes that a company is an "efficient"[535] organisation of economic activities and possesses excess capacity of resources and skills that are transferable amongst different industries.[536] Of course, the final product is the result of the organisation of the company, but the product itself is only one of several ways to use the company's internal resources; in fact, there could be a variety of products. Thus, companies are not specialised to a particular output, and the economies of specialisation, based on this notion, refer to the general capability of the company and not to the specificity of its products.[537]

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[532] Anker-Sørensen (n20) 147-149.
[533] For example, parent companies can decide to pool liabilities when cross-liability arrangements are present.
[534] Chandler (n515) 38-39.
[535] There is a debate on whether a company is an efficient organisation, or diversification follows from unused excess resources, on which, see David J. Teece, 'Towards an economic theory of the multiproduct firm' (1982) 3(1) Journal of Economic Behavior & Organization 39, 47-48.
[536] John Martin and Akin Sayrak, 'Corporate diversification and shareholder value: a survey of recent literature' (2003) 9(1) Journal of Corporate Finance 37, 40.
[537] Teece (n535) 46.

Diversification as a source of growth requires organisational change.[538] Although both large individual companies and corporate groups employ diversification and exploit the economies of scale and scope, corporate groups are fundamentally different as they are organised by incorporating new companies that engage in distinct lines of business. The choice of structuring the group by setting up new diversified entities depends on several factors. However, the literature highlights two primary factors influencing that choice. The first is proposed by Ayotte and Hansmann. They argue that organising activities into separate legal entities, such as in the case of corporate groups, facilitates the transferability of contractual rights and is the predominant way to achieve transferability; in particular, related contracts can be bundled and transferred together through the use of legal entities.[539] The second was proposed by Bethel and Liebeskind, who explain that diversified companies are organised in corporate groups as a matter of *legal* organisation, which confers the benefits of, amongst others, economising on transaction costs and limited liability; more specifically, it protects from exposure to tort liability.[540] This thesis has emphasised that a combination of legal and economic principles are adopted in group organisation. Parent company limited liability is the motivating force of corporate group structure as it protects parent companies from liability and facilitates asset partitioning.[541]

There are also other economic benefits of diversifying via a group, such as sharing costs and benefits amongst all the companies within it, reducing costs by allocating resources more efficiently,[542] or not being subject to the economic cycle. Specifically, the latter helps groups avoid fluctuations in their total sales throughout the year and generates a stable and new source of income.[543] Moreover, considering the life-cycle hypothesis, the more a company matures, the more it will pursue growth to become a multiproduct firm.[544]

As Chandler noted, the stimuli for diversification can be found both internally and externally of companies. External stimuli emanate from a changing market environment, with technological advancements, demographic shifts, etc.[545] Internal incentives derive from an excess of

[538] Jennifer E. Bethel and Julia P. Liebeskind, 'Diversification and the Legal Organization of the Firm' (1998) 9(1) Organization Science 49, 51-52.
[539] Kenneth Ayotte and Henry Hansmann, 'Legal Entities as Transferable Bundles of Contracts' (2013) 111(5) Michigan Law Review 715, 722.
[540] Bethel and Liebeskind (n538) 58.
[541] See ch 2 and 3.
[542] Rejie George and Rezaul Kabir, 'Heterogeneity in business groups and the corporate diversification-firm performance relationship' (2012) 65(3) Journal of Business Research 412, 413.
[543] Witting, *Liability of Corporate Groups and Networks* (n22) 31.
[544] Dennis C. Mueller, 'A Life Cycle Theory of the Firm' (1972) 20(3) The Journal of Industrial Economics 199, 208; Henry G. Grabowski and Dennis C. Mueller, 'Life-Cycle Effects on Corporate Returns on Retentions' (1975) 57(4) The Review of Economics and Statistics 400, 401.
[545] Chandler (n515) 40.

resources, both physical and human capital, that can be placed into employment.[546] Furthermore, they also derive from a changing condition in the company's demand curve that allows diversification into other markets to pursue growth and reduce transaction costs.[547]

Corporate groups capitalise on the economic benefits of diversification, such as improved resource allocation and stable income from different markets, while simultaneously externalising the risks associated with potentially harmful activities to third parties. By integrating distinct legal entities for different business operations, corporate groups can isolate liabilities within specific subsidiaries. The corporate group structure reflects the tension between economic unity and legal independence. Economically, the group often functions as a single enterprise, pooling resources, coordinating strategies, and using economic principles to achieve overall growth and expansion. However, legally, the group is fragmented. Each entity within the group retains its own legal personality, with separate pools of assets and liabilities. This duality enables the corporate group to maximise the economic benefits, while selectively enforcing legal boundaries to consolidate risk isolation. The final form of efficiency resulting from the economies of scale and scope is internalisation, which will be explored below.

Internalisation

Transaction cost theory and internalisation further explain growth. While internalisation explains the links between innovation and production, transaction cost theory focuses on the links existing between one production facility and another.[548] The starting point is the British economist Ronald Coase, as both the transaction cost theory and internalisation are related to his theory of the firm. When a company expands and produces more outputs, on certain occasions, it will be more costly for it to rely on external market transactions for inputs. Therefore, for the business to expand in a more cost-efficient way, it will adopt the process of internalisation, which allows companies to remove transactions from the market and bring them within the organisation.[549] Coase explained the organisational capabilities of companies in relation to the notions of "firms" and markets. A "firm" is formed when a system of relationships is the result of the internal control and direction of resources capable of

[546] Teece (n535) 48-50.
[547] ibid.
[548] Mark Casson, *The Multinational Enterprise* (Edward Elgar 2018) 210-211.
[549] According to Coase, economic organisation refers to the idea that firms, in contrast to markets, result from coordination through authority (internal structures). Therefore, firms are a system in which parties can coordinate their activities and efforts. On the one hand, economic organisation is related to the economic concept of "firm" as the former refers to the way in which a firm achieves its goal. On the other hand, "company" refers to the legal tool employed to conduct economic organisation. This distinction will be important for later discussion in ch 6.

internalising market transactions, and where markets are inefficient as they would result in higher transaction costs due to price discovery and contract arrangements for each transaction.[550] This means that whenever a firm can organise and carry out transactions internally at a lower cost, they will be internalised up to the point where the firm's costs will exceed its revenue. In layman's terms, if we bring transactions inside the firm, we can save on costs and have control over the sources required to produce a product or a service. An example is the General Motors (GM)-Fisher Body case.[551] Fisher and GM entered a contract in 1919 where Fisher agreed to supply car bodies to GM. When demand for GM's cars increased, Fisher met the demand but at a higher production cost, knowing that GM would cover it for lack of alternative. This led to significant transaction costs for GM, which, to reduce them, decided to vertically integrate by acquiring Fisher and bringing production inside the firm.

Although Coase's theory provides insights on the firm and how it comes into existence, it does not explain why transactions are economised in a hierarchical organisation.[552] Subsequently, Williamson revisited and extended Coase's theory, partly answering the question above. He argued that economising on transaction costs is influenced by behavioural factors and transaction features, such as the human nature of bounded rationality[553] and opportunism, and the dimensional aspects of transactions, namely frequency, uncertainty, and asset specificity.[554] With bounded rationality, Williamson proposes that the "organisation man" has limited computational competence, which makes economic exchange incomplete if organised by contract, while with opportunism, he realises that the "organisation man" is more complex motivationally.[555] In other words, there would be self-interest seeking with a tendency to misrepresent. At last, transactions are uncertain; whether they are more frequent, they would be less uncertain and similarly provide an incentive to economise. Asset specificity is the most important dimensional aspect of transactions. Due to the fact that specific assets require certain transactions and resources relevant for particular uses, the value of the products will decrease if the investments are used differently.[556] Hence, Williamson created a '*party-relevant transactions*' system,[557] where hierarchical organisations are fundamental to

[550] Ronald H. Coase, 'The nature of the firm' (1937) 4 Economica 386, 390-398.
[551] See Benjamin Klein, 'Vertical integration as organizational ownership: the Fisher Body-General Motors relationship revisited' (1988) 4 Journal of Law, Economics & Organization 199, 199.
[552] Abraham Singer, *The Form of the Firm: A Normative Political Theory of the Corporation* (Oxford University Press 2018) 60.
[553] Individuals and organizations have limited cognitive abilities and computational capacities to make decisions: see Oliver E. Williamson, 'The Economics of Organization: The Transaction Cost Approach' (1981) 87(3) American Journal of Sociology 548, 553.
[554] ibid 553.
[555] ibid.
[556] ibid 555-556.
[557] Singer (n552) 65.

attenuating these transactional features and there is a strong incentive to internalise market transactions.

Other scholars applied the transaction cost economics and internalisation approach to corporate groups specifically. For instance, Hennart, by citing the most relevant contributions to the field, proposed that multinational enterprises internalise market inefficiencies, and hierarchies[558] are formed when organising transactions[559] are more cost-efficient.[560] Furthermore, Buckley and Casson explained internalisation in terms of the transfer of knowledge flowing from innovation, reducing the costs of creating new knowledge.[561] Overall, the relevance of internalisation and the importance of the transaction cost approach have been reiterated throughout the literature. All the growth strategies underpinning the creation of corporate groups are significant considerations for their organisational capabilities and the decision to structure the economic activity as a group.

Corporate groups use subsidiaries to take advantage of economic organisational efficiencies and legal rules. Therefore, they should be understood and examined in the academic discourse as legal-economic structures. Economic theories are pivotal here because, while company law's narrative is that an economic activity begins and terminates within the boundaries of a legal entity, the application of economics highlights how much wider the horizons of the enterprise are. An economic activity can go beyond the boundaries of the corporate form; it is part of the whole enterprise or "firm", as labelled by economists. This wider perspective will be fundamental to the analysis in chapter 6, which will close the gap between legal and economic boundaries. The economic dynamics of corporate groups, intertwined with the legal principles of UK company law, provide benefits for the group while exacerbating the issue of risk externalisation. This creates a scenario where corporate groups can benefit from their structure and operate with minimal repercussions for the parent company while third parties bear the risks involved.

Legal and economic principles are essential for the structuring of groups. They will also dictate the methods of control employed by parent companies to benefit from the use of the corporate form at the expense of third parties. The following section will conclude the exploration of corporate group dynamics by evaluating the "hidden" and not-so-hidden forms of control

[558] Hierarchies is referred to by Hennart as methods of organisational control. See Jean-François Hennart, 'Theories of the multinational enterprise', in Alan M. Rugman (ed), *Oxford Handbook of International Business* (2nd edition, Oxford University Press 2009) 130.
[559] It includes both existing transactions and new capabilities.
[560] Hennart (n558) 129.
[561] Peter J. Buckley and Mark Casson, Future of the Multinational Enterprise (Palgrave Macmillan 1976) ch 2.

present in group structures to form an understanding of corporate groups that goes beyond the UK current legal framework.

3.5. Control in Corporate Groups

While the choice of organisational structure will depend on the industry and the desired degree of exercisable control over a company,[562] the separate incorporation of parent and subsidiary companies organised along hierarchical lines, which is the typical arrangement for traditional corporate groups, is now the predominant form of business in both the U.S. and Europe.[563] Control, in the sense of majority shareholding, is an important tenet to define the relationship between a subsidiary and parent company under UK law.[564] However, parent companies can achieve internal control, i.e., within the decision-making process of the subsidiaries, in two ways, namely through equity ties and other internal mechanisms.[565] Control structures are a key strategic consideration for corporate groups since they give parent companies the power to manipulate the decision-making process of a subsidiary, effectively having an influence on its board of directors, through taking an influential position in the subsidiary, *and* the use of group strategies, co-ordinated means, and corporate purposes.[566] While the former is relied upon to mitigate the issue of risk externalisation,[567] the latter is often overlooked. This section will argue that control in traditional corporate groups can rely on the group's internal mechanisms. The current concept of control under UK company law highlights a gap in the corporate group regulation that allows groups to use the corporate form to externalise risk.

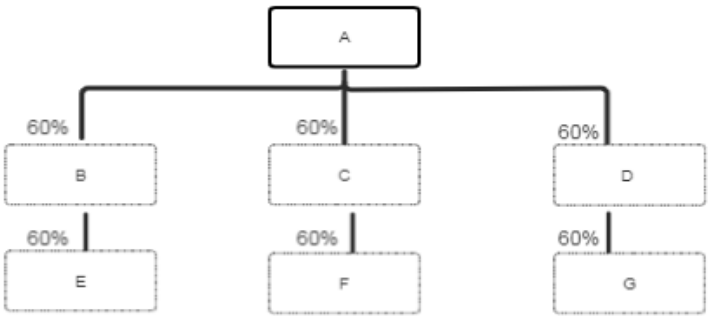
The test to determine control in UK company law relies mainly on the concept of equity-based control.[568] As such, UK company law provides a narrow conception of corporate group structures. The company law test ascertains the *de jure* - i.e., legal - control that a parent company may exercise to its subsidiaries by virtue of holding the majority of the voting rights in them and having the right to appoint or remove the majority of directors.[569] Being a shareholder awards the parent company the right to *influence* the board of its subsidiaries on fundamental issues, *inter alia* the election of the board, amending the subsidiaries' Articles of Association, and approving extraordinary transactions.[570] While parent companies have the

[562] Peter Muchlinski, *Multinational Enterprises and the Law* (2nd edition, Oxford University Press 2007) 66.
[563] Witting, *Liability of Corporate Groups and Networks* (n22) 37.
[564] CA 2006, s 1159(1)(a)-(c).
[565] Jones (n21) 172.
[566] Anker-Sørensen (n20) 39.
[567] See ch 4.
[568] CA 2006, s 1159(1)(a)-(c).
[569] ibid.
[570] See 2.1.3.

right to appoint[571] and remove the directors of their subsidiaries, the courts will treat in judicial decisions each director as acting for the company on which board they sit.[572] Due to the fact that they are regarded as *autonomous*, parent companies will achieve control through equity-based links but they will not directly *manage* groups[573] through the subsidiaries' board structures.

Equity-based control is manifested in parent companies holding both direct and indirect ownership in their subsidiaries. As shown in Figure Three, the parent company will directly control a number of subsidiaries, which in turn will own shares in other sub-subsidiaries, awarding the parent company indirect control of the latter. Consequently, immediate equity linkages from the parent company to the bottom-tier companies are not necessary to still have an influential position in all the companies.

Figure 3. Indirect Control



Equity-based control, formed by a majority of shareholding, is not an absolute definition of the concept of control. Indeed, a majority of voting rights or shareholdings allows the parent company to possess the power to influence subsidiaries. However, the equity-based shareholding present in traditional corporate groups is variable; it can take the form of both direct and indirect shareholding with a majority or less than a majority of voting rights. A direct control relationship refers to the ability of the parent company to control a subsidiary one-on-one, while indirect control is the capacity of the parent company to control affiliated entities further down the vertical structure through other equity-based links in more direct subsidiaries.[574]

[571] In the absence of any provision in the Articles of Association, which are chosen by the company's members. CA 2006, ch 2 para 65.
[572] A director of a subsidiary must act independently and in the best interest of the company of which he is a director: see *Thompson v Renwick Group plc* [2014] EWCA Civ 635, [2015] BCC 855 [24]-[25].
[573] This is relevant because management of subsidiaries' operations was an important factor in both *Vedanta* (n175) and *Okpabi* (n130) to extend liability. See 4.2.
[574] Muchlinski, *Multinational Enterprises and the Law* (n562) 65-73.

Parent companies can also own less than a majority of shareholdings, and coupled with shareholders owing different classes of shares grants *de facto* the same power.[575] For instance, a parent company may retain control of a subsidiary through issuing non-voting shares to other members, giving them a right to dividends but no right to vote.[576] Therefore, other shareholders could invest in subsidiary companies without having a say in their corporate decisions. The structure could also present forms of "hidden" control, where the parent company owns a minority stake in the subsidiary and the latter is formed by dispersed shareholdings. While at first shareholder ensemble appears dispersed, the structure can be one of intertangled ownership, which is usually the case in pyramidal and cross-holding groups.[577] Owning less than a majority of shareholdings intensifies the issue of risk externalisation because it gives parent companies further incentives to divert value from one entity of the group to another and engage in increased risks - given they will have limited financial exposure, and creditors will bear the losses of failed operations.

Internal group mechanisms can also maintain and establish control. Group structures are developed along two dimensions, horizontal and vertical linkages, and each has its internal mechanisms. The former refers to multiple sister entities affiliated with the group with differentiated roles. The latter refers to the connectedness between the ultimate owner, the parent company, and the associated sister entities through control of resources, creating vertical ownership. It follows that in corporate groups with a lower horizontal linkage, subsidiaries can be less interdependent among themselves. For instance, in a diversified business group all the companies will have common objectives but being in separate lines of business they may not have common strategies. Nonetheless, even in this case, corporate groups can increase their horizonal linkages when certain sister companies are able to access general competencies of the group regarding capital and information, generating stronger horizontal bonds in terms of group strategies.[578]

Therefore, parent companies can assume control via internal (group) governance. Strategic management by setting, for example, corporate strategies at the level of the parent company can complement organisational structuring. Alternative methods of control are the promulgation of group policies that subsidiaries adopt,[579] setting financial and operational

[575] Manovil (n433) 6.
[576] Derek French, *Mayson, French & Ryan on Company Law* (37th edition, Oxford University Press 2021) 149.
[577] Cross-holding groups are formed by entities which will all own a percentage of each other's shares. See Anker-Sørensen (n20) 98-99.
[578] Daphne W. Yiu and others, 'Business Groups: An Integrated Model to Focus Future Research' (2007) 44(8) Journal of Management Studies 1551, 1563.
[579] See Robert E. Hoskisson, Charles W.L. Hill and Hicheon Kim, 'The Multidivisional Structure: Organizational Fossil or Source of Value?' (1993) 19(2) Journal of Management 269, 274.

targets,[580] input of knowledge, and incentives to subsidiaries' managers.[581] The non-equity ties in the concept of control provide a more complete picture of how the entities forming a group interact with each other and control can be exercised in a myriad of ways. In certain specific circumstances, UK company law recognises that control can go beyond equity ties; however, the impact of these are modest and are not meant to respond to the issue of risk externalisation of the corporate form.[582] For example, to enhance corporate transparency, UK-registered companies have to maintain a public register identifying persons with significant control (PSC) in the company.[583] A person with significant control is a person that meets one or more of the five specified conditions in the Companies Act 2006 and it can be a company or a legal entity.[584] In addition to equity ties, the PSC regime adds the power to exercise significant influence or control over the legal entity.[585]

Significant influence and control are defined through statutory guidance with the latter indicating the right to direct the policies and activities of a company, and the former defined as ensuring that the company adopts the policies and activities desired.[586] The guidance is non-exhaustive;[587] however, it provides some examples that would catch parent-subsidiary governance dynamics, such as: adopting or amending the company's business plan, changing the nature of the company's business, making additional borrowing from lenders, or establishing or amending any profit-sharing, bonus or other incentive scheme of any nature for directors or employees.[588] The PSC conditions broadly match the test for establishing the parent and subsidiary undertaking relationship for accounting purposes.[589] Under both, in addition to the equity ties, we also find non-equity principles. Under section 1162 of the Companies Act 2006, an undertaking is a parent undertaking if it has the right to exercise a dominant influence[590] over another undertaking. The dominant influence can be exercised by giving '*directions with respect to the operating and financial policies of that other undertaking*

[580] Witting, *Liability of Corporate Groups and Networks* (n22) 37-38.
[581] Robert F. Freeland, 'The Myth of the M-Form? Governance, Consent, and Organizational Change' (1996) 102(2) American Journal of Sociology 483, 487.
[582] Witting, *Liability of Corporate Groups and Networks* (n22) 205-212.
[583] Department for Business, Innovation and Skills, *The Register of People with Significant Control* (2015), 3.
[584] CA 2006, s 790C(2),(6)-(7).
[585] CA 2006, sch 1A para 1.
[586] Department for Business, Energy, and Industrial Strategy, *Statutory Guidance on the meaning of "significant influence or control" over companies in the context of the Register of People with Significant Control* (2017), 5-6.
[587] ibid 3.
[588] ibid 5.
[589] CA 2006, s 1162(2).
[590] CA 2006, s 1162(4).

which its directors are obliged to comply with whether or not they are for the benefit of that other undertaking',[591] or by virtue of being managed on a unified basis.[592]

While these two tests expand the idea of "control" beyond shareholding relationships, they are not aimed specifically at corporate group externalisation towards unsecured tort creditors. The PSC regime is aimed at enhancing transparency and being a deterrent to tax evasion and money laundering.[593] It does not provide a direct mechanism through which the rigid legal entity approach can be disregarded in the case of externalisation towards unsecured tort creditors, nor does it tackle the incentives for corporate groups to cherry-pick the legal structure that benefits them the most.[594] Additionally, the parent and subsidiary "undertaking" definition is used only for financial and accounting purposes as a transposition of the EU Accounting Directive.[595] The term "undertaking" is used in these circumstances because subsidiary businesses for the purpose of group accounts could include a company or some other body corporate.[596] The term does not define control for the purpose of drawing the group boundaries and its liabilities. While the concept of "control" is essential for corporate groups, allowing them to economically operate as a unified enterprise, UK company law grants them the flexibility to choose the type of control within their structure without addressing its impact on the externalisation of risk. In other words, UK company law permits corporate groups to determine how to draw their boundaries and assumes that the economic and legal realities will align when ascribing liabilities.

3.6. Conclusion

This chapter answered the third research question of this thesis, namely whether and how corporate group structures intensify the issue of externalisation of risk. Corporate shareholders receive advantages from the use of corporate forms in group structures to externalise risk. The internal partitioning between a parent company and its subsidiary raises fairness concerns in respect of unsecured tort creditors. UK company law is the source of the incentives encouraging risk externalisation without providing a remedy. It is in effect withdrawing its help in regulating the company's legal framework. This chapter discussed the shortcomings and theoretical underpinnings of the use of the corporate form in groups at the

[591] CA 2006, sch 7 para 4.
[592] ibid para 4(3).
[593] Department for Business, Innovation and Skills, *The Register of People with Significant Control* (2015), 4.
[594] Jonathan Hardman, 'The butterfly effect: Theoretical implications of an apparently minor corporate transparency proposal' (2021) 50(4) Common Law World Review 180, 190.
[595] Council Directive 2013/34/EU of 26 June 2013 on the Annual Financial Statements, Consolidated Financial Statements and Related Reports of Certain Types of Undertakings [2013] OJ L182/19.
[596] CA 2006, s 1161(1).

expense of third parties. Corporate groups are a complex topic, involving legal, economic, and managerial considerations. Traditional groups consist of a parent company controlling subsidiaries through equity linkages and internal mechanisms. Whilst hierarchical shareholding defines their legal boundaries, it does not delimit the boundaries of the economic activity. This means that parent companies are incentivised to bring the main economic activity outside the boundaries of a singular corporate form to shield assets from liabilities and leaving unsecured creditors with limited recourse. Therefore, corporate groups highlight an important gap in UK company law - i.e., remedying the exploitation of the corporate form by shareholders, creating a discrepancy between the legal entity and the business. In addition to the "mainstream" incentives that company law provides to individual shareholders, parent company shareholders have the additional advantage of corporate ownership and control, which together render parent companies able to have an influential position and control the group without necessarily exerting control as recognised by the law. This also augments the risk externalisation and misalignment between the corporate and organisational forms. The next chapter will investigate the ostensible mitigations provided by UK law to address the relationship between shareholders and the legal entity to remedy the misalignment of the corporate form and provide remedies to third parties. The chapter will argue that the role of company law now becomes crucial.

Chapter 4- Problems with The Ostensible Mitigations

4. Internalising Externalities - The Current Legal Frameworks

Companies' negative externalities affecting uninformed and involuntary creditors are a problem in company law. Yet, commentators are reluctant to acknowledge this issue and to have company law take a leading or any role in resolving it.[597] This chapter will answer the fourth research question regarding the effectiveness of UK company law in addressing the externalisation of risk it creates; then, it will argue why there is a problem in leaving other areas of law to remedy its mistakes. The purpose of this chapter is to evaluate how various parts of the legal taxonomy have treated the issue of externalities of the corporate form within groups of companies. UK law offers some exceptions to the limited liability of parent companies *qua* shareholder and legal remedies for creditors to exercise if shareholders and directors have used the corporate form for their benefit at the expense of third parties.

The argument proposed here is that all these existing remedies - or ostensible mitigations - are either ineffective or not entirely applicable to the corporate group context. This is because the mitigations to the issue of externalisation proposed both in company law and other areas of law are not aimed at restricting the use of the corporate form - the internal cluster of relationships - within the organisational form. They are aimed at resolving something outside of the business structure, which does not involve a careful consideration of the internal dynamics. In contrast, the analysis so far has identified the internal environment as the cause of the external issue. It is the use of the corporate form in a group and the orthodox philosophy of upholding the legal entity principles that are at the heart of risk externalisation. Thus, tackling only the external effect without looking at the internal organisation, formed by the economic unity of the group, will result in a flawed analysis. Without addressing the root cause - the internal organisation and its legal framework - the external remedies will be insufficient and ineffective.

The legal approaches, which try to mitigate risk externalisation, and are available in the UK, can be separated into internal and external remedies. Internal to company law, we find the common law doctrine of veil-piercing, general creditors' protections that are available to all companies incorporated in the UK, and, with more relevance to parent companies, personal liability of *de facto* or shadow directors. There are various areas of the legal taxonomy trying

[597] See Hansmann and Kraakman, 'Toward Unlimited Shareholder Liability for Corporate Torts' (n2): shareholder liability is a problem of tort law rather than company law; Mendelson (n2): the proposed solution to shareholder limited liability is a change in the liability regime under tort law; Witting, *Liability of Corporate Groups and Networks* (n22): tort law should be used because company law adopts the entity as the basic unit of responsibility and the entity principles are fundamental.

to mitigate externalities, such as competition and human rights law,[598] and these laws have developed targeted mechanisms to extend corporate group liability in their respective domains and address specific harms. However, the focus of this thesis is on the externalisation of risk towards unsecured tort creditors, a specific issue that these other legal frameworks do not directly address. As such, the most important external mitigation to investigate is tortious liability via a direct duty of care. This is because it aligns with the focus of the thesis, namely providing a solution to the "disadvantaged" third parties harmed by the misalignment between corporate and organisational forms.

As the chapter will show, veil-piercing is a flawed doctrine with strict requirements, it rarely applies in the case of corporate groups and relies disproportionately on the legal entity view of companies.[599] Creditors' protections in UK company law aim at safeguarding third parties that would be affected by the opportunistic behaviour of shareholders in using the legal entity for their own benefit. Their effectiveness is debatable, which goes back to the main point of this thesis, namely that company law should set its own house in order and deal with the issues it creates. The misalignment between the separate legal personality and the economic activity conducted by the corporate group can only be remedied by UK company law focusing on the realignment of the two. As for legal capital rules, they have a trivial effect on unsecured tort creditors. Directors' duties and liabilities either do not apply to parent companies or present challenges in their application. Lastly, the direct duty of care could appear as a promising venue to scholars.[600] This is because recent decisions have confirmed parent company duties towards stakeholders.[601] Nevertheless, the courts exercised a factual analysis of the case at hand, which promoted a narrow definition of control from a theoretical perspective. When compared to the multitude of structures and strategies parent companies adopt to steer and influence the operations of their subsidiaries, this analysis is problematic.

[598] See for example competition law, where corporate groups are treated as single economic entities and companies are held jointly responsible: Case C-550/07 *Akzo Nobel Chemicals Ltd and Akcros Chemicals Ltd v. Commission* [2010] EU:C:2010:229 and Case C-434/13 *Commission v Parker Hannifin* [2014] EU:C:2014:2456; and regarding human rights: Modern Slavery Act 2015, s 54, covering disclosure of slavery and human trafficking for any part of the business or supply chains.
[599] The structure of the organisational form, by itself, is not sufficient, according to the courts, to impose liability on parent companies: see *Adams v Cape* (n94), 544.
[600] See generally Cees van Dam, 'Breakthrough in Parent Company Liability' (2021) 18(5) European Company and Financial Law Review 714.
[601] Carrie Bradshaw, 'Corporate Liability for Toxic Torts Abroad: *Vedanta v Lungowe* in the Supreme Court' (2020) 32 Journal of Environmental Law 139, 147.

4.1. Internal Solutions in Company Law

4.1.1. Veil-piercing

This sub-section will discuss the common law doctrine adopted to extend liability to parent companies under UK company law. Veil-piercing is an exception to the principle of separateness promoted by separate legal personality and limited liability. The courts can, in certain circumstances, scrutinise the relationship between the legal entity and its shareholders and decide to disregard this separation. Essentially, it is a potential mitigation to the issue of externalities generated by the corporate form within a group. It could extend liability to the parent company to compensate third parties negatively affected by the activities of a subsidiary. However, the doctrine is full of confusion, which is reflected in the inability of the courts to agree to each other's rationales.[602] This sub-section will evaluate the general doctrine of veil-piercing under UK common law and its applicability to the corporate group context. It will address first its theoretical challenges and then the issues generated by its requirements.

Veil-piercing in Corporate Groups

Veil-piercing faces theoretical challenges, rendering the doctrine an ineffective remedy to the problem of externalities. The confusion of the UK legal entity view regarding the intersection of separate legal personality and limited liability translates into when and how courts pierce the corporate veil. In turn, even the definition and the purpose of veil-piercing itself have led to a misleading conception of separate legal personality and limited liability. It is said that veil-piercing seeks to remove or ignore three features of incorporated companies, namely entity shielding, limited liability, and separate legal personality.[603] There is only one UK instance to date that distinguishes between veil-piercing used as a doctrine to extend the entity's liability to the shareholders and to impose liability on the company for the acts of shareholders.[604] The distinction was cited in *Hurstwood*[605] to identify the directions in which courts can pierce the corporate veil, but the Supreme Court in this instance did not analyse or engage in the theoretical differences between the two.[606] While the Court expressed its doubt on the

[602] Alan Dignam and Peter B. Oh, 'Rationalising Corporate Disregard' (2020) 40(2) Legal Studies 187, 189.
[603] Cabrelli (n214) 356.
[604] The former should be described as "forward veil-piercing" and the latter as "reverse veil-piercing".
[605] *Hurstwood* (n271) [68].
[606] Deniz Canruh and Alan Dignam, 'Into Reverse: Redesigning Veil Piercing' (2023) Queen Mary Law Research Paper No. 401/2023 <https://dx.doi.org/10.2139/ssrn.4375911> accessed 22 July 2024.

existence of veil-piercing as a doctrine to extend the entity's liability to the shareholders, it refrained from reaching any final view on the matter.[607]

Predominantly, the courts and commentators seem to apply the logic that the characteristics of the corporate form are all interconnected to the extent that once the company's separate personality is denied, courts are allowed to disregard the corporate form and extend liability to persons who own and control the company.[608] For instance, the UK Supreme Court stated that piercing the corporate veil is in effect disregarding the company's separate legal personality in certain circumstances.[609] However, this logic is flawed. Separate legal personality and shareholder limited liability are two separate and distinct features of the corporate form.[610] Therefore, veil-piercing is theoretically unclear. It is also rarely used. UK courts have the power to extend liability through this doctrine, albeit the lack of successful cases[611] adds to the uncertainty of whether there is an established test for its application. In fact, veil-piercing law has been described as '*exceptionally messy*'[612] and '*confused*'.[613] This section will first review the most important case law regarding the doctrine and then provide a doctrinal analysis that will address why veil-piercing is of little use in tackling the issue of risk externalisation of corporate structures.

The majority of veil-piercing cases have either been disapproved when they reached the UK Supreme Court[614] or subjected to alternative explanations,[615] leading to uncertainty and inconsistency as to whether courts agree on the corporate disregard.[616] It follows that the cases of importance are the ones that deal with whether the doctrine is even part of English law at all. *Prest v Petrodel*[617] is the leading authority in the field,[618] and the judgment delivered in this instance aimed to resolve the confusion surrounding the veil-piercing doctrine. The case

[607] *Hurstwood* (n271) [72].
[608] Davies and Worthington, *Gower: Principles of Modern Company Law* (n9) 340; Brenda Hannigan, *Company Law* (6th edition, Oxford University Press 2021) para 3.14.
[609] *Prest* (n262) [16].
[610] See ch 2.
[611] Dignam and Oh, 'Disregarding the *Salomon* Principle: An Empirical Analysis, 1885–2014' (n465) 31; Dignam and Oh, 'Rationalising Corporate Disregard' (n602) 197.
[612] Sarah Worthington and Sinead Agnew, *Sealy & Worthington's Text, Cases, and Materials in Company Law* (12th edition, Oxford University Press 2022) 35.
[613] Dignam and Oh, 'Disregarding the *Salomon* Principle: An Empirical Analysis, 1885–2014' (n465) 18.
[614] Several were criticised in *Prest* (n262) [31]-[32], such as *Gencor ACP Ltd v Dalby* [2000] 2 BCLC 734 (Ch) and *Trustor AB v Smallbone* (No 2) [2001] EWHC 703, [2001] 2 BCLC 436.
[615] Witting, *Liability of Corporate Groups and Networks* (n22) 315.
[616] Dignam and Oh (n602) 189.
[617] *Prest* (n262).
[618] It is a '*pivotal modern authority*': Witting, *Liability of Corporate Groups and Networks* (n22) 314.

was considered in *Hurstwood*,[619] which neither abolished nor clarified its reasoning. *Prest*[620] was concerned primarily with the allocation of a matrimonial home which was the property of one of the companies owned by Mr Prest. Consequently, the Supreme Court was asked to pierce Petrodel's veil, and the decision was delivered with a re-statement of the law on veil-piercing.

Lord Sumption in his judgment distinguished the justifications of the doctrine into two principles and, accordingly, narrowed its scope. The only two principles, he mentioned, upon which the courts are justified in looking behind the corporate veil are the evasion and concealment principles. However, only one of them represents the "true" form of veil-piercing. The concealment principle allows courts to identify who the real actors are, which means that companies in this sense are a façade to conceal certain personal liabilities.[621] The principle involves using a legal entity to conceal the real parties of a transaction, such as when a director would use the company to receive a payment that is in reality intended to be received by him.[622] Although according to this principle the law will look at the persons behind the corporate veil to attribute liability, it does not in fact disregard the separate legal personality of the company and hence it does not involve veil-piercing.[623] This is because liability exists regardless of the corporate entity. The company is simply used to conceal the true facts, but it does not involve the abuse of the corporate form to evade an existing liability.

Lord Sumption argued that the evasion principle alone justifies piercing the veil since it applies when there is an abuse of the corporate form via the evasion of existing legal obligations or liabilities.[624] In this instance, the separate legal personality of a company gives an advantage to the individual who circumvents a pre-existing liability or obligation by interposing the company in-between him and that liability or obligation.

The Court, evidently, wanted to restrict the principle of veil-piercing, but there are various logical flaws in the language used in the judgment leading to the dominant view of equating separate legal personality and limited liability. By trying to control the abuse of the corporate form with the creation of reasons to justify disregarding the separate legal personality of companies, we are simply adding confusion to legal concepts and blurring their boundaries.

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[619] *Hurstwood* (n271). Canruh and Dignam have referred to *Hurstwood* as the '*Schrodinger's Judgment*' where veil piercing both is and is not a legal doctrine. The Court expressed doubts on whether there is a doctrine capable of extending the entity's liability to shareholders and scepticism towards the "evasion principle". However, the Court proceeded to assess the application of the *Prest* (n262) to the facts at hand: Canruh and Dignam (n606) 15-16.
[620] *Prest* (n262).
[621] ibid [28].
[622] *Gencor ACP* (n613), cited in *Prest* (n262) [31].
[623] *Prest* (n262) [28].
[624] ibid [35].

