THE PRINCIPLE OF SHAREHOLDERS' LIMITED LIABILITY AND ITS EXCEPTION IN ALBANIAN COMPANY LAW

Erjola Aliaj, PhD Candidate
European University of Tirana

Abstract

The separation of company's legal personality from the personality of its partners/shareholders is a legal artificial creature created in order to promote commercial investments. By separating the legal personality of the company from personality of its partners/shareholders, it is reduced the liability risk that partners/shareholders might have, due to a not efficient investment, providing that their personal liability for commercial liabilities of the company extends up to the unpaid part of subscribed contributions. Notwithstanding the multiple efforts to strengthen the protection of investors in this area, their risk limitation up to a certain limit, is of significant importance, in order to make the whole system operate on interest of the economy and of the society in general. The Law "On Entrepreneurs and Commercial Companies" has introduced significant modifications in relieving the partners/shareholders from restricted liability and extending the level of liability that they must bear towards third parties in some specific circumstances. In the present research paper, through a critical review, special attention has been paid to these provisions not only for the important consequences but also for the fact that, there have been noticed legal uncertainties and lack of legal treatment, for which there may be offered the possible solutions.

Keywords: company law, principle, shareholders' limited liability, exception.

Introduction

The present research paper consists of three chapters. Subject of the first chapter is the concept of limited liability of Shareholders in Albanian company law, which is not uncontroverted. Although, for the economy and society as a whole, the benefits derived from the limitation of liability of the partners/shareholders in terms of facilitating investment in large-scale, are greater than the disadvantages associated with it. The second chapter gives a

brief summary of the corporate veil piercing doctrine as a common law doctrine. The last chapter deals with the exception of the limited liability company law in Albanian company law, mainly focusing on the identification of uncertainties and gaps in treatment of the grounds of personal responsibility. In the final conclusions are offered possible solutions to problems identified in relation to the causes of personal responsibility in commercial legislation.

The principle of shareholders's limited liability in Albanian company law

Based on Law "On Entrepreneurs and Commercial Companies" the liability of partners/shareholders in the limited liability companies and joint stock companies, are different from other types of legal persons, because the partners/shareholders are not responsible for the liabilities of the company. Whereas the liability of the company is unlimited and only the company with its all assets is responsible for its own liabilities. This principle is reflected in article 68 point 1^1 and article 105 point 1^2 of law "On Entrepreneurs and Commercial Companies" *(Malltezi, 2011).* In these articles it is provided the lack of personal liability for the liabilities of the company only as regards to the founders of the company, leaving unclear the situation in relation to subsequent partners and shareholders. (*Bachner, Schuster & Winner, 2009).*

Based on these provisions, only when the company shall be in difficult economic situation, in other words, when in losses, it may ask to the partners/shareholders to pay the unpaid part of the contributions they have committed to give to the company. Indeed, it cannot be like this, because the total payment of the contribution constitutes a financial source and is a contractual liability for the partners/shareholders, liability which has been undertaken at the moment when they agreed to establish the company. Therefore the company may at any time ask for full payment of shareholders contribution, in cases when they are unpaid and not only when there is need for additional funds, for example, in case that a company wants to expand its activity. *(Xhoxhaj, 2012).*

[1] Article 68 provides that :
The limited liability company is a commercial company, duly established by natural or legal persons, who are not responsible for the liabilities of the commercial company and cover personally the losses of the company up to the outstanding part of the subscribed contributions.

[2] Article 105 provides that:
The joint stock company is a commercial company, which capital is divided in subscribed shares by the founders. The founders are natural or legal persons, who are not found personally liable for the liabilities of the company, and cover only those losses of the company related to the outstanding amount of subscribed shares.

On the other hand, the partners/shareholders do not have any personal liability for the liabilities of the company but they assume economic risk by performing the investments in the company. Actually the "limited liability" has to do with risk limitation. This aspect is not fully covered in the Law "On Entrepreneurs and Commercial Companies". The contributions are an investment that aim at generating own returns in the form of dividends or of capital profits by a subsequent sale of quotas or of shares. In case that the company incurs losses, there will be no dividends nor profit from the subsequent sale of shares or quotas and the ability of the company to repay any contributions, will be reduced as well. This type of risk is assumed by any partner/ shareholder, to make an investment in the company without ensuring the return and maybe also to lose its initial investment. In case that all the properties contributed by partners/shareholders are swallowed up by the losses suffered by the company, the company itself will become insolvent and the partners/shareholders will suffer losses in all their investments, but they will not suffer beyond that. *(Dine, Blecher, Hoxha & Race, 2008).*

This "limited liability" which is actually a limited risk is considered as a doubtful privilege. In case that the company has many partners/shareholders with a wide range of personal education, the vast majority of these partners/shareholders will have neither the time, nor the expertise for administrating a complicated business activity. As a consequence, the decision-making should be delegated to a small group of administrators. This causes a potential conflict of interest between the administrators and the investors. *(Bachner, Schuster & Winner,2009).* The limited liability can be seen that creates "negative externality"[3] by transferring to the partners/shareholders all the profits, but not all the losses of the commercial activity, as well as by affecting the interests of certain groups, which are not included in these actions.

