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Putting Creditors in Their Rightful Place: Corporate Governance and Business Ethics in the Light of Limited Liability

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Abstract

Contemporary academic and policy discussions of corporate governance tend to accord primacy to the interests of shareholders. While the primacy (descriptive or prescriptive) of shareholders is argued for in various ways, others seek to promote a wider stakeholder model of the firm and its governance. In both cases the interests of creditors tend to be neglected. In this paper the fundamental position of creditors in a system of corporate law that offers limited liability is re-asserted and explained, and the implications explored. It is demonstrated that there are, in effect, two modes of governance possible for a limited liability corporation: the 'normal' mode, when shareholders' interests are primary; and the 'distressed' mode, when creditors' interests are paramount.

As a result of this analysis, writers on corporate governance who are influenced by certain managerial myths or economic theories of the firm are encouraged to view the position of shareholders in a more informed light. Writers on business ethics, who often find themselves contending, perhaps implicitly, with inappropriate understandings of the nature of business corporations and their governance, are similarly alerted to the weakness of certain positions perceived as antithetical to their agenda. Finally, business ethicists who advocate a stakeholder perspective are encouraged to recognize the position of creditors and to pay more attention to them as a stakeholder group.

Key words

Bankruptcy

Company law

Corporate governance

Creditors

Governance

Limited liability

Shareholder primacy

Stakeholder theory

Suppliers

Trade creditors

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Introduction

Views of corporate governance and business ethics tend to carry with them economic and/or legal assumptions about the nature of firms, particularly those firms that take the form of limited liability companies. Those assumptions are explicit or implicit in the many different theories, or bundles of theories (Norman, 2010), of the firm. Assumptions include those regarding the governance of the firm – perhaps in relation to how governance is to be practised but, more fundamentally, about in whose interests the firm should be established and directed.

The upsurge of academic interest in corporate governance in the finance and business ethics literatures has tended to focus on the relationship between the company and its shareholders (stockholders), as have policy debates and initiatives. Public discourse on practical corporate governance is consistent with, and indeed has been influenced by, the neoclassical theory of the firm (Blair, 1998), in particular its identification and analysis of 'moral hazard' within an agency theoretic analysis (Heath, 2010; see Hendry, 2001, p.161).[i] However, as explained below, at least one group other than shareholders also has a strong claim to be recognized in discussions of corporate governance. While some have written about governance in the context of a multi-stakeholder theory of the firm (e.g. Freeman & Evan, 1990; see Hendry, 2001 for a critique of such attempts), this paper complements recent debates by examining the position of the creditor – a party (or stakeholder) that is often omitted from debates about corporate governance[ii] and neglected in discussions of business ethics.[iii] This has implications for business ethics because certain positions antithetical to a 'fully

formed' or thoroughgoing ethical analysis of business[iv] are premised on what I seek to demonstrate is an ill-founded understanding of the nature of the position of shareholders with respect to the governance of the firm.

The paper is structured as follows. The first section reprises the topic of corporate governance, highlighting features and issues of significance for the focus of this paper and reviewing some of the arguments in favour of the primacy of shareholders. The second section describes some of the ways in which the interests of the creditors of limited liability companies are protected, paying particular attention to those features that relate to corporate governance. The third section then discusses the implications of recognizing the position of creditors in relation to the governance of firms incorporated with limited liability. The fourth and final section presents the conclusions.

On Corporate Governance and Shareholder Primacy

Corporate governance clearly raises ethical issues and, particularly when discussed in response to perceived ethical failures, entails an ethical agenda of some sort. Moreover, approaches to business ethics often entail assumptions about the nature of the firm and its governance.

Fuelled by successive waves of 'scandals' and large corporate failures (Rutteman, 1993; Monks & Minow, 2008), the past twenty years have seen an explosion in corporate governance policy initiatives such as the UK codes following on from The Committee on the Financial Aspects of Corporate Governance (Cadbury, 1993),[v] the OECD Principles and, in the US, Sarbanes-Oxley. Moreover, the last decade of the twentieth century "saw the emergence of corporate governance as a growing field of

study and research in universities and business schools around the world" (Stiles & Taylor, 2001, p.v), since when the major US bankruptcies of the early years of the present century have given it additional impetus (Monks & Minow, 2008). Such work has implications for business ethics and business ethicists, even if it is not often the case that the issues are considered and analysed in explicitly ethical terms.

During this period of expansion of corporate governance research, the term itself has been defined in a variety of ways (Keasey et al., 1997), some of them not altogether satisfactory. Sternberg (1998) argues, for example, that corporate governance is about corporations and hence is not about all businesses and, more important, is about enterprises other than businesses too, since the corporate form is used more widely, for example by charities. Davies (2010) similarly notes that, while the company is one of the mechanisms made available by the state for the carrying on of business, not all companies need to be formed with a view to making a profit. Not all authors fall foul of Sternberg's criticism though. For example, Cadbury (1993, p.46) writes that corporate governance "in its broadest sense takes in the whole framework within which companies operate"; and Monks & Minow (2001, p.1) define corporate governance as "the relationship among various participants in determining the direction and performance of corporations". Nevertheless, in this paper, when I refer to corporate governance I have in mind business corporations.

