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P A P E R S

towards a biblical mind

Risk, reward and responsibility: limited liability and company reform

by Michael Schluter

The modern world is built on two centuries of industrialisation. Much of that was built by equity finance which is built on limited liability.

The Economist, 31 December 1999

The consequences of the Companies Act 1862 completed the divorce between the Christian conscience and the economic practice of everyday life. Legally speaking it paganised the financial and commercial community. Henceforward an astute man by adherence to legal rules which had nothing to do with morality could grow rich by virtue of shuffling off his most elementary obligations to his fellows.

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Summary

Limited liability is contrary to biblical teaching because, exceptionally in the law of contract, it allows that certain debts may be left unpaid. As a result shareholders, who retain rights of ownership, are excused responsibilities of ownership, while directors bear some of the responsibilities of ownership, and share some of the rewards, but carry few of the risks. This flaw at the heart of corporate structure leads to problems in corporate governance, absence of corporate social accountability, and an unhealthy trend towards corporate giantism. Solutions lie, it is argued, in policies that restore shareholder liability, and incentives for business not to incorporate.

Introduction

Limited liability generally results in anger and a deep sense of injustice when companies 'go under'. In March this year, Uno, the parent company of World of Leather, became insolvent. People who had paid £1,500 for a new sofa were unlikely to get anything back, even if they could see the sofa they paid for in the showroom window. Many have been left stranded when their travel firms suddenly halted activities. In 1991, Robert Maxwell's empire collapsed, leaving tens of thousands without pensions. In 1993, Queens Moathouse Hotels became insolvent, leaving debts of over £1 billion. Yet in all these cases, due to legislation permitting limited liability, nobody had responsibility to pay outstanding debts after company assets had been sold and distributed.

There are more subtle problems associated with limited liability. In March this year, Barclays Bank closed 170 rural branches, leading to hardship for many rural customers as other banks had already left. Press reports suggested that the annual savings to the bank, reputedly £10 million, were possibly equivalent to the Chief Executive's annual salary package.² Who was responsible for imposing the hardship? Many blamed the directors. But directors are required to maximise returns to shareholders or risk losing their jobs. Arguably, it is anonymous shareholders who should accept responsibility.

There is a third issue. In April 2000, Vodafone bought Mannesmann, creating a corporate giant with assets valued at £235 billion. Microsoft had an asset value greater than the whole New Zealand economy or Canadian stock market. Such huge corporate size carries many dangers. Governments can be manipulated by corporates which can transfer production, and hence jobs, to other countries if they dislike the regulatory framework. Corporates owning media networks can undermine support for parties or candidates before elections if they do not get their way. There are many reasons for huge corporate scale today, but it is limited liability which has made it possible.

¹ Sir Arthur Bryant, *The Search for Justice, A History of Britain and the British People*, vol. 3, republished Collins, 1990, p177.

² *The Guardian*, 8 April 2000; *The Times*, 10 April 2000.

What is limited liability? How does it work?

Limited liability is the principle by which, in a situation of insolvency, shareholders cannot be made personally liable for any of the debts of the company beyond the amount of money they have already paid (or agreed to pay) for the shareholding. This does not mean that a company is not liable to pay its debts in full. It is liable to do so, like any other 'person', and if it fails to do so, it has to be 'wound up', which is the equivalent of personal bankruptcy. However, in such a situation, those to whom the company still owes money cannot sue the shareholders for any outstanding debts. The shareholders have the rights of ownership of the company – for example they can sell the company to another owner if they choose to. But they do not have the responsibilities that normally go with ownership, including payment of debts incurred by their enterprise in case of insolvency, or a duty to compensate communities for decisions adversely affecting them.

Before the legal changes of the mid-nineteenth century, larger business in Britain was organised in two main forms, incorporated and unincorporated. Companies could be incorporated either by royal prerogative or by Act of Parliament. Incorporation meant a company was given a legal personality quite separate from its members; generally members were not liable for corporation debts. The unincorporated sector included partnerships and what we call today 'sole traders'. In these cases partners were generally 'jointly and severally' liable for the debts of the enterprise, i.e. each partner could be sued for the entire debt in case of insolvency.

