Corporate Rights and Responsibilities: Restoring Legal Accountability

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Rise like lions after slumber
In unvanquishable number
Shake your chains to earth like dew
which in sleep have fallen on you
Ye are many – they are few.

Shelley, The Mask of Anarchy

The owners and directors of corporations must be made accountable in law for their actions.–Owner-shareholders and top executives exercise immense power in society both globally and locally, but are not responsible in law for their actions according to the law of limited liability. Giant corporations have the rights of a person, but none of the responsibilities. Corporations enthusiastically campaign to remove legal regulations that they say impede their businesses, just not the one they benefit from. Now corporations are pressing for society to become totally organised on corporate lines. This totalitarian momentum is solidifying the Tyranny of the Unaccountable Few as the new world order of the twenty first century.

Society needs successful businesses, but today business is taking over society. It is as if an over-indulged child had taken more and more liberties until it is entirely out of control. Everyone wants the child to do well, no boundaries are set, and before you know it the family is under the thumb of a teenager gone wild.

Box 1: The Rise of Corporate Power

- 51 of the world's 100 largest economies are corporations (*Institute for Policy Studies,* Top 200: The Rise of Corporate Global Power, 2001).
- 80% of the world's industrial output is made by 1,000 corporations (*The Economist,* 29 January 2000).
- The combined sales of the top 200 corporations are bigger than the combined economies of all countries minus the ten largest (*Institute for Policy Studies,* Top 200: The Rise of Corporate Global Power, 2001).
- Cross-border Mergers & Acquisitions (M&As) by collective investment funds have risen from $ 4.6 billion in 1987 to $ 134.6 billion in 2005 (*World Investment Report* 2006)
- In the US, the share of wages in gross domestic product (GDP) is the lowest on record (45.3%). The share of corporate profits is the highest since the 1960s. (*New York Times,* 28 August 2006).
- In Europe, "beginning in the early 1980s, there was a remarkable distributional shift to profits. The wage share in Europe began to fall, and may not yet have stopped falling. By now the wage share on the Continent is substantially lower than in North America." (*Robert Solow, Nobel Prize Laureate in Economics,* 1998).

Ironically it is the unfettered rise of corporate power (see box 1) that is the biggest threat to free markets, and the ability of free markets to promote individual freedom, equality before the law and equitable prosperity. Limited Liability is at the heart of this rise: a blanket exemption of a special interest group – owner-shareholders – from accountability for the actions of their companies. While the mantra of 'no rights without responsibilities' is used to regulate the behaviour of poor people who benefit from social security payments – from single mothers to the unemployed, from the homeless to the 'self-inflicted' sick–, 'The Unaccountable Few' enjoy feudal privileges.

It is, by no means, an exaggeration to note that owner-shareholders (and by extension manager-directors) are beyond the law to an extent not enjoyed by the Central Committees of Communist Parties, similar to the despotic monarchies, dictators and tribal leaders over which liberal Western societies claim moral supremacy and akin to the aristocracy in the Ancien Regimes of pre-enlightenment Europe .

Box 2: What does limited liability mean?

Most businesses are organised as companies with a legal structure in which the shareholders hold limited liability. This means that if the company fails or causes damage, the shareholders only lose the sum of money they invested. The company is designed to provide them with money, while protecting them from the responsibility for their actions or inactions in relation to it. A company can be prosecuted or sued if it sells defective products, destroys the environment or sells weapons to the enemy, but its shareholders are immune. The property rights of those damaged by companies have been removed to the benefit of a select group of property owners. This is at its clearest when creditors and employees can be made destitute if a corporation shuts down. Shareholders have regulated protection, at a time when other regulation is being swept away in their favour. Company directors also escape personal liability, seemingly because they are agents of shareholders, who are not liable. Nowadays, directors seem to exist in a privileged twilight zone beyond the reach of shareholders and public alike.

As with any rule by unlimited powers (or limited liabilities), the results are disastrous: since the end of mixed economies and after decades of corporate reign, despite the enormous wealth in society, there is a sense of corruption, increased inequalities and social tension, of declining life expectancy and health in the new 'under-classes' around the world and especially in the ex-communist world, of pending environmental disasters, of insecurity, war and terrorism.

It is no accident that the Western leaders in the victory in the Second World War, Winston Churchill and Franklin Roosevelt, made social security and labour rights key objectives for the post war world and that greater instability has followed their marginalisation. Today, the many who were to be freed from the yoke of state bureaucracies through the liberalisation of markets are the victims of businesses' powers to raise the prices of essential goods – transport, electricity, water, to name but a few -, and the many who were to escape basic poverty have instead been joined by a growing 'reserve army of the destitute'. Social protections are all too often regarded as impediments to free markets.

Shareholder primacy in corporate affairs has been controversial, in particular in the wake of spectacular corporate scandals, such as Enron and WorldCom, but more broadly in response to the negative impact of unfettered corporate power on the growth prospects of many developing economies, on the natural environment and on mass social welfare in advanced economies.

So far, the main plank of opposition to corporate power has been the promotion of voluntary reforms directed at an enhanced 'corporate social responsibility' (CSR) of large corporations (Kotler and Lee 2005, Vogel 2005, www.csr.gov.uk). The core remedies to the control of corporate power are, first, calls on corporate decision-makers to adopt a practice of 'good corporate governance' aimed at fairness, transparency and accountability, and secondly, the idea of increasing the power of owner-shareholders to control management.

But self-regulation and appeals to corporate social responsibility are not fit for the purpose of delivering responsible corporate behaviour. This is not surprising: The inherent vagueness of the 'good corporate governance' concept (see below) has made it easy for business to turn it from a rallying cry to curb its powers into a convenient marketing tool. But more importantly: The call for increased powers for owner-shareholders, presumably as a means to make large corporations more accountable for the social consequences of their activities, completely ignores a central device on which corporate power is built, namely limited liability: Limited Liability explicitly prevents owner-shareholders from having any legal right except to insist on the maximisation of returns. They cannot be the main drivers of ensuring responsible behaviour? *Limited liability establishes a unique legal case for the separation of ownership rights from obligations for a select special interest group. It makes no sense at all to rely on those without legal responsibilities for the behaviour of corporations to reign in the irresponsible actions of those same corporations.*

Box 3 : Corporate Social Responsibility is not fit for purpose.

- The report *Why Corporate Social Responsibility is Failing Children*, published on 26 March 2007 by ***Save the Children* and *the Corporate Responsibility Coalition*** (**CORE**) states:

  "Without clearer signposts from government, companies will continue to think about the bottom line before their social and environmental impact. We know that children around the world could be saved if companies were more accountable for their actions... It is time both companies and governments got their priorities right."

- Today only 4-5 % of the 70,000 multinational companies that exist globally, according to UN data, have signed Corporate Social Responsibility Agreements. These are not legally binding.

- "The image of companies working hard to make the world a better place is too often just that – a carefully manufactured image," – says *'Behind the Mask: The Real Face of Corporate Social Responsibility'*, a **2004 report from *Christian Aid***. As the case studies in this report – featuring Shell, British American Tobacco and Coca-Cola – demonstrate, the rhetoric can also mask corporate activity that makes things worse for the communities in which they work.

  "Some of those shouting the loudest about their corporate virtues are also among those inflicting continuing damage on communities where they work – particularly poor communities,' says Andrew Pendleton, senior policy officer at Christian Aid and author of the report. 'Legally binding regulation is now needed to lessen the devastating impact that companies can have in an ever-more globalised world."

'Rights without responsibilities': How did we get there?

The arbitrary exemption from equality of all before the law of owners-shareholders is not only questionable on ethical grounds. It has also been instrumental in making corporations powerful, in the first place, by *de facto or de jure* abolishing social control over them, and in so doing has undermined the case for free markets and for the compatibility of capitalism with transparency and democracy. How, exactly, did this happen?

On 18 February 2007, J. Bradford DeLong, Professor of Economics at the University of California at Berkeley, US, and one of the best-known US economists, posted a list of ten changes to US law over the past 225 years that, he argues, were initiated by judges without any lead from legislators. Fourth on this list is

> "[t]he post-Civil War empowering of corporations with exorbitant privileges of citizenship and limited liability at the expense of government regulators and creditors."
> (http://delong.typepad.com/sdj/2007/02/all_ten_of_the_.html).