Having delineated the scope of the application of the term for this paper, it is appropriate to comment a little more on the content of corporate governance. As Keasey et al. (1997) comment, different writers draw very different boundaries of the subject. However, a useful distinction, applicable to most if not all definitions of corporate governance, is made by Tricker, who distinguishes governance from the management of a company: "If management is about running business; governance is

about seeing that it is run properly" (Tricker, 1984, p.6). This simple contrast nicely brings out the 'oversight' aspect of corporate governance, but it begs the question of in whose interest the oversight is exercised, particularly by directors. Some approaches to corporate governance appear to be quite flexible about this, perhaps reflecting differences of emphasis internationally. For example, Prentice (1993, p.25) states that the debate about corporate governance "at its broadest level involves the issue of the relationship between the *stakeholders* in a company and those who manage its affairs (the board of directors)" (emphasis added). In the second edition of their well known text on corporate governance, Monks & Minow (2001, p.1), without using the term 'stakeholder', seem to be similarly disposed, for they begin by defining corporate governance as "the relationship among various participants in determining the direction and performance of corporations". They mention, *inter alia*, employees, customers, suppliers and creditors – the latter being the focus of this paper. However, they also refer to the three 'legs' of the corporate 'tripod' of 'primary' or 'direct' participants as the shareholders, the management (led by the CEO) and the board of directors; and it is this 'tripod', particularly the agency relationships within it, that commands their attention, with other participants, including creditors, subsequently neglected. In their most recent, fourth edition, Monks & Minow (2008) refer to the management, shareholders and board as "the three most significant forces governing corporations" (p.8).

Klein & Coffee (1988, p.118) similarly assert that the "formal structure for control and operation of a corporation can best be described by reference to three basic groups – shareholders, directors, and officers". Moreover, this is consistent with most conventional views of corporate governance where, whatever the particular definition chosen, it is taken for granted to be about the relationship between shareholders and

the company or, more commonly, between shareholders and directors.[vi] In interviews in the UK, Stiles & Taylor (2001, p.123) found, perhaps not surprisingly, that directors themselves "claimed that they acted in the interests of shareholders". Such a perspective is reflected in the definition of corporate governance propounded by Demb & Neubauer (1992, p. 187; quoted by Cadbury 2002, p.1): "the process by which corporations are made responsive to the rights and wishes of shareholders".

However, as Boatright (1999) notes, debate rages – at least in some quarters – over the nature of the corporation. This is not only within economics and management, but also within legal theory (Veldman, 2011). The primacy of the interests of shareholders, usually and traditionally interpreted as the pursuit of profits or, more recently, as 'shareholder value' or 'shareholder wealth' (Windsor, 2010), is taken for granted by many business people and other commentators. Finance textbooks, for example, rarely, if ever, argue for the claim that the objective of the firm is to maximize shareholder wealth (Boatright, 1999); it is simply asserted. However, there are significant debates over whether and why shareholders should be accorded primacy.[vii] Both legal and economic arguments tend to be drawn upon when the issue is discussed.[viii]

Perhaps the commonest justification for an exclusive shareholder orientation in corporate governance is that the shareholders are the owners. This opinion may be useful 'shorthand', but as an argument it has serious deficiencies. It is certainly not the case that a shareholder owns some proportion of the net assets of the business, nor even that the shareholders as a group own them; "as a matter of law a shareholder (even the sole shareholder) of a corporation does not own the assets devoted to the business of the corporation … the corporation owns the assets" (Klein & Coffee, 1988, p.108; see also Iwai (2007) for an extended analysis). In this understanding is

embodied the notion that the company is a legal person separate from its shareholders, which "is fundamental to the conceptual structure of company law" (Davies, 2010, p.9). Instead, the shareholders own only shares of stock of the corporation (Klein & Coffee, 1988).

However, property rights theory, which says that the corporation is the private property of the stockholders (Boatright, 1999, p.170), can be built on the basis of shareholder ownership of stock. For example, Sternberg (1998, p.21) writes that "the reason why corporate governance refers solely to shareholders, and not to stakeholders, is because corporations are the property of their shareholders in aggregate; corporations are owned by, and are created to service the objective of, their shareholders". However, although the rights that shareholders possess might make them look like owners, according to some interpretations of the law "strictly speaking, shareholders do not own their company" (Lucas, 1998, p.65), "despite frequent statements to the contrary by corporate managers" (Kay, 1996, p.11).

An alternative line of reasoning which has similar implications to those of property rights theory, but which avoids some of its legal weaknesses, is contractual theory. This holds that "the firm results from the property rights and the right of contract of every corporate constituency and not from those of shareholders alone" (Boatright, 1999, p.171). Thus a firm, including a corporation, is sometimes held to be a 'nexus of contracts'. In itself, this does not lead to the primacy of shareholders. There is a further argument that depends on the nature of the shareholders' relationship with the company. Participants such as creditors have a 'fixed claim' upon the corporation, whereas the position of shareholders is by its very nature 'residual'. It is this that forms the basis for claiming their primacy and not, for example, their role as a capital provider.