If investors were unable to obtain incorporation from King or Parliament, which was usually an expensive and lengthy process, they could seek to reduce risks through insurance (passing risk on to others at a price), or by establishing a portfolio of investments (reducing the risk of losing all in a single venture). However, neither reduced the risk comprehensively. Making limited liability available to investors almost as a right originated in New York State, which passed a law in 1811 limiting the liability of shareholders in the event of company insolvency to the amount the shareholder had paid to buy the shares. As a result, capital flooded into the state so that other states quickly followed suit.

In British company law, from 1844 companies could incorporate following new legal procedures open to all. However, this form of incorporation did not provide protection for shareholders, for the corporation could sue its members to pay its debts. In 1855 further legislation introduced limited liability for shareholders. A legal ruling in 1897 confirmed the principle that a corporation is something different from its members.³ If the company ceased to be able to pay its debts, shareholders were not obliged to meet those debts; in fact, no one had that responsibility.

Sir John Hicks has summarised the extraordinary situation created for shareholders by the 1855 Act: 'The shareholder in a company with limited liability is an anomalous animal. He has the rights of ownership, without responsibilities of ownership. His admission was a major departure from the age-old principles of property and contract on which the growth of trade and industry, up to the time of his appearance, had depended'.⁴ The legal structure was now in place to make possible the modern corporation with anonymous shareholders and global reach.

Apparent advantages of limited liability

The prevalence of limited liability companies suggests that they bring important economic advantages. They are said to contribute both to the rate of economic growth, and to equitable distribution of the benefits of that growth, for several reasons.

First, limited liability encourages owners of capital to buy shares as it reduces risk in case of corporate default. This is thought to lead to increased capital supply, thus making it easier for companies to generate wealth and employment. It also shifts resources away from interest-bearing instruments (i.e. loans) into equities where risk is

shared more fairly between capital provider and user. This gives a further boost to enterprise.

Second, limited liability is said to ensure capital goes to those who will use it most efficiently as it makes 'capital markets' possible. Without limited liability investors would need much more information, such as the identity and wealth of other shareholders, to assess who would be sued in case of company insolvency. Limited liability reduces and standardises the risk faced by each investor for each share. So, it makes it less necessary for investors to monitor each company in which they hold shares, enabling them to reduce risk further by holding a wider portfolio of shares.

Third, received wisdom is that economies of scale are a major factor in economic progress; if true, then limited liability has made much of our economic progress possible. Those holding this position point to mass air-travel, low-cost international communication, development of major drugs, and transfer of technology and skills to low-income countries. Mega-corporations arguably have contributed to cheap food, major infrastructure development and better health. The power and productivity of the mega-corporation are directly attributable to the provision of limited liability. M M Butler, President of Columbia University, concluded in 1911, 'the limited liability corporation is the single greatest discovery of modern times ... even steam and electricity are far less important ...'.⁵

Fourth, limited liability is said to spread wealth more widely in society. Today in Britain over 11 million individuals own shares, i.e. over 25 per cent of the adult population. Where companies have operated without limited liability, wealth has become highly concentrated, as can be seen historically in both Chinese and Jewish families. The broad distribution typical of Western societies in the last 150 years, it is argued, can be attributed in significant part to the impact of limited liability. A much larger number of people now own shares indirectly through pension funds and so also become beneficiaries of the growth of share values and earnings.

