MANAGERISM

Limited Liability (Part 1): Heads I Win, Tails You Lose

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If a limited liability corporation is bankrupt its assets are sold to pay the creditors. Its owners must pay the creditors nothing, because the private wealth of owners is protected by law. *Limited liability* in truth means — *No liability*.

ORIGINS OF THE LIMITED LIABILITY CORPORATION

In the mid-nineteenth century, Britain made several laws to regulate business organizations. The Limited Liability Act (1855) allowed people to legally declare their business a limited liability corporation. The British did not invent limited liability, but these laws gave free and easy legal protection for corporate shareholders against creditors. The limited corporation reduced the financial risk of owning a share of a business. Soon similar business laws and practices were adopted worldwide.

Some say, limited liability evolved naturally as a building block of the modern economy. Others say, limited liability is a political instrument that took absentee ownership one step further and created 'capitalism-without-capitalists'. It made it easy for business owners (and managers) to abandon their economic and moral obligations. Today many managers believe that business and morals are separate spheres. That was not how earlier generations saw business management. In the 1800s a majority of British factory owners considered limited liability a business malpractice. Almost all British bank directors opposed limited liability — they thought it would encourage risky and ruinous lending and cause people to mistrust banks. Politicians ignored these factory owners and bankers and instead favored the interests of company promoters and major shareholders — and created the limited liability law. Since then, behind the shield of limited liability, risky and irresponsible corporate practices have contributed to countless bankruptcies and financial crises — most recently the Financial Crash of 2008.

Limited liability and *corporation* are twin nineteenth-century concepts. Professor Paddy Ireland, University of Bristol, says about *the corporation*, "There has long been a tendency to see the corporate legal form as presently constituted as economically determined, as the more or less inevitable product of the demands of advanced technology and economic efficiency. …the corporate legal form was, and is, in large part a political construct developed to accommodate and protect the rentier investor. It is, moreover, a construct which institutionalizes irresponsibility." This is also true for limited liability law: it was created not as an economic law to benefit all, but as a commercial law to benefit a few.

Making it free and easy for citizens to legally register a business with limited liability had a deep impact on capital ownership, financial accountability, legal responsibility and moral obligations. All of these issues were debated then and are still relevant today. The foremost advantage claimed for a limited liability law was that it would help corporations to obtain commercially and economically necessary capital funds from investors.

LIMITED LIABILITY HAS NO ECONOMIC BENEFIT

Why was the limited liability law proposed? What was it for? The conventional answer is that British manufacturers could not attract sufficient capital funds for industrial expansion, because investors were afraid of *unlimited* liability. So lawmakers responded with a limited liability law.

There are two weak points in this argument:

Firstly, there is no evidence that either unlimited liability or non-incorporation held back the Industrial Revolution in England (1750-1850). Capital was successfully sourced or accumulated by firms long before the limited corporation was created by lawmakers. Manufacturing had evolved from cottage industry to factories and mass-production without incorporation and liability laws. During the late 1700s and early 1800s a nationwide canal network had been constructed in England. Canal companies required enormous upfront capital spending and therefore substantial capital funds, but they successfully obtained these funds, some from associations of manufacturers. Capital funding also came from associates, family, merchants, local banks, wealthy citizens and aristocrats. During the Canal Mania (1790-1810) there was, as the name suggests, no shortage of capital investors.

Canal construction was followed by another gigantic privately-funded nationwide infrastructure project, the railways, which also required enormous advance capital spending and therefore correspondingly large capital funds. The *Circular to Bankers* (1835) described how the railway system had grown without the London Stock Exchange and was funded almost exclusively by capitalists from the industrial North of England. Less than five per cent of the funds for railway companies came from members of the London Stock Exchange. All of this happened well before the limited corporation had been invented.

The Limited Liability Act was passed in 1855, but only later during the mid-1880s did the limited corporation become more popular. Limited liability was not generally adopted by British companies until after 1900. And even by 1914, when there were sixty-two thousand limited corporations — over three quarters were still private companies and, indeed, over half were still partnerships. They did not source their capital funds from the general public via share issues nor did they freely trade their shares on stock exchanges.