> The crux of the financial argument is that shareholders differ from other constituencies by virtue of being residual risk-bearers and that as such, they have peculiar problems of contracting that are best met by having control. (Boatright, 1999, p.170)

This might look like an ethical argument, and it can certainly be propounded as one; the vulnerability of shareholders, given their 'residual' position, entitles them to control. However, whatever the merits of this argument, Klein & Coffee (1988, p.42) note that shareholders, because they hold the residual, "are more likely to be interested in and to have control of the firm than are the holders of the debt, or fixed claim". In other words, it is more worthwhile to shareholders for them to have control than it is for creditors, since creditors are entitled to no more than their fixed claim. The structure of the 'game' or implicit bargaining between different parties is such that overall control falls almost naturally to the shareholders. Because of the incentives and risks they face as residual claimants, they will be, in effect, the 'highest bidders' for voting rights (Maitland, 2001, p.132) and so governance structures and mechanisms will be set up in their favour.

Such an outcome might be argued to serve the public interest too, not just shareholders'. Assuming that maximum wealth creation is the goal of business activity (Boatright, 1999), the corporation should be governed in the interest of the group with the strongest incentives for wealth-maximizing decisions, which in turn should be to the benefit of society as a whole.[ix]

However, contractual theory does miss one essential feature of corporate law; shareholders are not just a group of people with contractual rights of various sorts against the company but also are its 'members'. Davies (2010, p. 6) writes:

> To the Victorian drafters of the companies legislation it was as natural to vest ultimate control of the company in the shareholders (members), at least as the default rule, as it is still to us to think that the members of a cricket club or a students' union should be the ultimate repository of authority in those organizations.

Monks & Minow (2008, p.9) note that the etymological origin of 'corporation' lies in the Latin 'corpus', or body, as in a body of people organized to act as one. Under British company law the primary duty of the directors has traditionally been to the company (Cadbury, 2002; Tricker, 1984).[x] Since the company is made up of the members, [xi] it may be argued that this duty lies to the body of shareholders as a whole. Even if this is not strictly true, the difference usually does not matter (Cadbury, 2002) – and, whatever the case, the primary duty appears to lie nowhere else. While demonstrating the limited strength of some other arguments for shareholder primacy, this might appear to rule out other stakeholder groups from serious consideration in terms of corporate governance. However, as shown below, it does not, on its own, do justice to the position of creditors at least.

In conclusion, although there are some definitions of corporate governance that appear to take a stakeholder viewpoint,[xii] most approaches quickly, or without any apparent consideration, concentrate upon shareholders and the protection of their interests vis-à-vis the board of directors (and executive management). This has been the focus of virtually all recent debate and action with regard to corporate governance reform, reflecting the dominant discourse of shareholder primacy, whatever the attempted justifications – some of which appear to be problematic.

However, when it comes to governance, Davies (2010, p.4) reminds us that company law[xiii] has historically been concerned with more than just shareholders and the board/management); it has dealt with the activities of three main groups:

- the shareholders (or members) of the company;
- its directors and, to a lesser extent, its senior managers (whether they are directors or not); and
- its creditors.

The law seeks to regulate relations between and within the three elements of what he has referred to as the "traditional trinity" (Davies, 2002, p.6).[xiv] The next section considers the neglected third element of this trinity, the creditors. It begins so by looking at the historical origins of limited liability companies and their regulation.

Limited Liability and the Protection of Creditors

"The joint-stock company, with limited liability for its shareholders was an elegantly simple and eminently successful development of the mid-nineteenth century" (Tricker, 1984, p.2). In the UK, prior to the Joint Stock Companies Act 1844 – introduced by William Ewart Gladstone when he was President of the Board of Trade (Davies, 2010, p.1) – the creation of a corporation required an act of Parliament, but the 1844 Act provided aspiring promoters with a cheap and easy means of incorporation (Edwards, 1989, p.101).

Limited liability is a distinguishing feature of company law – perhaps *the* distinguishing feature (Easterbrook & Fischel, 1991, p.40). It is conventionally understood that it was not until the Limited Liability Act 1855 that shareholders in companies were granted the protection of limited liability, with the privilege not

extended to banks and insurance companies until 1858 and 1862 respectively (Page, 1982). However, the Winding Up[xv] Act of 1844 had provided for the first time that remedies of creditors of companies only extended to company property and not that of shareholders (Keay & Walton, 2003).[xvi] Moreover, as Klein & Coffee (1988, p. 139) point out, limited liability is a corollary of the concept of the corporation as an entity – it is the corporation that incurs the debt, not the shareholders. Indeed, strictly speaking the 'limited liability company' is a misnomer (Davies, 2010, p.10), since creditors' rights can be asserted to the full against the company's assets, even if they cannot be fulfilled. It is the liability of the shareholders that is limited, not that of the company.

The crucial feature for creditors is that doing business with a limited liability company increases the risk of non-payment when compared, *ceteris paribus*, with an unincorporated business such as a sole trader or a traditional partnership,[xvii] because the creditor does not have recourse to the personal assets of the people involved in the business of the company – the members (shareholders) and the directors (except in exceptional circumstances).

The widespread availability of incorporation with limited liability can be argued to have had an enormous impact on the mobilization of risk capital and hence economic growth. However, in response to the risks brought about by limited liability, legislatures have attempted to provide some degree of protection for creditors, to reduce the likelihood of companies not paying their debts. The frameworks or templates of 'default' rules (Maitland, 2001) vary from country to country (or from state to state, within the US) and have changed over time, but, in terms of the provisions of company law, they can be divided broadly into financial and informational measures.[xviii]

The financial protection of creditors could involve requiring companies to put aside a sum of money to cover what they owe, but, if significant, that would make the corporate form very unattractive for business and undermine some of the benefits of both limited liability and a credit-based financial system. Instead, attempts have been made using capital maintenance rules to prevent the assets being run down inappropriately, by restricting payments to shareholders. So, for example, until relatively recently UK law prohibited a company from purchasing its own shares, and even now re-purchases are subject to a prescribed procedure which aims to safeguard creditors' rights (Davies, 2010). Similarly, capital reduction schemes are 'hedged about' with protections for the creditors (Davies, 2010, p. 83).