The case against limited liability: 6 biblical principles

As argued elsewhere, Christianity is a relational religion.⁶ Christian understanding of reality is relational in the sense that ultimate truth derives from a trinity of persons in eternal and personal relationship. Christian ethics is rooted in the quality of relationships.⁷ The purpose of the cross was to restore the broken relationship between God and humanity.⁸ The purpose of our lives as Christians, now and in eternity, is a deepening relationship with God, that we may 'know him'.⁹ Christian maturity is defined in terms of capacity to 'love', a category of relationship.¹⁰

The primary role of biblical law is to define right relationships, for which the biblical term is 'righteousness'. This refers not just to defining what is right at the level of interpersonal words or actions, but includes defining the institutional context most likely to be conducive to right relationships. Israel's law is a God-given case-study of how a 'relational society' should be organised in a specific socio-economic and historical context.¹¹ This includes principles governing use of capital, handling of debt and limitations on liability as discussed below. It assumes that the principles governing relationships in the political, economic and social order do not change as technology becomes more sophisticated, industrialisation develops and capital accumulates. The Israelite economy may have been 'simple' in technological terms but was nevertheless sophisticated in relational terms.

Within the context of this biblical social paradigm, it is possible to distil out six specific principles to govern business organisation, which raise questions around limited liability:

5 Cited in Aubrey L Diamond, 'Corporate Personality and Limited Liability', in ed. Tony Ohnial, *ibid*, p42.

6 See Michael Schluter, 'Relationism', in Michael Schluter et al, *Christianity in a Changing World*, London: HarperCollins, March 2000.

7 Matthew 22:34-40.

8 2 Corinthians 5:18.

9 Ephesians 1:17, Philippians 3:8, John 17:3.

10 2 Peter 1:5-7.

11 Michael Schluter, *ibid*.

3 *Salomon v Salomon & Co* (1897).

4 Sir John Hicks, 'Limited Liability: the Pros and Cons', in ed. Tony Ohnial, *Limited Liability and the Corporation*, London: Croom Helm, 1982, p11.

(i) All debts must be paid

In biblical law debts must be paid. This is implicit in the discussion around all forms of contract, and is also stated explicitly, 'The wicked borrow and do not repay, but the righteous give generously' (Psalm 37:21). If a person cannot pay their debts, that person is to work to pay off their debt as a bonded labourer. There is provision for the creditor to 'forgive' the debt of the borrower, both as a personal act of mercy and as part of the seventh year of debt release.¹² However, under these provisions, the lender would have known beforehand about the universal application of debt forgiveness, and the timing was certain, so that it could have been taken into account fully when making the lending decision.

The cardinal importance attached to meeting debt obligations is illustrated by the way Jesus and the apostles use debt as a picture of sin.¹³ If debts did not need to be paid, if the matter was inconsequential, use of debt as an analogy for sin would have been inappropriate. Sin certainly has to be atoned for; otherwise Jesus would not have needed to die.

There is some provision for limited liability in biblical law. If an individual Israelite could not pay his debts, his freehold land could not be sold in perpetuity, but only leased until the next Jubilee year.¹⁴ Also, items such as a person's cloak, required for basic needs, and millstones as a necessity for making a livelihood, were protected from creditors.¹⁵ If a person was sold into bonded labour, the period of such labour was limited.¹⁶ Nevertheless, the consequences of insolvency for an Israelite would have been severe, so he would have been likely to seek wider support from relatives or friends before undertaking high-risk enterprise.

(ii) Ownership involves responsibilities as well as rights

God gives control of the created order to human beings,¹⁷ but that control involves responsibility. The created order is not given to humankind to exploit, but to steward. The principle of responsibility, and accountability to God and neighbour, characterises all biblical discussion of ownership.¹⁸

So in the context of business the owners of capital receive their reward for accepting both risk and responsibility for its use. This is clear in the parable of the talents where the antithesis of accepting risk and responsibility is described as putting money in a bank and getting interest, which is 'reaping where you haven't sown'.¹⁹ It is the absence of risk and responsibility involved in lending at interest which seems to lie behind its biblical ban.^{20,21} In a modern economy, taking equity in a blue-chip company is similar to making a loan; dividends are similar to interest, involving little risk and no responsibility.

