

**HOW TO MAKE  
CORPORATIONS  
ACCOUNTABLE**  
BY DR DAN PLESCH AND  
DR STEPHANIE BLANKENBURG





Dr Plesch is the Director of the Centre for International Studies and Diplomacy, School of Oriental and African Studies (SOAS), University of London and author of the Beauty Queen's Guide to World Peace, where he first analysed the destabilising effect on international society of corporate limited liability. Previously he was the Senior Research Fellow at the Royal United Services Institute and founding director of the British American Security Information Council.



Dr Blankenburg is lecturer in SOAS's Economics department. Previously she was a Research Fellow at the Centre for Business Studies, Department of Applied Economics, University of Cambridge, and Director of Studies in Economics at St Edmund's and Downing Colleges, University of Cambridge. She researches and publishes on the economics of neo-liberalism, the history of economic thought, private-public partnerships, and industrial policies in developing economies.

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**THE  
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OF  
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RIGHTS**

# how to make corporations accountable

by Dr Dan Plesch and  
Dr Stephanie Blankenburg

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# corporate rights and responsibilities

*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, not just 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 per cent 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 United States, the share of wages in gross domestic product (GDP) is the lowest on record (45.3 per cent). 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 the so-called advantages of 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 World War 2, 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.

This attitude, and the growing inequality of rights and responsibilities that follows, is particularly evident in – although not confined to – the case of employment rights and trade union legislation in the historical core countries of capitalism: towards the end

of the nineteenth and the beginning of the twentieth centuries, many European labour movements won varying forms of legal protection to defend the economic and social interests of the large majority of the working population, in response to widespread mobilisation, strikes and protests against horrendous working conditions and virtually unlimited powers of exploitation on the part of large private corporations. In Britain, the 1906 Trade Disputes Act granted a number of immunities to trade unions, most importantly amongst these that they could not be sued for damages incurred during a strike. On the European continent – led by Germany, France, Spain and Italy – the right to organise and to strike became a right protected by the national constitutions, over and above policy moves to pacify industrial relations by means of social legislation designed to avoid the worst abuses, most famously associated with the German Chancellor Bismarck. Yet, from the very start, this “balance of right” between differing interests – those of the minority in control of large corporations and those of the working majority – remained skewed in favour of the former. In Britain, much as the 1906 Trade Disputes Act represented an unparalleled legal victory for the labour movement of the time, the legal concept of “immunities” (rather than rights) was soon seized on by a class-conscious judiciary to limit trade union bargaining powers and to ensure that this was never to be extended to a notion of “rights” for workers or trade unions, as opposed to an ever-extending array of “rights” for corporations<sup>1</sup>. On the European continent, fascism put a brusque end to any illusions about the possibilities of a lasting legal protection of rights for workers far less empowering than those for corporations. With the transitory exception of the years of a fragile social-democratic consensus in Europe in the 1950s and 1960s, kept on course by the Cold War threat, the rights of workers have been repressed and/or eroded, while those of large corporations have been persistently extended. A pertinent example, in the present context, is the infamous “paragraph 116” of the German “Arbeitsförderungsgesetz” (Law for the Promotion of Employment), whose amendment in 1986 introduced liability rules for damages from strike actions that made such action virtually impossible. This stands in stark contrast to the limited liabilities granted to large private corporations of international reach.

Seen thus, the renewed rise of shareholder primacy in corporate

affairs against the background of European and US neoliberalism is only the latest advance in a long history of a persistent “imbalance” of economic and social rights across differing interest groups. Not surprisingly, this latest episode of shareholder primacy in the context of the globalisation agenda has been just as controversial as earlier episodes, 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.

