MANAGERISM

Limited Liability (Part 2): The Total Economic Cost

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The second part of this thinkpiece considers the economic cost created by the failure of limited liability companies and how this cost can be reduced or avoided. These economic costs are negative externalities that constitute a market failure caused by government intervention to protect capital owners. The private benefit of limited liability is small relative to the socio-economic cost.

HUGE IMPACT OF NEGLECTING ECONOMIC COST

Limited liability allows the owners of a corporation to risk nothing, apart from the money they spend on shares. As explained in Limited Liability Part 1, limited liability law was created to protect the owners of a failed corporation against personal financial liability. When a limited corporation fails, its losses become the costs of third parties.

The real cost of limited liability is the total economic cost of failed limited corporations. The economic cost includes costs imposed upon others. Unpaid debts of a failed corporation are imposed on stakeholders and third parties and therefore, from a political-economic standpoint, they are externalized (economic) costs. These economic costs are created by a legal agreement (liability law) between the state and capital investors, which has negative spillover costs for others that leads to a suboptimal economic outcome. The total economic cost of a failed business can be much greater than the commercial cost. Neglecting the economic cost of corporate failures has serious socio-economic consequences.

COSTS OF CORPORATE FAILURE

The *internal costs* of corporate failure are those paid by the limited corporation: these include administrative and accounting costs, redundancy payments to ex-employees, claims paid, fees for insolvency specialists, legal and court fees, and so on. These internal costs are captured by business accounting. There are also *external costs* of corporate failure; these are imposed upon suppliers, subcontractors, banks, financiers, customers, employees, community, agencies, authorities and the state. These external costs can be categorized as direct or indirect. *Direct* external costs can be directly allocated to a failed corporation, because they are recorded by business accounting: they are, for example, unpaid debts owed to creditors or lenders or other businesses. *Indirect* external costs cannot be directly allocated to a failed corporation (in economics these are called *negative externalities*.) The external costs (here for simplicity called *economic costs*) are the topic of this essay.

As already mentioned, economic costs have a negative economic and commercial impact, especially on small and midsize enterprises (often family owned businesses), which can then collapse because of these unpaid debts and cash-flow problems.

WHAT HAPPENS WHEN LIMITED CORPORATIONS FAIL?

Let us consider two recent cases.

The first case: **CARILLION PLC**
This was the second-largest construction and outsourcing services company in the U.K., withsome 20,000 employees. The corporation was compulsory liquidated in January 2018 with liabilities of almost £7 billion. This disastrous collapse sent shockwaves across the U.K. economy as construction stopped on £1 billion worth of private and public projects, and vital outsourced government services were threatened. Carillion owed £1.2 billion to about 30,000 suppliers, subcontractors, joint-venture partners and lenders. Many of the creditors were small and midsize family-owned enterprises whose futures were immediately threatened. Also, many cities that entrusted building projects and outsourced services to Carillion were badly hit. Major hospital-building projects in Liverpool and Birmingham were abandoned. Some municipalities must now find tens of millions of pounds to re-plan, reassign and reschedule vital projects and community services. The National Audit Office estimated that the Carillion crash will cost the UK central government (not including local government) at least £148 million, but warned that the overall total cost for taxpayers was likely to be much higher. Limited liability law has allowed the owners and managers of Carillion PLC to impose liabilities of £2 billion on others.

The second case: **HOUSE OF FRASER PLC**
This corporation, a U.K. chain store with around 18,000 direct and indirect employees, was declared insolvent in August 2018, after a decade of multiple owners and job-hopping executives. It collapsed with debts of nearly £1 billion. The official administrator told over 1,000 suppliers they will not receive any of the £500 million they are owed. The House of Fraser pension fund could be over £160 million in deficit, so that future company pensioners may not receive their full pension benefits. Soon after House of Fraser PLC entered insolvency administration, its suppliers began announcing financial losses, profit shortfalls and potential business closures. That is the first stage in the domino effect: orders are canceled, delivered goods remain unpaid, manufacturers cut output, and employee contracts are terminated. After the insolvency of House of Fraser, its main logistics supplier XPO Logistics immediately cut over 600 jobs. XPO was owed over £30 million by House of Fraser PLC.

FAILED CORPORATIONS — THE ECONOMIC DOMINO EFFECT

Let us now consider the neglected domino effect of the bankruptcy of those two companies.
The domino effect impacts the whole supply chain. If the unpaid creditors of a failed business also fail, they too will be unable to honor their liabilities. In January 2019, *Construction Manager*, reported that Hawk Plant (UK), one of the biggest independent plant hire companies in the UK, had become insolvent. The company was hit by historical problems with contracts, but in particular the fallout from the liquidation of Carillion. A year earlier, Hawk Plant had reported sales revenue of £93.5 million and pre-tax profit of £515,000. The company, with more than 40 years experience, was ruined by the liquidation of Carillion.