(iii) Employees and other stakeholders do not have a right to share profits

Because every person is made in God's image, with intrinsic worth as well as with gifts and creativity, and with decision-making capabilities, as far as possible all should have the opportunity to influence the organisations where they work. However, it is legitimate to employ labour on a wage (i.e. fixed-rate, not profit-related) basis, that is, labour does not have a right to share in the profits because it does not bear the risks or the responsibilities of ownership. These assumptions underpin the parable of the workers in the vineyard²² and lie behind many Old and New Testament commands to treat workers fairly.²³ Labour is protected from various unjust practices, including seven-day-a-week working and delayed payment of wages.²⁴

This is not to minimise the importance of involving employees in decisions, nor efforts to give workers a share of profits. However, employees are often not in a position to bear risks or responsibilities as they depend on their wages to meet basic needs. Other stakeholders such as customers and suppliers must also be treated fairly, so that there is a biblical emphasis, for example, on honest weights and measures.²⁵ So biblical norms are not violated in a company structure that gives residual profits to shareholders, provided workers and other stakeholders have been treated fairly and with respect.

(iv) Economic power should be diffused as widely as possible

Due to human sinfulness, the biblical paradigm establishes a political and economic system where power is widely diffused. The Jubilee laws on land, for example, would have kept land ownership widely dispersed; it would have been impossible for a wealthy individual to accumulate large land-holdings in Israel if this law had been observed.²⁶ The laws governing kingship equally were designed to discourage centralisation of political power in Israel.²⁷ This principle is widely accepted today in the political sphere. Democratic systems of government, separation of powers and the provision of a Bill of Rights are all safeguards against concentration of political power. However, there is no equivalent concern regarding concentration of economic power, although current trends towards corporate giantism clearly violate this principle.

(v) Social and economic life should centre on the extended family

In biblical law, the extended family is the cornerstone of social relationships. It is given extensive political, judicial, military, financial and welfare responsibilities.²⁸ Relatives and neighbours had a responsibility to prevent the physical proximity of the extended family from being disturbed.²⁹ Any economic or financial institution that undermines relationships in the extended family should be called into question.

From the Jubilee land laws, the biblical ideal for business organisation seems to lie in the business (farm) owned, managed and worked by the extended family, where every person lives 'under their own vine and fig tree'.³⁰ This ensures a coincidence in the interests of owners, managers and employees, and maximises opportunities for creativity and participation. It also avoids undesirable ethical consequences arising from concentration of power, and maximises commonality of interests among those involved.

Arguably, the larger companies become, the greater the likelihood that they will act against the interests of extended families and local communities, because the linkage between those controlling the company and those working at the grassroots is attenuated. Hence, lack of personal contact between distant decision-makers and employees may result in the requirement for mobility of labour from one region to another, closing of profitable production facilities to increase shareholder value, and demands for working hours which threaten the employees' capacity to meet family obligations.

(vi) Each person should be held as accountable as possible for their decisions

In biblical theology, while social influence over individual behaviour is acknowledged, each person is held accountable for their decisions. 'Legal personality' achieved through incorporation increases the potential for evil because it diminishes personal responsibility; a legal entity comes between the decision-maker and the other party. In biblical times, references to collectives such as cities or nations referred directly to their citizens, not to some artificial legal personality of that name. Some argue that incorporation is necessary to facilitate legal action. However, without incorporation it is generally still possible to sue partners as a group using the name

12 Deuteronomy 15:1-11.

13 Matthew 6:14-15, Matthew 18:21-34, Col 2:13-14.

14 Leviticus 25:8-17.

15 Deuteronomy 24:6, 12-13.

16 Leviticus 25:39-43.

17 Genesis 1:28-30.

18 For example, see Exodus 21:28-36; 22:5.

19 Matthew 25:14-30; Luke 19:11-27.

20 Deuteronomy 23:19-20.

21 Paul Mills, 'The Biblical Ban on Interest', in Michael Schluter et al, *ibid*, pp176-190.

22 Matthew 20:1-16.

23 Deuteronomy 24:14-15, cf James 5:1-6.

24 Exodus 20:8-11, Deuteronomy 24:14-15.

25 Deuteronomy 25:13-15; Proverbs 16:11.

26 Leviticus 25:8-28.

27 Deuteronomy 17:14-20, cf 1 Samuel ch 8.

28 See Michael Schluter and Roy Clements, *Reactivating the Extended Family: from biblical norms to public policy in Britain*, Cambridge: Jubilee Centre, 1986.