Yet, so far, contemporary opposition to corporate power has perhaps been less forceful and less belligerent than its predecessors in the late nineteenth and early twentieth centuries. Its main plank has been the promotion of voluntary reforms directed at an enhanced “corporate social responsibility” (CSR) of large corporations<sup>2</sup>. For the control of corporate power the state has relied first on 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<sup>3</sup>. 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 rein in the irresponsible actions of those same corporations.*

Before proceeding to a brief account of the rise of corporate power as we face it today, a note of caution is in place: while we are concerned with the promotion of a profound “imbalance of rights” at the heart of a global neoliberal agenda, our primary concern is with large Anglo-American listed companies for the simple reason that these have become the most powerful agents of global capitalism over the past two decades. Other types of companies, not necessarily subject to shareholder value norms to the same extent, as well as the legal structures of organisations such as trade unions, co-operatives and mutuals – often very different across differing legal regulatory frameworks – merit a separate analysis that is outside the scope of, and the space available to, this report. Generally speaking, the case we make against limited liability for large corporations is of the greatest importance for those many legal jurisdictions characterised by extremely weak, or even non-existent, *de facto* rights for non-commercial organisations, such as trade unions, but extremely strong rights structures for corporations. However, even in the case of legal jurisdictions with regulatory frameworks that also grant some degree of protection and exemptions to non-commercial organisations, we have chosen to focus on the relationship between large corporations and involuntary creditors, since this helps to highlight a currently very strong bias in public opinion and the media to overlook the responsibilities of large corporations for socially harmful events – such as rising oil and utility prices, increasing income inequalities and environmental destruction – and to blame these on conveniently weak players, such as trade unions engaging in industrial action and, generally, protest actions.

# restoring legal accountability

### 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 per cent 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, and one of the best-known US economists, posted a list of 10 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”.<sup>4</sup>

This neatly highlights two core issues: First, the tale of the “empowering of corporations with exorbitant privileges” unfolded in the second half of the nineteenth century, led by the United States 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 sixteenth and seventeenth centuries, which 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 personality – 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.”

**Santa Clara County v Southern Pac.R. Co.**<sup>5</sup>

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.

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 their founders, investors, directors and managers, has become a standard element of incorporation. In the United Kingdom, 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 v Salomon & Co**<sup>6</sup> 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 and 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. 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.”<sup>7</sup> 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”<sup>8</sup>.



## ... without responsibilities

Even if the ruling in **Salomon v Salomon & Co**<sup>9</sup> made legal history for firmly establishing the principle of the “corporate person” as an independent legal entity in the United Kingdom, the importance of the case derives from another attribute of separate legal personality – limited liability. It is one thing to separate the legal existence of a body corporate from the physical existence of individuals. It is quite another 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 the 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.”<sup>10</sup> (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 nineteenth 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).

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

## 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. | <p>If you come to grief and creditors are craving.<br/>         (For nothing that is planned by mortal head<br/>         Is certain in this Vale of Sorrow – saving<br/>         That one's Liability is Limited) –<br/>         Do you suppose that signifies perdition?<br/>         If so you're but a monetary dunce –<br/>         You merely file a Winding-Up Petition,<br/>         And start another Company at once!<br/>         Though a Rothschild you may be<br/>         In your own capacity,<br/>         As a Company you've come to utter sorrow –<br/>         But the Liquidators say,<br/>         "Never mind – you needn't pay,"<br/>         So you start another Company tomorrow!</p> |
| Chorus.   | <p>But the Liquidators say,<br/>         "Never mind – you needn't pay,"<br/>         So you start another Company tomorrow! [...]</p>   |
| King.     | <p>Well, at first sight it strikes us as dishonest,<br/>         But if it's good enough for virtuous England –<br/>         The first commercial country in the world –<br/>         It's good enough for us.</p>   |

registered companies to publicise their members<sup>11</sup>. 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 v Salomon & Co**<sup>12</sup> ruling referred.