Whereas for the creditors, the income from their investment are limited in their (contractual) claims related to the interest on principal loaned to the company. The creditors try to be protected by means of contractual clauses, which restrict the risk that can be incurred to the company in its commercial activity or simply by demanding a higher interest rate. But this protection is not possible in all the situations (for example the victims of a tort committed by the company, the maintaining of false accounting).

Regardless of the above, for the economy and the society in general, the profits deriving from the limitation of liability of partners/shares in the meaning of enabling investments at an expanded level are greater than the

[3] The term "negative externality" describes the situation in which the behavior of a person who aims to provide as much profits, imposes costs on a person or other group which is not directly involved in that certain action and can not defend his or her interests, trying to make a deal that compensates them for any disadvantage.

disadvantages associated with it (Malltezi, 2011). Consequently the lawmaker decision to allow the limited liability also for the small companies must be respected as a political decision that promotes the establishment of new companies that otherwise would not be founded.

Corporate Veil Piercing Doctrine

Piercing the corporate veil is a common law doctrine through which shareholders are held accountable by considering the corporate action as it was the shareholders' own *(Matheson, 2010)*.

Also, veil piercing is an equitable doctrine, which presents judges both great flexibility and amorphous standards (*Thompson, 2005).* When judges pierce the veil in the United States, they disregard both the legal status of a corporation as an entity separate from its shareholders – or, in some cases, from its officers or directors – and the limited liability concomitant with that separation. The defendants thus lose the principal benefit of the corporate form – the limitation of their liability for the obligations of the corporation to the amount of capital the defendants contributed.

Moreover, empirical research demonstrates that equity owners – particularly parent corporations rather than natural person shareholders–and not directors or officers, represent the overwhelming majority of the targets of veil piercing. It is true that cases in some states have held that a defendant need not own shares in a corporation to be held liable for a corporation's obligations under veil piercing. There are also cases in which veil piercing doctrines subjected to liability directors who were not also shareholders. Veil piercing arises most frequently in the context of either liability of a parent corporation for a subsidiary or a closely held corporation in which the controlling (or sole) shareholder also serves as an officer and director.

In different circumstances and for different reasons there are distinguished four different attitudes of the courts towards the company *(Ottolenghi, 1990)*. The first category is peeping behind the veil; the purpose is only to get information involving the persons who control the company and their inter-relation with regard to the control of the company *(Ottolenghi, 1990)*. The second category is penetrating the veil; the purpose is to impose upon the shareholders responsibility for the company's acts or to establish their direct interest in the company's assets *(Ottolenghi, 1990)*. The third category is the extension of the veil; the purpose is to extent the veil over a group of entities carrying out common activities and to consider them as a single one *(Ottolenghi, 1990)*. The fourth category presents the most extreme attitude by ignoring completely the corporate veil *(Ottolenghi, 1990)*.

The common law approach has led many courts to base decisions to pierce or not to pierce based on multi-factor tests without articulating the

weight given to individual factors.Some of the more common factors cited by courts include the following:(1) was the corporation the 'alter ego'[4] or 'mere instrumentality' of the plaintiff? (2) defendant's domination and control of the corporation (3) undercapitalization of the corporation (4) fraud or misrepresentation by the defendant (5) failure to observe corporate formalities and (6) commingling of defendant's assets with the corporation.

Exception of the limited liability principle in Albanian company law.

The limitation of personal liability of partners/shareholders is not a fundamental right, but a privilege acknowledged by Law "On Entrepreneurs and Commercial Companies". Consequently, the partners/shareholders which enjoy the privilege of limited liability must use it for legitimate purpose only and must not abuse with it in an unfair manner.

Article 16 "On Entrepreneurs and Commercial Companies" contains one of the innovations of the reform of commercial legislation of the year 2008. It is precisely this article that provides in the Albanian commercial legislation the principle "*piercing the corporate veil*", which we dealt with above.