29 Leviticus 25:25, 35.

30 Micah 4:4.

of the partnership as a procedural shorthand. Only in cases of extremely large partnerships are proceedings likely to become so complex that incorporation becomes a significant advantage.

What conclusions for company structure? Our approach is to see biblical teaching not as defining how companies should be organised, but as marking out an area within which organisational structures can legitimately be defined. To take an analogy from cricket, the 'square' marks out an area within which the stumps can be placed anywhere.

Limited company structure, then, for many reasons falls outside the biblical markers. In contrast, there is nothing in the 'unlimited company' at variance with biblical teaching. Debts in case of insolvency have to be paid by the shareholders. They are the owners of the company and have ultimate responsibility for its decisions, although they may appoint managers to run the enterprise on their behalf. Similarly, partnerships lie within the markers set by biblical law. Of course there is still much room for evil, for example in poor treatment of employees or local communities.

Relational consequences of limited liability

A further way Christians will want to test the desirability of limited liability is through analysing its impact on relationships within and between companies, and in wider society for, as argued above, Christianity is a relational religion. This section will examine four key relationships, and reform options, from this perspective.

The basic corporate structure resulting from limited liability is the same across all OECD countries. However, there are some differences between the so-called Anglo-American model of corporate governance, which is characterised by a clear separation between shareholder ownership and management control, and the continental Europe and Japanese corporate forms which mitigate that separation through cross-shareholdings, cross-representation of directorates, large investor involvement in corporate decisions, and greater concentration of share ownership. The latter is said to have significant relational benefits as it leads to greater inter-firm co-operation and greater 'relationship investments' between companies and their employees, suppliers, investors and consumer groups.³¹ The counter-argument is that these relationships are often less transparent. For example, the 'bearer share' system in Germany makes separation between shareholder and management complete, and in France the Byzantine complexity of shareholding structures obscures shareholder responsibility. This paper will focus exclusively on the relationship implications of the Anglo-American model, although many of the observations apply, either wholly or to a diminished degree, in the so-called 'insider system' of continental Europe and Japan.

Director-creditor relationships in cases of company insolvency

Around 25,000 companies are declared bankrupt each year.³² Some are large corporates, such as QMH, BCCI, the Maxwell Group and Barings. Small or large, whether arising from fraud or mismanagement, these insolvencies should not be treated lightly. They impact on the lives of millions of people each year. Directors are often able to walk away scot-free while employees and other stakeholders, including many pensioners in the case of the Maxwell group, have to live with genuine economic hardship and a lasting sense of injustice. It feels different when it happens to you!

Because these companies were known to enjoy limited liability, should not suppliers, customers, employees, pension-holders and other 'victims' of company insolvency have realised the risks they were taking in dealing with them? Under the 1986 Insolvency Act the Court may hold directors responsible if 'at some time before the commencement of the winding up of the company that person knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation'.³³

However, in practice directors have to make difficult judgements: they cannot let their financial problems be known publicly until the latest possible moment for fear of inducing a crisis which might otherwise have been avoided. It is impossible for individuals or companies to obtain sufficient information on every company they deal with to decide whether it is at risk of becoming insolvent. Furthermore, those least informed are worst affected. In cases of insolvency, the Inland Revenue and secured creditors, which generally includes banks and other financial institutions, are paid first. Small businesses and consumers receive only what remains.