Dividends have been restricted in a related fashion, with the general rule being that dividends may only be paid out of profits. Creditors are not the only intended beneficiaries of this, for one of the aims in the nineteenth century was to prevent investors being fooled into thinking that a company was doing better than it was.[xix] However, the convention of prudence or conservatism in financial accounting and reporting was developed to place a restraint on the declaration of profits and hence the distribution of dividends to shareholders, thus – *ceteris paribus* – providing for a degree of preservation of capital, to the potential benefit of creditors. One of the challenges is to ensure that the definition and hence calculation of profit is sufficiently robust to give the rule some purchase on company finances. In nineteenth century Britain, for example, when it was common practice to distribute as dividend 100% of the current year's profits, the profit might be calculated to equal the intended dividend; varying – or even eliminating – the depreciation charge was one method of achieving this (Edwards, 1989).

Dividend rules have varied over time and from place to place. The law of dividend is very divided in the US, "with some states requiring only that the dividend not render the corporation forseeably [sic] insolvent and others that it come out of a carefully defined fund on the corporation's balance sheet" (Klein & Coffee, 1988, p.142).

Although it is not entirely satisfactory, the 'doctrine' of capital maintenance (Davies, 2002, p. 78) can plausibly be argued to protect creditors, at least to some extent. However, it is only a partial solution. Not only is it difficult to find an appropriate method of putting it into practice (the challenge of finding suitable operational definitions of profit, capital and insolvency), but it does little or nothing to prevent a company's capital being eroded by a succession of losses (Edwards, 1989).

Although there are signs of significant and rapid global convergence, not all jurisdictions have equally stringent accounting and disclosure demands in return for the privilege of limited liability. However, company law does provide some help to creditors when it comes to losses, in the sense that there are financial reporting requirements laid upon companies that do not apply to, say, sole traders. Creditors can obtain that information and act accordingly, choosing either not to trade with the company or to adjust their terms of trade – perhaps even trying to deal only on a cash basis. Accounting information is not perfect – it may be somewhat out of date for example – but it is not the only source of information available; creditors can also look to credit rating agencies, their own experience of the company, or take account of views 'on the grapevine'. The essential point is that creditors can, at least to some extent, look after themselves. At the very least, the law puts them on notice by requiring incorporated businesses to append 'ltd', 'plc', 'inc.' or some other such suffix to their name to warn of the presence of limited liability.

Thus, although the law attempts to provide a certain level of protection, creditors can – if they decide to do business with the company, which is their option – attempt to obtain greater protection, if they think it is worth having.[xx] There are various methods of doing this, including the following:

- In the case of a potential trade creditor, retaining ownership, i.e. effectively allowing the company use of goods but without giving up title on delivery. Thus goods might be supplied to a retailer on consignment (effectively 'sale or return') or a reservation of title clause (a so-called 'Romalpa clause') might be included in the contract of supply. In effect, the supplier reduces or eliminates the period of trade credit.
- Finance creditors (e.g. banks) often wish to secure their loan against company assets (sometimes referred to as 'collateral'), so that if the company goes into liquidation (see below), there is an asset or assets specially identified to meet their claim (hopefully in full). Alternatively, a creditor might take a floating charge. Without such security, a bank might be unwilling to provide a loan, or only at a higher rate of interest. This move is also open to, but less commonly employed by, trade creditors. Secured creditors have not only a contractual right against debtors, but also a proprietary right in relation to some or all of the debtor's assets (Keay & Walton, 2003, pp.12-13).
- A creditor might ask for a personal guarantee from directors. This pierces, at least in part, the corporate veil of limited liability, and is likely to be used only in the case of small or medium-sized owner-managed companies.[xxi] Again, it is quite common for banks to ask for this, but it can also be used by trade creditors.

- Creditors, particularly banks, might seek to place various restrictions on the company's activities for the period that the credit is outstanding. For example, there might be covenants to limit the company's subsequent borrowing, or a contractual clause might restrict the ability to pay dividends, in a tighter and clearer manner, than the general provisions of the law.
- Trade creditors can sell, or 'factor', their debts to a third party – though if the customer is perceived to be risky they might be able to do so only at a deep discount, if at all.
- Finally, creditors might simply reflect the perceived risk of extending credit to a particular company in the prices or interest charged (Maitland, 2001). Mention was made earlier of the levying of higher interest on unsecured than on secured loans. Similarly, trade creditors might charge higher prices to customers perceived to entail greater risk of non-payment (Ross et al., 2007).

Creditors can thus help themselves, using commercial law and other means, to supplement the protection afforded by company law. However, sometimes a company is unable to meet all its obligations to creditors. In such circumstances the law of bankruptcy – or 'insolvency' as it is called when referring to corporations in the UK – comes into play.