Based on this principle in the commercial legislation, if the persons that enjoy the privilege of limited liability, offered by a commercial company, use it for unlawful purposes, or abuse with it to the detriment of other persons, then such privilege loses its economic function and these individuals are personally liable for obligations of the company.

In this article it is provided that the persons that act on behalf of the company (administrators, partners, shareholders or members of the administration council or of the supervisory council) are personally and severally liable for the liabilities of the company, if they abuse with duty and with the form of the company.

Based on article 16 of the law "On Entrepreneurs and Commercial Companies", the cases of abuse of duty and of form of the company are as hereunder:

a) abuse the company form for illegal purposes (for example the establishment of the so-called "ghost", etc.);
b) Treat the company assets as if they were their own assets (e.g., register their properties on behalf of the company, in order to take

[4] The doctrine of alter ego is commonly used in the United States. The doctrine requires the presence of two elements together before piercing the corporate veil. The first element requires the unity of interest and ownership between the corporation and its equitable owner; as a result the company and shareholder do not represent separate personalities. The second element requires that the inequitable result comes as a result of the act of the company owner who hides behind the corporate form.

advantage of more favorable legal treatment- e.g., to acknowledge expenses for tax purposes, etc.);

c) if they fail, with respect to the type of activities, to ensure that the company has sufficient capital at a time when they know or must have known that the company will not be able to meet its commitments as against third parties (e.g., do not take measures to finance the company, or alternatively to close it, by allowing the debts to third parties to increase and become unpaid).

The first of these grounds of liability clearly refers to abuse, thus requiring an element of fraud on the part of the persons who act or fail to act as required, and this fraud must be proved *(Bachner, Schuster & Winner,2009*). In this case the lawmaker uses the term abuse, which means that the partners intentionally use the form of the company to profit illegally. In this sense, there must exist the subjective part, in other words intentional, which must be proved by anyone who thinks they can use this provision as a legal ground to sue the partners (Xhoxhaj, 2012).

The element of fraud/abuse is not present in the wording of the second cause of liability. There can be no doubt that liability under article 16 point 1/b of law "On Entrepreneurs and Commercial Companies" requires at least an element of intentional behavior. This interpretation is based on rules for liability of the administrators for negligence in fulfilling their duties.

Based on article 98 point 3^5 and Article 163 point 3^6 of law "On Entrepreneurs and Commercial Companies", in case of a violation of his duties and the standard of diligence, an administrator is liable to compensate the company for any damage which occurred due to the violation. This rule about compensation for damage would be completely undermined if a mere failure to act with due diligence would render an administrator liable for all company commitments as per Article 16 point 1/b of law "On Entrepreneurs and Commercial Companies". Moreover, the partners/shareholders who do not owe a duty to the company to act with due diligence, cannot be liable under article 16 point 1/b on the basis of negligence, but only if they act, or fail to act, with the intent to harm the interests of creditors *(Bachner, Th.,& Schuster, E.,& Winner, M. 2009).*

[5] Article 98 point 3 provides that:
If the administrators act in contradiction with their duties and infringe the professional standards, are compelled to compensate the company for the damage arising from the incurred infringement and to transfer any personal profit that they or persons related to them have achieved by virtue of such irregular actions.

[6] Article 163 point 3 provides that:
The Administrators or members of the administration council, who act in contradiction with duties and infringe the standards of care, are compelled to compensate the company for the damages arising from the caused infringement, as well as to transfer any personal profit they or persons related to them have achieved by virtue of such irregular actions.

Commercial Code of Zog, considered the situation when one of the partners used the assets of the company for him/herself as cause for exclusion from the company. In the Albanian practice there are many cases when the partner, especially when is a sole partner but even when has the majority, considers the asset of the company as his personal property or property of the family. The provision analyzed above guarantees the protection of interests of third parties that have entered in relationship with legal entity, thus with the company and not with the partner. However, in order to claim the joint liability of the partner, it must be proved the situation provided in this point of the provision *(Xhoxhaj, 2012).*