Separate legal personality can certainly be argued to constitute a fundamental feature of companies, but theoretically it does not need to be disregarded to extend shareholders' liabilities. This is because, as argued in chapter 2, separate legal personality and limited liability are two separate and distinct concepts which do not need each other to operate. Professor Micheler argued that this confusion derives from the historical roots of viewing companies akin to partnerships.[625] She explained that veil-piercing has continued to exist as a doctrine of corporate disregard because, with the law developing in a path dependent way, associating the company with its shareholders is ingrained in the legal mind.[626] However, this is simply a symptom of an incomplete understanding of the corporate form.[627]

There are two further points weakening veil-piercing as a successful mitigation, namely its scope and grounds. First, as for its scope, it has been noted in the literature and by reflecting upon the rule given by Lord Sumption, there is a clear difficulty in distinguishing the evasion and concealment principles because both can be applied to the same state of facts.[628] For instance, in *Prest*,[629] both Lord Neuberger and Lord Sumption discussed the case of *Gilford Motor*.[630] There, Mr Horne, as a former managing director of Gilford Motor Co, was bound by a restrictive covenant in his employment contract. After leaving Gilford, Horne initially competed under his own name but later formed a company to avoid the covenant. The Court of Appeal granted an injunction against both Horne and the company. For the same state of facts, Lord Neuberger considered it to be a concealment case because the company was just a cloak to conceal Horne's personal liability,[631] while Lord Sumption stated that the Court clearly applied the evasion principle because Horne exploited the corporate form to evade the covenant – i.e., he interposed a company in-between himself and the obligation.[632] This weakens the doctrine and makes it appear as theoretically flawed. As Hannigan suggested, both principles arrive at the same conclusion by applying the same purpose, namely both principles deny corporate controllers of the advantages of the corporate form if the legal entity is interposed with the intent of frustrating legal obligations.[633] By not distinguishing clearly the

[625] Eva Micheler, 'Separate legal personality – an explanation and a defence' (2024) Journal of Corporate Law Studies (forthcoming), 10.
[626] Ibid 11.
[627] Explained in ch 5.
[628] Adrienne Leung, 'A revisit to Prest v Petrodel Resources Ltd' (2023) 34(2) International Company and Commercial Law Review 81, 85.
[629] *Prest* (n262).
[630] *Gilford Motor Co Ltd v Horne* [1933] Ch 935.
[631] *Prest* (n262) [70].
[632] ibid [29].
[633] Brenda Hannigan, 'Wedded to Salomon: Evasion, Concealment and Confusion on Piercing the Veil of the One-Man Company' (2013) 50 Irish Jurist 11, 31-32.

difference between evasion and concealment, it would be difficult to apply veil-piercing consistently and objectively.

Secondly, the rule lacks protection for unsecured tort creditors and restricts veil-piercing in tort liability cases. This limitation is evident in the common law approach in corporate group cases. A notable example is *Adams v Cape*.[634] The case involved Cape Industries, a multinational corporate group with a UK-based parent company that mined, sold, and supplied asbestos around the world. The injured claimants brought a suit against the North American subsidiary which had no substantial assets, and therefore they sought to enforce proceedings against the parent company in the UK.[635] The Court of Appeal reasserted the legal principle that each company within a group has separate legal personality with the rights and liabilities that are attached to it.[636]

It was stated that courts cannot lift the corporate veil of a member within the corporate group on the basis that the corporate structure was used to have another member take responsibility in respect of a *future* activity.[637] Thus, consistent with the reasoning in *Prest*,[638] veil-piercing is supposed to catch the evasion of pre-existing liabilities and not the avoidance of future liabilities. It is not straightforward to determine when a tort obligation arises under the evasion principle. For instance, in the *Adams v Cape* case,[639] it could be argued that the act of transferring the assets of the North American subsidiary to other subsidiaries was conducted to evade future obligations arising from *past* activities.[640] However, the Court did not reach the same conclusion. Due to the vagueness in the standards adopted by the courts, veil-piercing seems to leave great discretion to the judges in each individual case, increasing uncertainty and lack of predictability.[641] While there can be a claim that flexible standards will allow the courts to resolve egregious behaviour, without certainty in how the standards are applied, there cannot be justice for claimants, and remedying only the most egregious behaviours cannot be enough. In particular, if existing liabilities cannot include those future injuries given by latent products, such as asbestos in the case of *Adams v Cape*,[642] there will be widespread

[634] *Adams v Cape* (n94).
[635] ibid 509.
[636] ibid 536.
[637] ibid 544.
[638] *Prest* (n262).
[639] *Adams v Cape* (n94).
[640] As discussed in 1.2.2., asbestos is a toxic product with a long latency period of 10 to 40 years. Due to the latency period, liability risks materialise only in the future, while companies in a group can re-arrange the assets of the group in the present to evade future liabilities. Moreover, people in the industry knew of the risks of asbestos since the early 1900s and scientific evidence started to surface in the 1930s: see Edley and Weiler (n156) 388; Tweedale and Flynn (n151) 289.
[641] Bainbridge, 'Abolishing Veil Piercing' (n1) 481.
[642] *Adams v Cape* (n94).

societal damage passing unnoticed.[643] A conspicuous example is precisely the asbestos industry, which made incredible profits, shielded by the latency of asbestos-related diseases, until the "time bomb" of litigation exploded in the 1960s as a result of an increase in fatal cancers directly linked to asbestos.[644]

It must also be noted that veil-piercing analysis seems to ask the wrong questions. The courts will pierce the veil as a consequence of the parent company's control of the relevant subsidiary.[645] But control is only the initial condition, since Lord Sumption stated that the evasion principle also demands some level of dishonesty.[646] This is challenging as proving wrongdoing through control is problematic.[647] In the context of veil-piercing, control by parent companies should not be a necessary criterion for the application of veil-piercing, because a certain degree of integration and control is a natural consequence of the parent company being the single or controlling shareholder in the corporate group.[648] Again, there is the conundrum of how and what kind of control is exercised in an organisation.[649] Control is inherently part of the parent-subsidiary relationship - considering parent companies have shareholder rights; therefore, focusing on (legal) control as a determinant for veil-piercing is misguided. Parent company shareholders can exercise and obtain a multitude of degrees and kinds of control against the corporate forms within a group. This control ranges from strategic oversight and financial management to indirect influence through shared resources and policies.[650] Given the inherent and multifaceted nature of control in corporate groups, using the current definition of control as a criterion for veil-piercing creates inconsistencies and legal uncertainties. The real issue is understanding how and for what purposes this control within the group structure is used, specifically to externalise risks and liabilities by having a single economic unit that is legally fragmented.

Notwithstanding the issue of control, it is unclear what grounds other than evasion can be used to pierce the veil. Following *Prest*,[651] it appears the *only* available ground is the evasion of liability, which would seem to reject the majority of torts on its face,[652] considering the

[643] See 1.2.2.
[644] Tweedale and Flynn (n151) 277.
[645] *Antonio Gramsci Shipping Corpn and others v Recoletos Ltd and others* [2013] EWCA Civ 730, [2013] 2 CLC 44 [46].
[646] *Prest* (n262) [18].
[647] See 3.5.
[648] John H. Matheson, 'The Modern Law of Corporate Groups: An Empirical Study of Piercing the Corporate Veil in the Parent-Subsidiary Context' (2009) 87 North Carolina Law Review 1091, 1104, footnote 37.
[649] See 3.5.
[650] ibid.
[651] *Prest* (n262).
[652] Martin Petrin and Barnali Choudhury, 'Group Company Liability' (2018) 19 European Business Organisation Law Review 771, 775.

reference to existing legal obligations, as seen in the *Adams v Cape* case.[653] Thus, the requirement of having an actionable wrong to realign the liabilities of the entity with the business organisation will exclude most of the harms suffered by unsecured tort creditors. The harms generated using the corporate form at the expense of third parties, more specifically the use of several corporate forms for business operations, may not cause losses from an identifiable wrong as per the guideline of having "existing legal obligations". However, even if the wrong has not been identified yet, according to these restricted parameters, the loss will still be present. UK company law provides the incentives to use the corporate form to the advantage of shareholders, but company law and other areas of the legal taxonomy admit a harm only in the most egregious cases.[654] As a result, veil-piercing will not be effective in holding parent company shareholders liable due to its restricted standards, making it an exceptional event. With its unclear grounds, veil-piercing increases the uncertainty and confusion surrounding the principles of company law within the corporate form.

4.1.2. Creditors' Protection

The purpose of this section is to complement the discussion above by identifying the mitigations found in UK company law for corporate externalities. UK company law offers certain general protections to creditors,[655] who might be harmed by the corporate form - and the opportunistic behaviour of its members - by setting legal rules that levy a price in return for awarding companies' shareholders with limited liability. Those who control the company are incentivised to take action that will benefit themselves while harming creditors, especially in the event that the company becomes insolvent. Thus, there are a number of provisions in place aimed at reducing this opportunism and protecting creditors. The rules depend on whether the company in question is solvent or in the vicinity of insolvency. It is possible to divide creditors' protections into a tripartite classification: (1) *ex ante* strategies,[656] (2) *ex post* techniques regarding financially distressed companies, and (3) creditors' self-help.[657] Certain creditors, i.e., contractual creditors, can protect themselves by adopting self-help remedies when contracting with a company. [658] However, self-help remedies are not available to tort victims, which leaves the protection of this kind of creditors within the ambit of *ex ante*

[653] *Adams v Cape* (n94).
[654] Hardman, 'Fixing the misalignment' (n25) 456.
[655] As well as certain rights given by the traditional coverage of debts covenants: see Suren Gomtsian, 'Debtholder Stewardship' (2023) 86(2) Modern Law Review 307, 413-417.
[656] These are divided by Kraakman and others in affiliation (mandatory disclosure of basic information, such as name, status, etc.) and rules related to legal capital. This section focuses only on the latter. See Kraakman and others (n8) 119.
[657] Davies, *Introduction to Company Law* (n112) 225.
[658] See 2.2.2.

mandatory rules and *ex post* liability rules.[659] Hence, the remaining part of this chapter will focus on what rules can give general protection to the above category of creditors only.

Ex ante UK company law rules provide mechanisms to prevent the undercapitalisation of companies that would shift the burden of risk from the company to the creditor. *Ex post* rules aim at putting a company's directors under a duty to consider creditors' interests and not worsen their position when the company is in financial distress. In this section, the discussion centres on the fact that company law general protections for creditors are not effective. Additionally, when applied to corporate groups, they seem to reach an inconclusive approach. This section will be divided into three further parts. The following sub-section will provide an overview of the general protection for creditors to explain their purpose and how they relate to the issue of externalisation in corporate groups. The subsequent sections will focus in more detail on the *ex ante* and *ex post* solutions.

General Protection in Company Law

(1) Ex ante strategies

There are general protections for all creditors, including unsecured tort creditors, which encompass *ex ante* provisions to preserve companies' assets and facilitate creditors' compensation. They are provided when a company is a going concern and, more specifically, they work towards reducing the probability that a company will become insolvent in the first place. These general protections fall under the rules relating to legal capital. In company law, legal capital connotes the value of assets received by the company for the exchange of shares to investors.[660] It is used for the protection of creditors in two respects: (i) by prescribing minimum capital rules that identify the amount that must be contributed by shareholders to the company's assets, and (ii) putting a limit on distributions to shareholders,[661] which restricts the transfer of company's assets when their net asset value falls under the initial investment.[662] In

[659] See 2.2.3.
[660] Paul L. Davies and Sarah Worthington, *Gower: Principles of Modern Company Law* (10th edition, Sweet and Maxwell 2016) 571.
[661] Distributions to shareholders can occur in several forms, including paying dividends, redeeming or repurchasing the company's own shares, or reducing share capital: Louise Gullifer and Jennifer Payne, *Corporate Finance Law: Principles and Policy* (3rd edition, Hart Publishing 2020) ch 5. This sub-section focuses on dividends due to space constraints and because they represent the most direct and traditional form of distribution: Eilis Ferran and Look Chan Ho, *Principles of Corporate Finance Law* (2nd edition, Oxford University Press 2014) ch 9. The latter point is particularly relevant to the issue of externalisation towards unsecured tort creditors: see 4.1.3.
[662] John Armour, 'Legal Capital: an Outdated Concept?' (2006) 7(1) European Business Organization Law Review 5, 5.

respect to corporate groups, these provisions would be aimed at guaranteeing that subsidiaries are not thinly capitalised and safeguarding their creditors' interests.

(2) Ex post techniques

This kind of creditor protection is applicable when the company is in the vicinity of insolvency or insolvency is inevitable,[663] and therefore shareholders, who benefit from the company's assets, are motivated to engage in actions that would make them recover or increase their original investment.[664] In the corporate group context, subsidiaries are subject to a controlling shareholder, i.e., the parent company, who can transfer intra-group resources and assets for their own advantage or generally engage in financial transactions that would increase their share whilst undermining creditors' recovery.[665] Even when parent companies do not constitute the majority shareholder in a subsidiary, as noted in section 3.5., subsidiaries will still be subject to parent companies' directions and will follow group objectives. In insolvency, a parent company may be held liable for the debts of its subsidiary where it exercised control over its subsidiary's board of directors under the concepts of *de facto* or shadow directors. This section will, therefore, focus on this liability mechanism as it relates directly to the involvement or influence of the parent company in the subsidiary's operations. This liability to creditors comes from a more general idea of a shift in directors' duties when the company reaches insolvency.[666]

(3) Creditors' self-help

The final category of creditor protections is not applicable to unsecured tort creditors as self-help remedies arise from debt contracts between the company and its creditors. As a result, they will not be analysed except in this paragraph for a brief summary of what has been stated in section 2.2.2. Contractual creditors are the only type of creditors who can protect themselves when dealing voluntarily with a company. When in doubt that the company will be able to repay the debt, contractual creditors can insert covenants in the loan agreement with

[663] Kraakman and others (n8) 129.
[664] For instance, the practice of asset substitution, where low-risk assets are exchanged with high-risk assets before the debt is due. This practice harms creditors because it lowers the possibility of recovering the debt, whilst it benefits shareholders as it increases the volatility of the company's equity value: see Squire, 'Shareholder Opportunism in a World of Risky Debt' (n494) 1176.
[665] See Simon Johnson and others, 'Tunnelling' (2000) 90(2) The American Economic Review 22, 22-23.
[666] *BTI v Sequana* (n12) [86]: '(…) *the rationale for treating the company's interests as involving the creditors' interests is not based on insolvency in itself, but on a shift in the economic interests in the company, and consequently in the risk of loss arising from the manner in which the directors exercise their powers. That shift is discernible when insolvency is imminent: the onset of insolvency is merely the clearest sign that such a shift has occurred*'.

constraints on management, or take a security interest in the company's assets, and in the event of default they have certain rights, e.g. the right to accelerate the debt re-payment.[667]

4.1.3. *Ex Ante* Strategies

Minimum Capital

Minimum capital requirements serve as creditors' protection in a standardised form.[668] As such, they are important to examine as a mitigation of the issue of risk externalisation. Minimum capital requirements for companies were incorporated into UK company law via EU law. The latter introduced the Second Company Law Directive (1976)[669] and harmonised minimum capital requirements for public companies in all Member States.[670] In the UK, to commence trading, public companies must have a minimum capital of £50,000,[671] but there is no minimum for private companies. The rationale for this strategy is to protect creditors by guaranteeing that companies will not be thinly capitalised, and in the context of corporate groups it would make it more difficult to use an undercapitalised subsidiary for risky activities.[672] However, mandatory minimum capital rules at this low level are not an appropriate means to protect creditors. They merely represent a symbolic price to pay for limited liability. This section will explain the requirement and note its relevant objections.

The first objection is that the rule does not successfully protect creditors. Theoretically, the equity cushion provided by the requirement would protect creditors by attenuating shareholder-creditor agency problems.[673] Yet, it does not do so in practice. Notably, there is an absence of minimum capital requirements for private companies. This absence, coupled with the "one size fits all" approach, seems to add little value to the interests of creditors.[674] The minimum capital requirement is a precondition of the company starting to trade.[675] However, it is not a necessary condition to protect creditors of the ongoing business. Even without a trading certificate, creditors in this respect are protected because company transactions will be valid and its directors are jointly and severally liable for any loss

[667] Davies and Worthington, *Gower: Principles of Modern Company Law* (n660) 1744-1745.
[668] Kraakman and others (n8) 124.
[669] Now part of Council Directive 2017/1132/EU of 14 June 2017 relating to certain aspects of company law [2017] OJ L169/46.
[670] It was transposed into UK company law when the UK was still a Member State.
[671] CA 2006, s 761.
[672] Armour, 'Legal Capital: an Outdated Concept?' (n662) 14.
[673] See 2.2.1.
[674] Jennifer Payne 'Legal Capital in the UK Following the Companies Act 2006' in John Armour and Jennifer Payne (eds), *Rationality in Company Law: Essays in Honour of DD Prentice* (Hart Publishing 2009) 129.
[675] CA 2006, s 761.

incurred.[676] Thus, the effectiveness of this protection is questionable because a minimum capital requirement does not in itself impose any liability and for the purpose of not having undercapitalised companies; it should reflect the capacity of the specific company to absorb eventual losses, hence varying depending on the riskiness of the business.[677]

Indeed, any level of minimum capital comes with its drawbacks. A level that is too low will not be of any help to creditors, while a level too high is said to reduce entrepreneurship[678] and consequentially the amount of capital in the economy. Moreover, trying to find the right balance tailored to the specific company might be challenging. As shown by recent events, although minimum capital requirements for banks,[679] which are more regulated than public companies, are adjusted depending on the institution, they can still be subjected to external and adverse public and market pressures.[680]

The second objection is that the rule does not provide a sufficient "cushion" of assets for the protection of tort victims. Even with the level of minimum capital requirements being fixed for all companies, the rule would be justified if it yielded benefits to the category of creditors that are in the most disadvantaged position. Generally, the same considerations above can be applied to tort creditors and a "fixed rate" minimum capital requirement does not achieve sufficient capitalisation since the latter will depend on the activities conducted by the company. Furthermore, in the insolvent subsidiary case, the rule does not guarantee that the assets will be available when the entity reaches insolvency. Once the minimum capital has been raised to commence trading, it can still be depleted afterward due to trading losses and shareholders' opportunistic behaviour, and the few assets left will satisfy first the claims of secured creditors.[681] If the nominal value falls below the minimum requirement, there is no provision in the Companies Act 2006 that deals with this eventuality. The Act only mentions that the company will need to re-register as private.[682] It follows that protections aimed at reducing the risk of post-trading shareholders' opportunistic behaviour, which will affect the company's assets, would be preferable to a minimum capital requirement. The overall critique of minimum

[676] CA 2006, s 767(3) - (4).
[677] Davies and Worthington, *Gower: Principles of Modern Company Law* (n9) 642.
[678] John Armour and Douglas Cumming, 'Bankruptcy Law and Entrepreneurship' (2008) 10(2) American Law and Economics Review 303, 307.
[679] These requirements are more closely linked to the risks associated with banks; the minimum capital adequacy ratio consists of a percentage of their risk-weighted assets: see Bank for International Settlements, 'The Basel Framework: RBC – Risk-based capital requirements' (effective as of 01/01/2023) <https://www.bis.org/basel_framework/> accessed 21 August 2024.
[680] See Lucian A. Bebchuk, 'The Credit Suisse Collapse and the Regulation of Banking' (2023) Harvard Law School Forum on Corporate Governance, < https://corpgov.law.harvard.edu/2023/03/27/the-credit-suisse-collapse-and-the-regulation-of-banking/> accessed 12 May 2024.
[681] John Armour, 'Share Capital and Creditor Protection: Efficient Rules for a Modern Company Law' (2000) 63(3) Modern Law Review 355, 371-372.
[682] CA 2006, s 650.

capital requirements reflects the broader issue of the UK company law incentivising risk externalisation and private gains at the expense of others, in particular tort victims, without adequately addressing the harms it generates.

Restrictions on Distributions

Together with minimum capital requirements, other rules related to legal capital, such as restrictions on distributions to shareholders, aim at protecting creditors,[683] hence they form part of the existing legal framework that tries to mitigate risk externalisation. Part 23 of the Companies Act 2006 embodies the provisions of what scholars typically refer to as "capital maintenance", and its purpose is to ensure that shareholders would not undermine creditors' interests by distributing assets improperly. In practice, what the Act does is provide accounting-based tests aimed at declaring when it is possible to make distributions to shareholders.[684] The Act specifies that distributions can only be made out of accumulated profits.[685] The annual accounts of the company are taken into consideration, and in the case of a subsidiary company its own annual accounts are relevant.[686] The accumulated profits are then calculated by subtracting from the profits any previous distributions made and any accumulated and realised loss.[687] A further test, for public companies only, uses legal capital as a yardstick, and it stipulates that distributions can be made if the company's net assets, which are the aggregate assets less the aggregate liabilities, will exceed the value of issued shares and undistributable reserves.[688]

When analysing the distribution rules together with the minimum capital requirements, the regulation of the former is of little assistance to creditors, or more specifically non-adjusting creditors. Professor Armour argued that '*if creditors do not adjust, the optimal level of capitalisation for shareholders is zero*.'[689] This is because the level of capitalisation for public companies is set at £50,000, whilst there is none for private companies and it may effectively be zero since, if shareholders rely on their opportunism, they will try to limit their losses as much as possible. If the legal capital threshold is set at zero, the rule does not provide any general protection to creditors. In other words, the effectiveness of distribution rules will depend on the company's level of legal capital, and when the rules impede only an insignificant

[683] Kraakman and others (n8) 124.
[684] David Kershaw, 'Involuntary creditors and the case for accounting-based distribution regulation' (2009) 2 Journal of Business Law 140, 143.
[685] CA 2006, s 830.
[686] CA 2006, s 836(2).
[687] CA 2006, s 830.
[688] CA 2006, s 831.
[689] Armour, 'Legal Capital: an Outdated Concept?' (n662) 12.

amount from being distributed, it cannot protect non-adjusting creditors who do not voluntarily decide to enter into a transaction with a company. In addition, the rules focus only on balance sheet information, which will not correspond necessarily to the true financial position of the company.[690]

By looking at the balance sheet, the Companies Act 2006 provides only a narrow rule to prevent distributions. The rule can be circumvented by other means, such as share repurchases. Generally, companies may buy their own shares, whether they are redeemable or there is an agreement to re-purchase, and only out of distributable profits[691] or capital.[692] Although there are restrictions aimed at maintaining legal capital, subsidiaries may still return capital to the parent company *qua* shareholder by repurchasing their own shares, thereby increasing the parent company's earnings per share.[693]

While distributions are justified by reference to the relevant accounts,[694] a subsidiary's balance sheet will refer only to those liabilities that the company has actually incurred or will more likely than not incur in the future.[695] Liabilities that are of uncertain timing or amount, such as those tort claims with a long latency period or long-term pollution liabilities,[696] do not need to be recorded in the balance sheet. There is no requirement to consider them, in contrast to the statutory test to deem a company insolvent.[697] Accordingly, the problem resides in the fact that contingent tort claims will not have an impact on the company's realised losses on its balance sheet determining distributable profits, because they are too remote or unmeasurable. If profits are then distributable because not all liabilities will be legally relevant to consider, parent company shareholders will continue to receive profits, depleting the assets necessary to compensate future tort liabilities.

The impact of these general provisions on creditor protection is not merely debatable; rather, it can be argued that the current regulatory regime actively harms creditors. Firstly, UK company law is not concerned with whether a specific company will have sufficient funds to assist creditors in safeguarding their rights in respect of companies' assets. Secondly, those

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[690] Luca Enriques and Jonathan R. Macey, 'Creditors Versus Capital Formation: The Case Against European Legal Capital Rules' (2001) 86 Cornell Law Review 1165, 1190.
[691] CA 2006, s 687(2).
[692] Only private companies can buy their own shares out of capital under the *de minimis* exception or from a new issue of shares. CA 2006, s 709.
[693] Re-purchasing shares will decrease the number of outstanding shares, thus increasing the earnings per share. See Davies and Worthington, *Gower: Principles of Modern Company Law* (n9) 656-658.
[694] CA 2006, s 836.
[695] This is referred to as provision: see Financial Reporting Council, *FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland* (2022) para 21.4.
[696] See the factual circumstances in *BTI v Sequana* (n12).
[697] IA 1986, s 123(2): '*A company is also deemed unable to pay its debts if it is proved to the satisfaction of the court that the value of the company's assets is less than the amount of its liabilities, taking into account its contingent and prospective liabilities*.'

harmed by latent conditions, such as environmental and toxic tort victims, will have a claim resulting in liability years after dividends are paid, and the subsidiary may even be already insolvent. By allowing profits to be diverted away from the company, these provisions fail to adequately safeguard creditors' interests. In contrast, Professor Kershaw stated that UK accounting principles do take into account potential liabilities and liabilities arising from past actions.[698] He argues that having a '*more likely than not*' present obligation arising from past activities would also entail an involuntary creditor's claim, and he bases this on the '*available evidence*' that would suggest the likely outcome of litigation.[699]

However, in reality the principles do not integrate involuntary tort victims of corporate groups. This is true based on the wording of the principles and case law. The FRS 120 mentions that a present obligation is owed when there is *probability* that it exists, and it can be *measured* reliably.[700] According to courts' decisions on corporate group liability assessed so far, it is improbable that liability would exist for unsecured tort creditors and in regard to environmental and toxic tort cases, it cannot even be measured reliably and there may be very little evidence available at the time.[701] This is particularly concerning because the legal framework poses significant risks to creditors and undermines its effectiveness in protecting their rights. In sum, *ex ante* strategies offer only ostensible mitigations to the risk of externalisation and, in effect, harm unsecured tort creditors in their recovery. These strategies reveal a broader systemic issue where UK company law incentivises the use of the corporate form to externalise risks, shifting the burden onto vulnerable creditors, and exacerbating the problem of risk externalisation within corporate groups. The next step is to evaluate the effectiveness of *ex post* techniques in mitigating externalities.

4.1.4. *Ex Post* Techniques

Directors' Duties

The common law governing directors' duties was codified and reformed by the Companies Act 2006,[702] but the common law remains relevant for the purposes of interpreting and applying the general duties.[703] Directors owe general duties to the company.[704] Although the success

[698] Kershaw (n684) 148.
[699] ibid 148-149.
[700] Financial Reporting Council, *FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland* (2022) para 2.27.
[701] See 1.2.2.
[702] See CA 2006, ss 171-177.
[703] CA 2006, s 170(4).
[704] CA 2006, s 170(1).

of the company is equated to the benefit of shareholders as a whole,[705] when the company is in financial difficulties, the interests of creditors rather than shareholders become paramount.[706] In particular, section 172 provides a duty to consider creditors' interests when the company is insolvent or facing insolvency.[707] These duties apply to appointed directors (*de jure*), and also *de facto*[708] or shadow directors.[709] Therefore, in the context of corporate groups, parent companies could be subject to the duties if they qualify as *de facto* or shadow directors of the relevant subsidiary. This could potentially mitigate the issue of risk externalisation of the corporate form because third parties' interests will need to be considered when making corporate decisions.

A *de facto* director is any person who holds him/herself out as a director,[710] which is a question of degree including various factors; however, the substance is that the person was part of the corporate governing structure.[711] A shadow director refers to '*a person in accordance with whose directions or instructions the directors of a company are accustomed to act*'.[712] However, parent companies will not be regarded as shadow directors only by reason of the subsidiary being accustomed to act in accordance with instructions, directions, guidance, or advice of the parent company.[713] Therefore, the Companies Act 2006 provides an exception to protect parent companies from becoming shadow directors.

Even if parent companies are not subject to directors' general duties,[714] it is important to note that common law jurisdictions have adopted a shift in directors' duties as a form of creditor protection.[715] In practical terms, as also stated in section 172 of the Companies Act 2006, directors need to consider creditors' interests in their decisions. Surely it would be in the interests of creditors to be paid in full. Hence, an action that risks the company's ability to pay for its debts would be prejudicial to the creditors' expectations. It means that in the corporate group context, the directors of each company need to act in the best interests of that particular company, and not the group, which requires them to consider the interests of creditors "as a

[705] CA 2006, s 172(1). See also Keay, 'Having regard for stakeholders in practising enlightened shareholder value' (n78).
[706] Parker Hood, 'Directors' Duties Under the Companies Act 2006: Clarity or Confusion?' (2013) 13(1) Journal of Corporate Law Studies 1, 23.
[707] *Bilta (UK) Ltd v Nazir (No 2)* [2015] UKSC 23, [2016] AC 1 [123]–[124]. However, this is not an independent duty, it is a manifestation of the duty owed by directors to the company: see *BTI v Sequana* (n12) [66]-[67].
[708] CA 2006, s 250.
[709] CA 2006, s 170(5).
[710] CA 2006, s 250.
[711] *Re Kaytech International plc.* [1999] BCC 390 (CA), 402.
[712] CA 2006, s 251(1).
[713] CA 2006, s 251(2)(b)-(3).
[714] CA 2006, s 251(3).
[715] Andrew Keay, 'The Shifting of Directors' Duties in the Vicinity of Insolvency' (2015) 24(2) International Insolvency Review 140, 145-146.

whole" for each company.[716] When applying this duty jointly with the provisions of the Insolvency Act 1986, more specifically section 214, directors will be under a duty to minimise the potential losses to creditors and their interests become paramount in insolvency.[717]

Thus, it is clear that a duty exists,[718] yet there are other questions that need to be addressed. When a subsidiary reaches the point of insolvency, liability could potentially be extended to parent companies. First, through the Insolvency Act 1986, it is easier for parent companies to qualify as shadow directors. Secondly, once the qualification is satisfied, parent companies may be caught by this shifting duty to creditors. The following section will then answer when the duty is triggered and liability attaches, what behaviour by the parent company is actionable, and whether it is an effective mitigation to the externalities of the corporate form. This analysis is crucial as it provides insight into the implications of directors' duties in mitigating harm to creditors and highlights the importance of regulatory frameworks in safeguarding the interests of third parties dealing with a corporate form.

De Facto and Shadow Directors: Imposing Liability on Parent Companies?

When a company is in the vicinity of insolvency, its controllers have more incentives to pursue value-decreasing transactions at the expense of creditors because they can benefit from the company's actions while their personal assets are shielded from the consequences of its failures.[719] In the corporate group context, creditors might receive statutory protection under the Insolvency Act 1986 that would extend liability to parent companies, if qualified as shadow or *de facto* directors of their subsidiaries. The latter, as mentioned above, is any person who holds him/herself out as a director even if not formally appointed as such. The former, in the Insolvency Act 1986, differs slightly in the definition compared to the Companies Act 2006 regarding parent companies. The 1986 Act, while adopting the same definition of shadow director in the 2006 Act,[720] does not include the exception that protects parent companies from liability simply based on the parent-subsidiary relationship.

The statutory protections when dealing with insolvent subsidiaries would remove parental limited liability in relation to the company's trading. The relevant provisions can be found in section 213, fraudulent trading, and section 214, wrongful trading, of the Insolvency Act 1986. The law provides a corrective mechanism for directors' decisions that makes them assume

[716] Rosemary T. Langford, 'Best Interests: Multifaceted But Not Unbounded' (2016) 75(3) Cambridge Law Journal 505, 514.
[717] *West Mercia* (n325).
[718] *BTI v Sequana* (n12) [69].
[719] Kraakman and others (n8) 114.
[720] IA 1986, s 251.

additional liabilities when the company is facing financial difficulties. In effect, the director will be under a duty to take account of creditors' interests.[721] Under section 213, liability can be imposed on any person who has knowingly carried on the business of the company with the intent to defraud creditors.[722] Nevertheless, liability under this section will be challenging to prove because fraud involves actual dishonesty,[723] which is a high burden to satisfy. For this reason, this section focuses mainly on section 214.

Section 214 can be broadened to apply to persons who '*knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation*'.[724] The aim of the section was to extend liability to directors who allow debts to be incurred, and it was created out of the failure of fraudulent trading to prevent further losses at the expense of creditors.[725] In this scenario, liability may arise for parent companies as a result of their participation in the subsidiary's affairs. When the company continues to trade under the circumstances mentioned above, the requirements to impose liability are that the director failed to minimise the potential loss to the company's creditors,[726] and at the date of liquidation, the company was financially worse than it would have been if trading had been ceased earlier.[727] The section extends to shadow directors,[728] hence it can be applied to parent companies of subsidiaries that are '*accustomed to act*'[729] under their directions.

When companies are in financial difficulty, because of the principle of limited liability, directors are more willing, or may even be pressured by shareholders, to take more risk and let the creditors be the ones to lose out if the risk materialises.[730] This perverse incentive created by limited liability justifies the imposition of creditor-regarding duties on directors.[731] However, directors can escape personal liability by showing that they took every step to minimise creditors' potential losses.[732] The interpretation of "every step" does not include '*every*

[721] Andrew Keay, 'Director's duties to creditors: Contractarian Concerns relating to efficiency and over-protection of creditors ' (2003) 66 Modern Law Review 665, 668.
[722] IA 1986, s 213(1).
[723] *Re Patrick and Lyon Ltd* [1933] 1 Ch 786.
[724] IA 1986, s 214(2)(b).
[725] Rizwaan J. Mokal, *Corporate Insolvency Law: Theory and Application* (Oxford University Press 2005) 263.
[726] IA 1986, s 214(3).
[727] *Re Marini Limited (The liquidator of Marini Limited v Dickenson & ors)* [2003] EWHC 334, [2004] BCC 172 [67]–[68].
[728] IA 1986, s 214(7).
[729] IA 1986, s 251.
[730] Keay, 'The Shifting of Directors' Duties in the Vicinity of Insolvency' (n715) 145.
[731] Paul L. Davies, 'Directors' Creditor-Regarding Duties in Respect of Trading Decisions Taken in the Vicinity of Insolvency' (2006) 7 European Business Organization Law Review 301, 306.
[732] IA 1986, s 214(3).

reasonable step', but every step that a reasonably diligent person with the knowledge of the director would take, and it is a factual question.[733]

The main problem with section 214 is that, to impose liability on parent companies, they must be classified as shadow directors. But no clear statutory guidance is provided by the Insolvency Act 1986. Some degree of control is needed, although it is not enough that parent companies' directors sit on the board of the subsidiary and the parent companies approve or authorise the decisions taken by the subsidiaries' directors.[734] A clearer case would be when there is a cessation of the subsidiaries' autonomy, for instance, if the parent company engages in the complete determination of the subsidiary's trading strategy,[735] or the subsidiary's board does not exercise any discretion in its decisions.[736] The extent of control remains uncertain under the common law. In *Secretary of State for Trade and Industry v Deverell*,[737] the Court stated that the concept of shadow director should not be strictly construed and that it is necessary simply to identify the persons who have a *real influence* on corporate affairs.

As discussed in section 3.5., the power to exercise a real influence is given by a series of control mechanisms, but the definitions going beyond mere equity ties are not applied in the UK to draw the group's boundaries and its liabilities. Additionally, there are other hurdles to overcome to establish liability via section 214. First, the reported case law on wrongful trading is rather modest. Until recently, only the liquidator could initiate a wrongful trading claim.[738] Secondly, there are also factual issues of proving the point from which directors failed to take every step to minimise creditors' losses or, more generally, when the director's duty is triggered.[739] It is not easy to establish a particular date from when liability should start, since the Act does not provide any guidance. With no specific guidelines, the courts have applied a broad meaning of the relevant period prior to insolvency. For instance, in *Re Bangla Television Ltd*,[740] the Court found that the relevant date was when the company executed a business sale agreement for most of its assets and its directors knew prior to the agreement that the company was in financial difficulty.[741]

Overall, the courts seem to apply a cash flow test, namely liability will arise when it is clear that the company will not meet its trade debts.[742] However, if the test is applied to cases

[733] *Brooks v Armstrong* [2015] EWHC 2289, [2015] BCC 661 [259].
[734] *Re Hydrodan (Corby) Ltd* [1994] BCC 161 (Ch), 165.
[735] Davies and Worthington, *Gower: Principles of Modern Company Law* (n9) 708.
[736] *Re Hydrodan* (n734) 163.
[737] *Secretary of State for Trade and Industry v Deverell* [2001] Ch 340, 354.
[738] Now, both liquidators and administrators can bring claims, and assign them to third parties: see *Re Oasis Merchandising Services Limited* (in liquidation) [1997] 1 All ER 1009 (CA) and IA 1986 s 264ZD.
[739] Keay, 'The Shifting of Directors' Duties in the Vicinity of Insolvency' (n715) 153.
[740] *Re Bangla Television Ltd (in liq.)* [2009] EWHC 1632, [2010] BCC 143.
[741] ibid [53].
[742] *Re Rod Gunner Organisation* [2004] EWHC 316, [2004] BCC 684, 700.

concerning remote and unmeasurable liabilities, such as unsecured tort creditors of insolvent subsidiaries, liabilities in respect of those creditors will manifest at a much later date compared to other trade debts. Thus, it would be difficult to prove that parent companies, if classified as shadow directors, had the requisite degree of knowledge or ought to have concluded that the subsidiary would become insolvent based on these circumstances. Additionally, there is a further restriction even if the liability period is established, namely proceedings can be brought only if the company is wound up.[743] This condition restricts the range of directors' decisions caught by section 214. The effect is that directors will not be liable if the company recovers from financial difficulties or formal procedures are not initiated.[744]

Considering all the factors analysed, section 214 does not prove to be an appropriate remedy to extend liability to parent companies and mitigate the externalities of the corporate form. Not only it is inadequate to impose liability on individual companies' directors, but in corporate groups, it is even stricter regarding the categorisation of parent companies as shadow directors. The flaws of section 214 lie in its enforcement and the unclear guidance provided by the Insolvency Act 1986. From this section, it can be concluded that UK company law offers only ostensible mitigations and hence does not remedy the issue of externalisation it incentivises and exacerbates in corporate groups through its own rules. Tort victims or unsecured tort creditors could potentially be protected through tort law. The next section will evaluate the use of tort law as an alternative legal framework to mitigate the corporate externalities generated by the incentives to shareholders.