In 1866, a financial crisis hit London the seriousness of which was largely attributed to the mushrooming of limited liability companies after 1862. This led to the establishment in 1867 of a Select Committee of the House Commons to investigate the impact of limited liability. 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* 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 Liability Companies*." (30 October 1869)<sup>13</sup>

Perhaps in part because of this experience, only around 10 per cent of important British firms had taken advantage of incorporation with limited liability by 1885<sup>14</sup>, and by 1900 fewer than 100,000 UK Ltd companies had been formed. By contrast, the twentieth century saw a proliferation of limited liability companies, in particular since the 1980s, with now more than two million such companies registered at Companies House in Cardiff<sup>15</sup>. 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 amid 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 twentieth 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 United States, 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<sup>16</sup>, 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<sup>17</sup> argues that this deviation from the norm in the United States 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.

A law imposed in six US states at different points in time and surviving to this day in New York and Wisconsin, imposes shareholder liability for unpaid wages<sup>18</sup>. 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

## **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

**1855–1858:** 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 United Kingdom 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 US 394: US corporations elevated to persons under the law with the same rights as human beings

**1897: Salomon v Salomon** (1897) AC 22 (HL): “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, and France in the first half of the twentieth century

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

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”<sup>19</sup>.

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 nineteenth century when industrialisation had long been under way. *The Economist’s* leader for its

Millennium issue said: “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.”<sup>20</sup> This is a fact-free statement used to legitimise 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”<sup>21</sup>. 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’.”<sup>22</sup> 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 argues in great and fascinating detail for the emergence of the doctrine of the corporation as a natural entity in the United States, 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”<sup>23</sup>. The winners – from large US railroad companies to Mr Salomon – scored 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 nineteenth 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 Parexel

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 Ingelheim GmbH for Germany-based TeGenero to treat leukaemia 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 quantities. The Medical and Healthcare Products Regulatory Agency (MHRA) also criticised Parexel 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. Had they 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.

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

# three reasons why unequal protection through limited liability is harmful

### 1. 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*<sup>24</sup>. 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.”<sup>25</sup>

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 United States Supreme Court in **First National Bank of Boston v Bellotti**<sup>26</sup> 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 in the Supreme Court some 30 years earlier in **Kovaks v Cooper**<sup>27</sup>, namely that the right to free speech does not include the right to “drown out” someone else’s speech. No one doubts that, today, corporate wealth and influence very much “drowns out” the voice of ordinary persons<sup>28</sup>. 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, at para 10: 267)*

## 2. 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 United Kingdom and the United States, 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 per cent in 1960-1980 to 2.9 per cent in 1980-2000<sup>29</sup> and a slow-down of the growth of labour productivity from an annual 2.5 per cent to 0.8

per cent for the same periods, respectively<sup>30</sup>. 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 per cent in 1960-1980 to 2.9 per cent in 1980-2000 (World Economic Indicators 2005)

- **A reduction of the growth rates of labour productivity** from 2.5 per cent to 0.8 per cent 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 in 1870 to 51.6 in 1985 (Pritchard 1995).
- **A sharp increase in the ratio of the richest 10 per cent over the poorest 10 per cent 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 per cent richest US citizens received 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:** Value of world trade increases by \$3,000 billion and value of the gross international banking sector increases by \$7,000 billion
  - **1973–1995:** Foreign exchange trading rises from between \$10–20 billion per day to \$1,260 billion/day (\$80 billion in 1980); the 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 per cent of US GDP to 135 per cent (9 per cent in 1980); cross-border security transactions in the United Kingdom rise from almost nothing to more than 1000 per cent of GDP.
  - **1985–1995:** Foreign equity ownership (“capitalisation”) in “emerging markets” rises from near to nothing to 13 per cent 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 shares 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.”<sup>31</sup> (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 world 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 corpo-

rate fraud through limited liability. Since the 1990s corporate scandals have hardly left the headlines, from the United Kingdom 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 nations' 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**<sup>32</sup>. The case saw the most detailed judicial review of this aspect of company law ever undertaken in the United Kingdom. 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 judgment. 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."<sup>33</sup>

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 United States<sup>34</sup>.