This neatly highlights two core issues: First, the tale of the 'empowering of corporations with exorbitant privileges' unfolded in the second half of the 19th century, led by the US and Britain. By then, industrialisation had long been under way in the two leader countries, propelled and promoted, amongst others, by businesses and entrepreneurs not, as yet, invested with those privileges. Second, the tale comprises two essential chapters - the creation of the legal fiction of a 'corporate person' with rights, and the blanket exemption of this fictitious person from its responsibilities through limited liability.

How corporations came to be persons......

The predecessors of modern corporations were commercial organisations, such as medieval guilds and the joint-stock companies of the 16th and 17th centuries, that were granted a monopoly or trading privileges for specific sectors or regions by the state. Early joint-stock companies, in particular, were an arm of the state, risking criminal prosecution for violating or contravening the national interest, as perceived by the royal authorities. Probably the best-known examples of such colonial companies are the Hudson's Bay Company, the East India Company and the Royal Africa Company.

It was not until 1886, that the US Supreme Court, finding on a dispute about railroad taxation, decided that private corporations are natural persons under the US constitution with all the rights and protection granted to human beings by the Bill of Rights. This decision invoked the Fourteenth Amendment of 1868 to protect the rights of freed slaves, in effect extending the legal recognition of freed slaves as free human beings to private corporations. Remarkably, what today is the perhaps most important cornerstone of US corporate law – the doctrine of corporate personhood – was simply announced by Court Justice Morrison Remick Waite as a matter of opinion without discussion or legal validity:

> "The court does not wish to hear argument on the question whether the provision of the Fourteenth Amendment to the Constitution, which forbids a State to deny to any person within its jurisdiction the equal protection of the laws, applies to these corporations. We are all of the opinion that it does."
>
> (US Supreme Court, Santa Clara County v Southern Pac.R. Co., 118 U.S. 394 (1886) http://www.ratical.org/corporations/SCvSPR1886.html).

Subsequently, US corporations successfully used their thus won human right to lobby the legislature, not only to extend the human rights to free speech and to privacy to corporations, but also to exempt corporations from any duty to public goods provision, and to grant corporations additional – 'non-human'- rights, such as perpetual existence and the right to own others of their own kind (e.g. Bakan 2005, Nace 2003, Korten 1995, 1999, Hartmann 2004, Berk 1994).

Whilst the "Corporate Bill of Rights" has remained a US particularity, the concept of corporations as distinct 'persons' with their own personality, separate and independent of its founders, investors, directors and managers, has become a standard element of incorporation. In the UK, the transformation of corporations from privileged monopolies, brought into existence by a grant or charter of the monarch or state, into a 'person' and a legal entity of its own was also finalised through case law, rather than legislation by parliament. On 16 November 1896, the House of Lords issued a ruling in the case of Salomon vs. Salomon &Co. (1897, A.C. 22 H.L.) that was to become famous as the 'Salomon principle':

Mr Salomon, a boot manufacturer, had sold his business to a new corporation, Salomon & Co., owned by seven shareholders (then the minimum legal requirement): his five children, his wife and himself. His wife and children each obtained one share in the company, while Mr Salomon retained the remaining 20,001 shares, also assuming the position of managing director of the new company, whose two directors were two of his sons. Since, as the sole proprietor of the original business, he had sold this to the new corporation for cash as well as debentures, Mr Salomon was simultaneously the managing director, main owner-shareholder as well as creditor of Salomon & Co. When the company went into liquidation, the liquidators, treating Mr Salomon as the owner, demanded payment of his creditors. Mr Salomon, claiming his status as shareholder and holder of debentures against the company, argued that he should be paid rather than pay.

The trial judge sided with the liquidators against the shareholders, as did the court of appeal, on the grounds that Salomon & Co. had been formed for fraudulent purposes and constituted an abuse of the privileges of incorporation and limited liability. The House of Lords overturned these decisions, arguing that the Companies Act of 1862 (see below) had created companies as legal persons separate and distinct from the shareholders without specifying, in any way, a requirement for independence between shareholders or a 'disinterested' approach by shareholders to the company's management. It was not the role of judges to impose limitations where these had not been imposed by parliament.

Lord Macnaghten, one of the three Law lords in charge of the case, noted: "For such a catastrophe as has occurred in this case some would blame the law that allows the creation of a floating charge[1]. But a floating charge is too convenient a form of security to be lightly abolished. I have long thought, and I believe some of our Lordships also think, that the ordinary trade creditors of a trading company ought to have a preferential claim on the assets in liquidation in respect of debts incurred within a certain limited time before the winding-up. But that is not the law at present. Everybody knows that when there is a winding-up debenture-holders generally step in and sweep off everything; and a great scandal it is."(quoted at: http://www.swarb.co.uk/lisc/Cmpny18491899.php) Thus, despite misgivings about the 'catastrophe' caused in this case, the rights of the artificial 'corporate person' prevailed over those of the 'ordinary trade creditors' (e.g. Villalta Puig 2000).

...... without responsibilities

Even if the ruling in Salomon vs Salomon & Co. made legal history for firmly establishing the principle of the 'corporate person' as a an independent legal entity in the UK, the importance of the case derives from another attribute of separate legal personality – limited

[1] A floating charge is a transferable form of security under which business assets are used as security for loans.

liability. It is one thing to separate the legal existence of a body corporate from the physical existence of individuals. It is quite another thing to endow this body corporate with a blanket exemption from legal accountability. Mr Salomon had provided a perfect demonstration of the ease with which the special interest protection of shareholder-owners under limited liability is not only open to outrageous abuse, but actively encourages it – only to see this abuse sanctioned by the highest judges in the country.

The economist Adam Smith was one of the first to identify the problems of limited liability companies, or joint-stock companies, as they were originally called. Against a background of escalating market speculation and crashes following on from investment scams, that led to the 1719 Bubble Act – declaring common law companies with transferable shares a 'common nuisance' - Smith considered limited-liability companies in *The Wealth of Nations* (1776):

> "Joint stock companies, established either by royal charter or by act of parliament, differ in several respects, not only from regulated companies, but from private copartneries.
> First, in a private copartnery, no partner, without the consent of the company, can transfer his share to another person, or introduce a new member into the company. Each member, however, may, upon proper warning, withdraw from the copartnery, and demand payment from them of his share of the common stock. In a joint stock company, on the contrary, no member can demand payment of his share from the company; but each person can, without their consent, transfer his share to another person, and thereby introduce a new member. The value of a share in a joint stock is always the price which it will bring in the market; and this may be either greater or less, in any proportion, than the sum which its owner stands credited for in the stock of the company.
> Secondly, in a private copartnery, each partner is bound for the debts contracted by the company to the whole extent of his fortune. In a joint stock company, on the contrary, each partner is bound only to the extent of his share.
> The Trade of a joint stock company is always managed by a court of directors. The court, indeed, is frequently subject, in many respects, to the control of a general court of proprietors. But the greater part of those proprietors seldom pretend to understand anything of the business of the company; and when the spirit of faction happens not to prevail among them, give themselves no trouble about it, but receive contentedly such half yearly or yearly dividend, as the directors think proper to make to them. This total exemption from trouble and from risk, beyond a limited sum, encourages many people to become adventurers in joint stock companies, who would, upon no account, hazard their fortunes in any private copartnery ... The directors of such companies, however, being the managers rather of other people's money than their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own. Like the stewards of a

rich man, they are apt to consider attention to small matters as not for their master's honour, and very easily give themselves dispensation from having it. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company.

[...]

To establish a joint stock company, however, for any undertaking, merely because such a company might be capable of managing it successfully; **or to exempt a particular set of dealers from some of the general laws which take place with regard to all their neighbours, merely because they might be capable of thriving if they had such an exemption, would certainly not be reasonable**. To render such an establishment perfectly reasonable ... it ought to appear with the clearest evidence that the undertaking is of greater and more general utility than the greater part of common trades. ... The joint stock companies, which are established for the public-spirited purpose of promoting some particular manufacture, over and above managing their own affairs ill, to the diminution of the general stock of the society, can in other respects scarce ever fail to do more harm than good. Notwithstanding the most upright intentions, the unavoidable partiality of their directors to particular branches of the manufacture, of which the undertakers mislead and impose upon them, is a real discouragement to the rest, and necessarily breaks, more or less, that natural proportion which would otherwise establish itself between judicious industry and profit, and which, to the general industry of the country, is of all encouragements the greatest and the most effectual."