Although several commercial laws were created in the nineteenth century to make it easy to register a business as a limited liability corporation, the latter was not a precondition for growing a successful enterprise. During the late 1800s and early 1900s many major businesses were private firms and partnerships. Harland and Wolff (H&W), Belfast, formed in 1861 as a partnership is just one example. It was already building some of the world's biggest ships by the time it decided to register as a limited liability business in 1885. However, H&W did not register for limited liability to attract shareholder funds or to allow for greater risk-taking. The growth of the enterprise to become the world's leading shipbuilder was built upon successful management. H&W remained a private partnership and did not become a public company until 1924.[1]

Secondly, there is no empirical proof that capital accumulation is a crucial factor for economic growth. It is not capital accumulation that has made the economic world since 1800: It is productivity through innovation. Not limited public corporations, but advances in science and applied science are the productivity enhancers. One indisputable driver of economic growth during the Industrial Revolution in Britain (1770-1850) was innovation in engineering. After over three decades of new commercial laws, including limited liability law, to liberalize the corporation, by the 1870s political economists were referring to Britain as an economy in decline. Despite a deliberate political policy to deregulate business organizations, this marked the start of the Great Depression of 1873-1896.

A FAKE CONCEPT?

Before the mid-Victorian age, limited liability was not an important political issue. In the USA during the early 1800s, Chancellor Kent in his famous *Commentaries on American Law* (1827) made the point that corporations are evil, but wasted few words on limited liability. Neither was limited liability of interest to English political-economic thought, until mentioned by the father of liberalism John Stuart Mill in *Principles of Political Economy* (1848).

Who was the limited liability law for? When the Limited Liability Act (1855) was proposed in Parliament, there was not even a proper political discussion. This was because — as several politicians complained — the law was rushed through Parliament by the government, leaving no time for a proper debate. The Liberal politician Robert Lowe, Vice President of the Board of Trade, argued in Parliament, "My object at present is *not to urge* the adoption of limited liability. I am arguing in favor of human liberty — that people may be permitted to deal how and with whom they choose without the officious interference of the state; … . Every man has a right to choose for himself … ." The Vice President of the Board of Trade justified limited liability not because of its economic advantages but in the cause of human liberty.

After researching the evidence, the historian Philip Cottrell concluded that, "… it is extremely difficult to account for this sharp and dramatic change." Paul Johnson, Vice-Chancellor and President, La Trobe University, Melbourne, Australia in *Making the Market: Victorian Origins of Corporate Capitalism* investigated how the U.K. limited liability law of 1855 was introduced and how it worked in practice. He argues that limited liability was not the conclusion of a neutral political process but was in the interest of rent-seeking directors and limited company promoters.[2]

COMPANY PROMOTERS, MAJOR SHAREHOLDERS AND POLITICIANS

A company promoter is someone who starts a company and targets potential investors. Some business ventures could only attract investors if they offered legal protection (limited liability) against creditors. Otherwise that business venture was considered an unreasonable investment. This is how a limited liability law benefited company promoters, major shareholders and speculative investors.

By the 1840s and 1850s the motives of company promoters and corporate directors were under attack. The railway investment boom was a disaster for most investors in railway shares. New railway companies were still individually approved by an Act of Parliament, so any bankruptcies also harmed the reputation of Members of Parliament. During the Railway Mania (1843-45) hundreds of railway companies were proposed and funded, many were abandoned, others went bankrupt, and some became profitable. However, by then not only investment in railway companies but also generally the holding and trading of shares had become morally questionable. *The Times*, 14 Nov 1845, wrote that the London Stock Exchange, "... has also promoted gambling, and so far has become a great, though not unmixed evil."

It was easy for limited company promoters and major shareholders in London to lobby the politicians nearby in Parliament. Many of these lawmakers were also company shareholders. In fact, Parliament contained a continuing railway lobby (a railway party) of 50 to 150 lawmakers. Some Members of Parliament were shareholding directors of railway companies before their election to Parliament and others became railway directors after their election. The Limited Liability Act was definitely in their personal interest.

BANKERS AND FACTORY OWNERS

Many factory owners and bankers rejected limited liability as incompatible with honest business practice. A Royal Commission (1854) on limited liability for joint-stock companies reported that

over half of manufacturers and almost all bankers called as witnesses were opposed to the legalization of the limited liability corporation.