In many cases, whether or not there is evidence of fraud, bitterness characterises relationships between directors of insolvent companies and those with debts unpaid. In biblical law, as well as in 'natural justice', these creditors have a legitimate grievance. There is no easy way to restore these broken relationships.³⁴

Shareholder-creditor relationships in cases of company insolvency

No obvious relationship exists between shareholders and unpaid creditors. Indeed, creditors will probably not know the names of the shareholders. Any direct relationship is precluded by the position and role of the directors. However, shareholders surely should bear some responsibility for insolvency. They are in some sense the 'owners' of the company; at the very least they have important residual claimant rights over the assets, the takeover mechanism being the loudest statement of this reality.³⁵ They also bear some responsibility for the appointment of, or failure to dismiss, the directors under whom the company collapsed. However, at present there are no proposals to make shareholders accountable in any way for these unpaid debts.

Shareholder-director relationships

Under current company law, the shareholder-director relationship is seen as the archetypal problem of who should bear responsibility where a principal employs an agent. Directors are accountable to shareholders, but shareholders are not responsible for decisions of directors. The degree of responsibility of shareholders is partly determined by their rights, including the degree of control they have (see above), and partly by how much information they are given. Directors are only obliged to provide limited information on company performance to shareholders, in the form of accounts and associated information at the AGM. In addition, all recognised stock exchanges have minimum continuous disclosure rules requiring the board of directors to keep the market informed of events which may have a material effect on the price of company shares.

In practice, directors of larger companies are constrained in sharing information with larger shareholders by FSA listing rules which require that all shareholders are treated similarly. This means that the 'lowest common denominator' prevails; it is impractical and imprudent for a large company to make confidential information available to the smallest shareholder. Given that information available to shareholders is incomplete, it is difficult for shareholders to hold directors accountable for day-to-day decisions that may have huge social or environmental implications.

One extreme view of the position of directors is that as long as things are going well, they are in effect self-selecting, self-perpetuating, self-regulating oligarchies,³⁶ and take little account of shareholder interests. Board decisions cannot be challenged by anyone under their authority, and, depending on the company's sources of funds, the board may be under no obligation to consult, explain or seek consent anywhere but amongst themselves. As a result, shareholders are willing to allow the board secrecy of deliberation and decision-making, control of information and privileged access to it, and wide executive powers, as well as the power to delegate that

³³ Insolvency Act, 1986, S214, 2(b).

³⁴ The government is currently seeking to relax bankruptcy law still further to encourage risk-taking. The danger is that this will undermine further the seriousness with which these unpaid debts will be regarded.

³⁵ Cook and Deakin, *ibid*, p3.

³⁶ William J Reader in Orhnlial, *ibid*.

³¹ Jennifer Cook and Simon Deakin, *Stakeholding and Corporate Governance: Theory and Evidence of Economic Performance*, ESRC Centre for Business Research, University of Cambridge, July 1999.

³² HMSO, *Insolvency Service Annual Report*, 1998.

power to a small committee or individual. Shareholders have the ultimate sanction of removing the board or any member of it, but do not often exercise it.

The extreme view of the position of shareholders is that they own shares simply to make money and take little account of the concerns of directors or employees. In support, one might cite frequent short-termism (which makes long-term research and development investment by directors hazardous), takeovers motivated by asset-stripping, purely speculative trading of shares, and the preference of shareholders for selling shareholdings rather than using their 'voice' to support directors and employees in time of difficulty.

Lack of a long-term commitment of shareholders to the directors and other stakeholders, and the need for directors to deliver short-term profits to shareholders to keep their positions, results in negative consequences for relationships in wider society. Directors are unable to take a long-term view of business development, so long-term growth is often sacrificed for short-term profits. Also, pressure on directors to meet shareholder profit expectations results in accusations that directors take risks with passenger safety (Zeebrugge ferry disaster, Clapham rail crash), cause environmental damage (Exxon Valdez oil spill), allow excessive pressure on the family lives of employees (long and unsocial hours, mobility), and promote a selfish and materialistic culture (through advertising). Not all of this can be blamed on the problematic shareholder-director relationship resulting from limited liability, but the structure of the relationship, where neither shareholders nor directors carry ultimate responsibility, fails to provide an adequate framework of accountability.