4.2. External Mitigations

4.2.1. Tort Law

The following sub-sections will investigate the alternative liability framework provided by tort law to hold parent companies liable for torts committed by their subsidiaries, thereby mitigating the issue of risk externalisation. Tort law provides a potential pathway to realign the legal and economic boundaries of organisations by circumventing the traditional legal entity view with a direct duty of care and extending liabilities inside the corporate group. This section will explore its principles and argue that tort law does not internalise the externalities of the corporate form in a successful way, especially considering recent court decisions that do not understand the internal corporate group dynamics.[745]

[743] *BTI v Sequana* (n12) [94].
[744] Davies, 'Directors' Creditor-Regarding Duties in Respect of Trading Decisions Taken in the Vicinity of Insolvency' (n731) 321.
[745] See *Okpabi* (n130) and *Vedanta* (n175).

The solution provided by tort law starts with the notion of assumption of responsibility. It has become an important concept in relation to the law of negligence since the seminal decision of *Hedley Byrne v Heller*[746] in 1963. The judicial conclusion that an assumption of responsibility took place is triggered by the conduct of a party, person *A*, taking on a task or job for another, person *B*.[747] Once *A* takes on the task or job, it is then assumed that *A* will take on the duty to perform it with due care. In the context of parent-subsidiary liability, the assumption of responsibility lies on the "control" that the parent company exercised on a subsidiary and if sufficient, the parent will be subjected to the duty and incur resulting liability.[748]

The trend of imposing an assumption of responsibility on the parent company commenced in the late 1990s and peaked in 2012 with *Chandler v Cape,*[749] where the Court recognised a direct duty of care from the parent company to the injured party based on the relationship amongst the companies in the group.[750] Recent cases presented an opportunity for UK courts to expand the law since *Chandler*.[751] These cases have involved multinational corporate groups and their responsibility for extraterritorial environmental degradation.

These types of cases can be quite challenging, particularly because they involve environmental issues on a grand scale. In fact, to date, all these cases were decided only as a jurisdictional matter rather than on their merits,[752] which raises questions as to the effectiveness of using traditional tort law in these circumstances. Excluding jurisdictional issues, there are other ambiguities caused by recent court decisions on the parent's duty of care. These ambiguities fall under (i) the application of traditional tort principles, and (ii) the relationship between the parent company and its subsidiary. The following discussion will address these two points in relation to the parent company's direct duty of care and a re-evaluation of the issues of control[753] in corporate groups as highlighted by recent court decisions.

[746] *Hedley Byrne & Co Ltd v Heller & Partners Ltd* [1964] AC 465 (HL).
[747] ibid 497.
[748] Martin Petrin, 'Assumption of Responsibility in Corporate Groups: Chandler v Cape plc' (2013) 76(3) The Modern Law Review 603, 612.
[749] *Chandler v Cape Plc* [2012] EWCA Civ 525, [2012] 1 WLR 3111.
[750] Sadie Whittam, 'Responsible parenting: when might UK-domiciled parent companies be held liable for the actions of their foreign subsidiaries?' (2021) 42(12) Company Lawyer 389, 390.
[751] *Chandler v Cape* (n749).
[752] Dalia Palombo, 'The Duty of Care of the Parent Company: A Comparison between French Law, UK Precedents and the Swiss Proposals' (2019) 4(2) Business and Human Rights Journal 265, 271.
[753] Which were introduced in 3.5.

Vedanta Resources Plc v Lungowe

The relevance of *Vedanta*[754] lies in illustrating how UK company law facilitates the externalisation of risk through the corporate form and other areas of law are not effective in mitigating such risk. The case concerned a copper mine in Zambia that damaged the health and livelihoods of 1,826 Zambian citizens from the exposure to toxic emissions released into the local watercourses. The mine was owned by a public company in Zambia, which in turn was owned by the parent company in the UK, Vedanta Resources Plc. The claimants argued that, in terms of the law of negligence, the parent company owed them a direct duty of care since it exercised a high degree of control over both the mine and the company owning the mine. The Court stated that it was not a novel approach to hold a parent company liable to third parties for the actions of a subsidiary. The question was simply '*whether A owes a duty of care to C in respect of the harmful activities of B'*.[755] Hence, it did not constitute a new category of negligence for parent companies but relied on the assumption of responsibility.

The Court decided that determining what would satisfy the imposition of a direct duty of care to a third party is a factual exercise depending on whether the parent company:

(a) takes over management of the activity from, or exercises joint management of it with the subsidiary,

(b) advises or promulgates defective group-wide policies,

(c) not only promulgates these policies but also takes active steps in their implementation, and

(d) supervises and controls the subsidiary to a certain extent.[756]

In this specific case, group-wide policies indicated that the overall responsibility laid with the board of the parent company.[757] The emphasis of the decision was on the parent company *taking active steps* in controlling the relevant subsidiary or *holding itself out* as to be in control.[758] Therefore, it seems that both interventions and omissions from the parent company could be a stepping stone leading to access to justice for environmental claimants being harmed by large multinational groups.

[754] *Vedanta* (n175).
[755] ibid [54].
[756] ibid [49] (Lord Briggs SCJ).
[757] ibid [58].
[758] ibid [53].

Certainly, *Vedanta*[759] has expanded the scope of the parent's duty of care since the *Chandler* case.[760] The latter was limited in scope as both the parent and subsidiary companies were UK-based, and the tort claimant was an employee of the subsidiary. The Court in *Vedanta*[761] acknowledged that a claim can be extended to any third party - not just employees - who have suffered harm because of the actions of a multinational corporate group. This way, tort law may appear an effective method to remedy corporate externalities.

However, the problem of tackling risk externalisation outside company law is that legal principles are being pressed into service that have nothing to do with the theory of the corporate form and do not tackle the benefits and actions of the insiders of an organisational form. While it may seem that using a broad range of legal principles shows the flexibility and comprehensiveness of the legal system, it exposes a significant flaw: the inability of current frameworks to address the root cause of risk externalisation directly. These *ad hoc* solutions do not have the capacity or authority to change the fundamental building blocks of company law, such as the jurisprudential intersection of separate legal personality and limited liability, and the interplay between legal and economic realities, which are central to the problem.[762] The result is that company law is the only part of the legal taxonomy able to remedy the issues generated by the corporate form when economic and legal boundaries do not align. Furthermore, it is the area of law that should remedy them. Company law should have a moral obligation to lead the change in how companies are theoretically and legally perceived, ensuring that the benefits of the corporate form do not come at the expense of third parties.[763]

Under tort law, both interventions and omissions from the parent companies require the fact that parent companies want to be in "control", where, in reality, corporate groups are created to fundamentally reduce the amount of liability, in particular when the business deals with hazardous substances.[764] As demonstrated by *Adams v Cape Industries plc*,[765] parent companies structure their relations in a way that insulates assets from liabilities arising from group activities. The use of the corporate form in a group is then justified by the courts for this purpose.[766] Ultimately, the corporate form with all its characteristics under the law is what gives parent company shareholders the incentive to divide an economic activity into several legal entities. Absent legal control, parent companies are still able to profit from subsidiaries' risky activities, coordinate the overall economic activity, and walk away with no repercussions at

[759] *Vedanta* (n175).
[760] *Chandler v Cape* (n749).
[761] *Vedanta* (n175).
[762] As explained so far and expanded later when the issue of control is evaluated.
[763] See 4.3.
[764] Muchlinski, 'Limited Liability and Multinational Enterprises' (n1) 923.
[765] [1990] 1 Ch 433 (CA).
[766] It is regarded as a right '*inherent in our corporate law*': *Adams v Cape* (n94) 544.

the expense of third parties unless they are found to be managing specific operational parts, as established in this case. The following sub-sections will show that parent companies are rarely involved in the operations of the group and can use other means of control to unify economic boundaries while maintaining legal separation.

Okpabi v Royal Dutch Shell Plc

The *Okpabi* case[767] is another instance demonstrating how the issue of risk externalisation of corporate groups is inadequately addressed by tort law. Here, the claims were brought on behalf of two communities in Nigeria due to numerous oil spills that environmentally damaged the communities, contaminating their ground and water.[768] Royal Dutch Shell Plc[769] was the UK-based parent company and Shell Petroleum Development Company of Nigeria Ltd was the subsidiary responsible for the damage. The claimants wished to recover damages from both companies.

The way the Shell corporate group was structured allowed RDS to own directly and indirectly[770] various companies, which were legally independent entities. However, RDS represented the centre of financial and strategic operations through a single control framework,[771] with responsibility for corporate governance located at the board of directors of RDS.[772] The Supreme Court in its decision applied the earlier case of *Vedanta*.[773] It re-established the principle that parental liability for torts committed by subsidiaries arises when the parent company supervises or controls subsidiary management, imposes harmful group policies and is active in their implementation. [774]

While the Court accepted the complexities surrounding corporate group structures,[775] it set carefully controlled parameters around the attribution of responsibility to a parent company. The parameters were again set based on "controlling" actions exercised by the parent

[767] *Okpabi* (n130).
[768] ibid [4].
[769] Thereafter RDS.
[770] Directly through shareholding: See Shell, 'Annual Report and Accounts 2022', 367-381 <https://reports.shell.com/annual-report/2022/ > accessed 20 February 2024, and indirectly through the corporate governance located at the board of the parent company.
[771] Groups take various forms. Each form will have different frameworks. Some groups will present an inactive board at the parent company level, with little interdependence among group members. Others will have a dominant board with overall control, coordinating all member companies. See Brian K. Boyd and Robert E. Hoskisson, 'Corporate Governance of Business Groups' in Colpan, Hikino and Lincoln (n420) 685-687.
[772] Esther Hennchen, 'Royal Dutch Shell in Nigeria: Where do Responsibilities End?' (2015) 129(1) Journal of Business Ethics 1, 3.
[773] *Vedanta* (n175).
[774] *Okpabi* (n130) [26].
[775] Mark Wilde, 'Extraterritorial liability of parent company for the torts of its subsidiary' (2021) 37(3) Professional Negligence 142, 146.

company. The Court distinguished between two distinct types, namely control and *de facto* management (or, in other words, operational control). It stated that, generally, all parent companies are in control of their subsidiaries, and alongside the existence of control, there must also be evidence of *de facto* management of the activities of the relevant subsidiary.[776]

In this way, the parameters are variable as they are fact-dependent, yet they primarily rely on parent companies engaging in actively controlling conduct.[777] While there is nothing wrong with fact dependency *per se*, the management structure of corporate groups is not as clear as it was for RDS. Most often, as argued in the following sub-section, parent companies will not be part of the management structure of the group, and, even when they are, operational control will be exercised in an incredibly restricted fashion. Operational functions are mostly delegated to managers,[778] and "control" can be exercised via *indirect* and informal means of control among the entities in the group.[779] Therefore, limiting the parameters to impose a direct duty of care to show operational control will likely leave the majority of corporate group structures falling outside the scope of this test. Ultimately, in terms of these legally prescribed parameters, it would be rare to find a parent company responsible for the tort of a subsidiary, leaving risk externalisation untouched.

Direct Duty of Care and Control

The law governing parental liability for subsidiaries' torts seeks to mediate between two different principles, namely the principles of the corporate form and negligence. Courts have had a difficult task in trying to respect both the fundamental characteristics of companies while upholding tort liability rules. Compensating victims through a direct duty of care might seem like a promising solution, but corporate groups pose a significant challenge to remedy the externalities of the corporate form. The cornerstone of this challenge is that imposing liability on a parent company lies at the intersection of tort and company law, where traditional notions of the corporate form and negligence are in conflict.[780] The section will investigate first the application of traditional tort law and then how it relates to the concept of control, which this thesis argues to be limited and unclear in the UK.

[776] *Okpabi* (n130) [147].
[777] Lisa Benjamin, 'Group Companies and Climate Justice' (2021) 74(1) Current Legal Problems 235, 264.
[778] Simkovic (n369) 296-297.
[779] Jones (n21) 172.
[780] Petrin, 'Assumption of Responsibility in Corporate Groups: Chandler v Cape plc' (n748) 603.

The direct duty of care circumvents the issues of addressing the features of the corporate form; indeed, imposing a duty on the parent company does not involve veil-piercing.[781] Liability following a breach of duty respects the separate legal personality of companies, and as a matter of fact it is a consequence of corporate personhood as understood under the legal entity view. Parent companies can incur liabilities to third parties because of the relationship with their subsidiaries. Therefore, the first thing that the courts will need to look at is the relationship between a parent and a subsidiary company.

This analysis is factual, and courts are reluctant to categorise any specific instance in which parental liability may arise.[782] With no fixed test to apply, the standards to establish a duty become more unclear. For instance, in *Vedanta*,[783] the Court stated that parental liability is imposed when there is sufficient intervention in the activities of the subsidiary.[784] In *Okpabi*,[785] the Court demanded *de facto* management of the subsidiary's operations. Traditionally, courts focused on the proximity - the direct relationship - between the tortfeasor and the claimant.[786] In the corporate group context, liability can be extended from a subsidiary tortfeasor to a parent company. After *Chandler*,[787] the Court recognised that to extend liability to the parent company, proximity could be established between the parent company and the harmed party indirectly through the parent's relationship with the subsidiary. Proximity in this sense hinged on the assumed responsibility of the parent company for the overall control or responsibility of the group's safety measures.[788] How sufficiently close the relationship must be between the two entities depends on undetermined criteria and levels of influence that the parent company must exercise. The outcome of the cases is then variable, as in some cases the courts place relevance on the implementation of group policies,[789] while in others they were disregarded[790] or not considered as important.[791] It is difficult to say what will satisfy the test as the level of "control" within groups differs; however, the courts have not engaged in the exercise of defining group relations and parental "control", which ultimately has led to confusion in the application of different criteria.

[781] *Chandler v Cape* (n749) [69].
[782] *Vedanta* (n175) [51].
[783] ibid.
[784] ibid [53].
[785] *Okpabi* (n130).
[786] *Caparo Industries plc v Dickman* [1990] 2 AC 605 (HL).
[787] *Chandler v Cape* (n749).
[788] ibid [49].
[789] *Vedanta* (n175) [51]-[53].
[790] *AAA v Unilever Plc* [2018] EWCA Civ 1532, [2018] BCC 959 [34].
[791] *Okpabi* (n130) [76].

For instance, the operational control test in *Okpabi*[792] assumes that parent companies will exercise *de facto* management of the subsidiary's operations, similarly to Shell in this case. Shell exercised operational control because of the linkages that were adopted in the corporate group structure. Shell owned over 200 subsidiaries, each of which were petroleum-related businesses, and being a vertically integrated group, it required more "control" from the corporate centre - the parent company.[793] Shell is now organised around four business sectors, with each sector exercising control over the operating subsidiaries, and each country having a country head coordinating all activities of the country, and functional heads for technical matters.[794] The most important aspect of this organisational structure, as highlighted in *Okpabi*,[795] is that RDS, at the time, had promulgated mandatory environmental standards. It also held overall responsibility for those standards and monitored compliance by having country and functional heads report directly to RDS' CEO.[796] Nevertheless, these clear operational linkages are not a common trait found in all corporate groups.

Investigating actual involvement of the parent company narrows considerably the corporate structures in which liability can be extended within a group. This is because most corporate group structures *may* meet the control test based on equity links, which however does not lead automatically to liability,[797] but not the "control" test established in tort law - except in rare circumstances. Depending on the degree of linkage adopted, parent companies may be able, if they so wish, to exercise operational control. But operational control is not a necessity when parent companies can still assert control and have an influential position in the subsidiary simply by virtue of being a shareholder *and* the parent company of the group. We can take as an example the predominant arrangement adopted globally today called the multidivisional (M-form),[798] which is another hierarchical structure. The following paragraphs will explain and highlight the characteristics and developments of this modern type of corporate group to analyse how control is manifested.

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[792] *Okpabi* (n130).
[793] Robert M. Grant, *Contemporary strategy analysis: text and cases* (9th edition, Wiley 2016) 369.
[794] ibid 159.
[795] *Okpabi* (n130).
[796] ibid [29]–[30].
[797] *Adams v Cape* (n94) 544. In this case, courts will look at piercing the veil, which will rarely extend liability. See 4.1.1.
[798] Hereafter M-form. The arguments supporting this organisational structure rely on transaction cost economics to explain the hierarchical governance, consisting of decentralised operational management and a centralised integrated strategy. Although the M-form does not correspond to any standard framework that can be applicable to all corporate groups (because the structure may vary to some degree), it is accepted as the predominant form since there is no empirical evidence of any other "new form" having been adopted globally. See Paul N. Gooderham and Svein Ulset, ''Beyond the M-form': Towards a Critical Test of the New Form' (2010) 9(1) International Journal of the Economics of Business 117, 129-135.

The M-form decentralises operational decision-making to the single divisions, therefore giving, to a certain degree, autonomy to the management of subsidiary companies within the line of the parent companies' policies.[799] The M-form is a vertically integrated and horizontally diversified structure, where parent companies oversee strategies, planning, allocation of resources intra-group, and assessment of subsidiaries' performance by setting financial and operational targets; whereas subsidiaries are in charge of daily operational concerns and meeting the targets.[800] While it might appear that the parent company supervises its subsidiaries, it does so only to a restricted extent as it is not involved in any *de facto* management of the group's operations. In more technical terms, M-form structures possess a continued separation of strategic planning and operational management.

In M-form structures, subsidiaries are organised along different lines of businesses and each subsidiary is "self-contained" in the sense that coordination is carried out locally and attributed to the subsidiary's managers.[801] Due to subsidiaries being self-sufficient or *quasi*-autonomous, parent companies do not receive an overload of information, which means routine management related to operating functions is left to each subsidiary, monitoring of the latter is assigned to specialised corporate staff, and strategic functions are left to the parent company.[802] Therefore, albeit parent companies will not be active in the operations, they will still be in charge via other means of "control". Internal control in M-form groups is achieved by parent companies' inputs of knowledge, incentives to subsidiaries' managers, promulgation of policies, and measuring the returns on the investment in each subsidiary.[803]

It is possible to argue that the M-form possesses strong linkages both vertically and horizontally. Vertical and ownership linkages are manifested through its hierarchical governance, equity-based shareholdings, and the parent company overseeing strategies and integration of resources. Horizontal linkage is present when the affiliated subsidiaries are diversified along related industries, allowing the group to share resources or competencies.[804] For instance, the oil industry before and even more after World War II began to diversify in the production of petrochemicals and rubber, which are both related activities to the production of oil and therefore use the same resources.[805]

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[799] See Hoskisson, Hill and Kim (n579) 274.
[800] Witting, *Liability of Corporate Groups and Networks* (n22) 37-38.
[801] Yingyi Qian, Gerard Roland and Chenggang Xu, 'Coordination and Experimentation in M-Form and U-Form Organizations' (2006) 114(2) Journal of Political Economy 366, 382.
[802] Joseph T. Mahoney, 'The adoption of the multidivisional form of organization: A contingency model' (1992) 29 Journal of Management Studies 49, 51-52.
[803] Freeland (n581) 487.
[804] Yiu and others (n578) 1567.
[805] Chandler (n515) 102-104.

In M-form structures, the subsidiaries will be self-sufficient, and their management structure is the one in charge of operations. Yet, it will be kept in check, not through monitoring conducted by the management structure of the parent company, but through the subsidiaries' compliance with the parent company's targets and policies. It follows that the parent company of an M-form structure has complete internal control over its subsidiaries, without being exposed to the liability of group operations because it does not fit the description of control in the sense of *de facto* management ("operational control"). Empirical studies have confirmed that in countries where there are fewer ways to hold a parent company liable, business operations are structured with more incorporation of subsidiaries and divisionalisation.[806]

Accordingly, "control" is a flawed doctrine in UK law. It should not be defined by holding a majority of share ownership or voting rights in a subsidiary as described in UK company law,[807] or managing its activities as affirmed in the recent UK common law developments. There are various situations where a parent company can effectively control subsidiaries. And neither test aligns to the real internal dynamics of corporate groups. The test that would align best with how corporate groups operate is the *capacity* to control - or influence - the legal entities within the group. The PSC or accounting regimes theoretically recognise this by expanding the idea of control and integrating the directing of subsidiaries' policies and ensuring that they will follow them.[808] However, we do not know how this test would work in practice as it is not applicable to the extension of tort liabilities. Therefore, a more principled basis to extend liability is required and it will be discussed in the chapter relating to the solution proposed in this thesis.[809]

Strategic management allows parent companies to control subsidiaries' managers without being involved in their daily operations. Having group guidelines, although important, is not recognised as evidence of control in UK law.[810] Consequently, in these types of groups delegation of authority is common, granting that at the same time it is controlled by coordination of activities along functional lines of business, shared profits, common goals, and a group ideology.[811] The use of all these "informal" means of control is how corporate groups can easily escape liability under the current legal framework.

The result is that parent company shareholders not only are incentivised to externalise more risk onto third parties and enhance the misalignment between the corporate and the organisational forms conducting the economic activity, but they could easily walk away with

[806] Belenzon, Hashai and Patacconi (n129) 1614.
[807] See 3.5.
[808] ibid.
[809] See ch 6.
[810] *Okpabi* (n130) [145]–[147].
[811] Witting, *Liability of Corporate Groups and Networks* (n22) 170-171.

no downsides when the risk manifests itself. If control, as defined by the law, remains the main requirement to expand liability within the structure, few corporate groups will be held liable. Moreover, this may also cause corporate groups to constantly change their organisational form to evade liability. Teubner and Everson explained it in relation to highly centralised networks. Such "networks" are simply hierarchical corporate groups, unitary organisations with centralised information, distribution, and management, which use contracts rather than equity links as a strategic instrument for the purpose of evading liability laws.[812] Thus, it would be easier for parent companies to limit their liabilities by using re-organisation techniques, such as by changing the links upon which the group is organised, resulting in another type of '*organised irresponsibility'*.[813]

This thesis has suggested that the theme of "control" relies on a narrow definition of parental control in the corporate group context. Hence, the imposition of a direct duty of care on the parent company is ineffective in catching most corporate group structures. Not only does the control test not apply to many corporate group structures but it will also allow corporate groups to re-organise themselves.[814] Even without the flaws of the test itself, it seems inappropriate to circumvent the corporate form to internalise the issues caused by it. In other words, as established in this thesis, company law should address the issues it creates. Company law is the only area of law capable of looking at the internal clusters of relationship within a group and re-conceptualising the corporate form in a way that effectively remedies its externalisation of risk. We know that company law provides the means for shareholders to receive certain benefits from the corporate form at the expense of third parties, and in complex corporate structures the issue is exacerbated by the combination of additional incentives and enhanced benefits. As such, it should be company law's duty to answer the question of how access to the corporate form should be restricted. Assigning to shareholders the task of drawing the boundaries of the legal entity and expecting other areas of law to establish when these boundaries should be *de facto* disregarded is an approach that overlooks the role of company law. Company law is vital for the creation and regulation of companies, as it is the area that primarily deals with the corporate form and ascribes the infrastructure at the heart of companies' decision-making and operations.[815]

[812] Teubner (n168) 241-243.
[813] ibid.
[814] ibid.
[815] This approach, which highlights the role of company law, has been used to answer related questions as to how companies can promote sustainability and human rights. See Sjåfjell, 'How Company Law has Failed Human Rights' (n25); Beate Sjåfjell, 'A General Corporate Law Duty to Act Sustainably' in Hanne S. Birkmose and others (eds), *Instruments of EU Corporate Governance: Effecting Changes in the Management of Companies in a Changing World* (Kluwer Law International 2023) ch 3.

The exploration of tort law as an alternative liability framework and its application in recent court decisions highlights the challenges of effectively internalising the externalities of the corporate form in the current legal framework. Transitioning from this analysis, the next section will argue in favour of the role of theoretical company law, dissecting its underlying principles and proposing opportunities for reform to address the shortcomings explained in the preceding discussion on the existing legal mitigations.

4.3. The Role of Theoretical Company Law

"*With great power comes great responsibility*"[816]

The idea that those with power should use it for the good of humanity, or in a narrower sense that with power there are responsibilities, is not borne in the abstract. It is seen in our minds as something axiomatic adapted from the real world. From the "Sword of Damocles"[817] to the Bible,[818] or even as an integral part of popular culture,[819] benefit and responsibility are closely connected to each other. Greed and hubris can play a significant role in powerful decisions, and they have even been regarded as a major contributor to historical failures, such as the 2008 financial crisis.[820] Without knowing that there will be repercussions to the irresponsible use of power, any kind of power could bring about negative effects, regardless of the motive or intention that lies behind any given action. For example, shareholders' power to influence the company's decisions without experiencing the company's failures has negative effects on unsecured tort creditors.[821]

The law applies the same logic of having corresponding rights and duties, powers and liabilities.[822] The law on the corporate form, in contrast, took an illogical turn in classifying business units. The form is the focal point of regulation in company law, yet it is the concept of *form* that causes flaws in the legal system and unnecessary complexities. This focus has

[816] Stan Lee and Steve Ditko, 'Amazing Fantasy #15, "Spider-Man!"' (August 1962).
[817] The parable, telling us that above the throne there is a sword held by a single horsehair, signifies that the possession of power comes with dire consequences, and one cannot simply enjoy the power without its perils: see Cicero, *Tusculan Disputations* (Charles D. Yonge tr, Harper & Brothers 1877) 185-186.
[818] "*From everyone who has been given much, much will be demanded; and from the one who has been entrusted with much, much more will be asked*.": Luke 12:48.
[819] Lee and Ditko (n816), cited in *Kimble v. Marvel Entertainment, LLC*, 576 U.S. 446 (2015).
[820] See Tim Wray, 'The Role of Leader Hubris in the Decline of RBS and Lehman Brothers' in Peter Garrard and Graham Robinson (eds), *The Intoxication of Power* (Palgrave Macmillan 2016) 229–251.
[821] See Blumberg, 'Limited Liability and Corporate Groups' (n1); Muchlinski, 'Limited Liability and Multinational Enterprises' (n1); Hansmann and Kraakman, 'Toward Unlimited Shareholder Liability for Corporate Torts' (n2); Ireland, 'Limited liability, shareholder rights and the problem of corporate irresponsibility' (n195).
[822] Wesley N. Hohfeld, 'Fundamental Legal Conceptions as Applied in Judicial Reasoning' (1917) 26(8) Yale Law Journal 710, 710.

manifested in rules, which in turn transformed into a firmly fixed theology, characterised by an emphasis on the form of business units and a rigid set of postulates.[823] This approach, entrenched in the legal discourse and practice, left no room for growth.[824] It limited the flexibility needed to adapt to an ever-changing economic environment, hindering the creation of new postulates in response to emerging realities in business.

This thesis has argued that shareholders in limited liability companies face unlimited upside potential and limited downside risk.[825] Taking risk is, of course, not illegal *per se*. However, shifting the risk to individuals outside of the company creates substantial normative concerns, especially in situations where shareholders have access to inside information, power to influence the course of the company's decisions, and other incentives to externalise the risk of doing business.[826] In light of the shortcomings of current approaches, this thesis proposes a functional approach to the conceptualisation of the corporate form.

Companies perform functions in which economic and social forces are at play, and their operations cause third-party effects. Focusing on the form has overlooked the dynamics of economic activities and obscured the functions performed by legal entities. For instance, in corporate groups, subsidiaries are not static entities as defined by legal classification. They serve the purpose of being vehicles for specific economic functions and help to pursue growth for the underlying economic activity. To adopt a functional approach, in this instance, does not mean to completely refute the current legal thinking, but to supplement the established lines of inquiry. Assessing a legal entity's responsibility should not hinge on how we define its "nature".[827] Instead, the focus should be on the functions and consequences of its use.

It is important not to confuse this functional approach with other methodologies of legal research. This kind of functional approach comes within a theoretical framework that examines the activities and functions of business entities, acknowledging the dynamic nature of business operations, accommodating non-legal factors - such as economic and social considerations - and analysing how legal frameworks facilitate or hinder these functions.[828] Correlating business functions with legal analysis helps to identify regulatory needs to align legal rules

[823] William O. Douglas, 'Functional Approach to the Law of Business Associations' (1928) 23(7) Illinois Law Review 673, 674.
[824] ibid.
[825] See 2.1.4.
[826] See Goodhart and Lastra (n126).
[827] Martin Petrin, 'Reconceptualizing the Theory of the Firm - From Nature to Function' (2013) 118 Dickson Law Review 1, 43.
[828] This is aligned with the functional approach taken by Douglas (n823) or Petrin, 'Reconceptualizing the Theory of the Firm - From Nature to Function' (n827), compared to other types of functional approaches, such as the one in Kraakman and others, which focuses only on the economic analysis and function of company law to reduce costs of organising business: see R. Kraakman and others (n8) 2-4.

and business realities. This approach also avoids rigid conceptualisations, allowing legal frameworks to adapt to changing business practices and societal needs.

Shifting the focus away from the *form* of the business to its *function* as promoted by the law would, therefore, entail economic and social considerations. Currently, the focus on the corporate form plays a substantial role in the company's relationship with third parties. Its members, i.e., shareholders and directors, have considerable power in shaping and directing the form; but they are not directly subject to its correlative responsibility. Thus, they find themselves outside the logical duality of the law. Courts apply metaphorical conceptions of the form to disregard it when it is not socially beneficial,[829] whereas it is the conception of the form itself that is an impediment to socially beneficial outcomes. Because of the difficulty in moving away from the concept of form, company law has left other areas of law to deal with the consequences of corporate personality and the attribution of liabilities to shareholders. Nevertheless, as we have seen before for tort law,[830] external mitigations of risk externalisation are not effective because they do not investigate the internal dynamics of using the corporate form.

The corporate form has been interpreted through traditional corporate legal theories. The legal debate on corporate personality, which will be analysed in the following chapter, has given rise to two extremes: either the company is a social and moral actor capable of bearing duties to third parties,[831] or the human actors within the company have moral and legal obligations towards third parties.[832] The matter is more complicated than following the two extremes of the same school of thought. The question to be asked is not "what is a corporate form?", but "why do we have a corporate form?", namely what its functions and the consequences of its existence are.

First, the corporate form is used by shareholders as a legal vehicle for their own benefit.[833] Thus, the relationship between investors and the vehicle used is relevant to the analysis. It also does not appear theoretically sound to focus on one, the corporate form, and exclude the other, the shareholders, when addressing the consequences generated by the economic activity underlying the corporate form. A second factor to consider is the control that members

[829] See veil-piercing doctrine in 4.1.1.
[830] See 4.2.
[831] See ch 5. Under the concession theory, companies have (even if partly) public purposes under state law and because the state has the *locus* to regulate companies, they are subject to duties. Under the aggregate theory the focus is mainly on the members within the company, however, the company could comprise non-shareholder constituents, which benefit from corporate duties. Under the real entity theory the company, being distinct and separate from its shareholders, is a moral organism capable of pursuing societal interests - if willing - and subject to duties.
[832] Stephen M. Bainbridge, 'Interpreting Nonshareholder Constituency Statutes' (1992) 19(3) Pepperdine Law Review 971, footnote 1.
[833] Hardman, 'The nexus of contracts revisited' (n101) 9.

within a corporate form have on the direction of the business enterprise - directly or indirectly the insiders of corporate activities have an enormous influence on the activity itself.[834] Third, shareholders use the corporate form due to its shielding effect, letting other parties pay the costs of doing business and leaving shareholders' personal wealth untouched even after the failures of an economic activity have manifested.

These factors explain why the corporate form is attractive to investors as an investment opportunity. While investors could not fully realise all the benefits generated by the corporate form without its use,[835] it is true that the corporate form exists, and it is the foundation of UK company law.[836] The normative claims found in the theories of corporate personality, however, do not take into consideration that a disproportionate focus on the form will inevitably lead to incentives for insiders to use the form at the expense of outsiders and transpose the economic activity outside the boundaries of the company. Once the corporate form is granted under the law, its consequences - i.e., where the moral and legal responsibility lie - do not include the economic and social considerations that should be integral in drawing the boundaries of an economic activity.

Companies perform an economic function, which conveys the attribution of rights and duties in respect of the economic activity conducted. The corporate form serves an asset partitioning function allowing the existence of a business. Nevertheless, the economic function has been wrongly regarded as a justification for companies' and shareholders' rights to co-exist as core characteristics for the purpose of operating such a function.[837] Companies also have a social function, which has extensive societal effects,[838] and social considerations can help to guide company law in the regulation of corporate activities. In this regard, the corporate form cannot be the focus of wider moral and societal interests because it will bring back the circularity of considering the nature of the company currently involved in the theories of corporate personhood. In contrast, company law should focus on the tripartite relationship of shareholders, the company, and the economic activity. A functional approach would simply balance the benefits and harms of using a corporate form, by promoting an economic and social line of inquiry in the way we conceptualise the corporate form and attribute its liabilities.

The following chapter will consider this concept in more detail by addressing the role of theoretical company law in remedying the issue of risk externalisation of the corporate form.

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[834] See ch 2 and 3.
[835] See ch 2 and the attributes of shareholders.
[836] *Bank of Tokyo Ltd v Karoon* (Note) [1987] AC 45 (CA), 64 (Lord Sumption): '*The separate personality and property of a company is* (…) *the whole foundation of English company and insolvency law*.'
[837] See the advantages of limited liability in 2.1.4.
[838] Barnali Choudhury and Martin Petrin, *Understanding the Company Corporate Governance and Theory* (Cambridge University Press 2017) 246-249.

This issue is currently downplayed in the literature. The theories of separate legal personality have been a source of discussion for centuries;[839] however, the recognition of risks and opportunities that a theoretical dimension can compel on legal applications has been neglected. The theory of the corporate form represents the basis of future company law reforms, which also implies that a flawed theory will show flawed results in the law.

4.4. Conclusion

Various ways exist to mitigate the issue of externalities produced using a corporate form in group structures. This chapter discussed first the internal solution in company law. It started with the common law exception of veil-piercing to the parent company's limited liability. In the history of the doctrine, successful veil-piercing cases have been scarce, and there are uncertainties in its application to parent companies. After the *Prest* case,[840] it seems that the strict standards of veil-piercing would render the doctrine ineffective for the purpose of holding a parent company liable for the torts committed by a subsidiary. A second pathway to parental liability is provided by general creditors' protection. *Ex ante* rules are applicable to a subsidiary before it reaches insolvency, whereas *ex post* liability rules could attach to parent companies in certain circumstances. Regarding the former, a minimum capital requirement for public companies would limit the existence of undercapitalised subsidiaries, although in practice, the fixed amount as part of a "one size fits all" approach makes the rule ineffective for the protection of tort creditors. First, it does not provide a rule for private companies. Secondly, it does not consider company-specific business; and third, it does not guarantee that the assets will be available once the subsidiary reaches insolvency. A further *ex ante* rule that restricts distributions to shareholders will also be ineffective in the corporate group context. Due to the latency period of a tort claim to materialise, profits will be distributed long before liabilities will potentially attach, rendering any distribution rule of less importance.

The last internal remedy to company law discussed would extend liability to parent companies because of the subsidiary's insolvency and the shift of director's duties towards creditors. The Insolvency Act 1986 provides for this extension of liability when the parent company qualifies as a *de facto* or shadow director. The relevant provisions are found in sections 213 and 214. Nevertheless, section 213 is of limited application, considering its high burden to satisfy.

[839] The origins of the discussion can be traced to Roman law. The most heated debates can be found in the nineteenth century. Although the discussion seemed to have come to a halt after the work of Dewey: see J. Dewey, 'The Historic Background of Corporate Legal Personality' (1926) 35 Yale Law Review 655, it has become once again relevant in recent times. See ch 5 and 6.
[840] *Prest* (n262).

Section 214 is of little help because it is difficult for parent companies to qualify as shadow directors, and its requirements are unclear and challenging to prove.

Finally, the chapter evaluated the use of external solutions found in tort law. A direct duty of care circumvents the issues present in the veil-piercing remedy. However, it also promotes a strict approach to parental liability by imposing a requirement on parent companies to have some degree of control in the operations of their subsidiaries, which is rare in the context of large and complex structures adopting divisionalisation and decentralisation of responsibilities.

This chapter showed that leaving other areas of law to remedy the externalities generated and promoted by company law does not lead to effective outcomes. As such, company law should take a leading role in remedying the externalities of the corporate form. However, traditional conceptions of the corporate form founded in company law render it incapable of taking any remedial action. Company law has a focus on the form rather than the function of corporate entities in law. Therefore, there is the need to shift it towards a consideration of the economic and social consequences of corporate activities, and a nuanced understanding of the purpose and responsibilities of companies beyond their legal structure. The next chapter will focus deeply on this conception of form and the role of theoretical company law in shaping the course of future reform.

Chapter 5- Unveiling the Blind Spots: Reassessing Corporate Theory in Company Law

5. The Theories of The Corporate Form

This chapter will answer the fifth research question of whether theoretical company law can provide a solution to the issue of risk externalisation generated by the corporate form. Both doctrinal and theoretical company law have overlooked the complexities and challenges inherent in corporate forms, particularly in attributing liability within corporate groups. This neglect creates a gap between legal frameworks and business realities. This chapter will primarily focus on three major theories identified in the literature: the concession theory, the aggregate theory, and the real entity theory. It will focus on these theoretical interpretations of the corporate form and analyse the focus of the theories, namely "what is a company?". The answers provided in the literature are incomplete due to the erroneous starting point. As stated above,[841] the emphasis should be on the functions and consequences of corporate forms rather than their nature. Shifting the focus to how companies operate and their impact on third parties will help develop better regulatory frameworks that address real-world challenges and promote normative outcomes. For instance, when addressing corporate group liability, parental liability would include an assessment of the benefits and disadvantages of using group structures and the connections among the entities, rather than focusing on a consideration of legal control or the legal separation of the entity.[842] This shift in focus acknowledges that the "nature" of a company is not static or firmly fixed, but it can evolve, and because of its undefined nature, it is a concept that cannot provide normative outcomes.