(Smith 1776 [1981]: Book V, Pt III, Art 1, para.15-18, 36: 740-741, 757, emphasis added).

Smith's concerns – carefully omitted from the praise heaped on him by free-marketeers with no worries about corporate power – were shared, to varying degrees, by other eminent economists of the 19th century, including John Stuart Mill and Alfred Marshall.

Nor was there any shortage of strong and sometimes colourful criticisms of the concept of limited liability outside the professional community of economists. The Tory Prime Minister Robert Peel, Britain's richest industrialist in the 1820s, was also an uncompromising campaigner against limited liability, on grounds similar to J.S. Mill's and A. Marshall's concerns about the managerial limitations of joint-stock companies. Anthony Trollope's *The Way We Live Now* (1873) stands as an elegant and harrowing portrayal of corporate fraud, brought on by limited liability in combination with insufficient financial disclosure. But perhaps the most damning and biting indictment of limited liability was produced by Gilbert and Sullivan who, in 1893, dedicated a whole opera to the topic – Utopia Ltd. (see box 4)...

Box 4: Gilbert and Sullivan, *Utopia Ltd or The Flowers of Progress*, 1893

King. A Company Limited? What may that be?
The term, I rather think, is new to me.

Chorus. A Company Limited?
What may that be?

Sca., Phan., & Tarara. What does he mean? What does he mean?
Give us a kind of clue!
What does he mean? What does he mean?
What is he going to do?

SONG - Mr. Goldbury.

Some seven men form an Association,
(If possible, all Peers and Baronets)
They start off with a public declaration
To what extent they mean to pay their debts.
That's called their Capital: if they are wary
They will not quote it at a sum immense.
The figure's immaterial - it may vary
From eighteen million down to eighteenpence.

I should put it rather low;
The good sense of doing so
Will be evident to any debtor.
When it's left to you to say
What amount you mean to pay,
Why, the lower you can put it at, the better.

Chorus. When it's left to you to say
What amount you mean to pay,
Why, the lower you can put it at, the better.

Mr. Gold. They then proceed to trade with all who'll trust 'em,
Quite irrespective of their capital
(It's shady, but it's sanctified by custom);
Bank, Railway, Loan, or Panama Canal.
You can't embark on trading too tremendous -
It's strictly fair, and based on common sense -
If you succeed, your profits are stupendous -
And if you fail, pop goes your eighteenpence.
Make the money-spinner spin!
For you only stand to win,
And you'll never with dishonesty be twitted.
For nobody can know,
To a million or so,
To what extent your capital's committed!

Chorus. No, nobody can know,
To a million or so,
To what extent your capital's committed!

Mr. Gold. If you come to grief and creditors are craving.
(For nothing that is planned by mortal head
Is certain in this Vale of Sorrow - saving
That one's Liability is Limited) -
Do you suppose that signifies perdition?
If so you're but a monetary dunce -
You merely file a Winding-Up Petition,
And start another Company at once!
Though a Rothschild you may be
In your own capacity,
As a Company you've come to utter sorrow -
But the Liquidators say,
"Never mind - you needn't pay,"
So you start another Company tomorrow!

Chorus. But the Liquidators say,
"Never mind - you needn't pay,"
So you start another Company tomorrow! [...]

King. Well, at first sight it strikes us as dishonest,
But if it's good enough for virtuous England -
The first commercial country in the world -
It's good enough for us.

Initially, some of these concerns, criticisms and outright condemnations – in particular fears of encouraging excessive speculation, rendering credit provision more difficult and promoting fraudulent investment schemes – had some impact on company legislation, at least in Western Europe. In Britain, the 1844 Company Act still emphasised unlimited liability through the requirement for registered companies to publicize their members (Shannon 1931, Carney 1999). It was not until the mid 1850s, after prolonged debate, including a lengthy 1839 Report on the Law of Partnership prepared by H. Bellenden Ker at the direction of the Board of Trade and the 1851 Report from the Select Committee on the Law of Partnership, prepared at the direction of the House of Commons, that limited liability won the day, enshrined, finally and fully, in the Companies Act of 1862, to which the Salomon vs Salomon & Co. ruling referred.

In 1866, a financial crisis hit London whose seriousness was largely attributed to the mushrooming of limited liability companies after 1862. This led to the establishment of a Select Committee of the House Commons to investigate the impact of limited liability in 1867. While the Select Committee refused to question or reform the new principle of limited liability, public opinion was much more critical: The following suggestion by the conservative paper *Judy*, quoted in Taylor (2006: ch.5) was representative of the public mood:

> "From the public's experience of the Court of Bankruptcy for the last twelve months, it is suggested that in future limited liability companies be designated as *Unlimited Lie-Ability Companies*" (30 October 1869)

Perhaps in part because of this experience, only around 10 percent of important British firms had taken advantage of incorporation with limited liability by 1885 (Carney 1999: 663), and by 1900 fewer than 100,000 UK Ltd companies had been formed. By contrast, the 20th century saw a proliferation of limited liability companies, in particular since the 1980s, with now more than 2 million such companies registered at Companies House in Cardiff (Martin 2006: 1). Other Western European countries, notably Germany and France, relied to a still lesser extent on joint-stock companies – the shareholder model. In Germany, the Gesellschaft mit beschränkter Haftung (GmbH) (limited liability company) was not introduced until 1892, once again amongst much debate and opposition despite its much more stringent regulation in terms of minimum founding capital, the establishment of a supervisory board for GmbHs with more than 500 employees and potential liability of managing directors in violation of detailed duties. This more restricted form of limited liability was adopted in Austria and Eastern Europe in the early years of the 20th century, but did not become established in France until 1925. Similarly, more recent outstanding success cases of catching-up industrialisation, such as Japan and South Korea, did not make stock markets a major plank of their industrialisation strategies.

In the US, limited liability spread earlier and more rapidly, mainly due to a 'race to the bottom' competition between states to attract investors. By 1830, limited liability was the general rule (Carney 1999: 664), with some notable exceptions: California did not introduce limited liability until 1931, instead imposing pro-rata unlimited shareholder liability. This means that in addition to risking their investment, shareholders were responsible for the debts of the company in proportion to the amount of the company they owned. Weinstein (2000) argues that this deviation from the norm in the US did not have any discernable effects on the stock market price of companies' shares, although at that time Californians had not developed the art of suing corporations, still less their shareholders.

Box 5: Timeline- Limited Liability (LL) for the 'Corporate Person'

1816-1849: Different forms of LL for corporations introduced in most US states

1844: Companies Act, UK, still emphasises unlimited liability

1855 - 58: Introduction of LL for UK companies

1862: Companies Act: Extends LL to all companies of seven or more members with virtually no other conditions attached.

1866/67: Financial crisis in UK attributed to LL and irresponsible company foundations, leads to 1867 Select Committee on investigation into LL.

1886: *Santa Clara County v. Southern Pac. R. Co 118 U.S. 394*: US corporations elevated to persons under the law with the same rights as human beings.

1897: *Salomon v. Salomon AC 22 (H.L.)* : "The company is at law a different person altogether from the [shareholders]..., and, though it may be that after incorporation the business is precisely the same as before, and the same persons are managers, and the same hands receive the profits, and the company is not in law the agent of the [shareholders] or trustee for them. Nor are the [shareholders], as members, liable in any shape or form, except to the extent and in the manner provided for by the Act [Companies Act of 1862]."

1892: Gesellschaft mit beschränkter Haftung (GmbH) introduced in Germany, gradually adopted in Austria, Eastern Europe, France in the first half of the 20th century.

1931: LL introduced for the first time in California, US.