Insolvency law is generally very complicated, but for the purposes of this paper its intricacies are of limited significance.[xxii] It is generally invoked when a corporate debtor is in serious financial difficulty. Sometimes an attempt will be made at reorganization (or 'rehabilitation') of the company, but in cases of 'straight' bankruptcy or insolvency the company will be liquidated and the cash fund thus raised will be distributed in accordance with strict procedures. Creditors, of course,

rank before shareholders (who are likely to receive nothing) in the distribution, and secured creditors generally have their claims met before unsecured creditors, though in some countries the legislature has given certain unsecured debts (mainly employees' claims to wages – to a modest extent – and certain claims of the public authorities) statutory priority over the floating, though not the fixed, charge. However, whatever the complications, in essence it is the case that "When corporations are in distress, creditors take control from shareholders and the creditors' interests become primary until the firm recovers" (Boatright, 1999, p.178).[xxiii] As Cadbury (2002, p.44) remarks, it is the creditors' interests that the board has then to safeguard.[xxiv] McLaughlin (2009) summarizes the position, in UK law, by stating that, when shareholder equity has been dissipated, the economic owners of the company are the creditors: all that the company has, it owes to them. The directors do not owe a duty as such to the creditors – their duty is still to the company – but the duty needs to be performed with different priorities in mind.

Thus, at the heart of company law, reflecting the presence of limited liability, lies the possibility for the company not to be run in the interests of the shareholders but in the interest of the creditors. Therefore shareholders are not always primary. This conclusion is discussed further below, as are some of its implications.

Discussion

The modern corporate form has enabled the growth of large organizations with widely dispersed shareholdings, in which the agency issues that arise from the divorce of ownership and control per the neoclassical theory of the firm are likely to loom large. To that extent, the focus of corporate governance debates and policy initiatives on shareholder interests – particularly in the wake of corporate scandals such as Enron,

WorldCom and Tyco, in which managerial hubris and greed loomed large – is entirely reasonable and appropriate. However, a review of the nineteenth century origins of joint stock companies and the general thrust of the development of an associated body of law demonstrate that this is not the only issue of significance in relation to corporate governance. Not only for large corporations, where there might be a divorce of 'ownership'[xxv] and control per Berle & Means (1932), but also in relation to the smallest of incorporated businesses, there is the issue of limited liability. Many stakeholders are protected by particular branches of law (e.g. consumer law, labour law), but it is noteworthy that creditors – who can also make use of commercial law and practices to safeguard their interests – are protected by company law itself.[xxvi] Davies (2010) similarly notes that the relations between companies and their creditors are covered by general commercial law because it makes no difference that a company, as opposed to an unincorporated business, has incurred the debt. However, insofar as limited liability enables the company to act opportunistically towards its creditors in ways which are not open to those without limited liability, company law is involved.[xxvii]

In effect, a degree of protection for creditors is effected by regulating the relationship between the company and its members, for example by restricting the circumstances in which shareholders can be paid a dividend and, when the company is insolvent, removing control from them. As explained at the end of the previous section, when a company becomes – or threatens to become – insolvent, the focus for corporate governance shifts from shareholders to creditors.

This analysis suggests that there are not one but two possible modes of governance for a limited liability company. First, in what I term 'normal' mode, shareholders' interests are paramount, which – subject to agency problems and the objectives of the

particular shareholders concerned – will involve a focus upon the firm's positive residual or financial return.[xxviii] However, to operate in this normal mode, creditors' fixed claims need to be capable of being met, failing which a company can be placed in what I term 'distressed' governance mode, where there is a prospect of a negative residual. In this mode the company is governed in the interests of creditors, with shareholders hoping that there might be something left for them or that the company might eventually return to viability and hence normal governance mode.

In distressed mode, the shareholders still own their shares and they are still members of the company, but governance is not oriented in their interests. This implies that arguments for the primacy of shareholders in governance, when based on notions of ownership, membership or property rights regarding shares, are inadequate or even erroneous; the possibility of a company being governed in creditors' interests in distressed mode is a direct contradiction of such arguments. According to this analysis, the residual claim arguments are more convincing; when the company is insolvent, there is not – at least as constituted according to the varying operational legal definitions – a positive residual equity interest, and the creditors are bearing the risk because their fixed claims are vulnerable. The focus for governance therefore becomes their interests.

One implication of this argument is that a conception of corporate governance that includes creditors – such as Davies' (2002) 'trinity' of shareholders, directors/senior managers and creditors –is superior to one that does not (e.g. Monks & Minow's (2001) 'tripod'.). This is because creditors have a place alongside shareholders in company law and their interests can come to dominate those of shareholders in the governance of the firm (distressed mode). A fourfold cast of shareholders, board, management and creditors should be considered the 'primary' participants in

corporate governance, even if creditors are not actively involved or their interests prioritized most of the time, i.e. when in normal mode. Thus, even if widening the scope of governance discussions to other stakeholders is deemed unwarranted,[xxix] creditors should not be omitted, for their interests are a central feature of the historical development and current state of company law.