The Organisation for Economic Co-operation 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.”<sup>35</sup>

*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 directors’ 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 include 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.<sup>†</sup>

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 insolvent or shut down while the shareholders are long gone.

Companies have additional structures to protect themselves even

† But see Wedderburn (2004) for an excellent critique of the development of the 2006 UK Companies Act, in particular, its ultimate failure to establish effective means to control the new “global” elite of corporate governors.

further. This is through the creation of subsidiary companies. The parent company protects itself by becoming a shareholder in a subsidiary company. In this case the subsidiary may be sued but its parent company cannot because it is the shareholder. Its role as a shareholder allows it immunity from the consequences of any action it controls. 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 hide 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. (Muchlinski 2007, second Edition, ch. 8).

**Bhopal**, where an industrial accident killed many thousands by a cloud of toxic gas, 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. 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 (see SustainAbility 2005).

In most other cases, the corporate veil has not even been pierced: for example, **Nestlé, the Royal Dutch/Shell Group, Halliburton, 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

[www.corporatewatch.org.uk](http://www.corporatewatch.org.uk)

[www.business-humanrights.org/Categories/Individualcompanies](http://www.business-humanrights.org/Categories/Individualcompanies)

## **3. 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, while 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 in savings.

Farepak was owned by European Home Retail (EHR), formerly Kleeneze plc, a seemingly reputable and successful company that made £6 million in profits in 2005. But EHR had used the savings paid into Farepak as a “piggybank” for the acquisition of book sales 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 7 November 2006)

([www.thisismoney.co.uk](http://www.thisismoney.co.uk) 10 November 2006)

(Sunday 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 United States, 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.*"<sup>36</sup> (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<sup>37</sup>, not only are they the exception rather than the rule, but even this limitation of limited liability does nothing for those who lose 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 per cent 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 the 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 decision makers, but by the employees.

(BBC News report, 15 February 2007

<http://news.bbc.co.uk/1/hi/business/6364673.stm>)

Another example, from the more traditional manufacturing world of work, of the harsh and illegal treatment meted out to employees by the owners of companies with limited liability, is Friction Dynamics Ltd in Caernarvon, Wales. Following an increasingly bitter industrial dispute in 2001 over deteriorating working conditions and attempts by the US owner, Craig Smith, to break existing agreements with the previous owner of the factory, the striking workforce was locked out. They were replaced by 50 temporary staff, and 87 workers, Transport and General Workers Union members were sacked for refusing to accept the steep deterioration of the working conditions and a 15 per cent pay cut. They eventually won claims at an employment tribunal for unfair dismissal and were granted compensation. The response by the factory owner highlights the pitfalls of limited liability and its abuse, in perfectly legal ways, very clearly: Friction Dynamics Ltd went into receivership in August 2003, with the remaining 93 workers sacked, only to reopen as Friction Dynamex shortly afterwards. Craig Smith continued to own the new site, receiving £25,000 a month in rent from the new company. At least some of

the new company's assets were bought by companies connected with his family. In addition, the old company had received a £1 million Government grant in 1999, presumably to safeguard jobs. The affected workers asked the Welsh Government to investigate what happened to the grant, but none of it was ever recovered or even reclaimed.

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 indirectly through their pension schemes or through investment companies that manage the money of small investors. There is no doubt that this has benefited many millions of people. However, even in the United States only a 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 in a Florida prison serving a 6½-year sentence having been convicted of obstructing justice and three separate counts of mail fraud relating to the diversion of millions of dollars in non-compete payments from the sale of Hollinger newspapers – made clear: even larger shareholders' concerns over boardroom excesses (in this case the investment firm Tweedy Brown) are dismissed as "sanctimony" and "hysteria"<sup>38</sup>, not to mention the concerns of small shareholders.