A law imposed in six US states at different points in time and surviving to the day in New York and Wisconsin, imposes shareholder liability for unpaid wages (Carney 1999: 664). Finally, between 1865 and 1932, federal as well as state law routinely imposed double and even triple liability on the shareholders of banks. This meant that shareholders' liability would amount to two or three times the face value of the shares they owned. The face value is the value of the shares when they were sold to the public. For example, a company might offer 1,000,000 $1 shares for sale on the stock market, they might then be traded at a value of 10c or $10, but the liability would be based on the issued share price of $1, and could be $2 or $3. After a short flirtation with limited liability for banking shareholders after the Great Depression of 1929 – 1932, this was again "replaced with Federal deposit insurance and comprehensive monitoring of bank solvency by regulators" (Carney 1999: 664).

This brief look at the history of corporate law reveals a couple of interesting points: First, the legal foundations of the rise of corporate power – the Tyranny of the Unaccountable Few – had nothing to do with the economic dynamism of early industrialisation. These legal foundations – the fictitious legal creation of the 'corporate person' without responsibilities – only took hold in the lead economies of the 19th century when industrialisation had long been under way. The *Economist's* leader for its Millenium issue (23 December 1999) - "*The key to industrial capitalism: limited liability. The modern world is built on two centuries of industrialisation. Much of that was built by equity finance. Which is built on limited liability"* is a fact-free statement used to legitimate today's inequalities, and rather cavalier about the *Economist's* own historic stance against limited liability on the grounds, that "if limited liability was desirable [...] market forces would provide it." (ibid.). This leads straight to the second observation: Limited liability was *not* provided by market forces, as the *Economist* recognises: "But by 1926, this paper had been converted [to limited liability], suggesting that the nameless inventor of the concept might earn 'a place of honour with Watt, Stephenson and other pioneers of the industrial revolution" (ibid). Neither, however, was it invented by a 'nameless inventor' deserving of some Nobel Prize: It was gradually pushed and shoved up the legislative ladder by a conjunction of business lobbying, the contingent and situational initiatives of judges, and political debate, in general. As Berk (1994) argues in great and fascinating detail for the emergence of the doctrine of the corporation as a natural entity in the US, fending off the challenges of creditors in receivership, this was driven neither by technical necessity, not by the exercise of brute power, but by "historically contingent, not economically necessary, reasons" (ibid.: 51). The winners – from large US railroad companies to Mr Salomon – won their victories, not because they represented market forces or because of their inventive genius, but because some judges somewhere, and some members of parliament constituting a Select Committee at the time, happened to come down on their side of the argument, reflecting emerging balances of power.

Yet, today limited liability for the 'corporate person' has been elevated to the status of a 'natural law' or a religious dogma: To question its validity and legitimacy is to provoke instant scorn, ridicule or disbelief, rather than argument. Dogma is the enemy of accountability and a typical attribute of any tyranny. The concerns about limited liability raised in the 19th century debate remain valid – not only have they not been refuted by argument, but they have been confirmed by reality.

Box 6: The Northwick Park Six, TeGenero and Paraxel

In March 2006, six volunteers in a drug trial came close to death. All have suffered lasting disastrous effects on their health and medical experts have concluded that their life expectancy has been reduced.

The drug, TGN1412, had been manufactured by Boehringer Ingelsheim GmbH for Germany-based TeGenero to treat leukemia and rheumatoid arthritis. TeGenero had hired the US company Parexel to carry out the trial. Before the trial, TeGenero executives had agreed to compensate the volunteers in the event of an injury to comply with the guidelines of the Association of the British Pharmaceutical Industry (ABPI).

When disaster struck, TeGenero filed for insolvency three months later. It had insurance coverage of only £2 million for all six volunteers together despite much higher sums per case being standard in the industry. The very insufficient liability coverage also has a further drawback: Written by the Gerling Group the coverage contains a clause that voids the insurance in the case of any legal proceedings being brought.

Parexel's literature shows that, before the start of the trial, the possibility of a violent – cytokine – shock to the immune system, was known. It also suggests a remedy, a certain steroid. Parexel staff at the trial was unaware of this literature, and the steroid was not available in sufficient amounts. The Medical and Healthcare Products Regulatory Agency (MHRA) also criticised Paraxel for a series of errors. Yet, Parexel does not seem to be legally liable.

To-date, the volunteers have only received a nominal interim payment of £10.000 each. In the case of having received similar, or lesser or any injuries at the hands of the NHS, rather than those of TeGenero and Parexel, the volunteers could have sued for full liability immediately.

(http://www.businessinsurance.com/cgi-bin/page.pl?pageId=387, Simon Hattenstone in Guardian 17 February 2007, http://www.irwinmitchell.com/PressOffice/PressReleases/northwick-park-trial.htm)

Three reasons why unequal protection through limited liability is harmful

Limited liability violates the equality of all before the law in favour of the Unaccountable Few

Adam Smith's main objection to joint-stock companies with limited liability is also the most profound: A society should not exempt some people from general laws simply because their business may thrive as a result.

As mentioned, Smith's condemnation of limited liability, and thus of the legal structure of most modern businesses, is omitted from the way his views are handed down by free-market advocates. Britain's Adam Smith Institute is a bastion of corporate rights. Fans of globalisation such as Philippe Legrain find it useful to cite Smith's wisdom in support of their arguments, but omit his critique of the structure of modern capitalism.

Smith's concerns over limited liability are discussed by John Micklethwait and Adrian Wooldridge in their recent hymn to corporations, *The Company: A Short History of a Revolutionary Idea.* They state that Smith had two objections to limited liability: that such companies were inefficient and tended in his day to be monopolies, implying that somehow these objections are not relevant to present-day capitalism. But most importantly, Micklethwait and Wooldridge fail to consider Smith's main objection, namely that society should not exempt some people from general laws simply because they may thrive as a result.

This basic objection is all the more important since the people exempted from general law under limited liability are not just any interest group: They are the rich and those who trust the rich with their money, or see no alternative but to do so, such as for example, many modern day shareholders in private pension funds. Limited liability is unequal protection for the powerful (and their sources of finance). While, in an egalitarian and just society, it may make sense to grant protection to specific groups, on the grounds that their members are, for one reason or another, *systematically* disadvantaged or disempowered for no fault of their own, there can be no ethical justification for the unequal protection of the powerful:

> "[W]e are all aware that we live not only in a corporate society but a society of large corporations. The management-that is, the control-of these corporations is in the hands, at most, of a few thousand men. Who selected these men, if not to rule over us, at least to exercise vast authority, and to whom are they responsible? The answer to the first question is quite clearly: they selected themselves. The answer to the second is, at best, nebulous. This, in a nutshell, constitutes the problem of legitimacy."
> (Mason, The Corporation in Modern Society 1959 quoted in: Forouhar 2006:5)

That the answer to the second question is nebulous, is down to limited liability: By exempting owner-shareholders from any basic responsibility for the consequences of a corporation's decisions and actions, it is not only essential to the creation of the vast power they have been able to amass through access to finance and largely uncontrolled appropriation of wealth, in the first place. It then also provides giant actors, invested with such immense power, with further exemption from accountability to the rest of society.

Smith's fundamental objection to limited liability as a violation of the equality of all before the law is even more poignant, when we consider a legal development Smith could not have foreseen: The treatment of corporations as 'persons' before the law. So, on the one hand, we say that, before the law, corporations are just another person, and, in the case of US companies in particular, should have all the rights granted to human beings. This was the reasoning behind the decision of the US Supreme Court in *First National Bank of Boston v. Bellotti* (435 U.S. 765, 784) in 1978 to grant the right to free speech to corporations: Free speech should not lose its protection because its source is a corporation. This in flagrant disregard of another important principle, emphasised the US Supreme Court some 30 years earlier in *Kovaks v Cooper* (336 U.S. 77 (1949), namely that the right to free speech does not include the right to "drown out" someone else's speech. No-one doubts that, to-day, corporate wealth and influence very much "drowns out" the voice of ordinary persons. (Forouhar 2006). Today's important corporations may not be the chartered monopolies of Smith's times, but they are giant, beyond Smith's imagination. On the other hand, we say that these 'corporate persons', with access to the same rights as everyone else, should also have special and wide-reaching protection of exemption for accountability for the consequences of their actions, not accorded to anyone else in society.