In the British magazine *The Construction Enquirer*, June 2018, Kash Ahmad of Bibby Group (financial services to SMEs) said of the UK construction industry: "Bad debt is a serious issue for many construction businesses and across the entire sector more than £2.8 billion is written-off each year, representing a significant economic leakage. Almost a fifth of construction subcontractors say the most common reason for not receiving the full amount billed was a customer going out of business." Helen Wheeler at Bibby said, "Unless something more tangible is done, the growth of tens of thousands of small construction firms will continue to be stifled."

R3, a UK trade body, which represents insolvency and restructuring practitioners, reported that 32 per cent of businesses in West Midlands, England, suffered financial damage in the first-half of 2018, because customers, suppliers and debtors became insolvent. Mr. Radford, chair of R3 in the

Midlands, said: "The figures are evidence of the so-called domino effect, where one company's insolvency will increase the insolvency risk for others."

AUDITORS/CONSULTANTS — CORPORATE HELP OR HINDRANCE?

Governments introduced laws and regulations for the management of joint-stock corporations to protect shareholders against mismanagement. These laws and regulations include a legal requirement for limited corporations to be audited by accounting firms. However, just like some managers, auditing partnerships and auditors may prioritize their own personal interests. And sometimes their private interests coincide. Corporate managers hire and pay the auditors. Auditors depend upon the goodwill of corporate managers.

Auditing is a parabusiness: it sells its services mostly to major organizations. The accountants PriceWaterhouseCoopers received £17 million from Carillion for accounting and auditing plus consulting, before their client collapsed. PwC are now expected to earn a further £50 million for administering Carillion's liquidation.

Was the failure of Carillion due to mismanagement? Could the CEO and management team not handle the business? Why did they not hire management or financial consultants? In fact, the past three chief financial officers of Carillion were all ex-Big Four executives. Richard Adam and Emma Mercer, the most recent CFO, both worked at KPMG, while Zafar Khan and audit chairman Andrew Douglas have both worked for EY in the past.

The senior executives at the Big Four of PwC, EY, KPMG and Deloitte have come under pressure from U.K. politicians to justify their roles in the collapse of Carillion PLC. The selection of an administrator also proved difficult for U.K. authorities, when they found that each of the Big Four had been closely involved with Carillion. EY, who were pre-selected to oversee the liquidation, were ruled out because in July 2017 they helped to implement a strategic review to cut costs and collect more cash from contractors. Deloitte had been Carillion's internal auditors for some time, and KPMG, at the centre of the controversy, had been Carillion's external auditors since 1999, up to the profit warnings and corporate failure. As a result, the U.K. Financial Reporting Council (FRC) is now investigating the audits and consulting advice of KPMG during 2014, 2015, 2016 and especially their audit work of 2017. A Parliamentary committee has suggested the 'gang of four' were now "feasting" on the company’s "carcass" and pocketing more than £70 million in fees for administering the Carillion insolvency, which they had not prevented. Parabusiness partners can benefit from the failure of a corporate client.

People Do Not Trust Managers

Unsurprisingly, public trust in business in the U.K. is at its lowest since 2012. Only 43 per cent of the adult population "trust business" according to the latest Edelman Trust Barometer. In May 2018, a Parliamentary report said Carillion's collapse was, "... a story of recklessness, hubris and greed, its business model was a relentless dash for cash ...", and that the directors had misrepresented the financial realities of the business. Carillion PLC directors and auditors deny any wrongdoing: they claim they complied with the law. Nevertheless, they have a record of aggressive accounting, systemic late-payment of suppliers, creatively hiding losses, while authorizing ever-higher shareholder and executive payouts.

The UK has seen the failure of many limited companies including banks in recent years. The 2008 financial crisis and its consequences have not been forgotten. Millions of lives have been turned upside-down by the failure of corporations. But have things not gotten better since 2008? They could hardly have gotten much worse. In England and Wales, the number of company insolvencies grew to 16,090 in 2018 – the highest since 2014. Every year, tens of thousands of innocent people and firms are financially harmed by corporate failures. But does not pure market ideology predict that this economic damage will eventually be outbalanced by some general economic benefit?

NO PROOF THAT LIMITED LIABILITY HAS ECONOMIC BENEFIT

It is generally assumed that limited liability has an commercial and economic benefit. But there is no evidence to verify this assumption. There is, however, evidence that limited liability has a large and significant commercial and economic cost.