It would be simple, if necessary, to make a cut-off point for liability for small shareholders – just so long as that did not provide a loophole for large institutional investors. Options requiring further study include owners exercising a controlling interest and a standard percentage of the whole company. 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 of New York University in 1989, 10 per cent of US families owned 89 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<sup>39</sup>.

These US families were classified into wealth class by Wolff on the basis of their net worth. In the top 1 per cent of the wealth

distribution (the “Super Rich”) were families with a net worth of \$2.35 million or more in 1989; in the next 9 per cent (the “Rich”) were families with a net worth greater than or equal to \$346,400 but less than \$2.35 million; in the bottom 90 per cent (“Everybody Else”) were 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% <sup>40</sup> |

Supporters of mass shareholding often make exaggerated claims, which 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 than their initial small number of shares and the cost of providing them with information was very uneconom-ic for the privatised companies. During the stock market boom of the 1990s, conservative politicians in the United States and Britain began to campaign to privatise social security holdings. This would have meant that this money was no longer held by a cen-tral government bank but could be invested in companies. This idea was becoming fashionable until there was a sudden dramati-c fall in the stock market, after which little more was heard of it.

A more recent development, at least in the Anglo-Saxon econo-mies, is the concerted efforts by some trade unions to promote worker ownership of company shares in the interest of promot-ing socially responsible company behaviour. This differs from the above broad initiatives to promote mass ownership of shares insofar as there is a clear social motivation as well as organisation behind the acquisition of share ownerships. Yet, much as this move is to be welcomed and might, in time, produce results, to be successful it requires a questioning of the separation of (man-agement) control from ownership and a re-definition of the legal concepts of an “enterprise” with a view to moving away from an outdated legal and policy view of enterprises as separate legal entities (or even “persons”) with limited liabilities, and toward an

understanding of enterprises as groups of corporations and organisations with centralised control mechanisms and integrated business interests that, for this reason, are answerable to society as a whole. Put differently, worker ownership of shares by itself does not change the fact that owners of shares are insulated from the day-to-day decisions of management and their consequences for society as a whole. This said, if taken to higher levels of organisation and socio-political articulation, worker-ownership of shares might well turn out to be a valuable tool for achieving a reform of limited liability as it stands.

Currently, and despite its many drawbacks, legislation to extend limited liability is 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) internationally (see Box 12). The latter have been at the heart of recent corporate fraud, most notably as the business form chosen by Arthur Andersen and other accounting firms implicated in the Enron fiasco to shield its partners from liability (Mattera 2002). A similar hybrid company form in the United States – CLLs (see Box 12) – has become particularly popular in the energy and nuclear industry. A report prepared for Synapse Energy Economics by STAR Foundation Riverkeepers from August 2002 finds in relation to the United States:

“Over the last 10 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 utilised 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 fail-



ure, 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.”<sup>41</sup> (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 minimum capital requirements or other trade name regulations. (<http://jetro.go.jp/uae/topics/2006021808-topics>)

**Germany (June 2008):** New limited liability company law. “Law for the Modernisation of the German Limited Liability Company and the Prevention of Misuse” expected to come into force in October 2008 facilitates the formation of GmbHs by reducing the statutory minimum capital (only €5,000 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](http://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 United States, 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 double 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. Good corporate governance means companies being transparent about their social and environmental impact, responsible for managing this and minimising harm caused to workers, local communities and environment, and accountable to those harmed by corporate behaviour. 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. The Companies Act promotes this by making directors more accountable: they must have regard to the environment, employees, suppliers, the community and others. It also requires more transparency with certain companies mandated annually to report financially their social and environmental impacts. 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 cause, but is 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 Libertarian Manifesto*, Murray N Rothbard – perhaps the most eminent of libertarians, 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”<sup>42</sup>. 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 – 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, or fully reimburse the participants in the scheme. Scrooge would perforce have a change of heart. The Grinch would not have stolen Christmas.