Traditional theories of the corporate form predominantly centre their arguments on the legal form of companies as they endeavour to solve the nature of these entities and rationalise their establishment. Consequently, these theories narrowly concentrate on the characteristics and attributes delineated by its nature - i.e., whichever positive claim is argued in each theory. This fixation on the legal nature means that the theories tend to exclusively scrutinise the legal entity in the form of individual company. Therefore, their primary focus lies within the delineation of corporate boundaries without any explicit consideration of the complexities introduced by corporate groups. Indeed, corporate groups present unique challenges and dynamics that differ from those of single stand-alone companies.[843]

Due to these theories not explicitly discussing corporate groups in their analysis, it can be said that they all follow the traditional legal entity view. Despite the traditional theories having found

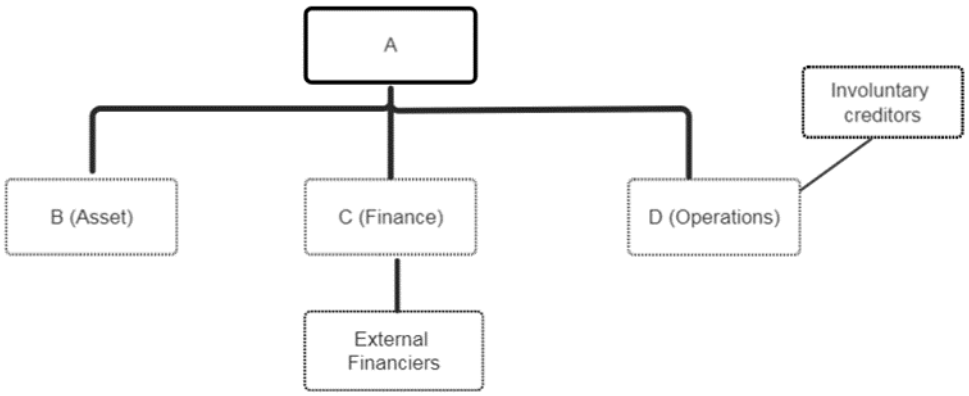
[841] See 4.3.
[842] Assessed in ch 6.
[843] See ch 3.

a modern application, such as for instance the aggregate theory stipulated from a modern economic perspective,[844] and contemporary scholars promoting their use,[845] they do not address what differentiates a single company from a corporate group and what impact these differences might have on the application of the theory. They are methodologically wrong. Starting from an abstract notion of the company means missing the broader picture of interconnected legal entities within a corporate group, leading to an incomplete and inadequate understanding.

Legal discourse often revisits the concept of separate legal personality, engaging in a continuous debate regarding the rights attributed to a legal entity when it is treated as a distinct person separate from its members. This severely limits company law's ability to grow and adapt to changing environments because the persistent focus on the corporate form has led to a stagnant legal framework, where the issues generated using a corporate form in complex corporate group structures have been left unremedied. The theories do not account for the functions of the corporate form and societal consequences of its use in corporate groups. The functions of the corporate form integrate not only the rights of companies but also the benefits that their members possess from the incorporation of a legal entity and the harms they generate.[846] Although debatable from a theoretical standpoint,[847] the legal reality is one that embraces the corporate form as a vehicle used to separate the wealth of the legal entity from the personal wealth of shareholders and gives both the legal entity and shareholders certain benefits, which can have a negative impact on external parties.[848]

Thus, the function of organisational law, consisting of both entity shielding and owner shielding, creates undesirable consequences for external and uninformed third parties. The theories of corporate personality, by focusing disproportionately on the *form*, have paid less attention to the attribution of liability arising from the underlying economic activity. To illustrate this, we can use the example of Figure Two in section 3.1.

[844] See 5.3.
[845] See generally Jonathan Hardman, 'The Making of Corporate Legal Concession Theory' (2024) 44(1) Oxford Journal of Legal Studies 181.
[846] See 4.3.
[847] As seen in ch 2, limited liability is not a necessary and logical consequence of separate legal personality.
[848] See the discussion in ch 2 and 3.



The resulting analysis[849] of this example argued that the parent company *A* takes advantage of the corporate structure to separate assets and operations within subsidiary companies *B*, *C*, and *D*, allowing it to exploit asset partitioning by setting boundaries on creditors' recovery and potentially diverting profits from operations, while shielding itself from liabilities incurred by subsidiaries. Accordingly, it illustrated the problems in the legal use of the corporate form to operate a coordinated economic activity divided into several entities. If company *D* commits a tort, UK company law would tell us to look exclusively at company *D* and within its corporate boundaries to attribute liability. The theories of the corporate form, by looking at ways to justify the corporate form, would also focus exclusively on the corporate boundaries and dynamics within *D*, and would miss the bigger picture, in which *D* is only a part of the whole economic activity and underlying business formed by interconnected legal entities.

The issue of risk externalisation can occur in two ways: accidental use of the corporate form, and strategic use of the corporate form. The former refers to situations where there is no intentional effort to avoid liability, but due to the structure or operations of the organisation, there might be limited or no recourse for third parties seeking compensation for damages arising from the organisation's economic activities. The latter refers to intentional actions taken by companies to structure their operations, or assets, in a way that minimises or avoids future potential liability for damages that have been caused by their economic activities. The motive, either accidental or strategic, is irrelevant here because the issue is not whether company members are inherently "good" or "bad",[850] but the presence of externalities and the incentives in the law promoting such externalities should signal the need for a change.

Focusing on the corporate form and its boundaries raises concerns regarding the theoretical application of company law, particularly in the context of corporate groups, where there is an intensified reliance on the corporate form, resulting in greater externalisation of risk. This

[849] See 3.1.
[850] Hill (n377) 498.

chapter will analyse each theory formulated in the past, their positive and normative claims, the evidence found in company law used to justify those claims and what would happen if the same lenses were used to understand corporate groups rather than single entities. All of this will be explained and unpacked respectively in sections 5.2., 5.3., and 5.4.

While the theories could be extended - or interpreted - in such a way that recognises corporate groups, they come with their limitations and the link between the theories and group structures by itself is irrelevant. The abstract nature of the form means that the theories can be interpreted to suit any author's rhetoric. Although there is nothing intrinsically "evil" about using the tool of rhetoric for persuasion, it can become deceiving when it serves solely to advance an argument's persuasiveness without substantial grounding in broader considerations.[851] Similarly, the theories of corporate form rely on rhetorical strategies to justify their normative principles, perpetuating a circularity that reinforces preconceived notions without reaching a definitive conclusion. This poses limitations on the theories' parameters and leaves questions unanswered due to their erroneous starting point and methodologies.

However, it would be wrong to simply dismiss the theories without giving them any merit. The theories help us illuminate and interpret the company (its legal boundaries) and the law governing corporate entities.[852] This means that the theories also guide the understanding of rules and future recommendations for reform. The traditional theories have made significant contributions to the corporate scholarship that is still a foundational part of modern company law.[853] Therefore, while this chapter will critique and highlight the flaws of traditional corporate theories in connection to corporate groups, it will not discard them completely. The aim of this thesis is to supplement the legal discourse with a different line of inquiry. This new inquiry will look at the consequences of using the corporate form within an economic activity[854] to promote normative outcomes, in contrast to the traditional legal inquiry of discussing only the nature of the corporate form to justify normative recommendations.

[851] Donald N. McCloskey, *The Rhetoric of Economics* (University of Wisconsin Press 1998) 168-170.
[852] Morton J. Horwitz, *The Transformation of American Law, 1870-1960: The Crisis of Legal Orthodoxy* (Oxford University Press 1992) ch 3; Millon, 'Theories of the Corporation' (n421) 241; Simon Deakin, 'Juridical Ontology: The Evolution of Legal Form' (2015) 40(1) Historical Social Research 170, 181; Eva Micheler, *Company Law: A Real Entity Theory* (Oxford University Press 2021) ch 1.
[853] See for example the agency conflicts within a company and the rules that help mitigate them in Kraakman and others (n8) ch 2. This contribution is made by the agency theory adopted within the contractarian approach to the company.
[854] See ch 6.

5.1. Positive and Normative Claims

Although there are several legal theories on corporate personality,[855] generally there are three major theories identified in the literature, which are the concession theory, the aggregate theory, and the real entity theory.[856] This is because the numerous theories can be reduced to three main ideas: (i) the company is an artificial entity created for juridical purposes, (ii) the company is a real entity, or (iii) the company is a fiction to represent its individuals.[857] Each theory provides an explanation for the nature of the company by stating a positive and normative claim. The positive claim relates to the interpretation of the company's legal personality, while the normative claim guides the understanding of company law and its application,[858] according to the author's normative beliefs. These two claims are not separate, but they have a relational link. The standard argumentation proposes a normative position justified by reference to a characterisation of the company, which means that the positive claim - the company is *x* - informs the normative claim – if *x*, then *y* should be advanced.[859] What these two claims together do is ultimately to justify whatever use of the corporate form suits the ideology of the historical period in which the theory was formulated.

UK company law describes the company as a separate person once incorporated.[860] What kind of "person" the company is, however, is a century-old debate that served historical and conflicting political ends but is yet to be settled.[861] Legal scholars are in disagreement on corporate personhood, leaving behind an inconclusive debate and an "undetermined" company. The concession theory, the aggregate theory, and the real entity theory have all garnered significant support from legal scholars. But, with no academic consensus, it is reasonable to assume that no single theory is inherently superior. Each theory has served its purpose in justifying the argumentative strategy of its proponents, reflecting the diversity of perspectives within the field of company law. These debates, aimed at supporting various normative claims, need still to resolve the fundamental question of what kind of "person" the entity represents. Just as the characterisation of the company remains controversial, so too

[855] There can be as many as sixteen: see Martin Wolff, 'On the Nature of Legal Persons' (1938) 54(4) Law Quarterly Review 494, 496.
[856] Eric W. Ortz, *Business Persons: A Legal Theory of the Firm* (Oxford University Press 2013) 12.
[857] Leonidas Pitamic, 'Analysis of the Notion of Juristic Personality' (1935) 10 Notre Dame Law Review 235, 235.
[858] Claassen, 'Political theories of the business corporation' (n33) 2.
[859] David Millon, 'The Ambiguous Significance of Corporate Personhood' (2001) 2(1) Stanford Agora: an Online Journal of Legal Perspectives 39, 40.
[860] *Salomon* (n32).
[861] Ron Harris, 'The Transplantation of the Legal Discourse on Corporate Personality Theories: From German Codification to British Political Pluralism and American Big Business' (2006) 63(4) Washington and Lee Law Review 1421, 1475.

do the normative issues surrounding it, highlighting the complexity of understanding the corporate form in terms of its legal personality.

The concession theory's focus is on the artificial personality of the legal entity,[862] which would align it with the public interest or, more generally, provide the state with a legitimate purpose of regulating business activities.[863] The aggregate or contractualist theory holds that either a company is formed by its participants or the contracts amongst its members;[864] therefore, the interests of the company align with the interests of shareholders, which are not an end in themselves but could potentially provide the means to the pursuit of aggregate social welfare.[865] The real entity theory sees companies as separate persons from their shareholders, subject to their own rights and duties.[866] The underlying group forming the company is what gives it its real personality, and the company will function in line with its group will.[867]

The thesis proposed throughout is that company law should focus less on the corporate form and more on the economic and social consequences of its organisational form, thereby re-purposing company law by aligning it with its original theoretical underpinnings. It is important to note here that the traditional theories were proposed within a framework in which the corporate form was the focus, namely they were proposed to justify the corporate form and the rights it provides. Nonetheless, as discussed above,[868] rights and liabilities are axiomatically linked to each other according to both human logic and legal duality. While in the literature there is scarcely any mention of liabilities and the theory of liability in the debated theories, the next sections will evaluate shareholder limited liability within the theoretical frameworks of the traditional justifications. In other words, it will discuss how each theory would theoretically address the allocation of rights and liabilities.

The allocation of liabilities is an under-researched area. This is because the positive and normative claims of the personhood debate refer predominantly to corporate powers[869] or internal relations; they do not and cannot explain by themselves the relation between the individuals within the company and outside the company by simply characterising the company.[870] The implications of following traditional theories of the corporate form are that the

[862] Discussed in more detail in 5.2.
[863] See for instance the concession theory in relation to Hobbes' work in Rutger Claassen, 'Hobbes Meets the Modern Business Corporation' (2021) 53(1) Polity 101, 123-124.
[864] Discussed in 5.3.
[865] Hansmann and Kraakman, 'The end of history for corporate law' (n45) 51.
[866] Discussed in 5.4.
[867] Richard Adelstein, 'Firms as Social Actors' (2010) 6(3) Journal of Institutional Economics 329, 345.
[868] See 4.3.
[869] See Claassen, 'Political theories of the business corporation' (n33) 2.
[870] See Micheler, *Company Law: A Real Entity Theory* (n852) ch 1.

theories do not answer to the normative consequences of using the form at the expense of third parties. It follows that, while each theory is correct within its own parameters, they all ask the wrong questions, and do not address the issue of externalisation in its entirety.

5.2. Concession Theory

During the nineteenth century, the debate surrounding the nature of separate legal personality[871] included a clash between two extremes: whether the company was a real entity or a legal fiction. The latter corresponds to the artificial legal personality conception, which is closely related to the concession theory.[872] Scholars agreeing with the view that the company is an artificial entity conceded that human beings were natural persons, and any other being recognised by law as having rights and duties was an artificial person, with the most notable example of the second category being the company.[873] Similarly, the concession theory acknowledges that companies are creatures of law, and they owe their existence to the state.[874] Being creatures of law, the state confers powers upon them, and ultimately the normative implication is that it is the state that can intervene in companies' activities and limit the rights and duties of the separate legal personality.

On the one hand, this theory resonates with the history of the formation of companies insofar as, in medieval times, incorporation was exercised by the sovereign power that also endowed companies with their purpose and privileges.[875] One example is the East India Company, chartered by Elizabeth I of England with the purpose of carrying out the spice trade on behalf of the state.[876] The conception of *persona ficta*, or legal fiction, has historical origins in the Middle Ages, where Pope Innocent IV referred to the company as a person who was not comparable in all aspects to the human being, effectively fabricating the legal personification of the corporate form for the first time, subject to limitations.[877] On the other hand, Berle stated that the first state concession itself can be traced to the Roman Empire since Trajan's time

[871] In the literature, the theory of the company and separate legal personality are used interchangeably. The assumption is that a company is an entity separate from its constituents and the debate revolves around what kind of person the company or this separate legal person is.
[872] Millon, 'Theories of the Corporation' (n421) 206.
[873] Otto F. von Gierke, *Political theories of the Middle Age* (Frederic W. Maitland tr, University of Cambridge 1900) XX.
[874] Micheler, *Company Law: A Real Entity Theory* (n852) 12.
[875] Carsten Gerner-Beuerle and Michael A. Schillig, *Comparative Company Law* (Oxford University Press 2019) 51.
[876] Nick Robins, *The Corporation That Changed the World* (Pluto Press 2012) 5.
[877] Maximilian Koessler, 'The Person in Imagination or Persona Ficta of the Corporation' (1949) 9 Louisiana Law Review 435, 438.

and beyond, where an association of individuals was considered a threat to the emperor and the creation of organisations was limited by governmental approval.[878]

Notwithstanding exactly when the theory originated, the important factor is that corporate personality is a grant of the state that, at its discretion, assigns the company rights and duties.[879] The theoretical discourse of corporate personality was not restricted to geography; it was in fact much more international than other traditional legal scholarships.[880] In England, the concession theory was promulgated in the common law and is associated with Lord Coke in the *Sutton's Hospital* case.[881] Although he did not expressly identify the company as a legal fiction, he stated that the company itself is '*only in abstracto'*,[882] a comment that inspired Chief Justice Marshall in the U.S. to quote Coke and say that a company is '*an artificial being, invisible, immortal, and rests only in intendment and consideration of the law'*.[883] Continuing this opinion, Marshall also stated that, as a consequence of corporate personality being a creation of law, companies possess only the features and properties that the law confers upon them.[884] Similarly, Lord Coke asserted that '*incorporation cannot be created without the King'*.[885] With legal personality derived from the crown, and not from a corporeal presence, the concession principle started to become influential in the UK.[886]

The theory in its original conception remained relevant until the Companies Act of 1844, which established a general incorporation principle allowing companies to register as separate legal persons without individual concession. Scholars began to consider the concession theory irrelevant because, if incorporation is open to the general public, there is no such thing as a concession from the state.[887] Since incorporation became more of a right than a concession, the scholarly understanding of the modern company gradually moved away from traditional concessionary thinking to an aggregate nature that was the product of individual initiative.[888] It has been said on this point that for more than half-a-century, corporate scholars have not taken the concession theory seriously.[889]

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[878] Adolf A. Berle, *Studies in the Law of Corporation Finance* (Callaghan and Company 1928) 4.
[879] Harris, 'The Transplantation of the Legal Discourse on Corporate Personality Theories' (n861) 1424.
[880] Brian R. Cheffins, *The Trajectory of (Corporate Law) Scholarship* (Cambridge University Press 2004) 39.
[881] *Case of Sutton's Hospital* (1612) 77 ER 960.
[882] ibid 973.
[883] *Trustees of Dartmouth College v. Woodward*, 17 U.S. (4 Wheat.) 518, 636 (1810).
[884] ibid.
[885] *Sutton's Hospital* (n881) 965.
[886] Watson argues that in England the idea was either developed or introduced by Coke in 1612: see Susan Watson, 'The Corporate Legal Person' (2019) 19 (1) Journal of Corporate Law Studies 137, 143.
[887] Claassen, 'Political theories of the business corporation' (n33) 3.
[888] Millon, 'Theories of the Corporation' (n421) 211.
[889] Bainbridge and Henderson (n291) 68-69, see also footnote 84.

Once the traditional concession theory is explained and analysed, it would be relevant to evaluate whether corporate groups can be explained and understood through its lenses. The claim proposed by the concession theory is that companies are artificial entities created by the state or law, with legal personality conferred upon them by external authority. Therefore, the company in this scenario is completely dependent on an external force, such as the state, to be recognised and created.[890] However, it is important to identify a gap in the legal thinking. Corporate groups were not explicitly considered or addressed within the framework of the traditional concession theory. Corporate groups would then not subsist within the parameter of a concession theory due to the fact that, originally, a grant from the state would not allow companies to own other companies' shares.[891] The traditional concession theory was formulated at a time when corporate groups did not exist, and hence they were not taken into account in the theory's discussion. Applying the original concession theory to corporate groups reveals a theoretical gap where the theory's principles and assumptions may not adequately accommodate the complexities and dynamics in modern corporate group structures. It follows that not only is the issue of risk externalisation of the corporate form not a relevant problem for the original conception of the concession theory, but the theory also completely fails to recognise it as a problem.

Naturally, the issue of risk externalisation might also be solved by preventing the existence of corporate groups altogether. If the corporate form is a gift from the state, the state has the power to impose limits upon such gift,[892] such as preventing companies from becoming shareholders of other companies and setting limits on how many corporate forms can be created within the same business. This would correspond to the historical position of the law in the early nineteenth century, when corporate group structures were not a legal possibility.[893] While persuasive as a matter of rhetoric, it is neither feasible nor desirable to displace corporate groups as a modern business reality. Corporate groups are a common business structure used for various legal and economic reasons.[894] They provide several advantages that cannot be easily replicated.[895] Rather than preventing their existence, there is an opportunity to refine the approach of the law in addressing the risk of externalisation by developing the theory behind corporate groups.

[890] Susanna K. Ripken, *Corporate Personhood* (Cambridge University Press 2019) 23.
[891] Blumberg, 'Limited Liability and Corporate Groups' (n1) 605.
[892] Jonathan Hardman, 'Looking beyond separate legal personality, or how many titles have Rangers won?' (2022) 1 Juridical Review 1, 4.
[893] See 3.1.
[894] See ch 3, in particular 3.4.
[895] See the application of mesoeconomics in 3.4.

The concession theory may still hold relevance in contemporary discourse, although it has often been misrepresented and criticised, portrayed more as a straw man argument to be challenged by its detractors rather than embraced by faithful adherents.[896] Contemporary scholars argue that companies are a legal construct, and acknowledge that legal personality does not exist as a creation of the state, yet it needs the assistance of the state to exist as a recognised person.[897] The modern version of the concession theory is further sustained by case law and statutory provisions; in other words, judges look at the wording of the Companies Act to understand the function and meaning of separate legal personality.[898] For instance, in *Salomon*,[899] the Court focused on the Companies Act of 1862, and Lord Halsbury pointed out that courts have to interpret the law; due to the fact that statutory provisions grant an artificial creation, the law should recognise the company's artificial existence.[900]

Modern scholarly contributions can be found, among others, in the works of Martin Petrin, who focuses on a functional approach to legal personality, which entails regarding it as a tool to pursue a collective goal, although he still states that the legislature has enabled its creation.[901] In addition, Susan Watson argues that legal personality derives from incorporation, and the latter requires the assistance of state officials to an extent sufficient to categorise it as a concession theory.[902] However, to counter this argument, it has been demonstrated that separate legal personality is not a uniform concept. There are examples, one being the Scottish Limited Partnership, which create a separate legal personality with strong entity shielding by private contracting rather than public actions.[903] This means that there are examples of business entities that do not rely on or involve the state in the creation of separate legal personality. This goes back to the statement above that no singular paradigm is superior;[904] they are all valid and correct when justified by the appropriate evidence found in company law. Ultimately, because there is no definite answer on what a company is, it is a matter of rhetoric. The company's nature can be interpreted in any way that would fit the author's belief.

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[896] Hardman, 'Fixing the misalignment' (n25) 448; Hardman, 'The Making of Corporate Legal Concession Theory' (n845) 184.
[897] Katsuhito Iwai, 'Persons, Things and Corporations: The Corporate Personality Controversy and Comparative Corporate Governance' (1997) 47 American Journal of Corporation Law 583, 603.
[898] Nnamdi Azikiwe, 'Corporate Personality in Company Jurisprudence: Divergences in Theoretical Perspectives' (2019) 10(1) University Journal of International Law and Jurisprudence 183, 184.
[899] *Salomon* (n32).
[900] ibid 30.
[901] Petrin, 'Reconceptualizing the Theory of the Firm - From Nature to Function' (n827) 43.
[902] Watson, 'The Corporate Legal Person' (886).
[903] Macgregor (n209); Hardman, 'Reconceptualising Scottish Limited Partnership Law' (n186).
[904] See 5.1.

The question that follows is, therefore, can the corporate group be interpreted and understood by this "loose" rhetorical paradigm? In the modern view of the concession theory, corporate groups as an "enterprise" could achieve a unified artificial personality if granted under the law. Ultimately, under this theory, '*corporate personality has no existence beyond that which the state chooses to give it*'.[905] While theoretically the possibility of creating an enterprise as a distinct artificial personality exists, it must be noted that both courts and contemporary academics supporting the concession theory follow a perspective of legal positivism, i.e., they centre their arguments on the law as it is.[906] The use of the concession theory by itself is inappropriate for modern types of business entities for two reasons. These two reasons are not a weakness only in the concession theory, but they are present in all the traditional legal entity theories. One is the reliance that the positive claim exercises on existing doctrinal law and the way it is interpreted to fit a normative conclusion, and the second is analysing corporate activities by using legal personality as a starting point.

The first claim is justified on the fact that no single paradigm can perfectly describe existing doctrinal law. Critics of the personality debate point out that scholars cherry-pick facts to substantiate a normative claim with their own desired end.[907] Therefore, traditional theories have relied on selective examples to support their arguments, without considering the broader context or counterexamples within company law. There is no universal position for all companies under company law. This is because companies can be used for extreme and contrasting purposes; they may operate as part of a series of legal entities within a group or be empty legally-registered vehicles with no economic activity behind.[908] The company is simply a legal tool that can be used for any desired end, as long as it is used within its legal limits.

Legal positivism does not have the capacity to adjust to particular situations. For instance, the perception of separate legal personality in company law provides a heuristic formula,[909] and as argued by Hardman, it sets out a '*common denominator applicable to all companies'*, but the same formula will not be as useful in cases where a company will have features departing from this common denominator.[910] What this means is that according to company law, the company is a separate legal personality with its own rights and duties, and its formula sets out the common rights and duties found in companies. However, not all separate legal

[905] W. Jethro Brown, 'The personality of the corporation and the state (1905)' printed in (2008) 4(2) Journal of Institutional Economics 255, 265.
[906] Herbert L. A. Hart, *Essays in Jurisprudence and Philosophy* (Oxford University Press 1983) 49.
[907] Dewey (n839).
[908] See the liquid and vessel analogy in Hardman, 'Fixing the misalignment' (n25).
[909] Kraakman and others (n8) 8.
[910] Hardman, 'Looking beyond separate legal personality, or how many titles have Rangers won?' (n892) 8.

personalities will possess the same features. Referring to Scottish partnerships, they are separate legal personalities without the automatically attached limited liability for their members.[911] Therefore, while granting corporate groups the designation of "enterprise" as an artificial personality might seem like a straightforward solution, it fails to address the inherent complexities and variations within corporate forms. Corporate structures can vary widely and attempting to fit them all into a fixed concept like an artificial personality risks oversimplification and may exacerbate the challenges of delineating their rights and responsibilities. Instead of offering a comprehensive solution, such an approach could potentially overlook the differences between corporate entities and how they are used and may not adequately address the diverse range of forms and functions they can adopt.[912] Thus, this approach does not offer a solution to the issue of risk externalisation in corporate groups.

Secondly, the concession theory would argue that the law attributes a distinct legal personality to an enterprise, when the concept of "enterprise" should transcend legal personality. The enterprise exists irrespective of its legal form, and it will be explained in greater detail in the next chapter. However, for the purpose of understanding this point, it suffices to say that the economic enterprise can be greater than the legal mechanism of the company and the principles of the corporate form established in UK company law. The latter accounts only for a fragment of the business activities conducted by a firm, and because of it, the legal system struggles to deal with the use of the corporate form that negatively affects third parties.[913] In fact, as this thesis has argued so far, the difference in boundaries between the corporate form and the (business) enterprise harms third parties dealing with the corporate group. Therefore, while the company is a legal vehicle used by and for internal stakeholders, i.e., directors and shareholders,[914] the enterprise theoretically and normatively should go beyond internal stakeholders due to its expanded boundaries.[915]

Regarding the attribution of liabilities under the concession paradigm, the company's rights and duties are only those granted by the state and under the law; as a result, the state could also decide to grant the shareholders certain rights or duties. Recent case law remarked on the fact that the corporate form is a bundle of rights conferred by statute.[916] Nevertheless, limited liability is not necessarily an important feature of the corporate form for the concession theory; in other words, the literature has never considered in detail limited liability in its

[911] Macgregor (n209).
[912] See ch 3.
[913] Simon Deakin, 'The Corporation as Commons: Rethinking Property Rights, Governance and Sustainability in the Business Enterprise' (2012) 37(2) Queen's Law Journal 339, 365-366.
[914] See (n80): CA 2006, ss 7(1), 8, 16(2), 16(5)-(6).
[915] See Hardman, 'The nexus of contracts revisited' (n101).
[916] Limited liability '*is a right conferred by statute*': *BTI 2014 LLC v Sequana SA* [2019] EWCA Civ 112, [2019] BCC 631 [151] (David Richards LJ).

debates. First, historically the state did not grant limited liability to all corporate forms, only those chartered by the state.[917] Although there are inconsistencies in the history of limited liability,[918] it was made generally available only with the Limited Liability Act of 1855. Unincorporated joint stock companies could replicate all the features of incorporated companies, excluding limited liability;[919] albeit limited liability was not as important as it is today because liability for tortious conduct generated by corporate activity towards third parties was relatively unheard of in the eighteenth century.[920]

Within the framework of the modern concession theory, the primary emphasis remains on the rights and powers granted to companies by the state, rather than on their liabilities. However, it is important to note that the concept of limited liability, central to contemporary company law, may still be subject to certain restrictions under this theory. If the company is a legal construct that derives its existence, rights, and duties from the state, the logical conclusion is that the company is compliant with the state and subject to public interest. Therefore, it could be argued that either the state legislature can and should limit companies' abuses through the law,[921] or, by virtue of granting legal status to companies, it tacitly endorses their current activities, while also retaining the authority to limit abuses through legislative means.[922] The concession theory allows for state intervention, such as altering the limits, in certain circumstances, of shareholder limited liability.[923]

It is true that this reflects reality, and the state currently does gatekeep what the company can and cannot do,[924] but the concession theory fails to adequately address the issue of risk externalisation due to its inherent limitations. Although concessionists might weigh the societal benefits against the harms caused by corporate entities, the theory primarily focuses on

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[917] And even in this case, the members could be forced to contribute to the company's liabilities: see Joshua Getzler and Mike Macnair, 'The Firm as an Entity Before the Companies Acts' in Paul Brand, Kevin Costello and W. Nial Osborough (eds), *Adventures of the law: proceedings of the Sixteenth British Legal History Conference, Dublin, 2003* (Four Courts 2005) 279-288.

[918] Whether it originated with colonial companies: Dari-Mattiacci and others, 'The Emergence of the Corporate Form' (n42), or not: Watson, *The Making of the Modern Compan*y (n103) 106-107, there is not enough evidence or real authority during the seventeenth and eighteenth century stating whether shareholders could be made liable for companies' debts to third parties.

[919] The deed of settlement could potentially limit shareholder liability, but shareholders were not protected from claims by third parties: see Watson, *The Making of the Modern Compan*y (n103) 115-116.

[920] Gary M. Anderson and Robert D. Tollison, 'The myth of the corporation as a creation of the state' (1983) 3(2) International Review of Law and Economics 107, 114-115 and footnote 43, citing that there is very little discussion in the records regarding corporate liability to third parties and lawsuits were practically unheard of.

[921] Ripken, *Corporate Personhood* (n890) 25-26.

[922] Incorporation starts with a check by the state and the state sets the rules by which companies operate. Nevertheless, states '*have seemed powerless to regulate or control* [companies]*'*: Watson, *The Making of the Modern Compan*y (n103) 281.

[923] Goodhart and Lastra (n126).

[924] Hardman, 'The Making of Corporate Legal Concession Theory' (n845) 197.

granting concessions within the framework of the corporate form without inherently advocating for significant restrictions to mitigate externalities going beyond the corporate form. Consequently, the concession theory provides a static conceptualisation of the company, centred on the legal framework provided by the state, which may overlook the dynamic nature of corporate activities and their impacts on third parties. Furthermore, the concession theory's emphasis on the state's role in providing legal recognition to corporate entities does not inherently compel it to intervene to address risk externalisation.[925] While acknowledging the state's authority to regulate corporate activities, the concession theory lacks an initiative-taking stance in demanding greater restrictions or counter-concessions from entities causing harm.

As Hardman argues, there should constantly be a balance between the benefits and harms generated by the business organisation holistically, and greater limitations should be put in place as a consequence of greater harm.[926] However, while Hardman suggests that the concession theory provides the state with the *locus* and duty to intervene, and hence the state could provide the limitations required, such an approach would not address the issue of risk externalisation effectively. The current theories of the corporate form, including the concession theory, lack a precise conceptualisation of the "enterprise" and its role in externalising risk. Without this, they lack adequate mechanisms for limiting corporate harm when the economic activity does not match the corporate form.

The traditional understanding of the corporate form, as outlined in the literature[927] and promoted in company law, conflates the legal boundaries of the corporate entity with the economic boundaries of the enterprise. This oversimplification overlooks the complexities of modern business structures, particularly corporate groups, which operate within a broader economic context.[928] Albeit the current law is essential for defining and regulating corporate entities, it does not fully capture the economic realities.

Recognising the distinction between the legal entity and the economic enterprise is crucial for addressing risk externalisation. The misalignment between these boundaries allows internal constituencies, such as directors and shareholders, to manipulate the corporate structure to their advantage, causing exacerbated harm to third parties outside the legal boundaries of the company.[929] For example, in corporate groups, assets may be partitioned among different units, diverting them away from unsecured creditors who lack awareness and legal recourse. Due to the concession theory being rooted in understanding the corporate form in terms of its

[925] Hardman, 'The Making of Corporate Legal Concession Theory' (n845) 197-198.
[926] ibid 198.
[927] See Deakin and others (n85).
[928] Expanded in ch 6.
[929] Issue generally recognised in the literature: see Squire, 'Strategic Liability in the Corporate Group' (n26).

artificial personality and the role of the state in limiting its concession, it provides a disproportionate focus on corporate boundaries rather than on the economic activity.[930]

However flawed, the concession theory offers a valuable scholarly contribution to the debate about the company. First, it illuminates the role of the state in regulating companies and the role of company law in creating a legal framework for companies. In turn, this should advocate for great corporate accountability to society.[931] Secondly, and as a result of the first claim, the concession theory could indeed provide the right narrative to stop equating the company's interests with shareholders'[932] and enforce greater corporate social responsibility norms.[933] Thus, this thesis does not wish to dismiss the theory completely, but only to point out the flawed line of inquiry. By acknowledging the gap between economic and legal realities, scholars can revisit existing theories and understand their limitations when it comes to providing greater protections to parties outside the corporate form. This re-evaluation should focus on developing mechanisms that account for the broader economic considerations of the enterprise and its effects on society while still respecting the legal framework of corporate entities.

5.3. Aggregate Theory

The aggregate theory views the company as an aggregation of individuals staying together for periods of time that are longer compared to market transactions.[934] In other words, it looks at the company as a set of ongoing relational connections rather than single exchanges that would be created by using the market. During the nineteenth century, this theory was also a competitor to the concession theory.[935] The latter was more popular in the U.S., whereas the former had stronger support in England.[936] This divergence can be explained by the dissimilar historical origins of companies within these two countries. On the one hand, the U.S. more readily accepted business organisations by granting incorporation through special acts of the legislature; on the other hand, in England before 1844, there was a reluctance to grant

[930] Which is the focus of ch 6.
[931] See Hardman, 'The Making of Corporate Legal Concession Theory' (n845) 198.
[932] See (n78): CA 2006, s 172(1).
[933] Stefan J. Padfield, 'Corporate Social Responsibility & Concession Theory' (2015) 6(1) William & Mary Business Law Review 1, 21-25.
[934] Easterbrook and Fischel, *The Economic Structure of Corporate Law* (n50) 8.
[935] During the first half of the nineteenth century, companies were considered akin to partnerships and based on their shareholders. Therefore, before incorporation was easily available, companies were not considered to be legally separate from shareholders. See Watson, *The Making of the Modern Company* (n103) ch 9.
[936] Nicholas H. D. Foster, 'Company Law Theory in Comparative Perspective: England and France' (2000) 48 American Journal of Comparative Law 573, 585; Choudhury and Petrin, *Understanding the Company Corporate Governance and Theory* (n838) 234.

charters, and therefore it was the influence of unincorporated partnerships that laid the foundations for the evolution of modern English companies.[937]

Following the discourse that companies were artificial creations, the aggregate theory reformulated the influence of state power on the incorporation of companies and put an emphasis on the fact that companies were formed by natural persons and created by private initiative.[938] Adopting the analogy of the partnership, theorists started to describe the company as a set of contractual relationships between corporate participants, and by describing it as such, the aggregate theory is the theory of separate legal personality that in reality does not accept that the company is a separate entity.[939]

This conception of contractual relations forming a company developed in England after the Bubble Act of 1720, which rendered unincorporated companies illegal.[940] Due to the great limitations of the Act, traders responded with the creation of "deed of settlement" companies.[941] After the 1720 Act, incorporation was only legally achieved when granted by the state. Yet, investors could mimic the corporate form with contracts and trusts, without a concession from the state. These types of companies were essentially common law partnerships imitating the corporate form, which did not possess by default shareholder limited liability,[942] and the assets of the company were held by trustees, which ring-fenced them from attack from the personal creditors of the trustees.[943] The use of trusts made it possible for investors to circumvent the difficulties posed by partnerships, namely that they could own property and have property rights over the fund as a whole.[944] Therefore, deed of settlement companies possessed entity shielding[945] and could effectively replicate the activities of incorporated companies without being recognised formally as separate legal entities.[946]

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[937] Laurence C. B. Gower, 'Some Contrasts between British and American Corporation Law' (1956) 69(8) Harvard Law Review 1369, 1371.
[938] Millon, 'Theories of the Corporation' (n421) 211.
[939] Michael J. Phillips, 'Reappraising the Real Entity Theory of the Corporation' (1994) 21(4) Florida State University Law Review 1061, 1066.
[940] Margaret Patterson and David Reiffen, 'The Effect of the Bubble Act on the Market for Joint Stock Shares' (1990) 50(1) The Journal of Economic History 163, 169.
[941] Andreas Televantos, *Capitalism Before Corporations: The morality of business associations and the roots of commercial equity and law* (Oxford University Press 2020) 36.
[942] Unincorporated joint stock companies could contract for limited liability, although tortious liability was still an "unexplored area": see Anderson and Tollison (n920).
[943] Michael Lobban, 'Joint Stock Companies' in William Cornish and others (eds), *The Oxford History of the Laws of England: Volume XII: 1820–1914 Private Law* (Oxford University Press 2010) 615.
[944] See an introduction to the concept of trust in Remus Valsan, 'The Trust as Patrimony: An Introduction' in Remus Valsan (ed), *Trusts and Patrimonies* (Edinburgh University Press 2017) 6.
[945] See 2.1.2.
[946] John Morley, 'The Common Law Corporation: The Power of the Trust in Anglo-American Business History' (2016) 116 Columbia Law Review 2145, 2170.