If equality before the law is to have any meaning, it must apply to human beings, not fictitious persons, and organisations – as opposed to persons – must not be handed blanket exemptions from accountability simply on the grounds that they can thrive through privilege. We cannot, on the one hand, treat corporations as if they were just any person, and on the other, invest them with unequal protection. Otherwise, we are guilty of a double blindness to power: We disregard it by setting human beings equal to powerful corporations before the law. And we disregard it again by granting special interest protection to the powerful through limited liability.

Box 7: Adam Smith on 'the interest of dealers'

"To widen the market and to narrow the competition, is always the interest of the dealers. To widen the market may frequently be agreeable to the interest of the public; but to narrow the competition must always be against it, and can serve only to enable the dealers, by raising their profits above what they naturally would be, to levy, for their own benefit, an absurd tax on the rest of their fellow citizens. **The proposal of any new law or regulation of commerce which comes from this order ought always to be listened to with great precaution, and ought never to be adopted till after having been long and carefully examined, not only with the most scrupulous, but with the most suspicious attention. It comes from an order of men whose interest is never exactly the same with that of the public, who have generally an interest to deceive and even to oppress the public, and who accordingly have, upon many occasions, both deceived and oppressed it**."

(*The Wealth of Nations* 1776 [1981], Vol. I, Book I, Part III, I.xi.p., para. 10: 267)

Limited liability promotes speculation and corruption, not economic growth and innovation

Apart from these fundamental considerations in the interest of equality and the proper recognition of the need to govern power, rather than to be governed by arbitrary power, the main concerns, expressed by contemporaries of the debates surrounding the gradual introduction of limited liability, referred to economic arguments: Limited liability, it was argued, was likely to facilitate sluggish management due to the separation of control from ownership, to encourage irresponsible risk-taking and speculation at the expense of society as a whole, and to deter creditors by making equity less risky at the expense of increasing the risk of debt. These were the most pressing issues, raised by J.S. Mill and A. Marshall, amongst others.

By contrast, advocates of limited liability often argue that limited liability is an ingenious device to raise equity finance and thus to promote productivity growth that benefits everyone. This reasoning is wrong. Limited liability was not a pre-condition of industrialisation anywhere in the world at any time. In the lead-countries, notably the UK and the US, it was one of its outcomes, promoted – along different routes, but haphazardly, haltingly and reliant on many political and judicial contingencies – by already existing modern business interests (many of these very large) in negotiation with judicial and political systems and institutions that were, if not already dominated by these special interests, at least biased in their favour to some considerable extent. In follower-up countries, from Germany to Japan and South Korea, equity finance played a very minor role in the financing of industrialisation. Limited liability and the shareholder mentality have only gained real ground over the past three decades with the rise of global financial deregulation and neo-liberalism.

But how important is equity finance encouraged by limited liability for economic growth in the twenty first century? The primacy of stock markets and speculative capital flows over the global economy since the early 1980s has seen a reduction of world growth rates from an annual average of 4.8% in 1960-1980 to 2.9% in 1980-2000 (World Bank, *World Economic Indicators* 2005) and a slow-down of the growth of labour productivity from an annual 2.5% to 0.8% for the same periods, respectively (Bosworth and Collins 2003). In addition, income inequalities across the world have escalated (see box 8)

Box 8: The Liabilities of the Globalisation of the Shareholder-Model since the 1980s

- A near **halving of the growth rates of world output** from an annual average of 4.8% in 1960-1980 to 2.9% in 1980-2000 (World Economic Indicators 2005)
- A **reduction of the growth rates of labour productivity** from 2.5% to 0.8% for the same periods, respectively (Bosworth and Collins 2003).
- A very **pronounced increase in the ratio of GDP per capita of the richest to the poorest countries** from 8.7 in1870 to 51.6 in 1985 (Pritchard 1995).
- A **sharp increase in the ratio of the richest 10% over the poorest 10% across countries**, (data from UN Development Programme Reports and World Development Indicators, various years):

  - In 2004, the combined wealth of the three richest persons in the world exceeded the total GDP of the 48 poorest countries
  - In 1980, the 60 million people with the highest incomes received 216 times as much as the 60 million poorest. By 2003, this gap had risen to 564 times.
  - In 2003, the 10% richest US citizens receive a total income that equals that of the poorest 2.2 billion in the world

- An **unprecedented and explosive increase of speculative financial exchanges relative to the growth of trade in real goods and services** (Eatwell and Taylor 2000):

  - **More than 70 severe financial crises** in developed and developing countries since 1980.
  - **1972 – 1992**: World trade increases by $3,000 billion and gross international banking increases by $ 7,000 billion
  - **1973 -1995**: Foreign exchange trading rises from between $10-20 billion per day to $1260 billion/day ($80 billion in 1980), ratio of foreign exchange trading to world trading rises from about 2/1 to 70/1 (10/1 in 1980).
  - **1970 – 1993**: Sales and purchases of bonds and equities between foreigners and US residents rise from 3% of US GDP to 135% (9% in 1980); cross-border security transactions in the UK rise from almost nothing to more than 1000% of GDP.
  - **1985 – 1995**: Foreign equity ownership ("capitalisation") in 'emerging markets' rises from near to nothing to 13% of the world total; international bank lending rises from $265 billion in 1975 to $4.2 trillion in 1994.

The millennium celebration of limited liability in the *Economist* conveniently overlooks all of this. Following Moss from the Harvard Business School, they argue that "the benefits of putting a ceiling on the potential losses faced by shareholders far outweighed the cost of a slightly higher risk of debt default". Even so, there were ups and downs for equity finance:

> "The crash of 1929 made the public aware for the first time that, for all their merits, equities had serious flaws (as did Wall Street brokers, happy to sell their own portfolios before those of their clients). Unsurprisingly, confidence in equities recovered only slowly, and then thanks only to tougher regulation of Wall Street and gradual economic recovery. The Dow did not exceed its 1929 high until 1954. Even then, after a bull market in the 1960s, between 1968 and 1982 the Dow lost three-quarters of its value in real terms; in August 1979 *Business Week* asked in its cover whether equities were dead.

> Since then, however, with the notable exception of Japan, and a brief wobble in October 1987, **shares in rich countries** have mostly been a one-way bet, while countries that once shunned shareholder capitalism now have flourishing if volatile stock markets. The total value of share in listed companies worldwide is now some $ 28 trillion. [...] **for shareholders over the past 20 years** capital growth has more than amply justified the risk."
>
> (*Economist*, 23 December 1999, emphasis added).

No-one could make the point with more clarity: Ever since the rise of neoliberalism, market liberalisation and privatisation, shareholders are the winners (in their totality, not necessarily individually). But so what? This is only to be expected, when free reign is given to 'corporate persons' who operate under limited liability, i.e. without responsibility. Of course, they will profit. The real question is whether their profiting also advanced the economy as a whole. It didn't – to the contrary (and to call developing countries stock markets 'flourishing if volatile' just two years after the Asian crisis of 1997 must be the overstatement of the year).

In addition to the question of the economic and social usefulness of stock markets – a question answered with a resounding no by J.M. Keynes, of course – there is also the facilitation of corporate fraud through limited liability. Since the 1990s corporate scandals have hardly left the headlines, from the UK Guinness Affair, the collapse of the Bank for Credit and Commerce International (BCCI), Robert Maxwell's mishandling of the Mirror Group pension fund, Enron, World.com. and Parmalat, to name but a few.