There was a history of opposition to limited liability. In 1833 the Country Bankers' Association had issued a unanimous resolution that, "… the proposition of the Chancellor of the Exchequer to grant charters to incorporated companies, with limited responsibility, ought strenuously to be opposed, because Banks formed on that principle would be unjust in their operation, … ." Similar statements followed from other provincial centers of banking. The head of England's oldest country bank, The Exeter Bank (est. 1769), wrote to Chancellor Althorp, "… to warn that the indubitable effect of chartering Banking Companies with limited responsibility would be to annihilate altogether the present establishments in a very few years ... . The whole body of Country Bankers are unanimous in that opinion." In early July 1833, Chancellor Althorp conceded defeat, "Finding the opposition of the Country Bankers too strong for me on the question of limited liability, my colleagues and I have decided that I must not persevere in this proposition."[3] Representatives of Joint Stock Banks were also opposed and argued that personal liability is the surest safeguard of careful management, which is the essence of banking. And, placing a limit on liability as proposed by the Chancellor would have removed the safeguard of good management. A few months later the Liverpool District Bank also issued a public statement and declared that the security afforded by Joint Stock Banks depends upon responsible owners. The Liverpool District Bank then publicly announced the names of its owners.

In 1837 the Manchester Chamber of Commerce asked local Members of Parliament to make every effort to prevent another proposed law, The Letter Patent Act (1837), which would have regulated and legalized limited liability. For a number of years, bankers, chambers of commerce, manufacturers and merchants in the major industrial cities protested to Parliament, to their Members of Parliament, and to their city councils to prevent limited liability laws. Their protestations, opinions and interests were eventually rejected by the majority in Parliament.

The banks and insurance companies, after years of protestation, were excluded from limited liability in the Act of 1855. However, a new Companies Act in 1862 permitted the registration of limited liability by banking, financial and insurance companies. But this did not mean that banks immediately registered as limited liability corporations. In fact, the 1862 Act did not noticeably change the behavior of most British banks, who remained careful and responsible lenders. For bankers, operating with unlimited liability was part of their personal outlook and business philosophy and so they avoided speculative lending, such as that to railway companies. And when, as they had predicted, due to excessive borrowing and lending, the next railway bubble burst in 1865, and triggered another financial crisis, although many new-style *limited* financial companies faced bankruptcy, the traditional *unlimited* banks and *unlimited* discount houses weathered the storm. Their unlimited liability forced British banks and discount houses to act prudently and be morally responsible.

IS LIMITED LIABILITY COMPATIBLE WITH MORAL BEHAVIOR?

Adam Smith in *Wealth of Nations* argued that, "... it was not reasonable to protect one group of society from the general laws simply because they could profit from it." As Victorian critics noted, limited liability law, "...completed a divorce between moral conscience and commercial everyday life. Henceforward an astute man by adherence to legal rules which had nothing to do with morality could grow rich by virtue of shuffling off his most elementary obligations to his fellows."[4] In the House of Lords, Earl Grey, a renowned Liberal Party politician, said of the Limited Liability Act (1855), "It proposes to depart from the old-established maxim that all the partners are individually liable for the whole of the debts of the concern." An early critic of limited liability, Edward William Cox, a lifelong member of the Conservative Party, wrote in 1855, "[T]hat he who acts through an agent should be responsible for his agent's acts, and that he who shares the profits of an enterprise ought also to be subject to its losses; that there is a moral

obligation, which it is the duty of the laws of a civilized nation to enforce, to pay debts, perform contracts and make reparation for wrongs. Limited liability is founded on the opposite principle and permits a man to avail himself of acts if advantageous to him, and not to be responsible for them if they should be disadvantageous; to speculate for profits without being liable for losses... ."[5]

Government laws did not eliminate liability for non-repayment of credit and loans, they used state power to transfer the liability to others. The Act legalized what had been wrongful actions and repudiated the common-sense idea that those who take the profits should also take the losses. Limited liability is state intervention that arbitrarily shifts entrepreneurial risk from owners to others, who had acted in good faith, without their consent. Even if owners or managers of a limited business have no legal obligation to compensate others for any harm their actions cause, this does not cancel their moral obligation. The limited corporation cuts the link between risk and accountability. Major limited corporations owned by non-responsible owners and managed by non-accountable managers are, like Lehman Brothers, The Royal Bank of Scotland and Hypo Real Estate, neither inevitable nor essential. Limited liability and the corporation when combined can be a poisonous mixture.

Moral behavior means not harming others. Limited liability encourages behavior that can harm others, because it is a form of free legal insurance which ensures that no compensation must be paid. If limited liability is incompatible with moral behavior this presents us with a problem. If we believe in justice, we must try to practice justice, but the management practices of limited corporations can stand in our way. This is because the Limited Liability Act legalized injustice.