After incorporation became widely available, legal personality was no longer considered a concession of the state;[947] instead, the role of the human beings behind the company was emphasised. This theory developed further in the twentieth century into the "nexus-of-contracts" model within neoclassical economic theory.[948] During this later period, with the growth of large companies and the separation between ownership and control, managers became the strategic centre of companies, and the governing power was vested in the directors, subject to shareholders' approval.[949] The economic theory challenged this vision and refocused attention on the individuals forming the entity. Scholars rely on transaction cost economics[950] to explain the existence of the company, specifically corporate participants who come together to maximise their returns by economising on transactions through a firm.[951] However, through these lenses all the interactions of a company are contracts, and separate legal personality is reduced as a tool to reduce transaction costs.[952]

In the economic analysis, the distinction between the purely legal concept of the company and the economic enterprise - to a certain extent - is present.[953] Economists use the concept of "firm". The firm is a more general concept that can incorporate the legal definition of the company within its formulation, insofar as firms are generally organised using companies.[954] The firm is based on contractual relations or is even viewed as a set of contracts,[955] which is understood in a wider sense as any kind of voluntary agreement involving an exchange of resources.[956] Thus, the core conception of the firm is founded on parties coming together to work on a common purpose, which can be realised by using the legal mechanism of the company.

Both the aggregate and nexus-of-contracts theories agree that the company as an entity exists only for the individuals and their relations. They have similarities in the conception of the company. Both agree on the fact that the entity is a legal fiction and use contractualism to critique hierarchies, such as the government.[957] While the aggregate view focuses on the

[947] Claassen, 'Political theories of the business corporation' (n33) 3.
[948] ibid 4.
[949] Bratton, 'The New Economic Theory of the Firm' (n52) 1476.
[950] Explained in the economic dynamics in 3.4.
[951] Micheler, *Company Law: A Real Entity Theory* (n852) 3.
[952] Frank H. Easterbrook and Daniel R. Fischel, 'The Corporate Contract' (1989) 89 Columbia Law Review 1416, 1426.
[953] This thesis will interpret the firm in ch 6. This paragraph relates only to other scholars' ideas.
[954] Simon Deakin, David Gindis and Geoffrey M. Hodgson, 'What is a firm? A reply to Jean-Philippe Robé' (2021) 17(5) Journal of Institutional Economics 861, 865.
[955] Armen A. Alchian and Harold Demsetz, 'Production, Information Costs and Economic Organization' (1972) 62(5) American Economic Review 777, 794; Armen A. Alchian, 'Specificity, Specialization and Coalitions' (1984) 140(1) Journal of Institutional and Theoretical Economics 34, 42.
[956] David Gindis, 'From fictions and aggregates to real entities in the theory of the firm' (2009) 5(1) Journal of Institutional Economics 25, 27.
[957] Bratton, 'The New Economic Theory of the Firm' (n52) 1515.

aggregation of shareholders, the latter favours the firm's aggregate parts, i.e., contractual relations, but both justify the superior position of shareholders. The aggregate theory regards the company's rights and duties as derivative of its shareholders or other corporate participants.[958] Similarly, the modern contractarian view and its supporters have promulgated the view of shareholder primacy.[959] Shareholders, in this view, are the residual claimants of the company.[960] Because their investment is variable, being based on what is left over after all the company's obligations are satisfied, they have the strongest incentives to maximise corporate profits, and managers' decisions are aligned with the company's decisions and the shareholders' interests.[961]

The contractarian approach, in both instances, poses limitations on legal personality. It does not fully engage with legal personality since the latter is simply a fictional construct under the law. By considering legal personality as fictional, the contractarian approach overlooks or downplays its significance in shaping the rights, duties, and liabilities of the company. It focuses more on the practical implications of contractual relationships among individuals within and with the company. The company is a term used to describe contractual arrangements organising economic activities and having the contractual individuals acting for the business.[962] This highlights the significant argument that the company functions primarily as a mechanism for saving transaction costs.[963] It is simply a tool or a device. Such logic implies that it is irrelevant to scrutinise whether the concept of separate legal personality works satisfactorily in respect of balancing the rights and responsibilities granted by law to the company.[964] The drawback of the economic analysis is, therefore, that companies have no precise boundaries, and even though legal personality is fictitious, it is not relevant since the entity itself, in its capacity as a participant in the "nexus of contracts", is used only as a matter of convenience.[965]

The weakness of the aggregate theory was in delimiting responsibility in connection with legal personality. This weakness lies in the consequences of failing to delimit responsibility, leading to potential confusion and unfair results. Under the aggregate theory, the company was still

[958] Petrin, 'Reconceptualizing the Theory of the Firm - From Nature to Function' (n827) 10.
[959] Seen as profit maximisation: Henry G. Manne, 'The "Higher Criticism" of the Modern Corporation' (1962) 62(3) Columbia Law Review 399, 402.
[960] They receive the residual profits after all the fixed claims (e.g. paid employees, suppliers, etc.) have been met. The idea of "residual claimants" is used to justify shareholder primacy. See Easterbrook and Fischel, 'Voting in Corporate Law' (n50) 403-06.
[961] Mark E. Van der Weide, 'Against Fiduciary Duties to Corporate Stakeholders' (1996) 21 Delaware Journal of Corporate Law 27, 57-62.
[962] Steven N. S. Cheung, 'The Contractual Nature of the Firm' (1983) 26(1) The Journal of Law & Economics 1, 3.
[963] Easterbrook and Fischel, 'The Corporate Contract' (n952) 1426.
[964] Hardman, 'Fixing the misalignment' (n25) 444.
[965] Bratton, 'The New Economic Theory of the Firm' (n52) 1499, footnote 137.

recognised as a unit capable of bearing rights and duties, although the lack of legal personality created issues. The issues resided in the conception that the legal entity's rights and duties were seen as being those of the shareholders.[966] Two implications follow from this. First, the aggregate theory struggled to reconcile with the idea of corporate liability because legal entities could not be liable; only its human representatives could be held responsible.[967] Secondly, the aggregate theory could not explain the rise of limited liability, which heightened the distinction between the company and its shareholders.[968] Accordingly, there were issues with both views of the company, even though the contractual model was exceptionally successful at the time and led to the belief that incorporation and legal status of the corporate form were not necessary for the success of a business.[969]

There is no doubt that companies today do possess legal personality, a fundamental aspect that shapes their rights, responsibilities, and interactions within the legal framework. Given the significance of legal personality in defining the scope of corporate activities and relationships, it is necessary to discuss the effect of legal personality and how the contractarian approach would look by extension at corporate groups. As aforementioned, when applied to single companies, the aggregate theory and its modern version refer to legal personality as a fiction representing the sum of its (contracting) individuals. It follows that at the corporate group level, the aggregate theory might also recognise the enterprise as a fictional construct that represents all the (contracting) units in the group, such as the parent companies and their subsidiaries. Easterbrook and Fischel, on this point, mention that corporate groups may choose among several types of organisational structures due to the contractual nature of the corporate form.[970] This means that by looking at companies as a set of contractual relations, it is possible to see the enterprise *in loco* of the individual companies within the group, forming the fictional entity that creates sets of contracts among those legal entities. When we expand the contractualist perspective to encompass an entire corporate group, we are essentially zooming out to look at the collective network of contracts and relationships that exist among all the companies within that group. Instead of viewing each company in isolation, we are considering how these entities interact and collaborate with each other as part of a larger organisational structure. Thus, the corporate group can be conceptualised into the aggregate of these contractual relationships and interactions within itself.

[966] Martin Petrin, 'Theoretical approaches to corporate liability' in Martin Petrin and Christian A. Witting (eds), *Research Handbook on Corporate Liability* (Edward Elgar 2023) 27.
[967] ibid 31.
[968] Avi-Yonah, 'The Cyclical Transformations of the Corporate Form' (n190) 789-790.
[969] Watson, 'The Corporate Legal Person' (n886) 149.
[970] Easterbrook and Fischel, *The Economic Structure of Corporate Law* (n50) 12.

By following the rhetoric of the theories of the company, the contractarian paradigm could interpret the company in a way that recognises the corporate group in its totality. Although this is a possibility and the theory could recognise the enterprise as opposed to the traditional legal entity view, by itself, it lacks the capacity to serve as a justification for extending liability within a group structure. First, more generally, the theory, by viewing companies as akin to the product of a multitude of private contracts, has normative implications insofar as it dictates an anti-regulatory approach to companies and avoids interfering with consensual actions.[971] This laissez-faire approach is justified based on the assumption that internal company rules typically do not generate external effects.[972] Contrary to this assertion, this thesis has proved in chapters 2 and 3 that internal company rules and dynamics can indeed have significant external effects.

Through the contractarian lenses, if the company is an aggregation of shareholders (and directors), corporate activity is nothing more than the pursuance of each of these individuals' economic objectives. The purpose of the company and its regulation are consequentially private and do not fall under a legitimate public interest.[973] Accordingly, corporate decisions will revolve around shareholders' interests, and the idea of an "extended social responsibility"[974] would appear illogical to the strictest proponents of this theory.[975] This is because private contracting will account for the interaction between shareholders and non-shareholders, and non-shareholders can either contract for further protection or, when protection is not accounted for, legal regulation alone cannot take into account the specific relationships between the company and other individuals.[976] From this conclusion, the implications of the contractarian paradigm are far removed from the normative position taken in this thesis regarding the use of company law to address outside harms and, hence, it provides no support and cannot be used for resolving the issue of risk externalisation. While the contractarian paradigm, and the other theories analysed in chapter 5, cannot serve as a comprehensive solution for resolving the issue of risk externalisation within the context of corporate groups, they can still bring value to the legal discourse. Hence, the following chapter will expand on these theories and supplement them with the holistic solution advocated by this thesis.

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[971] Susanna K. Ripken, 'Corporations Are People Too: A Multi-Dimensional Approach to the Corporate Personhood Puzzle' (2010) 15(1) Fordham Journal of Corporate & Financial Law 97, 111.
[972] Easterbrook and Fischel, 'The Corporate Contract' (n952) 1429-1430.
[973] Millon, 'Theories of the Corporation' (n421) 224.
[974] In the sense of looking beyond corporate boundaries and mitigating external harms.
[975] See for instance Milton Friedman, 'The Social Responsibility of Business Is to Increase Its Profits' *New York Times* Magazine (13 September 1970) 122.
[976] See, for instance, this argument in relation to hostile takeovers in Jonathan R. Macey, 'Externalities, Firm-Specific Capital Investments, and the Legal Treatment of Fundamental Corporate Changes' (1989) Duke Law Journal 173.

Indeed, the contractarian approach made significant contributions that persuaded scholars and informed UK company law. For instance, the residual claimant argument advanced by contractarian scholars informed s. 172 of the Companies Act 2006[977], which implies that the interests of the company are the same as those of the shareholders.[978] Moreover, the idea of the principal-agent model,[979] within the modern contractarian theory, developed the legal strategy of reducing shareholders' managerial agency costs by constraining directors' conduct with codified duties to the company.[980] Therefore the contractarian approach does have some merits. It sheds light on internal dynamics between shareholders and directors, albeit with a narrow focus that excludes external effects.

The theories of the corporate form can be interpreted in any way that suits any author's intended conclusion. The contractarian approach could indeed recognise the enterprise,[981] but only as a set of contracts between the entities that are part of the group and the respective shareholders. The outcome would recognise the existence of an enterprise, albeit considered a fictional personality, and imply that legal rules could be applied to the entirety of the corporate group. Nonetheless, there are limitations to the extent that such an enterprise would exist for the purpose of responsibility. As mentioned above, the aggregate theory struggles with attributing liability to fictional identities, which means that the responsibility for business conduct will rest on the individuals forming the companies within the nexus. Similarly, the enterprise's liabilities will need to be attached to the individuals acting on behalf of the entity committing a wrong. As a result, it will raise the same challenges of how to extend liability within the group analogously to the traditional legal entity approach, and it will disregard once again the relationships amongst the companies forming the horizontal and vertical links of the group.[982] Its modern version does not even consider external effects to exist or to be a problem.[983]

From the outset, the traditional aggregate theory appears to contrast with the rule of limited liability. An aggregation of individuals coming together for an economic activity implies that those liable for the operations of such activity are the individuals forming the aggregation and not the aggregation as a fictional character. If companies are simply the aggregation of shareholders, there is no justification for restricting creditors' access to shareholders' property

[977] See 4.1.4.
[978] Micheler, *Company Law: A Real Entity Theory* (n852) 6.
[979] See (n45).
[980] Davies, *Introduction to Company Law* (n112) ch 6.
[981] For this argument, the author considers only the internal contracts of the enterprise, i.e., only those between the corporate group and the shareholders.
[982] Virginia H. Ho, 'Theories of Corporate Groups: Corporate Identity Reconceived' (2012) 42 Seton Hall Law Review 879, 904.
[983] Easterbrook and Fischel, 'The Corporate Contract' (n952) 1429-1430.

and giving shareholders a right that individuals do not possess.[984] As a matter of fact, the traditional aggregate view is said to be able to restrict limited liability since the latter needs to be justified on the grounds that the company is a separate entity distinct from its shareholders.[985] The more recent contractarian view resolves this issue by regarding limited liability as a contract term and legal rules as irrelevant because parties can simply contract for limited liability.[986] The modern contractarian proponents consider limited liability as the norm. Either business organisations already possess it, or they will attempt to create it by contract.[987] As highlighted by several scholars, this view presents paradoxes. The company and its features cannot be formed by contract alone,[988] and it will be difficult to justify this position in the case of involuntary creditors. By definition, involuntary creditors will not join the nexus of contracts voluntarily; thus, any contractual term of limited liability within the nexus will not bind those parties.[989] Therefore, looking at the consequences of the use of corporate form from a contractarian perspective would not account for or present the right solution to the issue of risk externalisation.

5.4. Real Entity Theory

The real entity theory originated with German scholars. More specifically, Otto von Gierke is considered its father,[990] and its principles were later introduced into the Anglo-American sphere.[991] This theory did not profess that the company was a fiction, but a real person with a body and a will of its own.[992] Thus, due to its real nature, it existed independently from both the law and its shareholders, and the theory was used to support the expansion and legitimisation of companies.[993] Scholars arguing in favour of the company as a real entity believed that legal personality was not created by law; the law simply recognised the existence of an independent, pre-existing group-entity with legal capacity.[994]

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[984] Harris, 'The Transplantation of the Legal Discourse on Corporate Personality Theories' (n861) 1470.
[985] Horwitz, *The Transformation of American Law, 1870-1960: The Crisis of Legal Orthodoxy* (n852) 75-76.
[986] For a concise summary of academic articles on this point, see Ribstein (n301) 82.
[987] Easterbrook and Fischel, 'Limited Liability and the Corporation' (n225) 93.
[988] Hansmann and Kraakman, 'The Essential Role of Organizational Law' (n48) 390; Margaret M. Blair, 'The four functions of corporate personhood' in Anna Grandori (ed), *Handbook of Economic Organization* (Edward Elgar 2013) 440.
[989] David Gibbs-Kneller and others, 'Not by Contract Alone: The Contractarian Theory of the Corporation and the Paradox of Implied Terms' (2022) 23 European Business Organization Law Review 573, 595.
[990] Martin Gelter, 'Taming or Protecting the Modern Corporation? Shareholder-Stakeholder Debates in a Comparative Light' (2011) 7 New York University Journal of Law and Business 641, 667.
[991] Harris, 'The Transplantation of the Legal Discourse on Corporate Personality Theories' (n861) 1432.
[992] von Gierke (n873) XI.
[993] Daniel Lipton, 'Corporate Capacity for Crime and Politics: Defining Corporate Personhood at the Turn of the Twentieth Century' (2010) 96 Virginia Law Review 1911, 1916.
[994] Phillips (n939) 1069 and footnote 49; Micheler, *Company Law: A Real Entity Theory* (n852) ch 1.

The adoption of the real entity view in England[995] was driven by the impossibility of maintaining partnership analogies when describing modern companies. On the one hand, as stated above, investors sought the corporate form to procure the features of separate legal personality,[996] and on the other hand, they started to become more detached from the company's activities and lose its resulting responsibilities.[997] Moreover, general incorporation statutes rendered the corporate form available to anyone who complied with '*minimal formalities'*.[998] These changes led to a re-evaluation of the relationship between the state and the company, but also the view of equating the company with shareholders.[999] While jurists do not provide a uniform definition of "reality", one thing they all agree on is that the law should take into consideration social facts, since they form the content of the law and therefore cannot be excluded in its analysis.[1000]

Social facts are created when a group of individuals, *social beings*, share collective intentionality and participate in society, which implicates two factors: (a) individuals no longer act as individuals but as a collective, and (b) this social fact is recognised by everyone, leading to the collective itself, i.e., the company, being real.[1001] Although this perception of the company has been stretched to '*grotesque lengths'*, for instance, by giving companies human attributes, such as organs or genders,[1002] the heart of the company's identity is the social phenomenon of a group and not a corporeal presence. It is important to distinguish the broader aspect of a group from the aggregate theory. As mentioned above, the latter stated that a company was the sum of its members. In contrast, according to the real entity theory, the company as a social being is distinct, independent, and superior to a mere sum of individuals, whose change of identity is not relevant to the existence of the company.[1003]

At the time the real entity theory reached English scholars, there was a great deal of interest in sociology, and sociological jurisprudence originally employed the conception of the company corresponding to a natural person to eliminate the anomaly of a fictitious person being liable or "punished".[1004] Due to the difficulty of attributing liability to the "corporate

[995] Frederic W. Maitland, 'Moral Personality and Legal Personality' (1905) 6(2) Journal of the Society of Comparative Legislation 192, 193.
[996] Blair, 'Corporate Personhood and the Corporate Persona' (n106) 794.
[997] Gregory A. Mark, 'The Personification of the Business Corporation in American Law' (1987) 54(4) University of Chicago Law Review 1441, 1464.
[998] Millon, 'The Ambiguous Significance of Corporate Personhood' (n859) 43.
[999] ibid 43-45.
[1000] Frederick Hallis, *Corporate Personality: A Study in Jurisprudence* (Oxford University Press 1930) 139.
[1001] Adelstein (n867) 345.
[1002] Arthur W. Machen, 'Corporate Personality' (1911) 24(4) Harvard Law Review 253, 256.
[1003] Ripken, 'Corporations Are People Too' (n971) 113.
[1004] Mark Hager, 'Bodies Politic: The Progressive History of Organizational 'Real Entity' Theory' (1989) 50(2) University of Pittsburgh Law Review 575, 586.

person" under the concept of artificial personality promulgated by the concession theory, and the aggregate theory failing to explain the development of limited liability in the corporate form, the natural entity theory gained support in the Anglo-American discourse towards the twentieth century.[1005] In more detail, the proponents of the legal fiction could not attribute liability to the legal entity as it lacked the state of mind that a human person would require to be held responsible.[1006] While attaching liability to an artificial entity or legal fiction would be considered an anomaly, the real entity theory, by looking at the company as real, could recognise the company itself as being subject to liability.[1007] This idea of companies' liability can also be reconnected to the broader conception of the collective, as when individuals share a collective goal and contribute towards its outcome, it is the collective that acts as a whole and will be responsible for the action, whereas its members could only be responsible for their individual contributions.[1008]

Gindis distinguished three generations of real entity theorists.[1009] This separation is important because it demonstrates an evolution in the theory. He argues that a common criticism against the real entity theory is that it relies on organicist and vitalist claims - i.e., the company is a living organism - yet, these claims were rejected by later real entity theorists, who provided different foundations.[1010] The first generation began with German scholars and Gierke, where the idea was presented that the company's real person also had a real will of its own,[1011] which was described subsequently by Brown as the common will to continue to work collectively as a unit.[1012] The second generation focused on the sociological aspect mentioned above, and a prominent scholar of this generation would be Freund. He argued that the features creating a real entity are the unity of individuals, the distinctiveness of the unity, and the identity of the body in succession. [1013] Although the psychological unity creates reality and gives due weight to moral aspects of liability and action of the collective, the fiction theory was considered partly right in asserting that separate legal personality is an instrument of law.[1014]

Second generation theorists concentrated their arguments on the liabilities of the unit; as Machen stated, *'the essence of juristic personality [lies] in subjection to liabilities'*.[1015] The social consequences of the corporate form are visible in the company's actions that regulate

[1005] Millon, 'The Ambiguous Significance of Corporate Personhood' (n859) 43, 46.
[1006] Petrin, 'Theoretical approaches to corporate liability' (n966) 31.
[1007] Hager (n1004) 587.
[1008] Tracy Isaacs, *Moral Responsibility in Collective Contexts* (Oxford University Press 2011) 55.
[1009] Gindis, 'From fictions and aggregates to real entities in the theory of the firm' (n956) 32.
[1010] ibid 26.
[1011] von Gierke (n873) XI.
[1012] Brown (n905) 265.
[1013] Ernst Freund, *The Legal Nature of Corporations* (The University of Chicago Press 1897) 62-63.
[1014] ibid.
[1015] Machen (n1002) 263.

natural persons' lives to an increasing extent every day.[1016] Thus, a real entity view was originally thought to procure justice insofar as it would impose more responsibilities on the companies acting in an economic situation.[1017] As Freund pointed out, the connection between act and liability could be established only if the law dealt with "individuals".[1018] Nonetheless, Gindis suggests that this generation of theorists focused disproportionally on personality, and the term "person", by involving rights and duties, implies some moral issue that generates confusion.[1019]

Third generation theorists abandoned completely the discussion of personality. They emphasised the consequences of viewing the company as an entity.[1020] In light of this, it does not seem appropriate to regard these theorists as real entity theorists due to their detachment from the strictly traditional conception of the corporate form, which does not necessarily advocate for a "real" entity to exist but for the law to address the consequences of having an entity under the law. Berle, for example, whom Gindis cited as a third generation theorist[1021] advocated that the law should recognise the economic reality as an "entity" and move away from the limiting boundaries of incorporated legal personalities.[1022] It follows that this generation of theorists cannot be classified as real entity theorists because they move away from the debate over the company's nature, which is the traditional angle upon which the company is interpreted.

As a matter of rhetoric, corporate groups, based on one interpretation of the real entity theory, could be regarded as a unified entity for the purpose of attributing liability. Applying the real entity view to the corporate group would entail having a "real" enterprise, namely a corporate group identity of its own that is separate from the companies within the group. This would mean that the group itself would function as a legal distinct collective and no longer as a series of individual companies, with everyone acknowledging the existence of the group, leading the group to be "real". Therefore, even the real entity theory will, to some extent, reconcile the legal and the economic reality of the corporate group, where companies cease to act independently and will follow a system of unified control with group-wide policies and

[1016] George F. Deiser, 'The Juristic Person- I' (1908) 57(3) University of Pennsylvania Law Review 131, 141.
[1017] Harold J. Laski, 'The Personality of Associations' (1916) 29(4) Harvard Law Review 404, 416.
[1018] Freund (n1013) 9.
[1019] David Gindis, 'Some Building Blocks for a Theory of the Firm as a Real Entity', in Yuri Biondi, Arnaldo Canziani and Thierry Kirat (eds), *The Firm as an Entity: Implications for Economics, Accounting and the Law* (Routledge 2007) 275.
[1020] Gindis, 'From fictions and aggregates to real entities in the theory of the firm' (n956) 35.
[1021] ibid.
[1022] Berle, 'The Theory of Enterprise Entity' (n2).

management choices.[1023] Having a real enterprise also means that the enterprise will bear rights and duties, and consequentially, legal liability can be attributed to the group as a whole.

However, adopting a real entity view of corporate groups appears to be just as problematic as adopting any of the other theories discussed before. The characterisation of the enterprise as real will give rise to disagreement over what kind of person the enterprise is and the role of the law regarding such person. This is because the traditional theories of the corporate form focus on the "nature" of the company and its interpretation will be subject to the proponent's normative principles. As Gindis stated, any kind of personification creates moral confusion,[1024] unless there is no investigation into the meaning of "person" and one takes the term "person" simply as synonymous with a '*right-and-duty-bearing unit*'.[1025] In fact, by adopting a real entity view, opposite views can be justified. It could be argued that the company's conduct should not be regulated differently than that applicable to natural persons, hence favouring an anti-regulatory approach. It could also be argued that real personhood implies some social responsibility and promotes normative moral implications.[1026] It follows that the theories of legal personality, while influential in the scholarly debate, cannot, by themselves, fix the issue of risk externalisation. This thesis recognises the merits of the theories and does not wish to completely dismiss them. As it will be explained in chapter 6, the traditional theories will be supplemented by a separate line of inquiry, which will move away from the discussion on the company's nature to the effects of using a corporate form and its consequences to society.

A recent attempt to promote the real entity theory was undertaken by Professor Micheler.[1027] Her excellent monograph reconciles doctrinal company law with the real entity theory of the company. The author explains at the beginning of her book that she relies extensively on legal positivism without explicitly making a normative case for the theory.[1028] She wishes to decouple the positive and normative claim by arguing that the theories of the corporate form are inconclusive in answering normative questions.[1029] While it is true that all three theories are inconclusive and are simply a matter of rhetoric, it is important to guide the theory from normative principles. It is easier to shape a theoretical framework by basing it on normative principles, rather than arrive at normative conclusions by interpreting the theoretical framework in a way that justifies our normative position. Although Professor Micheler argues against a normative case for the theories of the corporate form, she arrives at the same

[1023] Manovil (n433) 6.
[1024] Gindis, 'Some Building Blocks for a Theory of the Firm as a Real Entity' (n1019) 275.
[1025] Which, by itself, conveys no implications except the fact that the company has rights and duties under the law. Dewey (n839) 656.
[1026] Millon, 'The Ambiguous Significance of Corporate Personhood' (n859) 46-49.
[1027] Micheler, *Company Law: A Real Entity Theory* (n852).
[1028] ibid ch 1.
[1029] ibid.

conclusion that if the company is *x*, and company law rules are *x*, then *y* should follow. In particular, she refutes that it is possible to deduce the configuration of company law by the positive interpretation of the company;[1030] nevertheless, she argues three normative claims as a result of her interpretation of the company.[1031] These three claims refer to the fact that a stakeholder perspective or, more generally, corporate social aims are unattainable because they do not affect the real social structure of the company.[1032] And they follow from the positive interpretation that companies are real social actors characterised by several factors, such as culture and habits, that are naturally created when human beings come together. Once again, we can see the rhetoric of the theories. There is in effect no decoupling of positive and normative claims, but the normative claims follow, consequently, the positive interpretation.

She also tries to make all existing legal vehicles fit into this conceptualisation of company law. Naturally, this approach can create confusion when parts of company law cannot be explained and justified simply through the real entity lenses. This observation underscores a broader issue in the theory of the corporate form: while each theoretical framework strives to provide the most accurate interpretation, none can offer a flawless explanation. Indeed, all theories, including the real entity perspective, have their limitations and fall short in fully capturing the complexities of corporate structures. The issue of risk externalisation that the corporate form creates can be considered one of the '*aberrations'* of company law that needs to be remedied and should not be regarded as a perfect description of existing company law.[1033] Professor Micheler discusses corporate groups through the lenses of the real entity theory.[1034] In this instance, we also find a disproportionate reliance on existing doctrinal company law with a focus on the traditional legal entity view. She states that the liability of corporate groups is not rooted in company law.[1035] However, as discussed in this thesis, it is crucial to acknowledge corporate group liability as a significant concern within company law and recognise the role of company law in addressing any associated issues. The alignment of corporate group liability with existing legal frameworks leads to unrepaired harms. This prompts further examination of the relationship between corporate group liability and company law, especially when company law rules seem to diverge from the theoretical underpinnings of company law principles.[1036]

[1030] Micheler, *Company Law: A Real Entity Theory* (n852) 265.
[1031] ibid 260.
[1032] ibid 260-261.
[1033] Jonathan Hardman, '[Review of] Company Law: A Real Entity Theory by Eva Micheler' (2023) 139 Law Quarterly Review 173, 174.
[1034] Micheler, *Company Law: A Real Entity Theory* (n852) 42-44.
[1035] ibid 68.
[1036] Such as the origins and purpose of limited liability. See 2.1.4 and 3.3.

The real entity view is important in the legal discourse. The rise of this theory led to the attribution of liability to the company as an entity. According to Horwitz, the theory played a major role in legal discourse on the development of limited liability by drawing a line between the company's own liability and shareholders' liability.[1037] From 1856 onwards, shareholder limited liability became the default position, and the company started to be recognised as a real entity separate from its shareholders. The real entity theory acknowledged this position. Although the legal entity was thought to be real, the theory was also confronted with the fact that the entity could not act by itself; instead, it needed "organs" that could bind the company as if it were the legal entity itself acting.[1038] The liability attributed to the company by the real entity theory is only in addition to personal liability, not a replacement.

Therefore, according to the real entity theory, personal liability can be attributed to the internal members of the entity when acting in their official capacity.[1039] The importance of this is that limited liability, as much as it is an important feature of the corporate form, should not be seen as an absolute concept. Even the real entity theory, which acknowledged a clear separation between the company's and the shareholders' liability, realised that the limited liability of shareholders is not a necessity for the corporate personhood to exist. It should be paramount for this theory to recognise also that a normative claim would argue in favour of a change in existing company law rules. It is not sufficient to say that existing company law accepts the entity as real. It is imperative that scholars appreciate the full extent of the corporate form. If we accept that company law grants the legal entity and shareholders the benefits of the corporate form, and it is the legal use of the corporate form that creates harm to third parties, then it is the role of company law to remedy those harms. It is also important to follow a theoretical framework that embraces these changes and detaches itself from the existing legal framework, which is the root cause of the issue. As a result, the traditional theories of the corporate form by themselves cannot provide a solution to the risk of externalisation.

5.5. The Incomplete Theories

The theories of legal personality - the concession theory, the aggregate theory, and the real entity theory - offer distinct perspectives on how companies are formed and their nature. As summarised (from the discussion above) in Table One, the concession theory posits that legal personality is granted by the state, rendering the company an artificial entity subject to state-defined rights and duties. In contrast, the aggregate – and contractarian - theory suggests that

[1037] Horwitz, *The Transformation of American Law, 1870-1960: The Crisis of Legal Orthodoxy* (n852) 91, 104.
[1038] von Gierke (n873) XXVI.
[1039] Petrin, 'Reconceptualizing the Theory of the Firm - From Nature to Function' (n827) 8.

companies emerge from the collective actions of shareholders, emphasising the contractual nature of corporate relationships and advocating for a more laissez-faire regulatory approach. The real entity theory contends that companies possess an inherent personality separate from their members, advocating for the recognition of this independent entity by the law and emphasising the importance of realising the collective will or corporate purpose. By examining these theories, scholars have promoted a deeper understanding of the theoretical underpinnings of the corporate form and its implications for legal reform.

Table 1. Summary of Traditional Theories

Theory	How the company is formed	Positive assertion	Normative implication	Evidence	Link to corporate groups
Concession theory	Granted by the State	Company is an artificial entity created by the State/law	The source of legal personality is external, the State/law defines its scope	State can give and limit corporate rights and duties; incorporation requires State intervention	Artificial personality granted by the State/law
Aggregate theory *(Variation: Nexus of contracts)*	Shareholders/individuals form the company	Company is a product of individual initiative	Anti-regulatory approach; corporate personality is a construct to facilitate economic activity	Adoption of general incorporation statutes; separation of ownership and control	Aggregate enterprise represents all the "contracts" within a group
Real entity theory	Company as an "entity" is a person in itself	Company has a distinctive and independent personality	(n + 1 model)[1040] Corporate personality is greater than company's members, it requires the law to recognise it, and it works to realise the group will or its corporate purpose	Larger companies were formed with a separation between management and ownership	Corporate group personality as a separate identity would exist

[1040] When a group of "n" individuals comes together to form an organised body, jurisprudence must recognise the original "n" + 1, which represents the group itself as a distinct person. Maitland (n995) 198.

However, this thesis has demonstrated that they significantly neglect corporate groups. While this chapter has linked the theories to a potential outlook of groups, they fall short in addressing the risk of externalisation of the corporate form, since their purpose is to look at the company's nature and not at its consequences. Incorporated subsidiary companies are the principal vehicle used by parent company shareholders to externalise risk because, in addition to the legal advantages of the corporate form, the corporate group's internal structure has several economic advantages.[1041] The corporate form, however, has evolved into a double-edged sword. The combined conception of separate legal personality and shareholder limited liability is believed to have resulted in '*unfortunate and unjust*'[1042] consequences.[1043] Company law has not been able to describe the theory behind the corporate form to a satisfactory level - i.e., there is still an inconclusive answer to the debate - and relatively few scholars have engaged in the same exercise.[1044] This can be attributed to the fact that it is now believed the theories of "personhood" are trivial beyond the functional purpose of legal personality; it is simply a label that bundles together the fundamental features of a company.[1045] However, the triviality of the theory is not a convincing argument, and several scholars[1046] have promoted the relevance of a theoretical foundation in company law.

The unfortunate and unjust results significantly accrue to unsecured tort creditors that involuntarily encounter an insolvent company, where shareholders receive advantages from the legal separation of assets and liabilities. The same will happen, albeit exacerbated, in corporate groups with incorporated companies and the compartmentalisation of liabilities within the structure. The concept of the corporate form as we know it today, formed by the intersection of the company's and shareholders' rights, has embedded itself in the modern

[1041] See ch 2 and 3.
[1042] *Commissioners of Inland Revenue v Sansom* [1921] 2 KB 492, 514.
[1043] The *Sansom* (n1042) case re-established that limited liability is a privilege conferred by law and can be awarded to one-man companies with a genuine and *bona fide* business. However, in the quote, the Court expressed concerns on the use of nomenclature and general terms adopted to formulate separate legal personality, which can lead to confusion and unprincipled decisions.
[1044] Murray A. Pickering, 'The Company as a Separate Legal Entity' (1968) 31 Modern Law Review 481, 481-482. Although there are modern scholars who engaged in researching the meaning of separate legal personality, and some also linked the analysis to parent companies, there is still an insufficient level of research to progress a coherent and complete theory explaining the use of legal entities to conduct an economic activity. See, for instance, Watson, *The Making of the Modern Company* (n103) 207-222; Deakin, Gindis and Hodgson, 'What is a firm? A reply to Jean-Philippe Robé' (n954) 868-869; Jean-Philippe Robé, 'Firms versus corporations: a rebuttal of Simon Deakin, David Gindis, and Geoffrey M. Hodgson' (2021) 18(4) Journal of Institutional Economics 693, 696-699; Hardman, 'The nexus of contracts revisited' (n101).
[1045] Kraakman and others (n8) 8. "Progressive" thinkers, as Horwitz addressed them, disregard metaphysical inquiries of legal personality, but simply look at it for the purpose of being a convenient technical device to achieve practical results in the modern world. See Horwitz, *The Transformation of American Law, 1870-1960: The Crisis of Legal Orthodoxy* (n852) 105.
[1046] As discussed in the following paragraphs.

realm of company law,[1047] although there are debates in the literature as to whether shareholders' rights are a natural consequence of the corporate form, or if binding the two together is a '*perversion of the ordinary and proper state of affairs*'.[1048]

The debate on the corporate form, which was thought to have ended[1049] after the philosophical essay of John Dewey in 1926,[1050] has sparked more interest in recent times.[1051] Dewey's argument concludes that theoretical debates on corporate personhood are irrelevant, as all the theories are in contrast with each other and reach the conclusions necessary to justify their own arguments with no determinative answer.[1052] It is true that the rhetoric of the theories is inconclusive.[1053] Nevertheless, debating the theories of legal personality is not irrelevant. The theory shapes the actual perception of a company under the law and justifies the adoption of certain legal rules,[1054] hence it is fundamental in legal reform. Horwitz contended that corporate legal theories have an influence on how the law legitimises a company's activities.[1055] Millon stated that legal theories express positive and normative assertions,[1056] which ultimately provide standards for criticising current legal doctrines while proposing new ones.[1057] In the same vein, this thesis aims to explain that the role the legal theories on the corporate form can play in remedying company law's mistakes is key. We should, however, move away from the fixed idea of the nature of the corporate form and instead investigate the functions and consequences it produces.