The concept of 'piercing the veil' describes some barely known circumstances in which under certain nation's laws shareholders can be held liable for their actions. According to one British specialist discussing a case relating to claims for asbestos-related injuries that were thwarted by layers of Russian-doll-like limited-liability companies with one hiding inside another:

> *Any modern consideration of lifting the corporate veil must almost certainly begin with the decision of the Court of Appeal in Adams v Cape Industries [1991] 1 All ER 929. The case saw the most detailed judicial review of this aspect of company law ever undertaken in the UK. Justice Scott, and then the Court of Appeal, refused to allow the veil to be lifted on an English parent company whose American subsidiary had been successfully sued by American litigants but which had insufficient assets to satisfy judgement. Lord Justice Slade said: 'Our law, for better or worse, recognises the creation of subsidiary companies, which though in one sense the creatures of their parent companies, will nevertheless under the general law fall to be treated as separate legal entities with all the rights and liabilities which would normally attach to separate legal entities.' The law will not permit the lifting of the corporate veil just because the interests of justice would be better served by doing so.*
>
> (Griffith 2003)

This specialist went on to say that the veil of incorporation may be lifted where a company is a sham and no third party has an involvement with it. It may also be lifted where the company is a party to a fraud. It will not be lifted just because justice demands it. A director can escape personal liability to a third party in negligence by acting through his company and ensuring that he is perceived as accepting no personal liability for what he is doing. He cannot escape personal liability where he acts fraudulently on behalf of his company. A similar legal protection exists in the US (Plesch 2004: 360 fn17).

The Organisation for Economic Cooperation and Development recognises that limited liability shields the corrupt, especially when hidden behind the seven veils of subsidiary companies. The 2001 OECD study ‘Behind the Corporate Veil: Using Corporate Entities for Illicit Purposes’ concludes:

> *Corporate entities – corporations, trusts, foundations and partnerships – are often misused for money laundering, bribery and corruption, shielding assets from creditors, tax evasion, self-dealing, market fraud and other illicit activities. The veil of secrecy they provide in some jurisdictions may also facilitate the flow of funds to terrorist organisations.*

‘Behind the Corporate Veil’ argues that the types of corporate entities that are most frequently misused are those that provide the greatest degree of anonymity to their beneficial owners. In response, the OECD calls on governments and other relevant authorities to ensure they are able to obtain information on the beneficial ownership and control of corporate entities and, where appropriate, to share this information with law enforcement authorities domestically and internationally. On 13 March 2007, the European Parliament passed a resolution, making similar recommendations. This resolution urges the European Commission to extend legal obligations to enhance corporate accountability, such as director’s duties, foreign direct liability, and environmental and social reporting. This entails a clear recognition of the failure of purely voluntary corporate social responsibility campaigns, and comes only a few months after the UK Companies Act 2006 that extends directors’ duties to the consideration of the impact of their business operations on the community and the environment, as well as strengthening reporting requirements for quoted UK companies to include environmental, social and community matters.

However, and as should now be clear, it is the company – the ‘corporate person’ that gets sued. A limited-liability company can simply be the expendable fall guy that can be declared bankrupt or shut down while the shareholders are long gone. Companies have additional structures to protect themselves even further. This is through the creation of subsidiary companies. In this case the subsidiary may be sued but its parent company cannot because it is the shareholder. In this way a further incentive to irresponsible behaviour has been created.

Box 9: Limited liability and multinational companies in developing countries

A long list of large multinational companies, standing accused of gross abuses of human rights, labour rights, children's rights and of the natural environment routinely hides behind the impenetrable wall of the complexities of **limited group liability**. In most cases, parent companies can walk away from disasters and abuses caused by their subsidiaries, even where the group's management has been highly integrated. (Muchlinksi 1995, ch. 8).

Bhopal has become a byword for disasters, similarly to Chernobyl. Because of the scale of the disaster, legal opinion regards Bhopal as a case of 'the corporate veil' having been 'pierced'. But the 1989 settlement of $470 million paid to the Indian government is considered woefully inadequate by campaigners and the Indian Supreme Court. In the meanwhile, Union Carbide, the parent company of Union Carbide India, has been bought by Dow. They continue to refuse any legal or moral responsibilities for the Bhopal legacy (e.g. SustainAbility 2005)

In most other cases, the corporate veil has not even been pierced: For example, **Nestlé, the Royal Dutch/Shell Group, Haliburton, Rimbunan Hijau, Monsanto, Afrimex and many large supermarket chains** all continue to face accusations from local and international campaigners and, in some cases, from governments about human rights abuses, environmental degradation, violation of labour rights, bribery and tax evasion. For detailed documentation, see

http://www.corporatewatch.org.uk
http://www.business-humanrights.org/Categories/Individualcompanies

Limited Liability enriches few but harms many

Limited liability encourages fraudulent behaviour not only at the scale of Enron or World.com, it does so every day in small-scale business. Mr Salomon (and Mr Goldbury) stand for this kind of behaviour. The creditors, in the cases, are mostly not large banks but ordinary buyers who cannot sue a company for bad services or even failure to deliver services, when this company can simply shut down and re-open under another Ltd label.

Box 10: The collapse of Farepak Ltd

Farepak, a savings club encouraging people to save monthly for vouchers to spend at Christmas, collapsed in October 2006, depriving around 120,000 people, mostly on low incomes, of around £40 million savings.

Farepak was owned by European Home Retail (EHR), formerly Kleeneze plc, a seemingly reputable and successful company that made £6m profits in 2005. But EHR had used the savings paid into Farepak by mostly low-income earners as a ‘piggybank’ for the acquisition of booksales firm DMG in 2000, later re-filling the Farepak accounts by taking out a loan from HBOS (Halifax and Bank of Scotland).

DMG made high losses and was sold again for a near nominal sum. HBOS called in the debt by seizing the savings paid into Farepak. Even though shares in EHR had been suspended in August 2006, Farepak went on to accept money from its customers for several months.

Not only was EHR’s use of Farepak as a ‘piggybank’ entirely legal – there is no requirement for Christmas Clubs to ring-fence the money they take in -, under limited liability, EHR and Farepak cannot be held accountable for their decisions.

Meanwhile, the owners and directors have been enriched. Majority shareholder Nicholas Gilodi-Johnson received £62,000 a year , apart from his estimated share dividend of almost £445,000. Of the other Farepak directors at the time of the DMG disaster, Sir Clive Thompson, was paid an annual consultancy fee of £100,000 and chief executive William Rollason a £275,000 annual salary, their company pensions will be paid by the taxpayer under an insurance scheme.

(BBC Business News 07 November 2006, www.thisismoney.co.uk/ 10 November 2006, The Telegraph, 29 October 2006)

Professions such as law, accountancy and architecture have all operated as successful businesses for many years without the protection of limited liability. However, starting in the US, a new concept of limited liability has been introduced to allow these professionals to escape liability for their actions. When new laws were proposed in Britain to extend limited liability to the professions, Andrew Phillips made a vain attempt to at least force companies to advertise any previous names they had used to conduct business. In debate, the government minister makes a crack at Phillips's own profession of law:

> *Lord McIntosh of Haringey: 'But was it not Adam Smith who also said that all professions were a conspiracy against the laity?'*
>
> *Lord Phillips of Sudbury: 'That is precisely why I have opposed this Bill stock, root and branch. I am a great admirer of my own profession. But I am afraid that this measure is apt to be a conspiracy against the public interest from start to finish. However, I am more concerned with the small traders who will take advantage of the special privileges of this Bill. Let us make no bones about it; this will provide your two-man cowboy building outfit with a uniquely flexible and light framed means of screwing the public, to put it in Anglo-Saxon terms ... One of my jobs is that of legal adviser on the* Jimmy Young Show. *Over 25 years I have heard of hundreds of thousands of cases of abuse in relation to small, local companies that get nowhere near the attention of the DTI and get nowhere near being addressed by the various provisions to which the Minister refers. It depresses me that in this House we are so far out of touch with public opinion, if I may put it this way, at the bottom end of the social spectrum.* ***People are ripped off, day in, day out, by the easy availability of limited liability for off-the-shelf companies and the protections provided for them, and with no real remedies.'*** (House of Lords, 24 January 2004, emphasis added)

If limited liability hits everyday consumers, day in, day out, large-scale speculation by irresponsible shareholders and their unaccountable managers is not only harmful to the economy as a whole (see box 8), as J. M. Keynes so stringently and clearly argued over 70 years ago. What is often overlooked is that when speculation leads to financial crises and bankruptcies of limited liability companies, the losers are not only creditors, but first and foremost the employees. If, to this day, New York and Wisconsin impose shareholder liability for unpaid wages (Carney 1999: 664), they not only are the exception rather than the rule, but even this limitation of limited liability does nothing for those who loose their jobs because of irresponsible management behaviour, company direction and shareholder indifference.

