The Economist

Schumpeter

Don’t limit the revolution

For all its virtues, limited liability continues to provoke criticism

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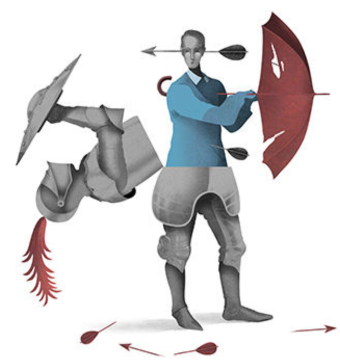
Brett Ryder

THE limited-liability company is one of man’s greatest inventions. The company encourages co-operation by allowing people to join together under the same organisational roof, regardless of race, creed or nationality. Limited liability encourages investment by limiting people’s downside risk—they can lose only the cash they put in the corporation. Put the two things together and you have an institution that allocates spare money to productive purposes and minimises fear and friction by freeing investors from the threat of personal ruin.

Economic historians have noted that limited liability sat at the heart of the Industrial Revolution. Before the 19th century you could obtain it in many countries only if you won special permission from the government. But as capital-hungry technologies such as the railroads arrived, followers of President Andrew Jackson (a prominent fan of limited liability) in America and free-market liberals in Europe threw the privilege open to all comers.

That the revolution has gathered pace in recent years has not been as well noted. Limited liability has gone truly global. China’s New Company Law statute of 2005 introduced elaborate rules governing its operation. The structure has also spread from very large to tiny businesses. Limited-liability partnerships (LLPs) allow partnerships to dispense with unlimited liability, which was traditionally the rule for groups of lawyers, accountants and so on. Limited-liability companies (LLCs) allow smaller outfits with a handful of owners (or even just one owner) to enjoy the benefits of the structure. Since 1993 America has created over 2.2m LLCs compared with 1.9m corporations.

Yet limited liability has always had a big weakness. Because shareholders don’t put their personal assets at risk, they stand to make huge gains if things go well but can lose their original stake only if they go badly. Even in the 19th century champions of unfettered free markets worried that this asymmetry—a sort of implicit subsidy—was unfair to society at large. A particular concern was that victims of corporate wrongdoing would get less money than they would have done under unlimited liability. The recent spread of limited liability to new regions of the world and to smaller firms has reignited the controversy.

Lawyers have developed an answer to the problem. Judges can pierce the corporate veil and expose shareholders to personal liability if they decide that the corporate form is being used to pursue dubious purposes. Piercing has always been one of the most well-applied doctrines in corporate law. But it is particularly popular with lawyers in countries such as China and Brazil, where many of the principles of business law are still heavily contested, and in many geographies for cases involving LLCs and LLPs, where the doctrine of limited liability is fairly new. American trial lawyers are particularly keen on pursuing veil-piercing in the case of smaller companies.

Critics of corporate "excesses" have developed an even more fundamental corrective: "concession theory". Ronald Green of Dartmouth College says that society has a right to demand socially responsible behaviour in return for the privilege of limited liability and the right to impose externalities on society. Will Hutton, a British journalist with a certain following, calls for a new law for firms that would grant them the privileges of incorporation only if they pursue some "noble, moral business purpose".

In their new book, "Limited Liability", Stephen Bainbridge of the University of California, Los Angeles and Todd Henderson of the University of Chicago give both arguments short shrift. Veil-piercing is hard to enforce because, in a world where the average holding period for shares is 22 seconds, it is impossible to determine who is liable for what. But even if you can enforce it there is no evidence that veil-piercing produces more responsible behaviour by firms. One reason is judges are unpredictable in when they choose to pierce the corporate veil. There are better ways of disciplining wayward companies, such as prosecuting managers.

The problem with concession theory is that if it were applied, everyone would be worse off. The idea of demanding social responsibility in return for limited liability would make sense only if the latter involved the transfer of resources from one defined segment of society to another. In fact, limited liability makes society as a whole richer by increasing the amount of money available for productive investment. This rationale is particularly strong in the case of smaller firms. They have in the past created a disproportionate share of new jobs, but many are now struggling to expand in part because of government regulation.

Another veil that needs to stay in place

When it comes to finance, critics of limited liability have better arguments. Victorian liberals were more reluctant to let banks adopt limited liability. The reasons were that bank failures pose such a big risk to the economy and that unlimited liability reinforces the most important virtue of a banker—prudence. In Britain most banks did not adopt limited liability until the failure of the City of Glasgow Bank in 1878. Goldman Sachs remained a partnership right up until the late 20th century. Banks have better access to capital as a result, but take more risk.

Many early banks tried to create mixed regimes combining the benefits of limited liability (more capital) with the discipline of unlimited liability. The British Companies Act of 1879 introduced the idea of "reserve" liability, under which a shareholder was liable to meet a failed bank's debt up to a fixed multiple of their equity investment. But such systems frequently produced the worst rather than the best of both worlds. Reserve liability was complicated to enforce and did not in practice prevent excess risk-taking. There are better solutions to the problems of financial leverage and risk-taking, for example forcing banks to fund themselves with a lot more equity, than fiddling with a mechanism that has been at the heart of the world's prosperity.

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