Shareholder-employee relationships

Generally few shareholders have direct contact with employees. Employees have rights enshrined in legislation, and excellent employment conditions in many companies are a result not just of enlightened self-interest by the directors but of a wider humanitarian concern, with implicit endorsement from shareholders. However, the relational distance between shareholder and employee may result in shareholders buying or selling companies with scant regard for employee interests. Shareholders will sometimes sell a company, treating it simply as a block of assets, with no understanding of the human consequences involved in its disposal. Indeed, the rules of corporate governance often preclude them having the detailed information required to trigger a conscience response.

Not all takeovers are undesirable. Sometimes a management team adapts too slowly to rapid change, so radical surgery resulting from a takeover is the lesser of two evils for employees. However, takeovers can be motivated by desire to increase market power through removal of a competitor, to increase firm size in a relatively risk-free manner, or to exploit unused tax breaks. In Britain, employees are generally not consulted; their livelihoods are in effect auctioned like second-hand furniture. Hence the bitterness of employees of the Rover car plant at Longbridge against BMW, although in that case it is not clear whether it was the shareholders or management of BMW who made the decision to withdraw, and also whether the scale of BMW losses justified their decision.

The TUC's main response has been to promote works councils on the European model, so that employees have to be consulted, but progress is slow. Employers have promoted employee share ownership. There is evidence that this increases worker productivity and lowers absenteeism. Ten per cent of companies now have such schemes, but rarely is the employee proportion of shares large enough to influence significantly collective shareholder behaviour.

The question of scale

All the relational problems noted above are intrinsic to the nature of limited liability. They arise from the structure itself. However, all are magnified as companies get larger. Limited liability led to the development of the stock market which fostered anonymous shareholding; shareholders generally have little relationship with each

other except in their desire for profit. Limited liability has also facilitated corporate capital accumulation. The protection afforded by limited liability made shareholders more willing to allow increased borrowing, as they would not be exposed to repay the debt in case of default; this then leveraged up the scale of companies still further.

Larger companies are associated with greater relational problems, in part because to meet shareholder expectations they exploit the power imbalance in their relationships with smaller stakeholders. Also, large size impacts on relationships between management and employees. In the past there has been a direct correlation between plant size and number of days lost through industrial action. The greater number of levels of decision-making in large companies makes it harder for lower level groups to participate in decisions affecting their lives. Scale widens pay differentials to levels over 300:1 in some large companies, undermining relationships not only within the company but also in wider society. Directors can more easily demand unsocial hours from their staff if they have no personal contact with families of employees. Decisions affecting local production, including plant closure, are made in corporate headquarters far from the daily realities of the workforce. Larger companies are also more likely to demand mobility from their workforce.

The main policy route to mitigate negative effects of scale has been competition policy. In the 1998 UK Competition Act, fines have risen sharply for anti-competitive behaviour. However, it remains difficult to prove. Scale could be tackled more effectively in our view by graduated corporation tax on profits and by requiring companies to prove public benefit before permitting mergers and takeovers. However, at present few political leaders are prepared to address the relational consequences of non-accountable corporate power.

There are also initiatives to mitigate the impact of company activities on the physical and social environment. This is coming from the media, non-government organisations (NGOs) and investors. The main means of intervention are ethical investment instruments and pressure on companies to undertake social and environmental audits. Both are in their infancy, but both show some promise. However, achieving effective accountability by this means may well prove impossible due to problems of access to information, especially on large multinational corporations.

Reintegrating risk, reward and responsibility

It is not easy to see how to restrict limited liability in the short term. Current corporate ownership is a structure built up over 150 years on the foundation of limited liability. The problem is how to remove the foundation without the whole structure collapsing with enormous negative consequences.