As Blumberg stated, legal concepts have a dual nature. They can be used both to influence judicial decisions, and as a basis for future cases and law reform.[1058] Therefore, the debate cannot be dismissed simply because legal personality is a legal product,[1059] and its meaning

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[1047] See *Prest* (n262) [34]: '*It may be an abuse of the separate legal personality of a company to use it to evade the law or to frustrate its enforcement.* (…) *It is not an abuse to rely on the fact (if it is a fact) that a liability is not the controller's because it is the company's*.' This quote was considered in *Hurstwood* (n271) [73]: '*it is not an abuse of the separate legal personality of the SPV to cause the liability for business rates to be incurred by the SPV by granting it a lease, nor to rely on the fact (if it is a fact) that the liability was not the defendant's because it was the company's*.' In relation to corporate groups, *AAA v Unilever* (n790) [36]: '*Parent and subsidiary are separate legal persons, each with responsibility for their own separate activities*.'

[1048] Davies and Worthington, *Gower: Principles of Modern Company Law* (n660) 420.

[1049] Cheffins, *The Trajectory of (Corporate Law) Scholarship* (n880) 39-40.

[1050] Dewey (n839).

[1051] Hardman, 'Fixing the misalignment' (n25); Gindis, 'From fictions and aggregates to real entities in the theory of the firm' (n956); Watson 'The Corporate Legal Person' (n886).

[1052] Dewey (n839) 669.

[1053] Discussed respectively in 5.2., 5.3., and 5.4.

[1054] Millon, 'Theories of the Corporation' (n421) 241.

[1055] Horwitz, *The Transformation of American Law, 1870-1960: The Crisis of Legal Orthodoxy* (n852) ch 3.

[1056] Discussed also in Claassen, 'Political theories of the business corporation' (n33) 2-3.

[1057] Millon, 'Theories of the Corporation' (n421) 241.

[1058] Blumberg, 'The Corporate Entity in an Era of Multi-National Corporations' (n380) 324.

[1059] Blumberg, 'Limited Liability and Corporate Groups' (n1) 576-577, discussing the concept of limited liability.

is '*whatever the law makes it mean'*.[1060] The theories of corporate personality have evolved from the corporate form itself as a way to justify and understand it.

The corporate form also evolved over time into all the features available today. For instance, if we look at the feature of asset partitioning as explained by the theory of organisational law,[1061] entity shielding and owner shielding are functionally complementary features of the corporate form due to their delimitation of property rights for both the company and its members.[1062] But these two features bound together have not always been present in the history of the corporate form. Defining them as functionally complementary implies and reinforces the common perception that separate legal personality and limited liability are two sides of the same coin when, in reality, they are distinct, separate, and do not need each other to exist - as evidenced, for example, by the existence of Scottish partnerships.[1063] The theory of the corporate form should recognise the significance of this evolution, taking account of the origin of the legal principles within it and their external effects. This is because the lack of focus on the theoretical underpinnings of the corporate form have led company law to disproportionately investigate what a company is and apply its principles as absolute and necessary rights for the corporate form to operate. This means that while the original debate is important to discuss, it should be supplemented with another debate looking at the perspective that the traditional theories miss.

The evolution of the corporate form has a long history. Starting in Ancient Rome, certain early forms of business organisations provided for a degree of limited liability,[1064] and simultaneously developed the right of perpetual succession, insofar as the death or departure of the entity's members would not inevitably lead to the cessation of the organisation's existence.[1065] From the Middle Ages to the early nineteenth century, companies and religious institutions that had been given a charter could hold property in perpetuity as a unit distinct from the individuals,[1066] deriving the idea that personality was a grant from the state or king.

Elizabeth I in 1600 granted royal charter to the East India Company, giving it monopoly of the spices trade between England and Asia.[1067] Motivated by high profits, England found the solution of collecting large investments and capacity to bear risks in a separate legal personality.[1068] This marked the beginning of the corporate form in England, enabling the

[1060] Dewey (n839) 656.
[1061] Hansmann and Kraakman, 'The Essential Role of Organizational Law' (n48) 393.
[1062] Explained in 2.1.2.
[1063] See 2.1.1.
[1064] Hansmann, Kraakman and Squire, 'Law and the Rise of the Firm' (n105) 1358.
[1065] Avi-Yonah, 'The Cyclical Transformations of the Corporate Form' (n190) 780.
[1066] Mark (n997) 1449-1450.
[1067] Robins (n876) 5.
[1068] Dari-Mattiacci and others, 'The Emergence of the Corporate Form' (n42) 196.

separation between the company and investors.[1069] At first, chartered trading companies were reorganised after every voyage, but due to the inefficiency of a frequent asset liquidation, they were then granted perpetual existence.[1070] The property rights of companies and their perpetual succession became extremely important to incentivise companies' profitability and facilitate investments.[1071] This was achieved through a permanent capital structure that granted companies an indefinite and autonomous life, which created the opportunity for long-term investments, yet at the same time it required a mechanism for investors to decide the duration of their investment.[1072] Thus, companies' capital was divided into transferable shares, allowing investors to contribute or withdraw their funds without damaging the existence of the companies.[1073]

To keep a tight control over corporate activities and unincorporated companies[1074] out of formal capital markets, the Parliament of Great Britain passed the Bubble Act 1720, which rendered the formation of a business raising money and transferring shares, similarly to a chartered company, illegal if acting without charter.[1075] Since incorporation began to be controlled by the state, the main form of business organisation in England was the partnership.[1076] As Hansmann, Kraakman, and Squire noted, partnerships present a weak form of entity shielding, where personal creditors may have a claim on the entity's assets once the entity's creditors have been paid in full.[1077] Partnerships were subject to the issue of dissolution, i.e., the company would cease to exist when members left or died, and they were consequently unsuitable for businesses requiring large amounts of capital to be available at all times.[1078] Therefore, a new form of partnership was designed to mimic chartered companies with the use of contract law and trust.[1079] These companies were called unincorporated joint-stock companies, or deed of settlement companies, and although they resembled the modern version that is present today, until the late nineteenth century they were regarded as a species

[1069] Robins (n876) 24.
[1070] Hansmann, Kraakman and Squire, 'Law and the Rise of the Firm' (n105) 1376.
[1071] Nicholas Kyriazis and Theodore Metaxas, 'Path dependence, change and the emergence of the first joint-stock companies' (2011) 53(3) Business History 363, 365-369.
[1072] Dari-Mattiacci and others, 'The Emergence of the Corporate Form' (n42) 207-210.
[1073] Leone Levi, 'On Joint Stock Companies' (1870) 3(1) Journal of the Statistical Society of London 1, 2.
[1074] I.e., companies without corporate charters.
[1075] Patterson and Reiffen (n940) 169.
[1076] Ron Harris, 'The Formation of the East India Company as a Cooperation-Enhancing Institution' (2005), 4, <https://ssrn.com/abstract=874406> accessed 1 May 2024.
[1077] Hansmann, Kraakman and Squire, 'Law and the Rise of the Firm' (n105) 1337-1338.
[1078] John D. Turner, 'The development of English company law before 1900' in Wells (n108) 128.
[1079] Watson, *The Making of the Modern Company* (n103) 113.

of partnership under the law.[1080] The designation meant that a "flaw" of this organisation was the fact that shareholders did not possess limited liability to third parties.[1081]

Blumberg acknowledged that in the early nineteenth century limited liability was not a fundamental attribute of the company,[1082] rather investors were seeking to be recognised as chartered companies for the characteristics of separate legal personality and an identifiable line of succession of company's property.[1083] The corporate form in principle was giving companies certain rights to act as a separate entity; it did not give rights to shareholders. Limited liability in incorporation is a right belonging exclusively to shareholders; it does not seem logical to regard it as a necessary feature of the corporate form. In fact, the function of separate legal personality is to separate the company from its economic owners, by giving the company certain rights to act in its own name and eliminate the risk that company's assets will be affected by shareholders' affairs.

The theories of the corporate form have focused on the function of separate legal personality and the corporate capacity of a separate legal entity. What they have missed, or perhaps not fully realised, is the covert insertion of shareholder limited liability into the corporate form as a necessity and an inseparable principle. Shareholders do play a key role in the corporate form, in the sense that they will use it as a vehicle for their own benefit to externalise risks onto creditors. The corporate form is not an absolute principle. The courts do recognise the moral intuition that when shareholders abuse the corporate form, the "veil" of incorporation can be disregarded,[1084] and as we have seen previously, even the theories implicitly acknowledge this, without fully discussing it. This is because none of the theories, theoretically, accepts limited liability as intrinsic to the corporate form, albeit they tacitly assume its insertion into the corporate form. Therefore, they do not address risk externalisation.

When trying to determine what a company is, traditional theories miss the development and deployment of the corporate form in groups of companies. Promoting a traditional debate poses the risk of overlooking the consequences of using the corporate form in complex corporate structures. By reconciling the theory with its practical effects, the theory of the corporate form should focus on shareholders' liabilities, and in particular the relationship among shareholders *and* the legal entity *and* the economic activity. A consequence of looking into this tripartite relationship would be to realise the misalignment of the corporate and organisational forms, and company law could subsequently be able to remedy its risk

[1080] Blair, 'Corporate Personhood and the Corporate Persona' (n106) 792.
[1081] Blair, 'Locking in Capital' (n107) 419.
[1082] Blumberg, 'Limited Liability and Corporate Groups' (n1) 579-580.
[1083] Blair, 'Corporate Personhood and the Corporate Persona' (n106) 795.
[1084] However, as analysed in 4.1.1., veil-piercing is a flawed doctrine resulting in unprincipled decisions due to the theoretical confusion on the subject.

externalisation. What the debate needs is a theory that can re-direct and integrate it into the functions and consequences of the corporate form rather than its nature.

5.6. Implications

The lack of discussion about the consequences of having differing boundaries between a separate legal personality and the underlying business implies a failure to recognise a significant problem in the corporate form, i.e., externalisation of risk. It follows that the theories, although with different approaches and justifications, align with the traditional legal entity view and are unlikely to be useful in tracking down a solution to the problem. However, scholarly debate has never looked at the theories from a more functional approach[1085] and, in doing so, considered them a means to reform the conception of the corporate form and, with it, the idea of shareholder limited liability.

The emphasis on legal personality over its consequences has allowed courts to shape company law in ways which are inconsistent with its theoretical underpinnings,[1086] notably exemplified by the *Salomon* case.[1087] The House of Lords in this instance unanimously agreed that once the formalities of incorporation had been respected, the company's separate legal personality was established, influencing modern company law into taking a legal entity approach and defining companies with immutable characteristics.[1088] The legal entity theories discussed above have shaped company law in several ways,[1089] and the consequences of their interpretation of the company could be seen as a mixed blessing. For instance, the real entity view could allow companies to be liable for their actions; at the same time, it helped justify the rise of limited liability for their shareholders.[1090] The companies' feature of liability partitioning led both courts and academics to stipulate limited liability as a logical consequence of separate legal personality.

The traditional thinking of the legal entity view is in contrast with the modern economic developments experienced by companies in terms of their structure and organisation. Blumberg stated that only those unaware of the origins of both limited liability and the legal

[1085] See the meaning of functional approach in 4.3.
[1086] See, for example, the entanglement of separate legal personality and limited liability in ch 2, or the theoretical flaws of veil-piercing in 4.1.1.
[1087] *Salomon* (n32).
[1088] Ireland and others (n193) 159.
[1089] See for instance the influence of the theory on shareholders' rights and powers in Iris H-Y Chu, 'The Meaning of Share Ownership and the Governance Role of Shareholder Activism in the United Kingdom' (2008) 8(2) Richmond Journal of Global Law & Business 117, 127-136.
[1090] Reuven Avi-Yonah, 'Citizens United and the Corporate Form' (2010) 4 Wisconsin Law Review 999, 1008.

entity theory wrongly assume that the two are interrelated.[1091] The concept of separate legal personality had been around for centuries before limited liability was converted into a fundamental feature of the corporate form. If we adopt Blumberg's definition, the corporate entity had some "core" rights[1092] that were also previously discussed, namely the capacity to hold assets, sue and be sued, and have perpetual existence.[1093] In contrast, the triumph of limited liability interlinked with a traditional legal entity approach was a mistake in company law, and the reason is that the entity's "core" rights have co-existed with the idea of unlimited liability for a long time without any issues.[1094]

The "core" rights are universally accepted and do not cause confusion or controversy in the analysis of the law. As such, both the second and third generations of real entity theorists are right in some respects.[1095] The focus should be on the consequences of regarding the entity as a separate legal personality, and normative issues are also important in this debate as a concern flowing naturally from this discussion. Complete corporate separateness in a group of companies is a controversial topic, stemming from the application of the principle of limited liability. Although the UK strictly recognises limited liability as a foundational principle,[1096] the role and implications of corporate personality in this context are rarely debated. What the "entity" entails and how it affects and relates to the corporate group regulation has never been a topic in the English law literature. Perhaps this was the outcome of treating corporate liability as a matter outside the scope of company law, when it represents an integral part of the discussion.

This thesis will argue below that to understand corporate groups to effectively attribute liability within the structure, it is essential to adopt another dimension, namely an enterprise approach, and develop an enterprise-entity distinction. This is because the conception of the corporate form poses limitations on the applicability of the law. These limitations arise from the inherent insubstantial nature of the corporate form. Traditional theories establish a framework that constrains the scope and reach of legal doctrines within the corporate context. By interpreting companies as distinct legal entities or legal tools capable of bearing their own rights and obligations, traditional theories inherently shape the boundaries within which legal principles operate. Consequently, the theoretical underpinnings of the corporate form establish parameters that implicitly influence how legal rules are interpreted and applied. To regulate corporate activities more effectively and realign the economic and legal boundaries of a

[1091] Blumberg, 'The Corporate Entity in an Era of Multi-National Corporations' (n380) 286.
[1092] ibid 322.
[1093] See 2.1.1.
[1094] ibid.
[1095] See 5.4.
[1096] See ch 2.

business, it is necessary to misalign the current conception of how liability is attributed to a legal entity within a group. It would be more beneficial to adopt an "enterprise-entity" view in certain circumstances, meaning that the corporate group will still possess the premises of the legal entity view in order to recognise the company's "core" rights, while it would be regarded as a *whole* for the purpose of restricting limited liability instead of engaging with its '*fragmented components*'[1097] to attribute liability. When considering which approach, enterprise or entity, is better at advancing legal rules, the question should focus on the result - which approach will further the purpose of the law? In this thesis, the purpose is to regulate corporate activities by realigning the legal entity with the organisational form to reconnect to the logical duality of the law, with rights and responsibilities, power and duties. The conception of enterprise according to this view will be evaluated in the following chapter.

5.7. Conclusion

This chapter has critically examined three major theories of corporate personality - the concession theory, the aggregate theory, and the real entity theory - in the context of their positive and normative claims. By scrutinising the historical developments and the ideological underpinnings of these theories, a common thread can be identified: an overwhelming emphasis on the legal form of the corporate entity rather than a holistic consideration of its functions and consequences.

The theoretical frameworks presented in this chapter, while influential in shaping the understanding of corporate personality, fall short in addressing the challenges posed by the externalisation of risks, particularly in the context of corporate groups. The narrow focus on the legal structure and the rights of the corporate entity has led to a lack of attention to the attribution of liabilities arising from economic activities.

Moreover, the persistent separation of legal personality debates from the broader societal impacts of the corporate form limits the adaptability of company law to evolving environments. While acknowledging the benefits that legal personality provides to companies and their members, the chapter argued for the need for a change in basic assumptions. The proposed thesis suggests that company law should pivot from an exclusive focus on the corporate form to a more comprehensive examination of the economic and social consequences associated with it. This would change the debate from a rhetorical and circular argument regarding the nature of the company to a holistic debate regarding the use of the corporate form.

[1097] Phillip I. Blumberg, 'The Transformation of Modern Corporation Law: The Law of Corporate Groups' (2005) 37 Connecticut Law Review 605, 605.

Chapter 6- The Solution in Company Law

6. Questioning The Dominant Theories

This chapter addresses the final research question: how can the law understand corporate groups to provide a more effective regulatory framework? In the preceding chapters, we have examined the limitations of existing legal and theoretical frameworks in regulating corporate groups and mitigating risk externalisation in respect of unsecured tort creditors. To summarise previous discussions, limited liability is a key characteristic of the modern corporate form. With the development of corporate groups, the concept has sparked controversy because the use of the corporate form, in particular limited liability for parent companies, incentivises and exacerbates risk externalisation. While limited liability has many private advantages, this thesis' analysis showed that conventional justifications for limited liability[1098] do not fully apply to these complex structures and simultaneously its use can exponentially increase the harms towards third parties.[1099] Currently, corporate group structures are not effectively regulated because the doctrinal application of the traditional legal entity view and the corporate legal theories fail to capture the intricacies of these groups, where economic and legal realities may not align.[1100]

This thesis has argued that it is not theoretically sound to uphold the principles of the corporate form in groups as absolute legal principles. It has also acknowledged a difference between legal and economic realities in group structures. This difference must be recognised by theoretical company law and, consequently, UK company law.[1101] As argued in chapter 3, corporate groups are a legal-economic *phenomenon*, where the economic organisation does not always match the legal entity. While company law views corporate groups as groups of separate legal entities, parent companies can use both economic and legal principles to operate towards a unified business goal, benefiting themselves without assuming responsibility, except in limited circumstances.[1102] Therefore, instead of looking at corporate groups as a group of individual and independent legal entities, each with its own rights and liabilities,[1103] this thesis posits that corporate groups can be a single enterprise where the parent companies make use of individual legal entities that are not independent to operate as a unified business.

[1098] See 2.1.4.
[1099] See ch 3.
[1100] See ch 5.
[1101] Theoretical and legal developments are interconnected. See Millon, 'Theories of the Corporation' (n421).
[1102] See ch 3 and 4.
[1103] See 3.1.

Scholars tacitly endorse the traditional legal entity view,[1104] and corporate groups are either believed to fall under this view or disregarded in the legal discourse.[1105] Traditional theories interpret and analyse company law and the corporate form, and while chapter 5 has acknowledged their merits in doing so, they do not and cannot integrate corporate groups in their analyses. As shown in chapter 5, they present a flawed methodology and an absent line of inquiry capable of understanding corporate groups. These discussions have revealed a significant gap in the current approach to corporate groups. This chapter aims to address it by developing a novel theoretical framework that provides a nuanced approach to corporate groups within UK company law. It is challenging to delineate the boundaries of a group's economic activity and identify its constituent units without a clear understanding. In the UK, where there is no clear statutory definition[1106] and the courts seem to oversimplify the topic,[1107] conceptualising what a corporate group is would make the attribution of liability within the structure less problematic.

The first step in this chapter is to address the gap between legal and economic boundaries in corporate groups. The concept of the company and its nature are insufficient and inconclusive. This chapter acknowledges the economic concept of "firm" as a possible solution to recognise the difference between legal and economic realities. Albeit broader than the company, the concept of firm is also insufficient and inconclusive in the economic literature. Therefore, to fill this gap, it is necessary to adopt a different concept, which will represent an in-between space called the "enterprise", being broader than the corporate form but more defined and with clearer boundaries than the economic concept of the firm. Only then can the law meaningfully recognise corporate groups and clarify the proper scope and nature of their regulation. This thesis will subsequently identify which structures will fall under the concept of enterprise, and supplement existing theoretical lenses with this concept. As stated throughout this thesis, the purpose is not to dismiss completely traditional theories of the legal entity but to supplement them in circumstances where the legal and economic realities do not match and so harm third parties.

This chapter will then discuss an enterprise theory that will integrate ideas developed from a different line of inquiry of the company. The proposed enterprise approach does not consider the legal form as the focus for both its positive and normative claims.[1108] It will not be another

[1104] See ch 5.
[1105] See Micheler, *Company Law: A Real Entity Theory* (n852) 68 (corporate group liability is not rooted in company law) or corporate groups are not considered in the debate: see Deakin, Gindis and Hodgson, 'What is a firm? A reply to Jean-Philippe Robé' (n954) 869.
[1106] Other than a distinction between parent and subsidiary company: CA 2006, s 1159.
[1107] See 3.1.
[1108] Unlike legal entity approaches in ch 5.

theory of legal personality because it does not intend to resolve the debate over the corporate form. The latter is and will be a perennial topic in company law.[1109] Regardless of claims that the debate over the nature of the company is '*dead*',[1110] irrelevant,[1111] or simply functional,[1112] scholars have argued their own stance on it for centuries and even contemporary scholars are still promulgating their views.[1113] The truth is that we do not know what a company is,[1114] and this question will likely remain unanswered. However, UK company law must understand the difference between an entity and an enterprise to regulate corporate groups and remedy the issue of risk externalisation.[1115]

From this, it will be possible to argue in favour of an enterprise liability, based on the normative principle of holding corporate actors responsible for their business activities. This thesis will pull together a string of arguments, from different disciplines, based on the normative principle that harms caused by an economic activity should be repaired by those profiting from that activity.[1116] At its core, this enterprise approach recognises that corporate groups can function as integrated economic units, transcending the formal legal boundaries of individual entities. This perspective acknowledges the interconnectedness of activities and interests across the group, emphasising the need for a more comprehensive regulatory framework that aligns with the complex organisational structures prevalent in modern business environments.

This chapter does not follow the line of argument of other company law theories. We have seen before that arguments presented in the theories of the corporate form are developed along the structure of: if the company is *x*, then *y* should follow.[1117] Instead, this chapter decouples the normative claim *y*, namely the enterprise should bear responsibility for the negative consequences (for third parties) of its actions, from the positive claim *x*, namely that the corporate group is an enterprise. In this thesis, the objective is not to describe the enterprise in a way that aligns with a specific normative agenda or aims to reform company

[1109] Hardman, 'The Making of Corporate Legal Concession Theory' (n845) 181.
[1110] H.L.A. Hart (n906) 17.
[1111] Dewey (n839) 669.
[1112] Kraakman and others (n8) 5-8.
[1113] Watson, *The Making of the Modern Compan*y (n103); Micheler, *Company Law: A Real Entity Theory* (n852); Hardman, 'Fixing the misalignment' (n25); Gindis, 'From fictions and aggregates to real entities in the theory of the firm' (n956).
[1114] Millon, 'The Ambiguous Significance of Corporate Personhood' (n859) 41.
[1115] Corporate groups are complex structures differing from individual entities (ch 3). Liability can be difficult to attribute without an understanding of the difference between a separate individual entity and a corporate group working as a unified enterprise (ch 4). Recognising the difference would entail to reconceptualise the corporate group through other theoretical frameworks (ch 5).
[1116] Guido Calabresi, 'Some Thoughts on Risk Distribution and the Law of Torts' (1961) 70(4) The Yale Law Journal 499, 517.
[1117] Millon, 'The Ambiguous Significance of Corporate Personhood' (n859) 40.

law.[1118] The positive claim does not inform the normative claim. As observed in the analysis of the theories of the corporate form, this rhetoric led all the theories to be valid within their own parameters. They justify a normative claim by framing their interpretation of the company in a way that fits this normative claim by cherry-picking descriptive evidence in company law. While the exclusive focus on the corporate form is methodologically flawed,[1119] the argumentative lines of describing the company in a way that affirms the author's own normative judgement is also methodologically incorrect. This approach risks circular reasoning, where interpretations of the company are tailored to fit preconceived normative positions.

In part, Dewey was right in stating that this method led to the debate remaining unresolved.[1120] His insight highlighted the necessity of breaking free from the cycle of normative bias influencing positive interpretations, a cycle that has hindered progress in company law theory. It is essential to emphasise the independence of the normative claim from the positive claim to ensure a rigorous examination of enterprise liability, preventing potential biases that may arise when normative imperatives are directly derived from positive interpretations without sufficient scrutiny. While recognising that corporate groups are enterprises, it is crucial to establish that the imperative to hold enterprises liable for their actions does not hinge on the fact that corporate groups are enterprises and *vice versa*. Rather, the premise that enterprises should bear the costs of their activities is a matter of societal fairness and accountability, irrespective of the structural organisation of business entities. By decoupling the normative assertion about enterprise liability from the positive description of corporate groups, we avoid falling into the trap of circular reasoning that plagued previous theories of the corporate form.

6.1. Drawing the Boundaries - Legal vs Economic Principles

Christopher Stone suggested that enterprise liability would involve intervening in the relationship between investors and the legal entity by altering the rules of limited liability.[1121] Boundaries drawn in terms of the legal entity and corporate personality make the imposition of liability on corporate shareholders difficult to realise, and as chapters 2 and 3 noted, UK company law is strongly entity-centric. However, company law's strong position of entity centricity is clear only regarding the imposition of duties relating to the asset partitioning, or demarcation of assets, between the company and its shareholders for monetary liabilities.

[1118] As seen in ch 5, traditional theories of the company often reflect normative biases and are influenced by rhetorical objectives rather than objective analysis, rendering the latter flawed.
[1119] See ch 5.
[1120] Dewey (n839) 658. Although he was wrong in saying that the debate itself is irrelevant: see 5.5.
[1121] Stone (n38) 9-11.

In contrast, entity boundaries fade when it comes to shareholders' rights - or benefits - in corporate group situations. For instance, rules relating to consolidated accounts, premium listings,[1122] or the mandatory bid rule for takeovers are primary examples of this kind of '*entity transparency*' in UK company law.[1123] The existence of entity transparency and the fading of boundaries in certain circumstances should, therefore, signal to courts and legislators that the corporate form and the concept of corporate separateness are not absolutes. While the company as a legal person is *distinct* from its shareholders, it does not follow logically that its shareholders, in particular controlling shareholders like parent companies, are completely detached from the company's business. Consequentially, conceptualising the corporate group as a single enterprise would not only represent the modern business reality, but, in some respects the modern law as well, where entity boundaries are increasingly been eroded.

However, the main problem is identifying the boundaries of an enterprise, which includes two important questions relating to establishing those boundaries and maintaining them, namely ensuring that neither the enterprise nor the claimants will engage in any opportunistic behaviour that would distort the established boundaries. When defining the scope of an enterprise, we are faced with the questions of "what organisational structures are enterprises?" and "for which activities?". The first question raises difficulties because of the formal boundaries in the sense of legal forms of corporate groups changing constantly, such as when the firm decides to restructure, shift businesses to new countries, merge, acquire, or incorporate new entities. It is also difficult to determine which activities linked to the enterprise will fall under the enterprise liability criteria. This is because it needs to be determined whether the activity in question is one on which the enterprise exerts meaningful control.[1124]

To be able to adjudicate whether an enterprise will be liable for harm, courts would need threshold circumstances triggering liability that are sufficiently certain and specific. Moreover, in the corporate group context, courts will also need to ascertain which actors can be identified as being part of the enterprise. These threshold boundaries have not been considered manageable enough by the courts to date because presumably all enterprises, for any given harm, would satisfy the criteria of enterprise liability, stretching the courts' capabilities.[1125] Thus, to have a workable theory and a conception of the enterprise in company law, the next

[1122] Such as requiring shareholders' approval for significant transactions: see FCA, *Listing Rules* (2024) LR 10, 10.5.1.: '*Notification and shareholder approval*'.
[1123] Mariana Pargendler, 'The New Corporate Law of Corporate Groups' (2023) ECGI Working Paper Series in Law N° 702/2023, 30-32 <https://ssrn.com/abstract=4412997> accessed 13 June 2024.
[1124] James A. Henderson, 'The Boundary Problems of Enterprise Liability' (1982) 41(4) Maryland Law Review 659, 663.
[1125] James A. Henderson, 'The Constitutive Dimensions of Tort: Promoting Private Solutions to Risk-Management Problems' (2013) 40(2) Florida State University Law Review 221, 245-246.

sections will address the following questions: how is an enterprise formed, what are its boundaries, and lastly, how can UK company law integrate this view?

To address the boundary delineation issue, the enterprise will be conceptualised as a theoretical space that goes beyond the boundaries of the corporate form and can be used to regulate corporate groups effectively, extracting valuable insights from both company law and economic analysis. In this theoretical space, it will be necessary to ascertain when and under what circumstances parties outside the corporate form, who encountered the economic activity, will be relevant to the analysis of attributing the enterprise's liability.

Legal theories focus on the legal form; they look at the corporate entities. Economic theory, in contrast, focuses on the behavioural ties linking all these separate units together.[1126] Although some believe that the law influences the economics of the firm,[1127] integrating economic perspectives into the development of company law is a useful tool. This is because while company law assumes that the boundaries of the legal entity correspond to the economic activity, this is not always the case. Thus, implementing an enterprise theory in company law would allow the latter to recognise the internal relational ties within a group and consider factors beyond the corporate form and the current conception of "control".[1128] We know that the concept of the company is not enough to regulate corporate groups; the next step is to analyse whether the economic concept of the firm would be adequate in delimiting the boundaries of the enterprise for the purpose of this thesis. While UK company law and corporate legal theories focus on corporate boundaries, economists offer a distinct perspective by discussing the firm (the economic activity) rather than the company. Economics could, therefore, enrich company law, albeit to a limited extent as argued below.

6.1.1. The Sorites Paradox of the Firm

The Sorites paradox, rooted in the concept of vagueness, holds significant implications for understanding the boundary delineation issue. Originally posed as a philosophical puzzle involving the classification of a heap of wheat grains, this paradox challenges conventional notions of clear delineation. It is generally framed as: '*Would you describe a single grain of wheat as a heap? No. Would you describe two grains of wheat as a heap? No. … You must admit the presence of a heap sooner or later, so where do you draw the line?*'.[1129] The puzzle

[1126] Anker-Sørensen (n20) ch 3.
[1127] Geoffrey M. Hodgson, 'Veblen, Commons and the Theory of the Firm', in Michael Dietrich and Jackie Krafft (eds), *Handbook on the Economics and Theory of the Firm* (Edward Elgar 2012) ch 5.
[1128] See 3.5. and 4.2.
[1129] Dominic Hyde, 'The Sorites Paradox' in Giuseppina Ronzitti (ed), *Vagueness: A Guide. Logic, Epistemology, and the Unity of Science* (Springer 2011) 1.

is considered a paradox because vague terms, such as “heap”, in an argument with true premises and a valid structure lead to an unexpected and apparently false conclusion.[1130] For instance, in the case of a heap, the argument can be concluded as follows: if 9,999 grains of wheat do not make a heap, then 10,000 do not.[1131] This is because the argument follows the rule of inference *modus ponens*, which states that if a conditional statement is accepted (e.g. if one grain of wheat does not make a heap), because the condition is true (e.g. one grain of wheat does not make a heap), then we can infer that the consequence is also true (e.g. then two grains of wheat do not).[1132] Due to the difference of one grain being too small and negligible, it does not make a difference to the truth-values of the antecedents and consequents. Despite seeming logically sound, the argument can be counterintuitive because it challenges our expectations of clear delineation. It illustrates how an ostensibly straightforward logical process can lead to unexpected and false outcomes, highlighting the inherent vagueness in concepts like “heap” and the difficulties in establishing precise boundaries.

This logical structure is crucial in the discussion about the nature of the enterprise. Just as with the grains of wheat, where logically an increasing number of grains eventually should form a heap, we need to understand that the activities of a corporate group extend beyond the legal entity, but using only the legal concept of company (the grain) and the economic concept of the firm (the heap) would produce a false and vague outcome. This means that the concept of a company, like a single grain of wheat, is not sufficient. This section will argue that while we could potentially look at the economic concept of the firm as a “heap”, this is also inadequate due to its lack of clarity. Therefore, we need to conceptualise the enterprise and define its boundaries more conclusively than those of the firm but as larger than the company.

Much like the heap paradox, the concept of the firm has become shrouded in ambiguity, blurring its boundaries and the distinction between economic and legal interpretations. It is true that there is a difference in realities between the economic idea of “firm” and the legal conception of “company”.[1133] Economic analysis describes the organisational structure,[1134] whereas legal analysis describes separate legal personality. A discrepancy between the economic and legal realities is present in corporate groups,[1135] where several companies can be part of a firm. Firms deploy the legal device of “companies” as the legal entity status confers benefits and facilitates firms to conduct their business by creating an organisational

[1130] Sergi Oms and Elia Zardini, *The Sorites Paradox* (Cambridge University Press 2019) 7-13.
[1131] Hyde (n1129) 2.
[1132] ibid.
[1133] This is challenged by Deakin and others (n85) and will be analysed in the following section.
[1134] See 3.4.
[1135] Iacobucci and Triantis (n430) 520.

framework.[1136] Therefore, the company is only one part of the firm, whereas the economic firm has a wider meaning. While these premises are true, in the literature there is a lack of certainty over what a firm is and whether it has clear boundaries. If we describe the enterprise as a firm, then we will reach an inconclusive and false outcome.

Scholars, such as Coase, Williamson, and Alchian and Demsetz have offered diverse perspectives on the nature of the firm, highlighting its role in mitigating transaction costs and facilitating internal coordination. Coase argued about the firm being an alternative to the market, led by internal authority.[1137] Williamson expanded the theory by proving, through a transaction cost framework, that internal organisation is preferred compared to a contracted relationship on the basis that it will save on transaction costs.[1138] Alchian and Demsetz pointed out the costs of internal authority.[1139] As it can be seen from these examples, economists assume that a firm exists, but they all argue about different aspects of it. Therefore, there is no formal definition of "firm", and there are various theories on what a firm is.[1140] Hardman argued that the boundaries of the firm are objectively determinable, and all theories of the firm converge on its boundaries, which are formed by the joint coordination of an economic activity and agreed by all participants of the firm.[1141] The reality is that there is no consensus in the literature, and debates are still ongoing.[1142] Difficulties reside in identifying all the participants in an economic activity because economic and contractual webs can extend throughout the whole economy.[1143] Economists are unable to agree on what a firm is to such an extent that it is believed that a standard definition of the firm should be avoided altogether.[1144]

For recognising an enterprise, however, it is not essential to have clear boundaries for what a firm is or even reach a conclusion on its definition. The essential point of this discussion is to realise that an economic activity conducted by legal entities can be much broader in terms of meaning than the legal conception of the company. The latter is simply a legal vehicle deployed for the internal use of directors and shareholders. The firm, thus, implies a broader "team" engaged in the economic activity,[1145] whereas the company is incorporated, controlled,

[1136] Robé, 'The Legal Structure of the Firm' (n82) 49.
[1137] Coase, 'The nature of the firm' (n550) 392.
[1138] Williamson, 'The Economics of Organization: The Transaction Cost Approach' (n553) 558.
[1139] Alchian and Demsetz, 'Production, Information Costs and Economic Organization' (n955) 780.
[1140] See Oliver Hart, 'An Economist's Perspective on the Theory of the Firm' (1989) 89 Columbia Law Review 1757.
[1141] Hardman, 'The nexus of contracts revisited' (n101) 4-7.
[1142] See Deakin, Gindis and Hodgson, 'What is a firm? A reply to Jean-Philippe Robé' (n954); Robé, 'Firms versus corporations: a rebuttal of Simon Deakin, David Gindis, and Geoffrey M. Hodgson' (n1044); Simon Deakin, David Gindis and Geoffrey M. Hodgson, 'A further reply to Jean-Philippe Robé' (2022) 18(4) Journal of Institutional Economics 703.
[1143] LoPucki 'The Essential Structure of Judgment Proofing' (n5) 158.
[1144] Geoffrey M. Hodgson, 'Taxonomic definitions in social science, with firms, markets and institutions as case studies' (2019) 15(2) Journal of Institutional Economics 207, 220.
[1145] Alchian and Demsetz, 'Production, Information Costs and Economic Organization' (n955) 778.

and used by and for shareholders and directors.[1146] The two concepts are fundamentally different, and there is no inevitability that they will converge. While ambiguity surrounding the concept of the firm persists, its relevance in the context of enterprise recognition cannot be overstated. Despite the absence of clear boundaries, the economic activities undertaken by legal entities transcend the boundaries of traditional legal definitions. The next section will evaluate the gap between the company and the firm, and the opportunity that this gap presents in terms of recognising the enterprise.

6.1.2. Firms and Companies' Boundaries

The theory of the firm, together with the theory of the company,[1147] was believed to be a debate where little theoretical progress was made for centuries,[1148] considering the complexities that come with it. Recently, scholars have changed this perspective. In 2017, Deakin, Gindis, Hodgson, Kainan, and Pistor advanced a thought-provoking argument.[1149] With the premise of legal institutionalism, they claimed that firms are creatures of law, and while not all firms will be companies, the corporate form - i.e., its legal nature - is what creates a firm and delimits its boundaries.[1150] They even claim that the growth of economically complex structures, such as corporate groups, does not undermine their argument but strengthens it, because these structures make use of the corporate form and other legal concepts to operate.[1151]

This appears to be an oversimplification of both the theory of the firm and the theory of the corporate form. The argument proposed above conflates the boundaries of the firm with the legal boundaries of the corporate form; hence, there is no difference between the economic and legal reality. In some instances, it will be true that legal and economic boundaries conflate.[1152] One example is the position taken by Berle and Means,[1153] who, concerned primarily with the separation of ownership and control, explored only large public companies with dispersed shareholders, where control is not based on legal control - in the sense of including only managerial control – thus, excluding pyramidal corporate groups.[1154] If, as Berle and Means suggested, one would take into consideration only those large public companies with no subsidiaries and dispersed share ownership, it is reasonable to assume that the

[1146] See (n80) and ch 1.
[1147] H.L.A. Hart (n906) 17.
[1148] Hodgson, 'Taxonomic definitions in social science, with firms, markets and institutions as case studies' (n1144) 220.
[1149] Deakin and others (n85).
[1150] ibid 194-197.
[1151] ibid 197.
[1152] Hardman, 'The nexus of contracts revisited' (n101) 15.
[1153] Berle and Means (n253).
[1154] ibid 79.

business - the economic activity - does not fall outside the legal boundaries of the corporate form. Then, the boundaries of the firm and the company do conflate.