Box 11: "Employees are a little further down the pecking order in private equity" (M. Gordon, chief investment officer, Fidelity)

A BBC report on the rise of private equity corporations stated: "The GMB union has branded Permira, involved in the takeover of the AA, as "buccaneering asset-strippers".

The current private equity boom – European private equity went up by over 40% in 2006 alone – consists largely of so-called leveraged buyouts: Firms such as Debenhams, AA and Birds Eye are bought with huge loans with the sole purpose of selling them off again at a profit.

One way of achieving these profits, is to cut jobs. The GMB union's comments were prompted by more than a quarter of AA's workforce getting the sack while under Permira's ownership, and by Michael Gordon's remarks above.

But an even bigger threat for jobs are the likely bankruptcies an over-heated private equity market inevitably produces: "If a company has too much debt, stops investing, runs itself to the point where it can't even buy enough stock to run the business, then you have bankruptcies." (Jon Moulton, Alchemy).

With limited liability, the price for irresponsible investment behaviour to obtain 'quick bucks' is paid not by the owners and the decisionmakers, but by the employees.

(BBC News report, 15 February 2007
http://news.bbc.co.uk/1/hi/business/6364673.stm)

Finally, one of the reasons most often given on behalf of business and shareholders for the continuation of limited liability is that anyone can freely choose to go into business or invest through buying shares. Millions of people own shares through their pension schemes or through investment companies that manage the money of many small investors. There is no doubt that this has benefited many millions of people, However, even in the US only one-half of all households participate in the stock market through pension plans, and of these households very few have more than a tiny proportion of the shares of any one company. As Lord Conrad Black, currently on trial in Chicago for allegedly stealing £30 millions from the shareholders of Hollinger International, made clear: Even larger shareholder's concerns over boardroom excesses (in this case the investment firm Tweedy Brown) are dismissed as "sanctimony" and "hysteria" (Guardian, 23 March 2007), not to mention the concerns of small shareholders.

It will be simple to, if necessary, make a cut-off point for liability for small shareholders – just so long as that does not provide a loophole for large institutional investors. In any case, the major corporations, institutions and the super-rich are the groups that own significant parts of major companies. As has been demonstrated in the studies by Professor Edward N. Wolff (1995) of New York University in 1989, ten per cent of US families owned eighty-nine per cent of stocks and bonds traded on the stock exchange. Since then these concentrations have increased. Similar concentrations of wealth protected by limited-liability laws now exist around the world.

US families are classified into wealth class by Wolff on the basis of their net worth. In the top one per cent of the wealth distribution (the 'Super Rich') are families with a net worth of $2.35 million or more in 1989; in the next nine per cent (the 'Rich') are families with a net worth greater than or equal to $346,400 but less than $2.35 million; in the bottom ninety per cent ('Everybody Else') are families with a net worth less than $346,400:

	Stocks	Bonds
Super Rich	46.2%	54.2%
Rich	43.1%	34.3%
Everybody Else	10.7%	11.5%

Supporters of mass shareholding often make exaggerated claims that a few years down the road result in great disappointment. In the 1980s Margaret Thatcher's government had TV advertising campaigns trying to persuade members of the public to buy shares in the newly privatised utilities. A few years later large corporations were buying out these small shareholders – few had ever bought more shares and the cost of providing them with information was very uneconomic for the privatised companies. During the stock market boom of the 1990s conservative politicians in the US and Britain began to campaign to privatise social-security holdings. This would have meant that this money was no longer held by the government bank but could be invested in companies. This idea was becoming fashionable until there was a sudden dramatic fall in the stock market, after which little more was heard of it.

Yet, despite these drawbacks, legislation to extend limited liability is currently under way in many leading economies. This is the other side of legislation or high-level recommendations for more legal supervision of good corporate governance (such as the OECD guidelines, the EU resolution and the UK Companies Act 2006, see above). These moves to facilitate limited liability include a new company law in Japan (April 2006), in Germany (in draft proposal) and, crucially, the promotion and rapid proliferation of Limited Liability Partnerships (LLPs) (see box 12)). The latter have been at the heart of recent corporate fraud, most notably as the business form chosen by Arthur Anderson and other accounting firms implicated in the Enron fiasco to shield its partners from liability (Mattera 2002). A similar hybrid company form in the US – CLLs (see box) – have become particularly popular in the energy and nuclear industry. A report prepared for Synapse Energy Economics by STAR Foundation Riverkeepers from August 2002 finds:

> **"Over the last ten years, the ownership of an increasing number of nuclear plants has been transferred to a relatively small number of very large corporations. These large corporations have adopted business structures that create separate limited liability subsidiaries for each nuclear plant, and in a number of instances, separate operating and ownership entities that provide additional liability buffers between the nuclear plant and its ultimate owners. The limited liability structures being utilized are effective mechanisms for transferring profits to the parent/owner while**

avoiding tax payments. They also provide a financial shield for the parent/owner if an accident, equipment failure, safety upgrade, or unusual maintenance need at one particular plant creates a large, unanticipated cost. The parent/owner can walk away, by declaring bankruptcy for that separate unit, without jeopardizing its other nuclear and non-nuclear investments." (p. 2, see also box 9).

Box 12: LL made easy – current developments

Japan (April 2006): New Company law that integrates 'limited liability companies' into 'stock companies'. A 'stock company' with limited liability can be formed with one board member; there are no more minimum capital requirements or other trade name regulations. (http://jetro.go.jp/uae/topics/2006021808-topics)

Germany (2nd draft proposal 2007): New limited liability company law expected to become law in 2007 facilitates the formation of GmbHs by reducing the statutory minimum capital (only 5000 Euros must actually be raised), abolishing the requirement for the sole shareholder of a single shareholder GmbH to provide security for any amount of registered capital not paid up, and allowing the GmbH to be founded before approval of its objective by a public authority. It is now sufficient to have applied for such approval. (www.freshfields.com/publications/pdfs/2006/15589.pdf

Limited Liability Partnerships (LLPs): A mix between conventional limited liability corporations and partnerships, LLPs are regarded as 'the best of both worlds' by accountants and business lawyers, in particular: They combine limited liability with the tax advantages and the lower disclosure requirements of partnerships. A conventional limited liability corporation is 'double-taxed': The company pays corporate tax, and the shareholders pay tax on their dividends. In partnerships, the partners' shares of earnings are taxed, but the partnership itself is not taxed. LLPs extend limited liability to the limited partners (the equivalent of shareholder-owners) and avoid double taxation.

Limited Liability Companies (LLC): In the US, these companies are a hybrid between fully quoted limited liability *corporations* and LLPs. Differently from LLPs, there is no ceiling on the number of limited partners/shareholders, and they are allowed to be active in the management of the company. **This means that business owners can avoid corporate taxation while fully enjoying the advantages of limited liability**.

Reforms for restoring freedom and equality

So, what can be done in the face of such blatant and deeply engrained special interest protection? We agree with a growing number of observers in the field (see box 3) that campaigns and appeals to the conscience of the 'corporate person' and to self-governed 'corporate social responsibility' are not working. They have had their day, and they have been largely ineffective. Recent legal and political moves to make 'good corporate governance' more legally binding (e.g. the UK Companies Act 2006, the OECD guidelines and the EU parliamentary resolution mentioned above) are very welcome, but it remains to be seen whether they will provide protection for those who are harmed by corporate behaviour. In our view, reforms that deserve the name are reforms that tackle the causes of a problem: Limited liability is not the only, but a very major cause of the Tyranny of the Unaccountable Few. We conclude this contribution with a discussion of the options. It is clear that we are at the beginning of a new debate on the importance of reforming limited liability and that it is only as more research and debate is conducted into the areas we have highlighted from the historical record and from the present century that the social momentum of reform will gather strength and focus.