Of course, if – and only if – creditors' fixed claims have been satisfied or adequately dealt with, a distressed company that has the prospects of being a going concern can once again be governed in the interests of shareholders. It might then be argued that the satisfaction of creditors' claims is itself in the interests of shareholders so that they can 'get the company back', and so there is a sense in which their interests might still be considered primary. However, there are at least two problems with this view. First, the decisions that are taken when a firm is in administration are first and foremost made in the interests of the creditors; they are not aimed at maximizing long-term shareholder wealth, and there is likely to be a shift towards a much more risk-averse and liquidity-friendly approach to decisions than would be in the interests of shareholders – even if there are some constraints upon how the company's assets are liquidated. Second, although it is in the interests of shareholders that creditors of a financially distressed company are satisfied or at least pacified – so that, in a sense, shareholders are 'in the wings', waiting to take governance 'centre stage' again – so also it is the case that creditors are 'waiting in the wings' when shareholders' interests are apparently paramount, for when creditors' interests are threatened, the nature of the governance of the company can be switched in their favour.

Indeed, what determines which governance mode a company is in is, in essence, the issue of whether creditors' fixed claims are being, or are likely to be, met in full (i.e. when there is positive residual value). Thus there is a case for arguing that not only

do creditors have a significant position in governance, but they actually have a fundamental one, even if that does not usually involve their participation or active consideration. Moreover, the meeting of the fixed claims of creditors is, at least to some degree, a constraint upon the pursuit of shareholders' interests in normal governance mode, a constraint written into company law – and like any constraint, it can be viewed as an objective[xxx] or overriding goal (Eilon, 1971). Even if company law is not completely effective in protecting creditors' fixed claims against the abuse or vagaries of incorporation with limited liability, the intention of the law is clear, and it is that intention that gives creditors their place along with shareholders in the governance framework – unlike other stakeholders.

Finally, the possible tension between shareholder primacy and a stakeholder conception of corporate governance was briefly mentioned earlier in this paper. Whatever the merits of a stakeholder conception might or might not be, this paper has argued that a shareholder-only approach is inadequate for conceptualizing the corporate governance of limited liability companies. Even within the traditional 'Anglo-Saxon' corporate governance model shareholders are not the only stakeholder whose interests are addressed in company law.[xxxi] This is so – and justifiably so – because of the special privilege of general incorporation with limited liability vis-à-vis sole traders and partnerships. Furthermore, although a stakeholder conception would enable creditors to be brought into the corporate governance picture, creditors *qua* creditors already warrant their place in a more conventional conception of corporate governance. They should not be forgotten, and the remembrance of them serves to place shareholders in a light different from that in which they are often viewed by business people and academics alike.

Yet it seems that creditors are frequently forgotten, in the academic literatures of both corporate governance and business ethics. Creditors are seldom, if ever, mentioned in textbooks on corporate governance.[xxxii] Nor, interestingly, do they receive much attention from writers on business ethics. Banks receive attention in the emerging literature on the ethics of finance (e.g. Cowton, 2010), but this is generally concerned with their behaviour, responsibilities etc, rather than the duties or rights that might be owed to them as financial creditors. Similarly, suppliers tend to feature in business ethics, including stakeholder-based treatments, mainly in terms of their responsibilities as participants in the supply chain and thus as an issue for the praiseworthiness or blameworthiness of ultimate consumer-facing companies. What duties might be owed to them as suppliers not just of goods but also of trade credit are rarely discussed (cf. Cowton & Low, 2002). Nor are the ethics involved in the payment of trade credit addressed in mainstream finance textbooks; indeed, the commonly recommended treatment of suppliers (delaying payment as long as possible, *ceteris paribus*) has a distinctly unethical ring to it. Thus, while the development of company law – which is understood by legal scholars, of course – has sought to provide some safeguards for the interests of creditors, including giving them a place in governance, they are largely missing from the recently burgeoning literatures of corporate governance and business ethics.

In addition to proposing creditors as a valid focus for stakeholder-based business ethics, there is a possible further implication for those who wish to promote stakeholder thinking, particularly in relation to governance. This present paper does not seek (as some have done) a re-conceptualization of corporate governance in line with a stakeholder theory of the firm, which would involve arguing *for* such a theory. However, in establishing the importance of the position of creditors, this paper has

provided a reminder of the shortcomings of some of the arguments upon which defences against, or attacks upon, a stakeholder approach, tend to depend. Crucially, if any argument against stakeholder theory would simultaneously remove creditors from their established position within company law and governance, as sketched in this paper, that argument should not be relied upon.

Similarly, in relation to arguments in favour of shareholder primacy, careful attention to the position of creditors in the governance of conventional limited liability corporations shows that the institutional assumptions upon which much discourse about governance takes place are under-specified. Two things are particularly important to recognize. First, as more sophisticated commentators recognize, shareholders are not owners of a business in the way that sole traders or partners are; there are significant differences.[xxxiii] Second, the position of creditors is fundamental to the origins and modern institutional form and regulation of the limited liability company. Recognition of these features of the legal-economic world should form part of any understanding of, or proposal for, the governance of the modern corporation.

Finally, before reiterating the conclusions, and hence contribution, of this paper, the nature of the argument on which they depend should be addressed. It is acknowledged that, over time and between different states, company law varies. This is the case even for the Anglo-Saxon/Anglo-American approach, which has been the focus of this paper. Moreover, while some writers have argued not only for the superiority of the corporate form in many contexts, but also for the 'end of history' of company law and governance as it supposedly converges on the Anglo-American model (see Hansmann & Kraakman, 2004), others have pointed to the persistence of diversity – including insider, bank-centred systems such as the German model – because of the importance of path dependence in the evolution of company law (e.g.