The immediate problems in UK legislation seeking to remove, or even to restrict, limited liability of shareholders are threefold. First, shareholders may move their capital to some other jurisdiction where they can enjoy total limitation of liability. Second, the UK probably could not unilaterally change company law in a way which made it at root different from EU law. Third, shareholders could hide their identity behind some corporate identity registered elsewhere, making it difficult and time-consuming to trace them.

There would also be other significant problems to overcome if the limited liability provision were to be removed. Ways to provide financial support for small entrepreneurs, who are essential to economic growth, would need to be found. Many small companies have little limitation of liability in practice because directors have to give personal guarantees to banks to cover any possible future debts their company is unable to pay. But the threat of litigation from customers or suppliers, in a litigious culture such as ours, means limited liability still provides some comfort to smaller business. This remote risk could possibly be covered, although less reliably and more expensively, by insurance.

Also, some new means would need to be found to encourage investment by smaller investors. The risk of being held responsible for debts would be a significant disincentive to putting savings into

equities. They might opt for interest-bearing instruments (e.g. bonds), which would do nothing to increase investor/saver responsibility. Arguably, increasing investor responsibility through removal of limited liability would require simultaneous changes (legal and/or fiscal) to discourage a shift to interest-based forms of investment.

If it were possible to achieve international agreement to restrict limited liability, a first step might be to make shareholders liable for, say, ten per cent of the debts of the company in case of insolvency. This approach would require a further provision to ensure shareholders are only liable for their share of the debts, so that it would be the largest shareholders, rather than the wealthiest, who would be pursued in cases of insolvency, and shareholders would not need to know the wealth of all other shareholders to assess their exposure. Such a provision is not without precedent. As Lord Templeman observed in a different context, 'The history of the Companies Act illustrates the power of Parliament, if it please, to impose some liability on shareholders as a condition of the grant of incorporation'.³⁷

Even without international agreement, the UK could take steps to move away from the principle of limited liability. Company law could change the order of payment of creditors in case of insolvency. At present, the Inland Revenue is paid first, generally banks and other financial institutions next as they make such priority a condition of loans, and smaller creditors, including consumers, last. A reversal of this order would increase the incentives of both the Treasury and financial institutions to find ways to recover debts from insolvent companies, which would cause them to re-examine shareholder rights and responsibilities.

A further initiative might be to give a significant fiscal incentive to companies not to incorporate. For example, the UK could abolish corporation tax on unlimited companies, acknowledging moral questions around limited liability. This might persuade some companies to forego limited liability, especially perhaps smaller companies where shareholder-directors have had to give personal guarantees that have the effect of removing limited liability.

Another approach would be to seek to increase shareholder accountability, for example through a 'Shareholders' Responsibility Movement'. The aim would be to encourage shareholders to attend company AGMs, and pension policy fund holders to monitor and

evaluate investment decisions by fund managers. Already, from July 2000 pension funds have to disclose whether they have taken into account ethical concerns in investment decisions. Accountability could be further enhanced by requiring that the Financial Services Authority publish daily on the Internet the 100 largest shareholders for every listed company. Such a Movement would represent a step beyond ethical investment, as it would seek not just to direct the funds of major institutional investors away from specific uses such as tobacco or armaments, but to hold pension funds and other financial institutions accountable for the decisions of corporates where they hold shares.

Some might argue limited liability is so entrenched that it cannot be changed. This is reminiscent of arguments against abolishing slavery: 'Western wealth is built upon it'; 'it will harm the very people it is expected to benefit', etc. In practice slavery was dismantled in stages, over 30–40 years of campaigning. Of course, slavery was more emotive, a more obvious evil. However, if limiting liability of shareholders in situations of insolvency is morally wrong, and if limited liability leads inevitably to the negative consequences in company relationships and in wider society described here, it will be worth a long-term and sustained effort to modify it, and ultimately to remove it completely.

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37 International Tin Council Case [1990] 2AC 418, Lord Templeman at p479.