But this is not always the case. In the UK, a significant portion of economic activities operate as corporate groups. According to the data collected and analysed by Underwood, out of the 100 largest public and private companies in the UK, each company in the dataset was operating as part of a group, with public companies having an average of 400 companies within their group.[1155] Robé argued that firms are organisations, and a single firm can use several legal entities as part of a group forming the structure of its organisation.[1156] Firms can use companies, but they are not legal entities; they simply employ the legal concepts promoted in company law to structure their organisation using corporate forms. Moreover, Robé states that it is hard to describe the firm as an entity given the fuzzy boundaries of the former.[1157] Although, as stated before,[1158] it is not necessary to define the firm precisely, Robé's argument is better justified than the one proposed by Deakin and others.[1159] Firstly, Robé's perspective acknowledges the significance of corporate groups in today's business environment, where corporate groups are prominent and the division of large swathes of economic activity into separate legal entities is noticeable. Secondly, Robé's argument stresses the distinction between the legal form of the company and the broader economic concept of the firm. While legal entities play a role in structuring business activities, they do not fully capture the complexities and interconnections inherent in the economic analysis of organisations. This differentiation allows for a more comprehensive analysis of organisational structures and their implications.

In this business reality, it would be wrong to conflate the firm with the corporate form.[1160] Deakin, Gindis, and Hodgson justify referring to the firm as legally recognisable on the grounds that the law is necessary for the firm to function.[1161] Even in the case of corporate groups, they acknowledge the group as a single firm, but because their definition of "firm" implies a legal form, they admit that a definition of corporate group should exist alongside the definition of firm.[1162] Legal rules are undoubtedly important in the organisation of economic activities.[1163]

[1155] Peter Underwood, *Corporate Group Legitimacy Reconceptualising The Corporate Group* (Routledge 2024) ch 3.
[1156] Robé, 'The Legal Structure of the Firm' (n82) 49.
[1157] ibid 54.
[1158] See 6.1.1.
[1159] Deakin and others (n85).
[1160] Hardman argues that this conflation is given by their analysis of the firm only through the use of companies. See Hardman, 'The Making of Corporate Legal Concession Theory' (n845) 190-191.
[1161] Deakin, Gindis and Hodgson, 'What is a firm? A reply to Jean-Philippe Robé' (n954) 867.
[1162] ibid 869.
[1163] As argued in this thesis, corporate groups use both economic and legal benefits to structure the business via several legal entities.

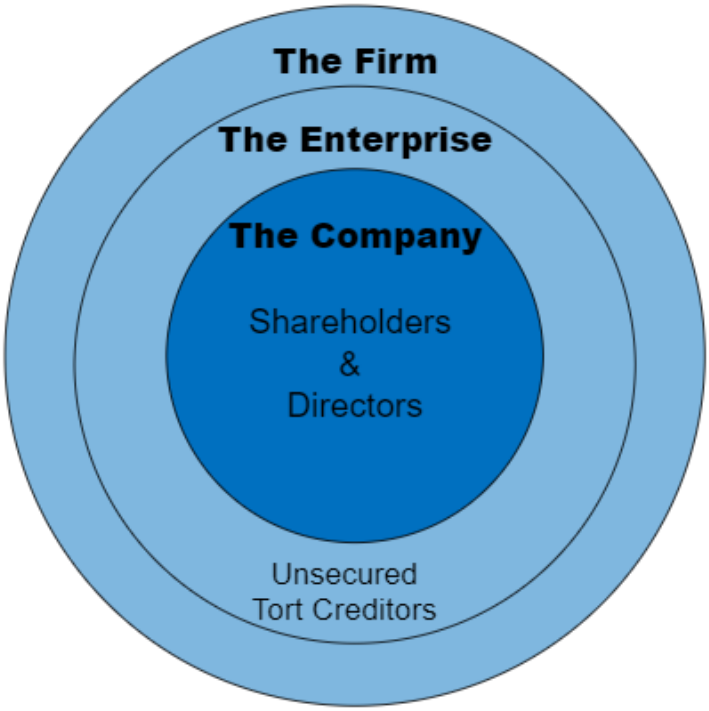
However, while implicitly they agree that corporate groups are an example where it is not possible to have economic and legal boundaries overlap, they strongly believe that firms and companies are not mutually exclusive.[1164]

Deakin and others put forward a thought-provoking evaluation of both the firm and the company. It is important to note, however, that this theory was created using an economic analysis for an economic audience; consequently, they might not have been as careful or concerned with legal considerations.[1165] The instances in which a firm can divide an economic activity into several legal entities, creating a misalignment between the economic organisational form and the legal corporate form, are not evaluated in terms of a company law analysis, although company law also assumes that the boundaries of the firm and the company are the same. This can be witnessed by its disregard of externalities, treating them either as internalised within the company or addressed by other areas of the legal taxonomy.[1166]

This assumption is wrong because there is in fact a misalignment between the boundaries, and this causes the issue of risk externalisation at the expense of third parties. Once the misalignment is acknowledged, there is room to decide what to do with it. Hardman argued that this '*delta*' should give scholars a chance to revisit the nexus of contract theory and provide more protections to parties outside the corporate form.[1167] This thesis argues that the difference between economic and legal realties can provide the level of protection that an exclusive focus on the corporate form eliminates from the analysis with regard to tort victims and unsecured tort creditors. As shown in Figure Four, we can think of the firm and the company as existing in two concentric circles. The outer circle is the economic conception of the firm. Although undefined and with fuzzy boundaries, the firm can be wider and contain all the economic considerations that the corporate form does not. The inner circle is the company. The company is situated inside the firm as one of the ways employed by firms to organise their structure. The enterprise would come within this space between the company and the firm.

[1164] Deakin, Gindis and Hodgson, 'A further reply to Jean-Philippe Robé' (n1142) 704.
[1165] Hardman, 'Fixing the misalignment' (n25) 454.
[1166] See 1.2.1.
[1167] Hardman, 'The nexus of contracts revisited' (n101) 32.

Figure 4. The Enterprise



As aforementioned, the focal point of the corporate form and company law is directors and shareholders.[1168] These constituencies can manipulate the boundaries between the firm and the company to their advantage.[1169] This can cause harm to third parties that are external to the corporate form. In the case of corporate groups, having a difference between the boundaries means that the internal constituencies can partition the assets of a business among several units and potentially divert the assets to themselves.[1170] Unsecured tort creditors, unaware of the structure and with limited legal remedies,[1171] would find themselves outside the scope of regulating the corporate form. Recognising the gap between the firm and the company would also mean recognising an in-between space in which parties outside of the company but within the firm are relevant. This in-between space represents the enterprise and should be the subject of regulation. The following section will apply this approach by carving out specific corporate group structures that can be considered an enterprise for the purpose of supplementing the legal entity approach.

[1168] Blair and Stout (n96) 248; Jensen and Meckling (n81) 309.
[1169] See ch 3.
[1170] See the example in Figure Two, 3.1.
[1171] See 2.2.3.

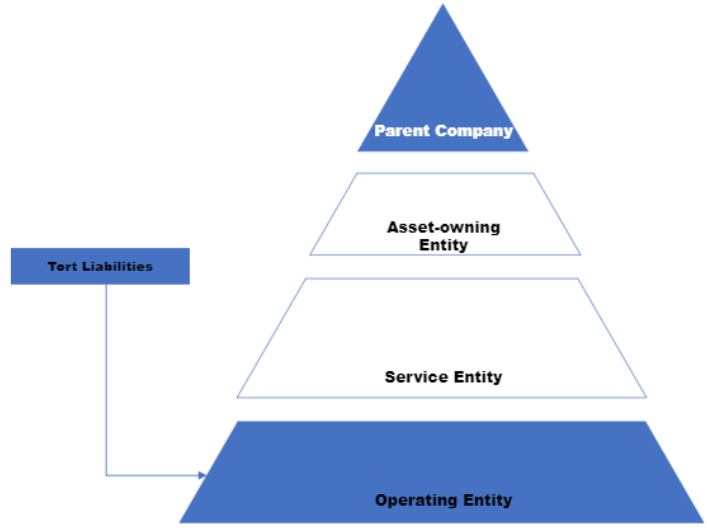
6.1.3. Realignment of The Boundaries – Misalignment of Liabilities

LoPucki argued that two or more entities having a symbiotic relationship, where one generates high risks and the other owns high levels of assets, is the single essential structure of judgment-proofing.[1172] The legal separation defeats the liability system due to the requirement that judgments are enforceable only against the liability-generating debtor, which will not own assets of significant value. In the corporate group context, the parent-subsidiary relationship is a form of judgment-proofing, considering that the parent company can hold or distribute most of group assets within the other entities of the group while owning shares in the operating entity and having limited liability. LoPucki again provides an excellent illustration of the issue by describing the two entities in question as two halves of a unified business, due to the fact that '*together, they own the same assets, conduct the same operations, employ the same people, and have the same creditworthiness*'.[1173] LoPucki was, naturally, not the only scholar who noted that within corporate groups, separate entities can undertake well-coordinated activities and be part of an organised "whole". Proponents of looking at the group as a unified enterprise have consequently advocated in favour of the imposition of liability on *any* entity benefiting from these risk-generating coordinated activities.[1174]

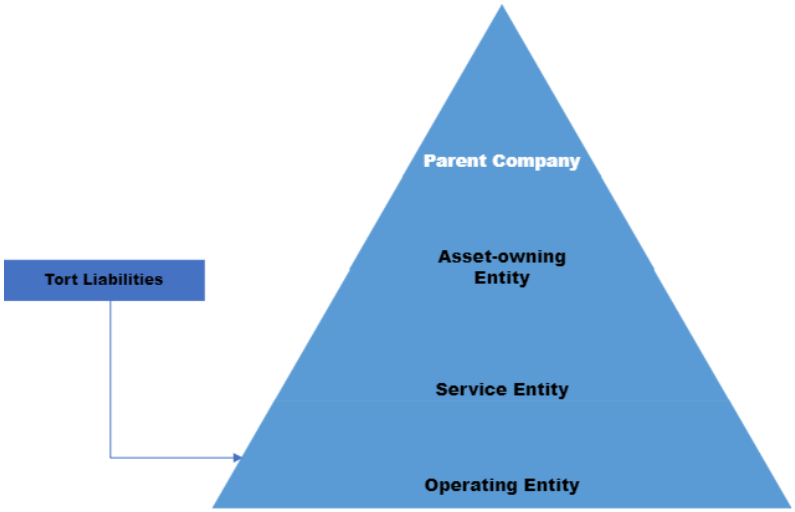
By taking the same model as Figure Two in section 3.1., Figure Five depicts the judgment-proof situation promoted by the traditional legal entity view in *A* compared to a unified business perspective promoted by an enterprise approach in *B*.

[1172] LoPucki 'The Essential Structure of Judgment Proofing' (n5) 149.
[1173] ibid 153.
[1174] See Irit Mevorach, 'The Role of Enterprise Principles in Shaping Management Duties at Times of Crisis' (2013) 14 European Business Organization Law Review 471, 489-491; Stone (n38) 8.

Figure 5. Entity vs Enterprise



A.



B.

In *A*, there is a clear separation among the legal entities in the group. In this instance, there is a parent company, a holding entity, and a service entity used to raise finance for the bottom-tier operating entity. If the operating entity commits a tort, the victims harmed by the operating entity will be able to claim against this legal entity only. However, as argued in this thesis, when a coordinated and controlled economic activity is divided into several legal entities, those legal entities are *not* actually separate and independent. They are only treated as such under UK company law. As depicted in *B*, they will work together in cooperation, with the use of

legal, strategic management, and culture-based links,[1175] to form a unified business. The corporate legal boundaries, in these instances, become irrelevant because, by operating as a unit, the cost of business - including the aggregate of its potential and crystallised liabilities - would not follow strict legal boundaries but a unitary economic perspective.

Closing the gap between the boundaries of the economic activity and the boundaries of the corporate form would shift the conception that liabilities follow legal personality and hence destabilise the firmly fixed concept of the corporate form. Concepts are powerful because they implicitly shape the course of the law and have the potential to serve as a bridge from normative principles to legal norms.[1176] They assist legal interpretation, which oftentimes is not a result of conscious and deliberate actions taken during individual legal proceedings; it just so happens to be visible over the passage of a period of time in respect of a large number of legal texts.[1177] This is how the conception of separate legal personality and shareholder limited liability became intermingled as a norm; the legal entity view in the form of a concept served as a bridge to move from fact to norm and then "reality". This reality is, nevertheless, distorted and based on the wrong assumption that legal and economic boundaries perfectly align. In the UK, this simply does not happen, and the high presence of corporate groups as dominant corporate structures[1178] is significant.

As Witting proposed, if we look at corporate groups as enterprises, it is important to differentiate between positive and normative treatments.[1179] A positive treatment would simply explain the law in positive terms and rely on pre-existing legal concepts to facilitate innovation, for instance, by imposing liability within group structures based on the concept of "control".[1180] Normative treatments would allow us to focus less on pre-existing legal rules and more on the forward-looking role of the law, following the perspective embraced in this thesis. As such, liability can be justified as a cost of doing business[1181] that needs to be internalised by company law.

Because the single legal units are part of a unified business,[1182] the organisational form itself could logically be regarded as one for the purpose of attributing liability. However, the gap will not include any kind of corporate group or organisational form falling under this regulatory remit. As previously stated, there are corporate structures in which there is no difference

[1175] See 3.5 and 4.2.
[1176] See 5.5.
[1177] Deakin, 'Juridical Ontology: The Evolution of Legal Form' (n852) 173.
[1178] Underwood (n1155) ch 3.
[1179] Witting, 'The Corporate Group: System, Design and Responsibility' (n384) 587.
[1180] Blumberg, *The Multinational Challenge to Corporation Law* (n6) 116.
[1181] Choudhury and Petrin, *Corporate Duties to the Public* (n169) 121.
[1182] Which will need to meet the criteria of (i) being an enterprise, (ii) that generates a legally recognised harm, (iii) while conducting an activity with a characteristic risk.

between legal and economic boundaries.[1183] Only organisations where there is a gap present will fall within this space. Another limitation of this study was that it focused on corporate shareholders only. Situations in which only individual shareholders are concerned were not evaluated.[1184]

Moreover, while network structures were also beyond the scope of this thesis, using the concept of the enterprise would expand the pool of corporate groups that can become liable under the law. A common objection to the theories of liability in the corporate group context is that if parent companies are always held liable and there is no limited liability, they will lose their benefits and incentives to structure the economic activity in a group to begin with.[1185] Groups will then re-organise into unincorporated groups, and liability will become even rarer.[1186] First, it is not true that parent companies will lose the incentives to organise into incorporated group structures. As argued in chapter 3, corporate groups are legal-economic *phenomena* and their benefits stem from the combination of legal *and* economic principles. Secondly, the enterprise approach does not displace the legal entity view. According to the argument presented in this thesis, the enterprise theory can be used as a supplement to the traditional legal entity view whenever the attribution of liability will be dependent on the activities of a collective group recognised as the enterprise.

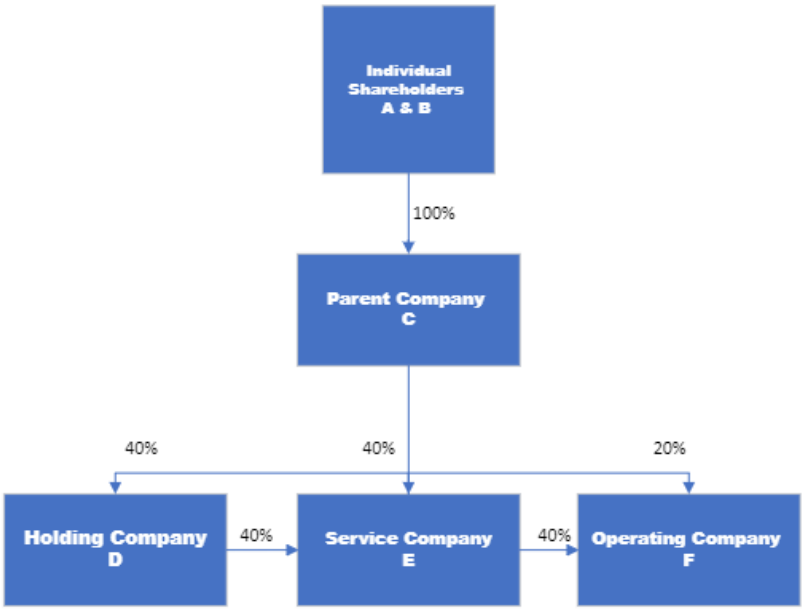
When considering circumstances where the misalignment of boundaries between a corporate form and the economic activity harms third parties, such as unaware unsecured creditors lacking legal remedies,[1187] the application of the enterprise theory becomes justified. The first criterion to determine when the enterprise theory should supersede the traditional legal corporate entity is then the recognition of an enterprise which generated a legally recognised harm.

The organisations included within this gap and to which liability can therefore attach are traditional corporate groups. The parameters of such groups would be expanded compared to the current law. This thesis proposes a definition of a traditional corporate group that does not rely on legal control. As discussed in sections 3.1. and 3.3., traditional corporate groups are based on the principle of authority and have the parent company as the *controlling*

[1183] Such as large public companies with no subsidiaries. See Berle and Means (n253) 79.
[1184] Limitations flow from the specific scope of the research. While the same arguments might be applicable to other types of shareholders, the subject extends beyond the purview of this study and would require separate and detailed investigation.
[1185] Couwenberg (n450) 634.
[1186] See Teubner (n168) 241-243.
[1187] See ch 4.

shareholder.[1188] In the UK, currently, control is identified based on legal ownership[1189] or *de facto* control of operations,[1190] which are both flawed legal conceptions related to traditional corporate groups.[1191] In contrast, extending the definition - and consequential liabilities - based on the *capacity* to control would include groups in which parent companies are not the only or majority shareholders, as seen in Figure Six. The capacity to control would rely on both formal and informal methods of control that parent companies adopt in their organisational structure.[1192]

Figure 6. Example of Enterprise



In this example, individual shareholders *A* and *B* will still possess limited liability with regard to the parent company *C* because the enterprise approach proposed by this thesis applies only to corporate shareholders. The parent company, according to the current law, will have little financial exposure to the potential harm committed by operating company *F* due to its mere 20% share ownership position. This 20% share ownership, coupled with the absence of *de facto* control over the management of company *F*, would protect parent company *C* from financial exposure according to current UK legal liability rules. The parent company will, in fact, only lose the nominal value of the shares it holds in *F*.[1193] However, according to the

[1188] See Asli M. Colpan and Takashi Hikino, 'Foundations of Business Groups: Towards an Integrated Framework' in Colpan, Hikino and Lincoln (n420) 20.
[1189] CA 2006, s 1159 (1). Although 3.5. argued that in certain limited circumstances the idea of "control" is expanded, non-equity links are not used for the purpose of attributing liability in the UK.
[1190] *Okpabi* (n130) [147].
[1191] See 4.2.
[1192] See 3.5. and 4.2.
[1193] CA 2006, s 542. When applicable, the nominal value of the shares will be in addition to a premium: CA 2006, s 582.

enterprise approach, this rigid legal separation would not exist anymore, and the potentiality of causing harm as a result of a unified business would be caught under the regulatory scheme, thus satisfying the requirement of having an enterprise. It follows that company *C* can be liable to contribute to company *F*'s shortfall of assets. The following section will use this concept of enterprise to supplement traditional corporate theories.

6.2. Understanding Corporate Groups

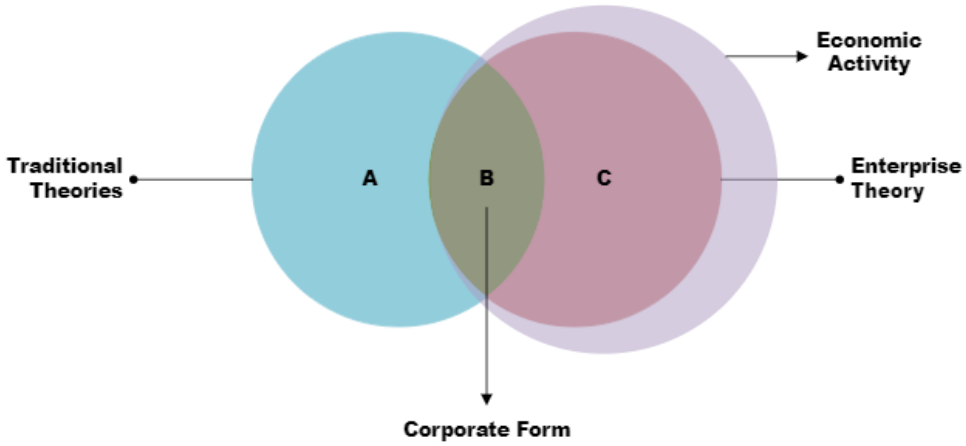
Corporate groups can represent a complex structure of interconnected entities that operate collectively in a legal framework of entity centricity.[1194] Traditional theories of the corporate form, which follow this orthodox thinking of entity centricity, cannot understand the dynamics within these groups due to their primary purpose of understanding only the dynamics of individual companies. The original debate on the traditional theories cannot be resolved and most likely will continue to be a perennial debate in company law.[1195] However, the concept of enterprise can supplement each theory, allowing scholars following any of these paradigms to understand corporate group structures and their behaviour to progress and enrich company law, due to the interconnectedness of theoretical and legal developments.

To depict this, we can imagine the theories of the corporate form and the enterprise theory through the mathematical logic of the set theory, in Figure Seven. Traditional theories (*A*) encompass various perspectives in understanding the legal aspect of individual companies, with the corporate form (*B*) serving as the focus through which the company is examined. Therefore, we can say that $A \supset B$, namely *A* has the same elements of *B* and more. The concepts and ideas within traditional theories are equivalent to those concerning the corporate form but explained through different paradigms. Essentially, they are looking at the same aspects of corporate entities, albeit from different theoretical perspectives. The enterprise theory (*C*) aligns corporate entities to the reality of how they are used. It uses the broader conception of an economic activity (*D*) to refer to the activities and operations undertaken by individual companies but within the unified enterprise. It is important to note that while the enterprise theory considers a wide spectrum of economic activities, the specific definition of corporate groups as enterprises, as outlined above,[1196] imposes certain limitations compared to the entirety of economic activities. Therefore, $C \in D$, meaning that the concepts and ideas within the enterprise theory come within those related to the economic activity, but in a narrower sense. In other words, the economic activity corresponds to the idea of "firm"

[1194] See ch 2 and 3.
[1195] Hardman, 'The Making of Corporate Legal Concession Theory' (n845) 181. See also ch 5.
[1196] See 6.1.

containing any kind of organisational structure. The enterprise theory focuses on understanding the corporate activity outside the corporate form but within an economic activity. The conclusion is that traditional theories and the enterprise theory are distinct and separate conceptual frameworks. However, there is an intersection between the two, because while the traditional theories focus on the corporate form and the enterprise theory does not, the latter looks at the consequences of using the corporate form within a broader economic activity. The corporate form *B* is an element present in both *A* and *C* ($A \cap C$). There are elements shared between both sets ($A \cap C \neq \emptyset$). It is possible for the enterprise theory (set *C*) to encompass and build upon traditional theories (set *A*) by providing a broader framework that contains the use of the corporate form (*B*) within the conception of the economic activity (*D*).

Figure 7. Theoretical Framework of The Enterprise



This section will juxtapose established theories with the concept of the enterprise, aiming to explain what corporate groups are and the implications of their organisation on legal, economic, and social dimensions. The analysis begins with the concession theory, which views the company as a legal construct granted by the state, and how the enterprise theory can supplement this paradigm in recognising corporate groups and shifting from a single entity perspective to the enterprise. Subsequently, the aggregate theory will be examined and how the contractual narrative can incorporate the enterprise theory, gaining insight into interconnectedness and interdependencies within corporate groups. Ultimately, the real entity theory will be investigated. The theory, which posits that the company possesses existence and autonomy beyond its natural members, can be informed by the enterprise theory into considering the implications of corporate groups and their accountability. Through this comparative exploration, this thesis seeks to reveal the separate theoretical underpinnings of corporate groups and their implications for corporate legal theory. By understanding the

interplay between theoretical frameworks and practical realities, the aim is to enrich our theoretical comprehension of the complex dynamics inherent within corporate groups.

The concession theory, originating from historical practices of state-granted charters,[1197] conceptualises companies as legal entities conferred with corporate status by the state. According to this theory, the company's existence and powers are derived from a concession or grant from the sovereign authority, which establishes it as a distinct legal person separate from its individual members.[1198] This perspective emphasises the role of the state in creating and regulating corporate entities, positioning companies as artificial constructs that owe their existence to statutory recognition.[1199] Within the context of corporate groups, the concession theory cannot understand groups as a whole "entity".[1200] This is because the paradigm understands only the single concession of personality granted by the state. It interprets the company and not the group.[1201] Moreover, the theory understands companies as creatures of law often in terms of legal positivism, by looking at statutory and other legal provisions.[1202] This creates further limitations on its theoretical application to corporate groups.[1203]

The concession theory, therefore, overlooks the dynamic and interconnected nature of corporate groups. To enrich the understanding of corporate groups within the concession theory paradigm, we can integrate insights from the concept of enterprise, which offers a more holistic perspective on corporate entities as cohesive operational units. One significant way in which the enterprise supplements the concession theory is by recognising that the state grants a concession to an economic reality. Hardman argues that the company is a concession to something real to operate.[1204] This something that uses the company as a concession by the state, a legal tool necessary to operate a business, is the enterprise. In other words, the state grants the concession of separate legal personality through incorporation, but there is and must be something else beyond the company.[1205]

[1197] Gerner-Beuerle and Schillig (n875) 51.
[1198] Harris, 'The Transplantation of the Legal Discourse on Corporate Personality Theories' (n861) 1424.
[1199] Watson, 'The Corporate Legal Person' (n886) 140.
[1200] The concession theory's narrow focus on the legal boundaries of corporate entities and their relationship with the state does not fully capture the economic realities and complexities of modern corporate structures, particularly corporate groups. See 5.2.
[1201] See ch 5.
[1202] See *Salomon* (n32) 46: '*we have to interpret the law, not to make it*'.
[1203] Corporate groups lack an agreed-upon definition and distinct legal rules that regulate them. Legal positivism cannot accommodate the development of corporate group theory, and the concession theory lacks an initiative-taking stance in demanding greater restrictions or counter-concessions from entities causing harm. See 5.2.
[1204] Hardman, 'Fixing the misalignment' (n25) 448-451, based on Paul Vinogradoff, 'Juridical Persons' (1924) 24(6) Columbia Law Review 594.
[1205] The company is a legal creation employed to attribute the presence of something. Hardman, 'Fixing the misalignment' (n25) 449.

While the concession theory primarily views companies as legal constructs established through state concession, corporate groups often function as integrated entities with shared goals, resources, and decision-making processes.[1206] In corporate groups, the company is used as a legal tool to divide the economic activity. The underlying economic activity - the enterprise - is not delimited within the boundaries of the single legal entity. It comprises all the entities incorporated for the purpose of conducting a single co-ordinated and interconnected business. By considering companies as concessionary legal tools to something else - i.e., the economic activity - the concessionists can recognise the corporate group as an enterprise with a cohesive operational structure that simply uses the concession as a legal tool. The result of supplementing the concession theory with the enterprise theory is that the concessionists can recognise the concession *and* the economic activity that goes beyond the concession. The implication of this original approach is that the enterprise can be subject to the regulation of the law. The economic and social effects of the use of the corporate form can now come within a company law analysis. This argument is summarised in Table Two below.

Table 2. Supplemented Concession Theory

Concession Theory Claims	Supplement with Enterprise
Originates from historical practices of state-granted charters.	Builds upon the idea of state concession, recognising that the concession will be granted to an economic activity.
Positions companies as artificial constructs.	Business activity extends beyond the boundaries of single artificial entities.
Focuses on the single concession of personality granted by state.	Considers the company as a legal tool for operationalising economic activity.
Understands legal boundaries between parent companies and subsidiaries.	Recognises corporate groups as enterprises with cohesive operational structures.

In the discourse surrounding company law and theory, the contractarian approach has long had great influence with a number of scholars following this paradigm.[1207] It conceptualises companies as mere aggregations of individual members bound by contractual relationships.[1208] The view of the company as a contract reduces separate legal personality to

[1206] See 3.5.
[1207] See Cheung (n962); Easterbrook and Fischel, 'The Corporate Contract' (n952); Jensen and Meckling (n81).
[1208] Easterbrook and Fischel, *The Economic Structure of Corporate Law* (n50) 8.

a beneficial mechanism that facilitates transactions and relationships between participants.[1209] While this perspective has provided insights into the dynamics of shareholder-manager relationships and economic objectives within companies, it falls short of capturing the broader complexities inherent in corporate groups. Because this paradigm also tries to understand the company and shed light on the internal dynamics of corporate boundaries, corporate group analysis has been neglected as it was considered irrelevant to the contractual nature of the corporate form.[1210] Thus, its analysis is too narrow.

However, it would not be a challenge to supplement the contractarian approach with the enterprise theory. Both recognise the importance of the economic activity and the company, albeit conceptualised in different terms. Scholars, following the conception of the company as a contract, often exchange economic and legal concepts in the form of the company and the firm.[1211] For instance, Jensen and Meckling refer to the firm and the company interchangeably as a nexus of contracts.[1212] Although their use of economic and legal concepts can often be blurred,[1213] the enterprise can offer a supplementary perspective that enriches the understanding of corporate groups within the framework of the contractarian approach. This is because the firm refers to a wider concept of which companies form part.[1214] Similarly, the enterprise theory identifies the corporate group as an enterprise, an organisational form operating within a broader economic activity of which legal entities form part. The enterprise posits companies as tools used for a cohesive unity formed by strategic and collective decision-making processes. Therefore, if the company is part of the firm, it is also part of the enterprise. The enterprise, in turn, can guide the arguments surrounding the design of company law.[1215] By adopting the enterprise lens, scholars can focus on the intricacies of corporate groups and their resulting corporate activities, transcending the limitations of individual contracts and corporate forms. This is because the enterprise considers the broader economic relationships and strategic coordination within corporate groups, which are not fully captured by traditional legal concepts of individual companies.[1216]

One of the key contributions of the concept of enterprise is its emphasis on operational dynamics within corporate groups. While the contractarian approach focuses primarily on contractual relationships between the members and the company, the enterprise expands the

[1209] See for example the agency relationship between directors and shareholders. Kraakman and others (n8) ch 2.
[1210] Easterbrook and Fischel, *The Economic Structure of Corporate Law* (n50) 12.
[1211] A more thorough examination of the two will be conducted in the following sections.
[1212] Jensen and Meckling (n81) 311.
[1213] See 6.1.
[1214] Robé, 'The Legal Structure of the Firm' (n82) 48-49.
[1215] The reason for focusing on the enterprise rather than the firm is rooted in the inherent ambiguity and lack of clear boundaries surrounding the concept of the firm, as discussed in 6.1.2.
[1216] This aligns with the structure and reality of corporate groups, explored in 3.1. and 3.5.

analysis to consider how these relationships translate into collective action and operational efficiency[1217] within broader corporate group structures. By recognising the use of the corporate form as a strategic entity pursuing common goals, scholars can explore the underlying dynamics that drive decision-making processes and operational performance in a coordinated structure of separate legal entities.

In addition to operational dynamics and intra-group relationships, the enterprise concept broadens the scope of regulation within corporate groups. While the contractarian approach tends to focus on shareholder-manager relationships,[1218] the enterprise perspective recognises the roles and interactions of various stakeholders. This holistic view enables scholars to examine the mechanisms that facilitate coordination and interdependencies across the entire enterprise, thereby acknowledging the relevance of protection for external parties.[1219] These claims are summarised in Table Three.

Table 3. Supplemented Contractarian Approach

Contractarian Approach Claims	Supplement with Enterprise
Conceptualises companies as aggregations of individual members bound by contractual relationships.	Perceives companies as unified entities that make decisions collectively, emphasising the strategic coherence of their operations.
Focuses on dynamics of shareholder-manager relationships and economic objectives within companies.	This approach extends the analysis beyond internal dynamics, examining how a company's relationships and interactions with its environment produce external effects.
Overlooks intra-group relationships because the company is only a fiction to achieve private ordering.	Recognises significance of protection for external parties and mechanisms facilitating coordination across entire enterprise.
Neglects broader complexities inherent in corporate groups.	Emphasises operational dynamics and intra-group relationships within broader corporate group structures.

[1217] The operational efficiency (part of the economic dynamics of groups) is discussed in 3.4.
[1218] Kraakman and others (n8) ch 2.
[1219] See details in 6.1.3.

The real entity theory posits that a company is not merely a legal fiction but a real person with its own will and existence, separate from its shareholders.[1220] It emphasises the social reality of companies as a collective formed by individuals with shared intentions being recognised by society - and ultimately the law.[1221] In other words, companies are autonomous actors representing a social structure that is formed when human beings work together, and they are formally recognised as subjects of law by company law.[1222] While the real entity theory lays the groundwork for recognising the autonomy and social significance of companies, its singular focus on individual entities limits its ability to grasp the complexities in corporate groups. This results from treating each company as a separate and distinct entity, which overlooks the interconnectedness and interdependencies that exist in a corporate group structure.[1223] Supplementing the real entity theory with the enterprise theory provides a perspective integrating all the relevant factors regarding corporate groups. The enterprise recognises that corporate groups can operate as unified enterprises pursuing common goals, transcending individual company boundaries.

Hardman reconciled the concession theory and the real entity theory by stating that the two theories talk about slightly different things regarding separate legal personality, yet underneath this discussion there is a "real" business that both theories acknowledge.[1224] Thus, basing the argument on the two-step process of Vinogradoff,[1225] there is first a business reality that comes to life and then the legal tool used to operationalise it.[1226] If the discussion on the nature of the company - i.e., understanding what legal form it is - is only the second step of the process, then we can understand the first step of the business reality by supplementing the theories with the enterprise. The real entity view merges the two steps into one and hence the company is a real, social organisation.[1227] In essence, by investigating the nature of the company, it recognises the company's operational realities and its legal status simultaneously. The enterprise is not concerned with the second step, but only the first. It seeks to understand the operational realities of the company without delving into the complexities of the nature of its legal form.[1228]

[1220] Phillips (n939) 1069.
[1221] Adelstein (n867) 345.
[1222] Micheler, *Company Law: A Real Entity Theory* (n852) 28-29.
[1223] See 3.1. and 3.5.
[1224] Hardman, 'Fixing the misalignment' (n25) 445.
[1225] Vinogradoff (n1204).
[1226] Corporate groups make use of the corporate form to operate, see Deakin and others (n85) 197; or firms use companies: Robé, 'The Legal Structure of the Firm' (n82) 49.
[1227] Micheler, *Company Law: A Real Entity Theory* (n852).
[1228] Ewan McGaughey, *Principles of Enterprise Law The Economic Constitution and Human Rights* (Cambridge University Press 2022) 9-10.

The real entity theorists can still acknowledge the company as a real, legal entity. However, this entity is part of a bigger reality - the enterprise. The enterprise theory recognises that the corporate form is used as a benefit in corporate structures and at the same time it contributes to the larger organisational form, whose actions and decisions impact external parties.[1229] Furthermore, the enterprise addresses the practical implications of corporate groups, namely the business reality underlying the legal entities.[1230] These implications refer to governance structures, intra-group relationships, and other dynamics that are excluded from the analysis of traditional theories.[1231] Thus, supplementing the real entity theory with the enterprise perspective gives more space to the examination of group-wide dynamics, such as coordination, policy formulations, and other legal and economic organisational links, which are essential for understanding the holistic functioning of corporate groups.[1232] These claims are summarised in Table Four.