Abolish limited liability altogether

This is the position of the starkest defenders of free markets, the libertarians. In *For a New Liberty: The Liberitarian Manifesto*, Murray N Rothbard – perhaps the most eminent of Liberitarians, Friedrich von Hayek apart – approvingly quotes Robert Poole, a fellow-libertarian and contemporary US intellectual entrepreneur: "A libertarian society would be a full-liability society where everyone is fully responsible for his actions and any harmful consequences they might cause." (ch. 13) This puts an unambiguous finger on the sorest point of limited liability for corporations: A free market society cannot tolerate unequal protection. In particular, it cannot do so without total loss of face and legitimacy if, at the same time, free markets – or the God of the Invisible Hand - are being held up as the saviour of all mankind. *Either* we have free markets *or* we have giant corporations without responsibilities. The present sort of corporate "freedom" is the freedom of the uncontrolled child, all of whose needs must be met without any reciprocal responsibility.

Were there no limited liability in the cases we have cited in this study, there would have been a great incentive on shareholders and directors to avoid the circumstances that created the trouble. Thus, the incentives driving Enron would have been very different. While where damage and company failure did result then creditors and those suffering damages would have their day in court with the owners. The major shareholders of Farepak and its parent companies would have had to deliver the Christmas hampers as advertised. Scrooge would perforce have a change of heart. The grinch would not have stolen Christmas.

Therefore, in our view, limited liability as it stands must go, without any doubt. It does not follow, though, that the proposal of replacing limited liability with full liability for everyone restores the equality of all before the law. It does not do so, so long as there aren't equal opportunities for everyone. Liberitarians *assume* this is the case. We know, it is not. Mr or Ms Tom, Dick or Jones, having observed government recommendations to take responsibility for their old age rather than to rely on a state pension by joining a private pension fund, are not in the same boat as Mr Salomon or Lord Conrad Black. Nor are the unsecured creditors of Farepak – those paying in their meagre savings in good faith – in the same boat as the Farepak managing and executive directors, who turned out to be the unsecured creditors of EHR.

When the London City crashed in the wake of the UK Companies Act 1862 and the proliferation of limited liability companies, *Punch* (2 October 1867, quoted in Taylor (2006, ch.5) exclaimed:

> "Let us have no *ex post facto* laws, but let it be understood that the Directors of the next Assurance Company that collapses shall be hanged. The process can do no harm, and may do much good." (2 October 1867)

Gratifying as this outlook may be for the victims of limited liability, it is not constructive: The point is not to threaten all those who engage in business activities with possible ruin (let alone death by hanging) when things go wrong. Not only would this discourage innovation and entrepreneurship that is indispensable to progress. It would also subject those small and powerless shareholder-owners that find themselves in pension funds because of misleading and badly designed government policies to the same discipline as those with unfettered powers to themselves bring destruction onto others. The objective should not and cannot be to deter the daring or to punish the powerless in equal measure with the tyrants. The objective is to restore the basic principle of any free society, namely the equality of all before the law and to encourage the constructive dynamism this will bring for innovation, economic prosperity and progress. This does require the abolition of any limitations for *those in control of their actions* on their liability for damages towards others. In this sense, limited liability, as it stands, must go.

The California model – pro rata liability

One way out of the conundrum of how to balance reasonable protection from unforeseeable complexities (as opposed to designed fraud) with equality of all before the law is to replace the current system with a pro-rata liability system, operated in California until 1931. Pro-rata liability means that in addition to risking their investment, shareholders are responsible for the debts of the company in proportion to the amount of the company they own. Own one per cent of the shares and be responsible for one per cent of the debt. As an extension of the same idea, the system operated by the US banking sector of double or triple liability would follow the same logic: Make the liability proportional (by one, two or three times) to the investment. 'Sue the shareholders' may look good on a protest banner. But to be effective, a campaign to restore equal freedoms to the economic market needs to pay attention to detail, and to have some practical intermediate stages.

The balance of rights and the socialisation of risk

In more general terms a clear understanding of the special status enjoyed by shareholders should make it easier to argue for balancing rights for community groups, elected governments and trade unions. Limited liability, as it stands, is an affront to the equality of all before the law, a feudal privilege of shareholder-owners. As the report for Synapse Energy Economics, quoted above, shows very clearly, limited liability serves only one purpose: To shift the cost of taking risks from those earning the profits, when things go well, to society, when things go wrong. As seen, not only does this violate the basic legal foundations of a free society, it also encourages reckless free-riding and corrupt behaviour by the few at the expense of the many.

There are two basic solutions to rectify this open invitation to abuse: First, balance the special protection extended to shareholder-owners by the special protection for other interest groups, such as trade unions, elected governments, and consumer organisations. Second, socialise risk, not by using the 'corporate veil' to secretly shift it from profiteers to taxpayers, but by using democratically established collective institutions to assess which risks society wants to take at what price, and which risks it doesn't want to take at all. Put differently, replace limited liability with an insurance system with clear and socially agreed upon criteria for the appropriate insurance of particular investment risks on the basis of scientific and societal debate and discussion. When TeGenero was found to have only a £2 million insurance for the TN1412 trial, no-one disagreed that this was pitiful. There were rules and guidelines on what constituted a reasonable insurance sum for this kind of trial, based on experience, country-and sector-specific factors and scientific knowledge. Any free society that takes the principle of equality before the law seriously, has the means and possibilities to pay for a national insurance system that assesses risk from the point of view of all concerned and offers those willing to take the risk in order to make profits a reasonable insurance deal to go ahead. Taxpayers will prefer to pay up for this societal assessment exercise and to abolish the current system of limited liability: That which leaves risk assessment to those with no responsibilities for the consequences, and shifts the often extremely high costs of risks gone wrong from the Unaccountable Few to the nameless taxpayer without any kind of democratic control.

Developing debate and research

In addition to these basic reform outlines, debate and research on limited liability raises a number of specific issues for further consideration and discussion:

There are many opportunities to explore the use of the limited liability debate in respect of attempts at privatisation. For example, opponents of privatisation may wish to insist that any new company accept the same liability as the previous community or state owned enterprise. For example, those injured by malpractice in a hospital may wish to retain the right to compensation they have with the National Health Service but would lose in any case similar to Tegenero.

The ability of capital to move across borders may create a fear of capital flight from attempts to raise the problem of limited liability in a single country. As seen, for example, the early spread of limited liability in the US in the 19th century was largely down to competition between states to attract investment, and a subsequent 'race to the bottom'. However, in this era of instant global communications such blackmail can be avoided, and a 'race to the bottom' replaced with a 'climb to the top', by parallel and inter-related debates in many communities and economic sectors and at the inter and supra national institutions. Discussions of the problem of limited liability might be usefully conducted more or less simultaneously at national level, at the level of the European Union, US federal institutions, the Word Trade Organisation, the UN Economic and Social Council and within emerging major economies of East and South Asia. It is worth noting that until 1931 California apparently required corporations with limited liability in other U.S. states to forgo this privilege when operating in the sunshine state.

Without limited liability, as it stands today, many of the guidelines for 'good corporate governance' – such as those recently recommended by the OECD and the EU parliament, amongst many other international organisations and institutions, and incorporated into the UK Companies Act 2006 -, would not be mere appeals to the goodwill of companies to abite by them, but could instead become legal standards. To quote but one of these guidelines, the OECD (2001) recommends that governments should consider taking action to:

- Require up front disclosure of beneficial ownership and control information to the authorities upon the formation of the corporate vehicle;
- Oblige intermediaries involved in the formation and management of corporate vehicles (such as company formation agents, trust companies, lawyers, trustees, and other professionals) to maintain such information;
- Develop the appropriate law enforcement infrastructure to enable them to launch investigations into beneficial ownership and control when illicit activity is suspected.

If limited liability were abolished and replaced by an appropriate insurance system to assess social risks and to provide reasonable insurance deals for companies, such guidelines would be unnecessary. Their contents would be law, and many of the disasters companies have visited on powerless stakeholders in the past, would not happen. Further research will be needed into appropriate consultative and legal processes regarding the legal structure where a person or corporate person should be held accountable.

The privilege of limited liability also provides a material rather than a moral argument for progressive individual and corporate taxation. That is to say, wealth that has been accumulated by overriding other people's property and employment rights gives society a general right of compensation from the profits. In the most general sense such taxation provides society at large with the insurance fund to pick up the pieces of corporate damage.

"Power tends to corrupt and absolute power corrupts absolutely". Lord Acton

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