WHAT SHOULD BE DONE AND BY WHOM?

Limited liability law is state intervention in the market that violates market principles and fosters risky business ventures, safeguards major shareholders, and protects speculative investors.[6] One lesson to be learned from the history of the limited liability corporation is that there is nothing natural about it. The industrial revolution and innovative business enterprises were well established before the limited liability corporation was created.

Although people may accept that the economic benefit and moral value of limited liability are questionable, many will believe that the present state-of-affairs is normal. But as the Italian philosopher Antonio Gramsci said, powerful parties will tend to condition the cultural and economic environment, so that their interests are believed by the citizenry to be natural and inevitable. Nevertheless, the commercial world is not static, it is dynamic and continually evolving. And commercial law is a flexible framework. It is desirable and necessary that progressive ideas are proposed to reform a commercial law that is no longer fit for purpose, which is arguably the case with limited liability.

Some basic proposals:

1. Laws and rules for stricter liability and accountability:
Government regulation should prevent shareholders and managers (of limited corporations) from causing harm to others. Members of Supervisory Boards and Management Boards should share responsibility and accountability for debt levels and avoidable bankruptcies. Directors should declare their corporation has sufficient reserves or insurance to pay debts when due in the upcoming fiscal year.

2. Supervision and authorization of corporate financial policies:
A Supervisory Board should set limits for key financial levers such as cash reserves, reinvestment in business, payout to shareholders, directors and managing executives, share repurchases and so on.

3. No more "free liability insurance" for corporate shareholders:
The government should charge fees for legal limited liability, which is equivalent to private insurance protection, and those fees should be used to compensate any unpaid creditors.

4. Obligations to be lifted from non-responsible shareholders:
Not the liability of shareholders should be limited but their rights of ownership. Their status should be reduced similar to that of corporate bond holders. They have no effective control over directors, are profit-focused, non-responsible, non-accountable, and ignore the behavior of 'their' corporation. The logical, legal and political consequence should be to relieve them of their moral obligations. No obligations, no rights. The rights and obligations of corporate ownership should be transferred to the individual and separate members of two corporate bodies: Supervisory Board (of representatives of selected dependent or impacted groups: employees, suppliers, customers, industry associations) and Executive Board.

Limited liability must be reformed to prevent avoidable harm to innocent parties. Anyone harmed by a corporate bankruptcy must be compensated. Commercial laws should be dependable but also responsive to changes in the business and political-economic environment. In the same way, reforms of limited liability should be gradual and pragmatic but also far-reaching — as far-reaching as the Limited Liability Act of 1855.

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Upcoming - **Limited Liability (Part 2): The Total Cost**

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1. Harland and Wolff (est. 1861) was a business partnership that built some of world's largest and most luxurious passenger liners. By 1900 it was the world's leading shipbuilder. By 1913 it had 14,500 employees (36,000 in 1919) and was Ireland's largest employer. Within only four years (1910-1914), H&W built no less than 45 great passenger liners including the three sister-ships *Olympic*, *Titanic* and *Britannic*.

2. In such unregulated times, many limited company promoters were fraudsters. The corrupting impact of dishonesty in business was described by great mid-Victorian authors: The fake company was parodied as The Anglo-Bengaleee Disinterested Loan and Life Assurance Company by Dickens in *Martin Chuzzlewit*. A finance swindler, railway company fraud, crazy speculation and a finance bubble appear in *The Way We Live Now* by Trollope. While *The Newcomes: the Memoirs of a Most Respectable Family* by Thackeray features a sophisticated swindle, a bankrupt bank and private financial ruin.

3. Quoted by Julia Elizabeth Chaplin, *The Origins of the 1855/6 Introduction of General Limited Liability in England*, July 2016, University of East Anglia, England.

4. Sir Arthur Bryant, *The Search for Justice, A History of Britain and the British People*, vol. 3, republished Collins, 1990, p17.

5. *Limited Liability, Shareholder Rights and the Problem of Corporate Irresponsibility.* Ireland, P. (2008), Cambridge Journal of Economics. 34 (5): 837–856.

6. In the *Westminster Review* (1834), a lawyer asked a similar question: Why should the government "... protect the inferior capitalist to the disadvantage of the superior capitalist ...