Therefore, in our view, limited liability, as it stands for large shareholder corporations, must go, without any doubt. It does not follow, though, that the proposal for replacing limited liability with full liability for everyone restores the equality of all before the law. It does not, so long as there aren’t equal opportunities for everyone. Libertarians *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 by joining a private pension fund rather than to rely on a state pension, 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* exclaimed in October 1867:

“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.”<sup>43</sup>

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 the 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 bring destruction onto themselves and 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 limitations for *those in control of actions to further their own economic interests* on their liability for damages towards others. It is in this sense that limited liability must go.

The same reasoning applies to the immunities, regulations and rights granted to trade unions, corporations, mutuals and organisations with an explicit and exclusively social purpose in the course of history. As mentioned briefly in the introduction, the immunities and rights granted to this kind of organisation always have been more limited than those of large shareholder companies that can choose to incorporate in virtually regulation-free jurisdictions. As, for example, the case of the 1986 amendment of the German Arbeitsförderungsgesetz (Law for the Promotion of

Employment) shows, limitations of the liabilities of social organisations have also been abolished or restricted with great ease and harshness, while those of large shareholder corporations have been extended, for example to commercial partnerships (see Box 12). Most importantly, however, the regulations governing employment relations, workers' and also consumer rights have been an integral part of society's attempts to impose some kind of social control on the actions of large corporations, precisely in the implicit recognition of their otherwise unfettered powers, far beyond those of the majority of the populations whose lives they regularly and profoundly affect.

## 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 1 per cent of the shares and be responsible for 1 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 for large listed companies (and now partnerships) 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. This line of argument would, for example, reinforce current attempts by trade unions in the United Kingdom and elsewhere in Europe to at least restore the full meaning of rights and regulations, including the right to strike without a crippling liability for damages, in the United Kingdom granted a century ago and undermined ever since. 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 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 £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. In the current grave international financial and banking crisis and in the aftermath of the vast liabilities of enterprises that taxpayers are having to take on (about which they knew nothing) – of which Northern Rock is a prime example – it may be possible to convince taxpayers to adopt an insurance system for liabilities. Taxpayers will prefer to pay up for this societal assessment exercise and to abolish the current system of limited liability 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 tax-

payer 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 relation to attempts at privatisation. For example, opponents of privatisation may wish to insist that any new company accepts 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 following attempts to raise the problem of limited liability in a single country. As seen, for example, the early spread of limited liability in the United States in the nineteenth 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 World 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 US states to forego this privilege when operating in the Sunshine State with no noticeable adverse effect on the state’s development.

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 and incorporated into the UK Companies Act 2006 – would not be mere appeals to the goodwill of companies to abide by them, but

could instead become legal standards. To quote but one of these guidelines, the OECD 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.<sup>44</sup>

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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Ex employees from Dexion hold a naked protest about their robbed pensions outside the Labour Party Conference, Bournemouth 2007.

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The Institute of Employment Rights was launched on 28th February 1989 and was granted charitable status in 1994. As a labour law “think tank”, supported by the trade union movement, our purpose is to provide research, ideas and detailed argument on all aspects of employment law. As a charity, however, we are not a campaigning organisation.

The Institute has attracted wide and distinguished support creating a unique network of lawyers, academics and trade unionists. Among the membership are John Hendy QC, Professor Keith Ewing, Professor Aileen McColgan, Professor Brian Bercusson and the general secretaries of Britain’s largest trade unions.

The results of our work are published in papers and booklets. We also provide short articles, free of legal jargon, for trade union journals and other publications. Dissemination of our ideas is increasingly achieved through seminars and conferences as well as our educational courses.

The Institute does not assume that legal measures can offer ultimate solutions for political, economic and social problems. However, we recognise that law has a part to play in influencing the employment relationship, both individually and collectively.

Our funding is from various sources, including subscriptions, which entitle subscribers to a copy of all our new publications and reductions in conference fees.

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