Bebchuk & Roe, 2004; Schmidt & Spindler, 2004; Gilson, 2004; see also McCahery et al., 2002). Nevertheless, one of the five basic characteristics of business corporations across different sorts of jurisdictions is limited liability (Hansmann & Kraakman, 2009). Many subtle but important variations provide much scope for detailed legal analysis. However, although it utilizes reflections upon the law, this paper is not a legal analysis as such. It is not concerned with the level of detail that would constitute a legal analysis *per se*, and hence there is no detailed comparison and analysis of particular cases within or across jurisdictions; nor is it motivated by the kind of question that would call forth such an analysis. As comparative company law shows, different jurisdictions (and particular jurisdictions at different times) make different regulatory choices that give different weight to alternative policy considerations (Kershaw, 2009). Instead, through a consideration of the broad thrust of company law and, in particular, the way in which it has sought to protect the interests of creditors – particularly of running the company in their interests when financially distressed – the key place of creditors in corporate governance since the earliest days of company law has been re-asserted. Even if *how* they are protected is not converging, *that* they should be protected as a part of the law relating to limited liability companies is widely accepted across different jurisdictions.[xxxiv] Perhaps this principle is well established legally;[xxxv] but if so, that reinforces the point of this paper – that creditors should not be forgotten in discussions of corporate governance, both because they are of significance and because their omission risks a misreading of the nature of the modern company and of its governance. For if creditors are forgotten, the likelihood of a misinterpretation of the position of shareholders is increased; and such misinterpretations can form the basic assumptions, explicit or implicit, of

misconceived theoretical positions and policy recommendations, which can be bad for understanding of both corporate governance and business ethics.

Conclusion

Limited liability is a fundamental feature of modern company law that leads not only to shareholders' but also to creditors' interests falling within its scope. In particular, in situations of financial distress, decisions will be made within a governance structure, the prime objective of which is to protect creditors' fixed claims rather than to maximize shareholder wealth. It is suggested that the literatures of both corporate governance and business ethics would benefit from a proper recognition of the place of creditors– whether as suppliers of capital or as suppliers of goods and services – in company law. In particular, writers on corporate governance, especially those influenced by certain managerial myths or theories of the firm, are encouraged to view the position of shareholders in a more informed light. Writers on business ethics, who often find themselves contending, perhaps implicitly, with inappropriate understandings of the nature of business corporations and their governance, are similarly alerted to the weakness of certain popular managerial and theoretical positions deemed antithetical to their agenda. Finally, business ethicists who advocate a stakeholder perspective are encouraged to recognize the position of creditors and to pay more attention to them as a stakeholder group.

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Notes

[i] In doing this they are focusing on the divorce of ownership and control famously identified by Berle & Means (1932).

[ii] At a basic level, creditors can be divided into *trade* creditors and *finance* creditors. Trade credit constitutes the single largest source of short-term funds for many companies (Rigby, 2002, p.75). Finance credit is, broadly speaking, the provision of funds in the form of loans etc, on which the borrower pays a rate of interest. Unlike trade creditors, "even if lending money is not the principal business of a finance creditor, it is the principal purpose of the financial creditor's transaction with the company" (McLaughlin, 2009, p.167). What they have in common is that they have a *fixed* claim to

the payment of the principal amount plus any associated interest. Unlike equity shareholders, whose rewards as residual claimants are variable with no entitlement to a return (Maitland, 2001), they do not receive extra rewards if the company does well; nor do they lose their right to payment if the company does badly. Furthermore, both are voluntary or "consensual" (Keay, 2007) creditors. Generally speaking, the points I shall make apply to involuntary creditors too, such as many victims of torts committed by companies (Davies, 2010) or employees paid in arrears. However, some of the points, particularly where I discuss how creditors might protect themselves, apply only to voluntary creditors.

[iii] A rare exception is Sorell & Hendry (1994), which has a discussion of responsibilities of, and towards, creditors.

[iv] Cf. writing on the so-called 'business case' for ethics, where congruence with the financial interests of shareholders is the focus of attention. (For a review of the empirical evidence, see, for example, Orlitsky et al., 2003.)

[v] Fisher & Lovell (2009) – a business ethics text – provides a useful overview of developments in corporate governance in the UK subsequent to the Cadbury Report, which has also influenced many codes around the world (Mallin, 2010).

[vi] Sternberg, for example, writes that it refers exclusively to "ways of ensuring that corporate actions, assets and agents are directed at achieving the corporate objectives established by the corporation's *shareholders*" (Sternberg, 1998, p.20, emphasis added).

[vii] E.g. normative stakeholder theory.

[viii] Where legal matters are referred to in this paper, they will tend to refer to British or US law. Although US law depends, to some extent, on which state is being considered, company law developments in the US followed the British path more closely than did countries in mainland Europe (Tricker, 1984), and the parallels in the economic and legal systems of the UK and US mean that there are still significant resonances. These parallels or resonances are sufficient for the level of argument of this paper which is not, in any detailed sense, a *legal* analysis.

[ix] Equating wealth maximization with shareholder wealth maximization clearly involves subsidiary arguments, e.g. in relation to issues such as the efficiency of markets (and hence welfare significance of prices), externalities, and whether shareholders are really the only residual claimants (cf. employees who make firm-specific investments, for example – see Blair, 1998).