Table 4. Supplemented Real Entity Theory

Real Entity Theory Claims	Supplement with Enterprise
Posits that a company is a real person with its own will and existence, separate from its shareholders.	Considers corporate groups as unified entities pursuing common goals, transcending individual company boundaries.
Emphasises social reality of companies as collectives formed by individuals with shared intentions.	Expands beyond singular entity focus to consider interconnectedness of corporate entities within a group.
Overlooks complex relationships and interactions within corporate groups with external effects.	Better accounts for complex relationships and interactions within corporate groups, considering their external effects.
Focuses on internal dynamics and may exclude practical implications of corporate groups.	Addresses practical implications such as governance structures, intra-group relationships, and other dynamics, essential

[1229] Consider the dynamics of groups discussed in ch 3. Parent and subsidiary companies interact based on ownership, control, and economic dynamics. These interactions result in complex relationships that transcend the boundaries of the individual legal entities. In turn, they have far-reaching impacts on individuals outside of the corporate form and the group.
[1230] The traditional theory might acknowledge a "reality" underlying the corporate form: Hardman, 'Fixing the misalignment' (n25) 445. The focus of the theories, however, remains on the individual legal entities and ignores or assumes corporate groups to fall under the traditional legal entity view. See ch 5.
[1231] See ch 5.
[1232] See ch 3.

	for understanding holistic functioning of corporate groups.

Examination of the theories of the company reveals the complexity of conceptualising corporate groups within the legal entity theoretical framework. Each theory offers unique insights into the nature of companies, but also presents limitations when applied to understanding corporate groups. The enterprise concept provides a valuable supplement to these traditional theories by emphasising the interconnectedness of corporate entities within larger group structures. When we consider corporate groups, we are not merely looking at separate entities operating in isolation; instead, we are dealing with a complex structure of interlinked entities that together constitute a larger organisational form.[1233] These entities, while legally separate, often function as an integrated whole, carrying out a single economic activity.[1234] By acknowledging the existence of enterprises as subjects to the law, a theory of the enterprise can extend beyond the boundaries of individual companies, offering a framework to analyse group dynamics and socio-economic impacts more holistically.

The next step is to define '*how liability is to be allocated among* [the companies within the enterprise]*'*.[1235] This points to the need for a doctrinal application of the enterprise theory, which leads us directly to the concept of enterprise liability. This concept, elaborated in the concluding parts of this chapter, is deeply rooted in normative considerations. The next section will, therefore, discuss the enterprise theory as a separate line of inquiry regarding the company, which relies on a distinct approach to the legal entity view to solve the issue of risk externalisation. In doing so, it will also set the test of enterprise liability and its normative foundations.

6.3. Enterprise Theory

As discussed in chapter 5, the theories of legal personality could potentially acknowledge the enterprise because their analysis is based on a rhetoric that accommodates any of the author's claim. However, even if the potential to recognise an enterprise is there, they all come with their limitations of either not considering risk externalisation as a problem or being unable to remedy it because of their narrow confines. In part, the limits of such theories derive from the fact that once complex business structures like corporate groups became an economic reality,

[1233] See ch 3.
[1234] Jones (n21) 172.
[1235] Petrin and Choudhury, 'Group Company Liability' (n652) 791.

legal thinking continued to apply the same concepts, designed for individual companies, to parent and subsidiary companies. This formed the basis for a wider argument that traditional theories fail to recognise the issues generated using the corporate form in group structures, where economic and legal realities do not always align. The difference between economic and legal boundaries produces an opportunity to revisit corporate groups as legal-economic *phenomena* and reconceptualise them as enterprises, refining the enterprise-entity dichotomy under UK company law.

The difference in boundaries is not purely theoretical, but it can be witnessed in practice. Underwood's data[1236] extends beyond mere subsidiary presence; it unveils a profound discrepancy between the traditional legal conception of a single corporate entity and the reality of business organisation. In his findings, case studies emerge as compelling illustrations of how a single business is effectively split into separate legal entities within corporate groups. Examining companies like Shell and BP in the mining and extraction sector unveils a common practice of establishing "development" companies to conduct specific operations for the group.[1237] These entities, such as The Shell Petroleum Development Company of Nigeria Ltd, operate within distinct jurisdictions and carry out specialised functions for the whole business, compartmentalising the business operations across multiple legal entities.[1238]

This data and its analysis can be supplemented by this thesis' discussion. Sections 3.5 and 4.2 explored corporate group structures, where control is characterised not only by equity ties but also by integrative relationships and internal decision-making mechanisms. Together they show that an economic activity and the corporate form do not always overlap, and when they do not, there is the need to reconceptualise how we see and regulate companies. Company law should, in these circumstances, recognise the enterprise and place less importance on the corporate form. As argued in chapters 4 and 5, the disproportionate focus on the legal entity led company law to retreat from its role in regulating business activities, leaving other areas of legal taxonomy to deal with the risks generated when the corporate form does not align with its organisational form. The enterprise theory provides a wider picture of what should fall within the scope of company law, which is undergirded by economic perspectives,[1239] and

[1236] Underwood (n1155) ch 3.
[1237] ibid.
[1238] Shell was also considered as an example in this thesis in ch 4. There, this thesis shed light on the fact that Shell subsidiaries were not autonomous and independent legal entities based on the group structure adopted by Shell.
[1239] Bratton, 'The New Economic Theory of the Firm' (n52) 1471. Bratton seems to use interchangeably firm and corporation. However, according to him, if we engage in the exercise of tracing the history of the theories of the "firm", economic theory has always been informing legal doctrine - even though it only intermittently appeared in the legal discourse.

is essential for understanding how corporate groups function and the implications of their organisation on legal, economic, and social dimensions.

The entity-enterprise dichotomy in common law jurisdictions is more difficult to resolve compared to European legal systems[1240] because in the former there is no statutory or common law answer to the questions asking which theory governs corporate groups.[1241] In the UK, there is not even an answer to what a corporate group is and how the law can define it.[1242] This is why this chapter has reached a definition of enterprise. Nonetheless, when limited liability is not at issue, UK law seems to be less reliant on the legal entity approach if it serves the purpose of a particular area of law. Entity boundaries fade when it comes to shareholders' rights - or benefits - in corporate group situations.[1243] For instance, for the purpose of financial reporting, the directors of a parent company, limited to some exceptions, are required to prepare both individual and group accounts for the financial year.[1244] By preparing group accounts under the definition of "undertaking",[1245] it is possible to witness a faint hint of enterprise principles in a predominantly traditional legal entity system.

Past judicial decisions confirmed that an enterprise approach is not far-fetched in UK legal thinking, especially when it furthers the benefits of the group as seen in *Beckett Investment Management Group Ltd v Hall*[1246] and *DHN Food Distributors v Tower Hamlets*.[1247] In *Beckett*,[1248] the Court was called to interpret a restrictive covenant involving employees who provided services through the subsidiary companies of a corporate group. Lord Justice Kay expressed his opinion on a '*purist approach to corporate personality*'[1249] that mimicked Lord Wilberforce's in *Stenhouse Ltd v Phillips*,[1250] who also considered the reality of a big business where subsidiaries are instrumentalities used by the parent company to integrate its economic activity.[1251] Generally, the law on restraint of trade will respect the legal entity view; however, the courts also acknowledge that when the companies within a group have related businesses, the interests of one company will extend to the other companies, hence generating a unitary

[1240] Marcus Lutter, 'Enterprise Law Corp. v. Entity Law, Inc.- Phillip Blumberg's Book from the Point of View of an European Lawyer' (1990) 38(4) The American Journal of Comparative Law 949, 952.
[1241] Namely what are the theoretical foundations to understand corporate groups.
[1242] See 3.1.
[1243] See 6.1.
[1244] CA 2006, s 399, exceptions under ss 400 (company included in EEA accounts of larger group), 401 (company included in non-EEA accounts of larger group), and 402 (company none of whose subsidiary undertakings need be included in the consolidation).
[1245] See 3.5.
[1246] [2007] EWCA Civ 613, [2007] ICR 1539.
[1247] [1976] 1 WLR 852 (CA).
[1248] *Beckett Investment Management Group Ltd v Hall* [2007] EWCA Civ 613, [2007] ICR 1539.
[1249] ibid [19].
[1250] [1974] AC 391.
[1251] ibid.

view.[1252] Therefore, in *Beckett*,[1253] the Court of Appeal held that a covenant in restraint of trade between an holding company, as the employer, and an employee, providing services through a subsidiary company, was enforceable and reasonably protected a legitimate business interest.

In *DHN*,[1254] there was a corporate group comprised of three major players, where the parent company, DHN Food Distributors, was responsible for the operations and wholly owned two subsidiaries, Bronze Investments Ltd, which owned the premises of the business, and DHN Food Transport Ltd, which owned the vehicles used by the business.[1255] All three went into liquidation as a result of Tower Hamlets London Borough Council buying the premises owned by Bronze, even though the parent company was operating its business.[1256] If the three functions outlined above had been carried out by the same legal entity with single ownership, compensation would have been paid.[1257] Nevertheless, only the company owning the premises was compensated. The Court of Appeal returned the decision that the Court was '*entitled to look at the realities of the situation'*,[1258] and treated the three companies as a single entity, allowing the parent company to receive compensation.

Lord Denning justified it based on the idea that in certain specific circumstances, the law looks at the economic unity of the group, such as in the case of group accounts.[1259] It follows that the cases presented above show that it is not unattainable for the UK common law to recognise enterprise principles when the underlying objective of the law can only be achieved through the recognition of an enterprise. Unfortunately, in cases concerned with limited liability, the UK takes a strict legal entity approach. Subsequent decisions rejected the view suggested in *DHN*,[1260] and as analysed in section 4.1., most recent decisions uphold a purist approach to the corporate form by maintaining the separate legal personality of each member company within a corporate group. Despite this case not being considered a good point of law anymore, its decision serves as an example of how UK company law allows the group to be one enterprise when beneficial to shareholders and completely separate and independent companies when liabilities are at issue. The presence of this decision, however, draws attention to a fundamental issue: the discrepancy between legal form and economic reality.

[1252] *Dyson Technology Limited v Pierre Pellerey* [2016] EWCA Civ 87, [2016] ICR 688 [92].
[1253] *Beckett* (n1248).
[1254] *DHN Food Distributors v Tower Hamlets* [1976] 1 WLR 852 (CA).
[1255] ibid 852.
[1256] ibid 854.
[1257] ibid 857.
[1258] ibid 861 (Goff LJ).
[1259] ibid 860.
[1260] *DHN* (n1254).

Strict adherence to the legal entity doctrine can obscure the true nature of corporate operations and prevent just outcomes, particularly in complex corporate group structures.

An enterprise approach has already been applied to particular areas of law, but to date there is no general principle applicable specifically to corporate groups under company law. For instance, when discussed in tort law, the enterprise theory can refer to alternative forms of liability applied to corporate actors, such as the principle of vicarious liability, or employees' compensation provisions, amongst others.[1261] Recently, Professor McGaughey has developed a theory of "enterprise law". In his theory, the idea of enterprise covers any activity conducted for a business purpose, irrespective of the legal form, and it includes every regulated industry, such as education, healthcare, banking etc.[1262] Its principles encompass broader economic and social interests by integrating into its legal analysis finance, governance, and rights.[1263] Because his analysis hinges on the use and abuse of power of economic organisations, he explains that company law alone cannot understand the enterprise and its behaviour.[1264] Therefore, his theory goes beyond company law and embraces the integration of other areas of law to regulate "enterprises". In contrast, this thesis formulates an enterprise theory to supplement the traditional legal entity theories of corporate personality to attribute liability within group structures under company law.

As demonstrated in chapter 4, to address the issue of risk externalisation towards vulnerable parties, company law should play a vital role and has a normative responsibility in doing so. The concept of enterprise allows for the liability of one entity to extend throughout the enterprise. And by having a clear definition of enterprise, we can determine whether liability can be attributed to the collective economic activity of the enterprise as a whole or to individual legal entities within the corporate group.[1265] The enterprise theory concedes the point that, based on the capacity to "control" an economic activity,[1266] a corporate group can be regarded as a single entity even though it consists of separate, but *related* companies. As such, it recognises the entire group as a single unit for regulatory purposes[1267] where the responsibilities will match the collective economic activity.[1268] This perspective bridges the gap

[1261] See in more detail in Douglas Brodie, *Enterprise Liability and the Common Law* (Cambridge University Press 2010) 1-15.
[1262] McGaughey (n1228) 1-8, 91-92; Ewan McGaughey, 'Enterprise Law and the Eclipse of Corporate Law' (2023), 2 < https://ssrn.com/abstract=4379144 > accessed 20 May 2024.
[1263] ibid.
[1264] McGaughey (n1228) 3-4.
[1265] See 6.1.
[1266] Integrating the idea of influence via both formal and informal means.
[1267] Thomas Raiser, 'The Theory of Enterprise Law in the Federal Republic of Germany' (1988) 36(1) The American Journal of Comparative Law 111, 114.
[1268] Mevorach, *Insolvency within Multinational Enterprise Groups* (n414) 39.

between traditional legal interpretations and the operational realities of contemporary business enterprises, thereby addressing the issue of risk externalisation more effectively.

General principles of enterprise liability in the common law of tort, in relation to "enterprise risk", recognise the risk-bearing capacity of the enterprise, potentially generating a legal model for the latter that is wider than the company law conception of the company.[1269] Legal concepts have the power to bring about social change, thus being an instrument of policy, because of their influence in shaping the law and, in part, the content of legal rules.[1270] In 1947, Berle wrote that '*more often than not, a single large- scale business is conducted, not by a single corporation, but by a constellation of corporations controlled by a central holding'*.[1271] From both a theoretical and business reality perspective, as seen above, this is justified.[1272] It would then make sense to move past the rigid conception of the single entity-legal form and shift towards an enterprise.[1273] Ultimately, the failures of the legal theories of personality have brought about only confusion, both theoretically and practically. By stripping companies away from this theoretical level of uncertainty, what remains is that a company, albeit incorporated for any lawful purpose,[1274] is often '*a profit-seeking enterprise of persons and assets organized by rules'*.[1275]

Berle stipulated that for the purposes of determining an enterprise, parent companies should become liable for subsidiaries' obligations.[1276] This thesis adopts this same view as it focuses on the theoretical underpinnings of parent company limited liability. However, theoretically, extending lability both horizontally and vertically, namely extending liability to each unit of the enterprise, is possible. By recognising the enterprise as a whole working in unison, each unit could be potentially liable.[1277] This thesis has indicated so far that the main issue with the traditional legal entity view as applied in corporate groups is that vulnerable third parties affected by the incentives of risk externalisation will most often remain unsatisfied with no viable remedy under the law. It follows that the enterprise theory will be concerned with the concept of limited liability for parent companies *qua* shareholders. This is because shareholder limited liability is controversial for parent companies and the critical aspect that affects third parties impacted by risk externalisation of the group. By focusing on this, the enterprise theory

[1269] Deakin, 'The Corporation as Commons' (n913) 365.
[1270] Deakin 'Juridical Ontology: The Evolution of Legal Form' (n852) 181-182. See discussion in 5.5.
[1271] Deakin, 'The Corporation as Commons' (n913) 343.
[1272] See the case of Shell in 4.2. or the way corporate groups operate in 3.1. and 3.5.
[1273] As defined in 6.1.
[1274] CA 2006, s 9(2)(e), amended by the Economic Crime and Corporate Transparency Act 2023, s 2.
[1275] Melvin A. Eisenberg, 'The Structure of Corporation Law' (1989) 89 Columbia Law Review 1461, 1487.
[1276] Berle, 'The Theory of Enterprise Entity' (n2) 348.
[1277] Whether it is justified or convenient in practice to remove limited liability, in certain circumstances, for all corporate shareholders is outside of this thesis' scope.

aims to provide remedies for those affected by the actions of corporate groups when traditional legal entity approaches fail to adequately address these concerns.

The UK largely rejects the enterprise approach due to the fact that the "substance" of corporate personality is '*legal substance, not economic substance'*.[1278] This view forms the basis even for scholars, such as Witting, who reject enterprise theory due to the courts' struggle to give importance to economic integration as more than just a factor for consideration.[1279] However, it is important to reiterate that the economic realities of corporate groups do not always match the legal regime adopted by UK courts. Limited liability also reflects the willingness to integrate politico-economic values into the legal system, and it does not rest theoretically on a fundamental concept of jurisprudence to recognise a company as a legal unit.[1280] Furthermore, various other areas of the legal taxonomy in the UK follow enterprise liability or generally the concept of enterprise. Competition law,[1281] tax law,[1282] and labour law[1283] are examples of laws applicable in the UK that recognise an enterprise and provide mechanisms for holding any vehicle within an enterprise liable in their respective domains. Only UK company law stands out by not recognising economic activities independent of their legal forms. Consequently, it fails to address the repercussions, argued in this thesis, stemming from the misalignment between the boundaries defined by a corporate form and those of an organisational structure.[1284]

The enterprise theory does not need to coincide with the corporate form. As this thesis has argued and demonstrated,[1285] while the corporate form remains relevant, it should not be the sole focus of company law, and it is the firmly fixed concept of the corporate form that creates issues in the first place. The enterprise theory does not displace the legal entity view. The two can co-exist and be applied to the "enterprise-entity" whenever the objective of the law requires either an enterprise approach or an entity approach. The coexistence of the two concepts - entity and enterprise - is not merely a speculative possibility; rather, it represents a necessary reconciliation that acknowledges the complementary roles they play in addressing the complex challenges posed by corporate groups.

[1278] *Re Polly Peck International plc. Barlow & Ors v Polly Peck International Finance Ltd & Anor*. [1996] BCC 486 (Ch), 494.
[1279] Witting, *Liability of Corporate Groups and Networks* (n22) 184-185.
[1280] Blumberg, *The Multinational Challenge to Corporation Law* (n6) 7.
[1281] Each member of a single economic entity may be held liable for infringements of competition law for violations of other members of the group: see *Akzo Nobel Chemicals* (n598) and *Commission v Parker Hannifin* (n598).
[1282] CA 2006, s 399-401; corporate group tax liability relief Corporation Tax Act 2010, s 140-141.
[1283] *National Union of Rail, Maritime and Transport Workers v United Kingdom* (2015) 60 EHRR 10.
[1284] See 4.3.
[1285] See ch 4 and 5.

The “one-size-fits-all” approach of UK company law does not apply to groups that can adopt a myriad of structures and have variable purposes. Both the legal entity view and the enterprise theory can play a role in the legal system, as the former is engaged with the attribution of “core” rights to companies and the latter is mainly concerned with their responsibilities,[1286] which means that they do not undermine each other but can supplement each other. Whenever the objective of the law necessitates a comprehensive understanding of interconnected economic activities within corporate groups and the allocation of collective responsibilities, an enterprise approach becomes imperative. Conversely, in situations where legal rights and benefits need to be attributed to individual legal entities within the group, an entity approach would be more appropriate. Thus, this thesis suggests two separate systems, supplementing each other, under company law, one for rights attributed to the entities within corporate groups and one that serves the allocation of their collective responsibilities.

It is important to remember that the issues, which this thesis argues it is important to remedy, arise when the boundaries of an economic activity do not match the legal boundaries of a corporate form.[1287] This means that the enterprise theory is not always necessary or applicable, as in certain circumstances it will yield the same results as the legal entity approach. The enterprise theory serves as a powerful tool for realigning corporate activities, ensuring that economic and legal boundaries coincide effectively. By embracing the enterprise perspective, we can rectify the current discrepancy where harms extend beyond individual legal entities but liabilities do not, thereby enhancing the coherence and efficacy of UK company law. Considering this analysis, the following section will expand the idea of enterprise liability by determining the criteria necessary for a principled extension of liability in groups.

6.3.1. Enterprise Liability

Traditional legal thinking believes that a business activity is carried out by individual and separate legal entities.[1288] Business reality differs from the traditional legal thinking, and an enterprise analysis would determine legal responsibilities according to the developments of the modern era, namely the deployment of separate legal entities as a vehicle to benefit the whole enterprise and partition the underlying business assets.[1289] This idea is interpreted within a wider concept of enterprise liability developed in other disciplines.[1290] This section will

[1286] Blumberg, *The Multinational Challenge to Corporation Law* (n6) 237.
[1287] Due to the corporate group structure exacerbating the incentives to externalise risk and the harms of third parties left unremedied.
[1288] Witting, *Liability of Corporate Groups and Networks* (n22) 174.
[1289] See ch 3.
[1290] The concept of company does not correspond to the idea of enterprise, because company law is not concerned with the relations of production and as a result describes the company only in terms of

first group together the literature on enterprise liability and its normative foundations, and then it will focus on how enterprise liability relates to corporate groups.

Enterprise liability originated in scientific management.[1291] In the late nineteenth century, when companies started to pursue growth and expansion, entrepreneurs were exploiting the economies of scale, scope, and diversification by re-organising business activities,[1292] such as by removing transactions from the market and bringing them within the boundaries of the enterprise.[1293] The second re-organisation wave focused on managerial approaches to the running of the economic production of the enterprise. With the focus now on managers being responsible for the entire production process, scholars began to theorise about workplace safety.[1294] In the nineteenth century, railroad companies, with the creation of accident compensation funds, pioneered the idea that the industry should bear the responsibility of accident costs in the workplace.[1295] According to managerial engineers, companies were the actors best capable of internalising those costs.

Scientific management, however, focused almost exclusively on deriving the value of business activities from the capacity of organising collective endeavours,[1296] hence by looking at the role of managers as paramount, the concept of the "enterprise" became a negligible issue. In fact, the enterprise was not defined in terms of its legal-economic boundaries - there is no definition of what organisational structures are enterprises - but by how the "new" role of managers had to balance differing interests within an enterprise.[1297] Scientific management then influenced tort law in the development of the enterprise theory of liability by translating an enterprise reasoning to liability rules.[1298] From the changes in workers' compensation laws, legal theorists also resonated with the logic that it is fair for the enterprise to absorb its costs, and encouraged the development of liability rules in several areas.[1299]

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its internal members: see Simon Deakin, ''Enterprise-Risk': The Juridical Nature of the Firm Revisited' (2003) 32(2) Industrial Law Journal 97, 97-99.

[1291] Witting, 'The Corporate Group: System, Design and Responsibility' (n384) 587.

[1292] See 3.4.

[1293] Coase, 'The nature of the firm' (n550) 392.

[1294] John F. Witt, 'Speedy Fred Taylor and the Ironies of Enterprise Liability' (2003) 103(1) Columbia Law Review 1, 21-25.

[1295] ibid.

[1296] Blanche Segrestin, Andrew Johnston and Armand Hatchuel, 'The separation of directors and managers: A historical examination of the status of managers' (2019) 25(2) Journal of Management History 141, 148.

[1297] A useful analysis and summary of this was presented in: Andrew Johnston, Blanche Segrestin and Armand Hatchuel, 'From balanced enterprise to hostile takeover: how the law forgot about management' (2019) 39 Legal Studies 75, 76-80.

[1298] Witting, 'The Corporate Group: System, Design and Responsibility' (n384) 587.

[1299] ibid. The same idea can be connected to strict liability and other liability rules theorised even for corporate groups, such as the work of Blumberg: Blumberg, *The Multinational Challenge to Corporation Law* (n6).

According to Priest, there are three premises for enterprise liability. First, injuries created by the activities of the enterprise are recognised as one of its costs, and the enterprise is capable of bearing the cost more adequately than the injured person because the enterprise could pass it along to consumers in the form of higher prices for products.[1300] The second premise relied on risk distribution. Based on the first premise, losses would be spread broadly over society, and the risk would then be reduced by shifting the loss from the party unable to bear it to the enterprise, which can pass the cost of insurance premiums along to the consumers.[1301] Thirdly, standardised contracts in the modern era are one-sided, leaving unprotected consumers and employees as the weaker party burdened by an inequality of bargaining power.[1302] Both scientific management and tort law, ultimately, agree that enterprises are in a superior position to assess, prevent, and make arrangements for the costs and dangers of business activities. This rationale can easily apply to a wide range of injuries in modern economic life[1303] and is the foundation for this thesis' proposed enterprise liability.

The normative foundations of enterprise liability do not pin responsibility on fault; rather, the costs of an injury should be borne by those profiting from the activity causing the injury;[1304] they should not be concentrated on the victim or on the agent inflicting such injury.[1305] The nature of enterprise liability is harm-based.[1306] Harm-based liability applies to a conduct causing harm even if the conduct itself is justified and the harm was not the person's fault. In other words, conducting an activity, such as operating a business, can be undertaken '*only on the condition*' that any harm generated by the activity will be repaired regardless of whether the conduct itself is considered wrong or blameworthy.[1307] Therefore, instead of concentrating the cost on the specific wrong-doer (for example a subsidiary company), the costs should be distributed among the enterprise (for example the parent company). Moving away from the idea of fault, enterprise liability would bring justice in two respects. Some scholars theorised that, in the context of fairness, those who benefit from an imposition of risk should bear the burdens of the risk.[1308] Others believed that enterprise liability would bring allocative efficiency

[1300] George L. Priest, 'The Invention of Enterprise Liability: A Critical History of the Intellectual Foundations of Modern Tort Law' (1985) 14(3) The Journal of Legal Studies 461, 466.
[1301] ibid 471.
[1302] ibid 493-494.
[1303] Witt (n1294) 41-42.
[1304] Calabresi (n1116) 500.
[1305] Gregory C. Keating, 'Enterprise Liability' in Petrin and Witting (n966) 332.
[1306] This would avoid the issues of fault-based liability and the factor of control used in such liability framework. See 4.2.
[1307] Keating (n1305) 335.
[1308] Gregory C. Keating, 'The Idea of Fairness in the Law of Enterprise Liability' (1997) 95(5) Michigan Law Review 1266, 1269.

by incentivising the enterprise to take steps to prevent accidents and spread risks, through mechanisms like insurance, in order to more easily manage and bear the costs.[1309]

The idea of enterprise liability represents a change in legal thinking that shifts the burdens of an activity to the enterprise and away from the individuals outside the enterprise. It does not arise out of wrongdoing or misconduct; it is not a duty not to inflict harm, but a duty to repair harm.[1310] It arises as a result of the activities of a firm that have characteristic risks.[1311] Therefore, there is a direct link between the harm suffered by the claimant and the inherent risk of the enterprise. Enterprise liability simply argues that the negative cost of an economic activity should be allocated to the party who has more "control" of the activity. It follows that extended liability could be based on the capacity to control and could be used to integrate corporate groups into the idea of the "enterprise". This capacity for control would be broader than the legal definition of control currently used in UK law.[1312] A mere capacity to control would catch situations where parent companies noticeably have control and can exercise it whenever they wish to, but have chosen to decentralise and grant autonomy, thus not exercising control under the law. While legal control is not exercised, as we have seen in sections 3.5 and 4.2, other types of control can still be present. It would be fair to attribute liability in these circumstances because decentralisation and autonomy in corporate group structures are carried out within a highly controlled environment that adheres to a coordinated business purpose, regardless of whether control[1313] is present or not. It follows that this reality, where a single business is divided into "compliant" separate legal entities, necessitates a different normative and legal inquiry that the traditional legal entity view can neither provide nor undertake.

The idea of characteristic risks is a key component to this argument.[1314] Attributing liability according to the enterprise approach would not be the same as extending liability in all circumstances. Based on the proposed enterprise approach, there is a clear conceptual limit on liability, namely liability ceases when the activity does not create a risk characteristic of the

[1309] Steven P. Croley and John D. Hanson, 'Rescuing the Revolution: The Revived Case for Enterprise Liability' (1993) 91(4) Michigan Law Review 683, 712; Gregory C. Keating, 'The Theory of Enterprise Liability and Common Law Strict Liability' (2001) 54(3) Vanderbilt Law Review 1285, 1287.
[1310] This difference is important because it shifts the focus from the conduct of the party causing the harm to the outcome. In a fault-based system, liability arises out of conduct, which however causes several issues in attributing liability within corporate groups (see 4.2.). Enterprise liability focuses on the consequences of an economic activity regardless of who is at fault.
[1311] Risks that arise regardless of reasonable care and precautions exercised because of a continuously repeated and organised activity: see Gregory C. Keating, 'Enterprise Liability' in Petrin and Witting (n966) 332, 340, 344.
[1312] See 3.4.
[1313] Either equity-based and/or "active" role: see 3.5. and 4.2.
[1314] This characteristic risk is inherent to the organisation's activities, which means that it refers to both situations of accidental and strategic use of the corporate form that causes harms to third parties - i.e., regardless of motive. For a distinction of the two uses, see ch 5.

enterprise. The test to extend liability would need (i) a consideration of the enterprise, and (ii) a harm that is legally recognised[1315] and (iii) a consideration of the activity generating the harm. Therefore, corporate groups will not always be liable for any harm. But they will be liable when (i) they fall under the definition of enterprise,[1316] and (ii) generate a legally recognised harm (iii) resulting from an inherent risk of their activity. To understand what activities will fall under this regulatory remit, we will need to understand the enterprise's characteristic risks.

The enterprise risk argument is a common justification for strict liability.[1317] For example, in UK labour law, it was accepted that if there is sufficient connection between an employee's wrong and the inherent risks of an enterprise, the employer can be held vicariously liable.[1318] The argument was also accepted in a later case in the House of Lords, which was justified normatively as: if the enterprise places a risk in the community that materialises in loss, it is just to make the enterprise bear the cost.[1319] If harms arise out of an inherent risk, it is axiomatic that such risk is characteristic of the enterprise.[1320] For instance, if a chemical manufacturing plant pollutes a residential area, it is highly foreseeable that the pollution will harm nearby residents. This is because there is a strong sense that the activity is the leading cause of the harm. The rationale hinges not on the conduct itself but upon whether the activity exposes third parties to the specific risk that resulted in injury in the case at hand.[1321] It would then bring back the logical duality of the law in the corporate group context, where the law attributes rights and responsibilities to activities. Enterprise liability, therefore, does not differ normatively from other legal liability systems.[1322] The characteristic criterion simply fuses factual and evaluative considerations that are common to fault-based torts, such as negligence, but without the idea of fault. It shifts the attention from the wrongful conduct to the activity of the enterprise and whether the activity significantly increased the risk of the generated harm.

Since enterprise liability aims to repair harms, it would ensure that tort victims or unsecured tort creditors of insolvent subsidiaries would be compensated. The idea of restricting

[1315] Such as torts.
[1316] See 6.1.
[1317] See, for example, regarding vicarious liability: *Various Claimants v. Catholic Child Welfare Society (CCWS)* [2012] UKSC 56, [2013] 2 AC 1 [35] (Lord Phillips SCJ).
[1318] In *Lister v Hesley Hall Ltd* [2001] UKHL 22, [2002] 1 AC 215, the Court used the test of whether the employee's act causing the tort is sufficiently connected to the acts authorised by the employer, which was influenced by *Bazley v Curry* [1999] 2 SCR 534. *Bazley* explicitly established that an "enterprise risk" creates vicarious liability.
[1319] *Dubai Aluminium Company Limited v. Salaam* [2002] UKHL 48, [2003] 2 AC 366 [21].
[1320] Brodie (n1261) 29.
[1321] Of course, the injury must be legally recognised by a branch of the law - i.e., tort law - and has been left unremedied.
[1322] Gregory C. Keating, *Reasonableness and Risk: Right and Responsibility in the Law of Torts* (Oxford University Press 2022) 277.

shareholder limited liability when it comes to compensating tort victims is not novel in the legal discourse,[1323] and thus, developing a system of enterprise liability for corporate groups would not be so far-reaching. The concept of enterprise liability represents a paradigm shift in legal thinking, transcending traditional fault-based approaches to liability by focusing on the broader implications of business activities. This principle can be used to extend legal thinking beyond individual legal entities to encompass the collective actions of corporate groups as an "enterprise". As businesses choose to deploy separate legal entities to achieve their objectives and partition assets, the notion of enterprise liability serves as a mechanism to ensure that the costs and risks associated with their activities are borne by those who benefit from them, thereby fostering accountability and fairness.

6.4. Conclusion

This chapter explored how the law should better regulate corporate groups by acknowledging their economic reality. It highlighted the limitations of the traditional legal entity view in addressing the complexities of corporate structures and proposed the adoption of the enterprise theory. This theory suggests moving away from the concept of the corporate form and embracing the concept of the enterprise, distinct from traditional legal entities, to ensure fair and accountable regulation of corporate groups. The chapter also argued for the adoption of the enterprise theory as a supplement to traditional legal entity theories, particularly in addressing the complexities of corporate groups from a theoretical perspective. It discussed the need for a holistic perspective that considers economic realities, exemplified by the discrepancy between legal and economic boundaries within organisational structures. By integrating the enterprise theory into traditional debates, scholars can develop a more comprehensive understanding of corporate group dynamics and their socio-economic impacts. Enterprise liability differs from fault-based liability by focusing on repairing harm rather than assigning blame, thus reflecting a societal shift towards holding enterprises accountable for the risks of their activities. The idea extends legal responsibility beyond individual entities to encompass collective actions of corporate groups. This chapter aimed also to define the boundaries of the enterprise by integrating insights from both company law and economic analysis. The company and the firm represent distinct concepts with boundaries that do not always align with each other. The discrepancy between economic and legal realities has implications for understanding risk externalisation and the protection of third parties outside the corporate form. Ultimately, the enterprise theory proposes a shift in liability

[1323] Blumberg, 'Limited Liability and Corporate Groups' (n1); Muchlinski, 'Limited Liability and Multinational Enterprises' (n1); Bainbridge, 'Abolishing Veil Piercing' (n1); Leebron (n1).

attribution, considering the unified economic activity rather than strict legal boundaries. This chapter outlined criteria for determining liability under this theory and proposed expanding liability to include traditional corporate groups, based on its capacity to control rather than legal ownership and operational control. This shift aims to address the gap between economic and legal realities and ensure accountability for harm caused by unified business activities.

Conclusion

This thesis started with two important questions, namely whether UK company law generates incentives to shareholders to externalise risk and what these incentives are. Chapter 1 laid the foundations by exploring the idea that companies produce externalities which harm third parties and are considered irrelevant or pass unnoticed under company law. However, this thesis showed, in chapter 2, that it is the use of the corporate form, with all its characteristics, which generates these harms. UK company law incentivises risk externalisation and has tangible negative effects on society. Chapter 3 argued that these negative effects are exacerbated in complex corporate group structures. Corporate shareholders benefit from using corporate structures to externalise risk with limited repercussions. They also have additional advantages, such as influential control without legal recognition, exacerbating risk externalisation and raising fairness concerns for unsecured tort creditors.

This thesis claimed that UK company law encourages this risk externalisation without providing adequate remedies, withdrawing support from regulating the corporate legal framework. Chapter 4 showed that while there are ostensible mitigations both internal and external to company law to ease the issue of externalisation, they are flawed and do not adequately address the issue. Mitigations internal to company law, such as veil-piercing and general creditors' protection, are theoretically misinterpreted and do not work when applied to corporate groups and unsecured tort creditors specifically. External mitigations found in tort law try to circumvent the problems of internal mitigations, albeit unsuccessfully. They promote an incomplete picture of the corporate group, and the requirements hinge on fault and control, which are two concepts creating additional issues for complex structures that adopt divisionalisation and decentralisation of responsibilities.

This thesis advocated that company law should take a leading role in remedying the production of externalities that it incentivises. Ultimately, the issue stands on the use of the corporate form and it is UK company law that should regulate it. Corporate legal theory can help untangle the Gordian knot of the corporate form. However, as chapter 5 argued, traditional corporate legal theories focus disproportionately on the form rather than the consequences of its use, hindering company law to take any effective remedial action. It follows that this thesis argues for a shift in legal thinking. The traditional theories analysed and evaluated in this thesis were the concession theory, the aggregate theory, and the real entity theory. Each theory has its own merit in illuminating and interpreting the company. However, their foundations lie on a circular rhetoric that led scholars interpreting the company, by picking selective evidence in company law, in a way that would justify their normative claim. Due to

their flexibility, they are all correct within their own parameters. They could also be all applied to corporate groups to address the issue of externalisation. Nevertheless, these theoretical frameworks present challenges, and their narrow focus on the legal entity obscures the consequences of using the legal entity that generates harm to third parties.

Therefore, this thesis suggested, in chapter 6, that to regulate corporate groups effectively, we should supplement traditional corporate legal theory with a novel approach, the enterprise theory. Unlike traditional theories that predominantly focus on the legal form and nature of individual companies, the enterprise theory directs attention towards the economic functions and consequences of corporate activities carried out by a group of companies. As argued in chapter 5, since the theories have practical consequences for the treatment of companies under the law, it is essential to adopt one that corresponds to today's reality. The world has changed profoundly since the nineteenth century. The use of the enterprise theory would reflect these changes by developing a comprehensive theory that holds complex corporate structures accountable for their business actions. There is a need, as evidenced throughout this thesis, for a theory that gives more relevance to theoretical company law and aligns it with its purpose of regulating corporate activities by looking at the size of the enterprise, irrespective of its legal form.

The theory formulated in this thesis is one that looks at the economic realities of the corporate group and realises the misalignment between the corporate and the organisational form. By applying the enterprise theory, we can hold the corporate group accountable. The requirements proposed in this thesis are based on three main pillars: i) the enterprise, ii) a legally recognised harm that is currently left unrepaired, and iii) a characteristic risk of the enterprise that results in a legally recognised harm. The enterprise theory expands the current UK legal framework in attributing liability to corporate groups and it bridges the gap between corporate legal theory and practical applications.

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