LIMITED LIABILITY CREATES BUSINESS UNCERTAINTY

Owners and managers who are legally or financially liable for a company failure will manage it prudently. That is not necessarily true for a limited company: in fact, it can be in the interest of owners, directors and executive managers to follow a hazardous strategy. All the time, that strategy will spread uncertainty among suppliers, lenders and other parties: business relations are no longer based upon trust.

From day one of limited liability it was argued that because limited companies declared that status in their name (Ltd, PLC, GmbH) any firm dealing with them freely chooses to risk that debts and loans may not be repaid. So why do firms deal with a limited liability company? They do so because today almost all companies take advantage of limited liability, which is virtually free of charge. Therefore most firms are *forced* to deal with limited liability companies. This means small and midsize businesses must act more cautiously than otherwise, and it also encourages managers of limited corporations to take more risks than otherwise.

LIMITED LIABILITY ENCOURAGES SHORT-TERM RISK-TAKING

The failure of limited liability corporations is also the story of managerism. A farmer who does not make hay when the sun shines to feed livestock during a long winter, is not a poor farmer, he is but a bad farmer. Managers who take on so much debt that their business becomes insolvent during a fallow year are bad managers. However, this bad management is not always caused because managers are 'incompetent'. Today corporate managers are often incentivized and pressured to take unreasonable risks by shareholder expectations, peer pressure, and even false management doctrines like shareholder value.

LIMITED LIABILITY INDUCES CORPORATE FAILURE

It does this in two ways.

Limited Liability Induces Managers to take on too much Debt

It encourages shareholders to mandate and incentivize managers to focus on risky short-term profits instead of reliable long-term resilience. Consequently, managers are obliged and rewarded for taking risks. And the interests of agents (bonused managers) and principals (shareholders) also now coincide. Whatever happens, they both avoid most of the economic pain.

In January 2019, R3, issued its latest Business Distress Index; one in six companies in North West England were just paying the interest on debts, rather than repaying the debt itself. It also found that 18 per cent of North West companies were struggling to pay their debts when they fall due; 21 per cent were renegotiating payment terms and conditions with creditors; and 5 per cent said they could not repay their debts if interest rates increased by a small amount. Only being able to pay the interest, not the original debt itself, is one potential sign of a so-called 'zombie business' – a company which is only surviving thanks to low interest rates but which otherwise might not be viable. A survey of 1,200 companies across the UK revealed a similar picture in all regions.

Limited Liability Creates a Domino Effect
Businesses that are over-indebted and barely solvent, when hit by non-payments of a failed corporation, themselves run into cash-flow problems and face bankruptcy. So how much uncertainty does limited liability combined with over-indebtedness and bad debts actually create? According to *Construction Enquirer*, UK, June 2018: "Subcontractors are writing off a staggering £2.8 billion in bad debts every year as non-payment continues to blight construction. ... over 60 per cent of subcontractors have suffered from bad debt in the last 12 months... ". The problem of late payment or non-payment of debt is not restricted to the construction industry, it is a widespread problem.[1]

WHAT IS TO BE DONE?

There is no generally recognized economic accounting method to identify and allocate the economic costs externalized by failed corporations. Such an economic accounting method does not yet exist because these economic costs have been neglected. Although economic costs can be hard to monetize, quantify, disentangle, proportionately assign and objectively verify, there are economic accounting methods which could be adapted and modified to capture at least the magnitude of these costs: for example, ecology professionals use methods like life-cycle assessment. Other economic accounting methods are cost-benefit analysis, economic-impact analysis, risk-benefit analysis and true-cost economics. For the purpose of this essay, such an economic accounting method has been assumed.[2]

Apart from environmental costs, the total economic cost of limited liability has often been disregarded, despite the fact that corporate liabilities morphe into tangible costs and it is radical state intervention in the market with significant negative consequences. However, questions are now being asked about the economic impact of limited liability and of managerism.

Some basic proposals:

1. **Allocation of economic costs**
   Economic costs should be allocated to failed limited companies. This method of economic accounting could prevent these costs at source and by regulation or market methods reduce their negative impact. Economic accounting methods should be developed to capture these costs.

2. **Directors and Boards**
   Stricter rules on corporate governance, bankruptcy, corporate failure and the accountability of directors and executives are needed. Directors and boards should more closely overwatch their appointees: the executive managers. Shareholders are often absentee owners or speculative investors; the complexity of large corporations prevents effective supervision by shareholders. Therefore some rights and responsibilities of ownership could be transferred to directors and boards.