The third cause of the liability provided in article 16 point 1/c is the most problematic cause. The element of reasonableness or due diligence imported into the provision by virtue of the words "must have known", which goes far beyond any concept of "abuse". Another serious problem stays in the inability of preliminary determination at a security level of "sufficient capital" to run a commercial activity. Also, if the provision is provided only with the prupose of being implemented only after the company has become unable to pay its liabilities, seems to be confused the "capital" with liquidity, because the last determine the ability of the company to pay its debt. It should be emphasized that according to this cause, in no event the partners/shareholders are obliged to assume additional contributions in the capital of the company, but brings them before alternative choices of forward financing, if they are interested to continue the activity, or make decisions for its liquidation or insolvency. Moreover, in this article it is not provided the causal connection between the action or omission to act of persons and measure of their liability. For example, let's assume that the company was in a healthy financial condition until, at some point, its financial situation deteriorated to the point where it was no longer able to pay its creditors, but the partners/shareholders and administrators (knowingly) continued the business for several more weeks until the opening of insolvency proceedings. Will this conduct render the members and administrators only liable for the damage caused to creditors as a result of the delay in opening the insolvency proceedings? *(Bachner, Schuster & Winner,2009).*

In light of these doubts, this cause of liability needs additions and amendments which will offer a narrow interpretation, by focusing only on a clear insolvency situation. Regardless of the situation, partners/shareholders do not take any measures to initiate the procedures provided by law on insolvency, but continue the commercial activity by endangering the asset of the company and of loans of third parties.

Conclusion/ Recommendations

Like any other liability provided by civil legislation, in the broadest sense (part of which is also the commercial legislation), any personal liability arising from the utilization of limited liability privilege for illegal purposes, or abuse of it, in contradiction with the provisions of article 16 "Entrepreneurs and Commercial Companies" in each case must be certified upon final court decision.

Otherwise, putting the personal liability to one person, for the obligations of another (entity) person, without a fair judicial process, would risk the violation in an unfair manner of the personal rights of individuals, sanctioned by the Constitution of the Republic of Albania.

From the strategic point of view of commercial policies, if the certification of cases provided by article 16 of Law "On Entrepreneurs and Commercial Companies" is made without following a normal legal process, this would endanger and seriously damage the economy, by shrinking foreign investments in the country, because the investors, except for the normal risk of investment would feel unsafe related to their investment, due to unpredictability of the maximal value of loss that must afford.

Also, taking in consideration that from the legal point of view, liability under article 16 of law "On Entrepreneurs and Commercial Companies", is an extra-contractual liability for the damage incurred, in analogy with the provisions of the Civil Code, in relation to the liabilities deriving from the causing of damage (article 608 and following), it should be determined also the intentional element of abusive behavior that causes liability of compensation towards third parties. Consequently, the actions or omission of actions determined as per article 16 of Law "On Entrepreneurs and Commercial Companies", must be performed by the responsible persons in order to provide to themselves or to third parties an unfair economic profit, or to incur to a third party the reduction of property.

As we mentioned above, article 16 of law "On Entrepreneurs and Commercial Companies" does not provide the liability that partners/shareholders of the company have to assume the issuance of additional contributions in the capital. In order to avoid any potential concern by the side of the partners/shareholders, in article 16 point 1(c), by providing that the administrator, partner/shareholder is personally liable towards third parties, only if at the moment he became aware of the shortages of the necessary capital for exercising the activity, did not take the necessary decisions to interrupt the continuance of activity and/of assuming new liabilities toward third parties, including public authorities.

Also, based on the constitutional principle of proportionality, we estimate that the personal liability of administrators, partners/shareholders, in case of infringement of what is provided in article 16 of law "On

Entrepreneurs and Commercial Companies", to not exceed in value, beyond the incurred damage by the creditors, due to the specific infringement. Consequently in this article it may be provided that:

- In case of abuse of the company form for illegal purposes – the personal liability shall be up to the general value of unpaid liabilities of the company;
- In case of treating the company assets as if they were their own assets – the personal liability shall be up to the market price value of these assets (e.g., they register their personal assets on behalf of the company in order to profit more favorable legal treatments);
- If they allow the company to continue exercising business activity, and/or to assume new liabilities towards third parties, including the public authorities, the personal liability shall be up to the general value of unpaid liabilities of the company, arising after being aware of the shortage of the necessary capital for exercising the activity.

Finally, taking in consideration that cases in article 16 of Law "On Entrepreneurs and Commercial Companies" constitute "residual" liability, in other words, for which in other normal circumstances there wouldn't exist legal liability, it must be clarified that the only liable partners or shareholders are the individuals, and not legal entities. Such clarification constitutes only a better coordination of legal provisions, but does not excludes the liability the legal entity in these cases. According to article 209 and 210 of law "On Entrepreneurs and Commercial Companies", the controlling partner/shareholder (legal entity), who by means of actions or omission of actions of its administrator, causes the cases as per Article 16, is liable to pay the damage caused by his own property. In these cases the liability of the controlling legal entity and of the administrator, is a joint liability.

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