[x] The Companies Act 2006 has, in a section discussed below, introduced the notion of shareholder primacy, albeit in the form of enlightened shareholder value.

[xi] This notion of shareholders as members is perhaps a somewhat neglected one that would reward, in the context of business ethics, some further consideration. However, that is beyond the scope of the current paper.

[xii] In which case creditors would be part of the corporate governance agenda.

[xiii] He is referring to the UK but, by extension, it applies to similar regimes.

[xiv] This 'trinity' can be contrasted with Monk & Minow's (2001) 'tripod' of shareholders, management/CEO and board of directors, mentioned earlier.

[xv] Winding up of companies is often called liquidation.

[xvi] After 1862 such provisions were incorporated in companies legislation (Keay & Walton, 2003).

[xvii] 19th century judges viewed companies as special cases of partnerships and derived law accordingly.

[xviii] If protection proves insufficient and creditors find themselves in trouble with an insolvent company, bankruptcy/insolvency law is available – see below. Note, though, that for the argument of this paper, it is not the details of the protections that matters, but the fact that they are included in company law.

[xix] Dividends can act as informational signals, as highlighted by modern finance theory.

[xx] Greater protection, whatever form it might take, is likely to cost something in some way.

[xxi] Even if such guarantees effectively removed the benefits of incorporation with limited liability, there might still remain tax advantages from using that form (Klein & Coffee, 1988).

[xxii] Klein & Coffee (1988, p.219), for example, refer to US federal bankruptcy law as "exceedingly complex". In the UK, the law relating to the insolvency of companies used to be part of the companies legislation but is now to be found mainly, though not entirely, in the Insolvency Act 1986. This brings it together with personal bankruptcy (Davies, 2010). However, notwithstanding the complexity, it is the intentions and general principles that matter for the argument of this paper.

[xxiii] This is broadly in accordance with creditors' bargain theory, which argues that the goal is to maximize the amount that creditors receive (Keay & Walton, 2003).

[xxiv] There are differing requirements internationally (see Parkinson, 1993), and there have been over time, regarding when directors should give primary consideration to creditors' interests; creditors' interests may be primary not only when the company is insolvent but also when insolvency might

reasonably be foreseen. However, this is a technical legal issue and not relevant to the argument of this paper, where it is sufficient to establish that creditors' interests may become primary at some stage.

[xxv] See the earlier comments on shareholders as 'owners'.

[xxvi] Notwithstanding the UK Insolvency Act 1986, I am continuing to bracket corporate insolvency law with company law, which is where its origins lie.

[xxvii] Coffee (2006) argues that the corporate governance debate has also ignored the professional agents of the board and the shareholders, who inform and advise them. However, his interest is in the responsibilities of these parties in relation to the bilateral relationship that dominates the current governance literature, rather than in the legitimate interests of a third principal party, the creditors.

[xxviii] I note that there are legal cases in the UK and the US which some commentators argue mean that companies do not have to maximize profits (it is certainly the case that they do not have to maximize short-term accounting profits). I also note that, in a closely held corporation, where there in no divorce of 'ownership' by shareholders and 'control' by executive management (Berle & Means, 1932), non-financial goals may have an important part to play, as Friedman (1970) acknowledges.

[xxix] This paper leaves that an open question.

[xxx] A 'degenerate' one, according to Tocher's (1970) analysis.

[xxxi] Some US states have passed 'stakeholder laws' that permit (or even require) directors to consider the impact of their actions on constituencies other than shareholder, including employees, customers and suppliers (Monks & Minow, 2008, p. 48). The UK Companies Act 2006 also appears, *prima facie*, to be a piece of pro-stakeholder legislation, since Section 172(1) states that directors must have regard to the interests of stakeholders. However, this regard is to be paid while the directors are giving paramount consideration to the interests of shareholders. It is thus an example of 'enlightened shareholder value' (McLaughlin, 2009), consistent (at most) with instrumental stakeholder theory rather than the normative stakeholder theory propounded by many business ethicists (Donaldson and Preston, 1995). 'Enlightened' shareholder value is, analytically, no different from shareholder value. Indeed, a member of the steering group whose report led to the passage of the Companies Act 2006 comments that they thought there was a strong case for making explicit the law's true character, having come to the opinion that it was widely misunderstood in too narrow and short-term a way (Mayo, 2008). Moreover, far from being a piece of pro-stakeholder legislation, the 2006 Act actually introduced explicit shareholder primacy in statute law for the first time. Moreover, as a reinforcement

of the argument of this paper regarding the place of creditors in corporate governance, it is noteworthy that creditors are not listed alongside other stakeholders in Section 173(1). Instead, Section 172(3) makes the duty to promote the success of the company 'for the benefit of its members as a whole' subject to "any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company" (McLaughlin, 2009, p.326).

[xxxii] See, for example, Mallin (2010) – who does mention protection of creditors and identifies them as a stakeholder group, along with others – Monks & Minow (2008) and Solomon (2010).

[xxxiii] As Norman (2010, p. 155) comments, "the 'folk theory of the firm,' whereby shareholders are special because they own the firm as a piece of private property, is dead".

[xxxiv] A case of functional convergence, even if there is not convergence of form (see Gilson, 2004).

[xxxv] Hence this paper does not make a *legal* contribution.