3. **Bankruptcy laws**
   Limited liability provides investors with state-regulated free financial liability insurance, a unique insurance in which the insurer (the state) guarantees the insurer protection against claims by third parties by rejecting any claims. Claims should be considered and compensation paid. The fees that corporations are prepared to pay for private or public limited liability insurance could reveal their own assessment of the risks and costs they currently externalize.[3] In this way, too-risky business ventures and irresponsible investments are gradually priced out.

4. **Corporate debt limits**
   Legal debt limits could be set for limited liability corporations. At present, limited liability relieves shareholders of responsibility and accountability for excessive debt levels. Actually,

shareholders could obtain limited liability with adebt ceiling) that directors may no exceed. Directors or managers do so, shareholders could insist the directors be personally liable for those extra debts.

This is not a utopian idea; it was common practice in the mid-Victorian era, before limited liability was created. Today, legal guarantees from directors are demanded by suppliers in Australia, who insist on them before supplying goods on credit. Corporate directors could be required to declare their corporation's ability to pay debts due in the upcoming fiscal year. Directors would then self-interestedly supervise and prevent managers from risking over-indebtedness and bankruptcy.

These reformed procedures must be preventive, unlike limited liability, which is palliative. New and simple codes of professional behavior could be introduced and these would be gradually internalized by managers. Simple is the operative word: for centuries Jews and Christians managed with only Ten Commandments. Executive managers should consider themselves as professionals, like lawyers and physicians, as highly respected members of civic society, proud of being accountable and accountable for their decisions. These are the They should aspire to such honorable professional standards.

CONCLUSION

There is no proof that limited liability has an economic advantage over unlimited liability.[4] Limited liability is radical state intervention in the market with negative commercial and economic consequences. The purpose of joint-stock corporations (legalized by society) must ultimately be to serve the welfare of society, not only the private interests of incentivized managerists and speculative investors. Reformed corporate governance, limited liability and bankruptcy regimes would in all likelihood generate more commercial and economic benefits than today's limited liability laws. They could be transformational especially for small and midsize enterprises, and would reduce business failures.

Such reforms would prevent negative impacts on communities and the economy and make business enterprises more confident, efficient and resilient.

Derek James Brocklehurst, February 20, 2019

NOTES

1. Mike Pavitt, chairman of R3's southern committee and partner and head of the corporate restructuring and insolvency group at Paris Smith in Southampton, England, said: "Tougher trading conditions and much uncertainty over the future of the economy have contributed to a significant chunk of businesses in the South East finding themselves stuck in 'zombie business' mode. On the one hand, this means thousands of businesses are stuck in a position where they'll struggle to deal with external shocks. This presents a problem if they all were to become insolvent at the same time. The future for these 'zombie businesses' is mixed. Some might eventually be able to restructure or find new investment, and grow. Others will run out of road and become insolvent."

2. Here *economic accounting* is presumed; in the same way that economists presume *perfect markets*, *perfect competition*, *homo economicus* or *comparative advantage*: although they do not exist in the real world, they are merely models.

3. Unlike the limited liability regime today, Michael Simkovic, Professor of Law, University of Southern California, proposes in *Limited Liability and the Known Unknown*, Duke Law Journal, Vol. 68, 2018, that corporations should pay a fee equal to the economic risk they impose on other firms and society. Private firms often withhold information or contest scientific knowledge when public revelation could lead to costly regulations or liability. This concealment leads to negative externalities and public harm. He argues that firms that desire limited liability for their capital investors should be forced to pay what they believe limited liability is worth. This would have several salutary effects. Their choice between unlimited liability and higher liability insurance fees would reveal important information about their internal risk assessments. These fees could flow into a compensation fund to pay the external cost (harm and damages) caused by the failure of limited liability corporations.

4. Bratton William W. and McCahery, Joseph A. *An Inquiry into the Efficiency of the Limited Liability Company: Of Theory of the Firm and Regulatory Competition.* University of Pennsylvania Law School, Faculty Scholarship, 1997, Paper 904, Pages 630-631. In their research, Bratton and McCahery found no proof that limited liability has an economic benefit: "In an ideal world, an inquiry into the efficiency of a legal regime would require the collection and analysis of empirical information concerning costs and benefits. But due to cost constraints and limits on available means of measurement, fact studies are the exception rather than the rule in law and economics. Instead, legal policy debates respecting efficiency usually deploy economic theories in the absence of determinative empirical evidence. Efficiency emerges as a presumption not fact. ... The economics we reviewed offer new theoretical perspectives on limited liability. But instead of sending a new efficiency signal, these economics only further complicate the existing picture. Upon concluding our review, we found ourselves in a position to recommend only that the best presumption is that the present economics support no presumption at all."