David Campbell, Lancaster University Law School

Stephen M Bainbridge and M Todd Henderson, *Limited Liability: A Legal and Economic Analysis*, Cheltenham, Edward Elgar, 2016, pp xvii, 315, hbk, isbn 978 1 78347 302 1, £90

This book attempts to justify the place limited liability enjoys as the most important doctrine of (to adopt the British usage) company law. The authors, two noted US contributors to the law and economics of company law, concentrate on the US law. But the book is by no means addressed only to specialists and it accessibly introduces that law – the foundations of which are the same as the UK law, from which, indeed, they are derived - to other than American readers. The book also accessibly puts the law in the context of the basic doctrine of limited liability (ch 1), the history (ch 2) and general justification of that doctrine (ch 3), its exceptions (chs 4-6), its related doctrines (chs 7-8), and the law of other jurisdictions (ch 9). Limited liability and its exceptions are then extensively evaluated from an ultimately Posnerian law and economics perspective. This book can readily be recommended to that part of the readership, including more advanced students, of this journal who have an interest in (US) company law or in law and economics as such. It is unfortunate, then, that one imagines the book will have few personal, rather than institutional, purchasers, as its hardback price is daunting even by contemporary standards.

I do not mean by these remarks to imply that this book dumbs down. It must be said that a history of limited liability, for example, which is of only 24 pages is bound to be in some respects superficial, and it was perhaps unwise to start this history so far back as with what Plutarch tells us of Numa Pompilius, who, succeeding Romulus, was the second King of Rome (p 21). But if one accepts that chapters like this and the one on comparative law were to be included, then what is said is similar to what is said of such things in well-regarded company law textbooks and perfectly defensible at their intended level. And when the book turns to the detailed law, it is not open to this sort of criticism. The criticism one is obliged to make is of a different sort.

The authors accept the principal justification long given for limited liability (14-15, 47-51, 302-304), though some questions which have been raised about this justification are, rather gesturally (pp 51-52), taken up. Given the scale and scope of the large companies which have become the principal institutions of capitalist growth, investment in those companies would place great risks on private investors if that investment meant that all of those investors’ personal assets could be used to satisfy claims on companies which had incurred liabilities greater than the company’s own assets. The members of an ordinary partnership are exposed to risk in this way (pp 14, 56-58). But incorporation creates the company as a legal person in itself, distinct from investors, and limited liability partitions the investors’ personal assets away from the company, shielding them from company liabilities. In the most important case, a shareholder’s liability is limited to its share capital. The claim that limited liability made capitalist growth possible by reducing investors’ risks and so encouraging investment by a wide public has been stated very boldly. The authors approvingly quote (p 2) one of the most famous such claims: limited liability is ‘the greatest single discovery of modern times’, more important than, say, electricity, because without limited liability sufficient private investment in electricity supply would not have been possible.

The authors claim, however, that this justification (and some less important ones (pp 46-47, 52-53)) do not provide a ‘complete theory of limited liability’. That theory is provided by regarding limited liability as ‘a majoritarian default rule’:

If corporate creditors and shareholders could costlessly bargain, we predict that limited liability would emerge as the majoritarian default rule; that is, the rule most parties would adopt most of the time. Because creditors and stockholders as a class obviously cannot bargain, however, society properly adopts limited liability as the governing legal rule (p 53).

The immediate losers from limited liability are, of course, those to whom the company incurs liabilities, for the very point of limited liability is to reduce the pool of assets from which those liabilities can be satisfied. The authors, however, postulate a number (pp 56-85) of ‘hypothetical bargain[s]’ (p 54) between those with (in some ways opposed) financial interests in the company and conclude that they would agree a default rule of limited liability.

The character of the hypothetical bargain approach is captured in the following examples. Limited liability works, as it were, in reverse. The investor’s personal assets are shielded from company liabilities, but equally the company’s assets are shielded from the investor’s personal liabilities (p 7), and this ‘entity shielding’ has the corollary that the investor *qua* investor is largely excluded from the management of the company, for management must be conducted in the interest of the company, not directly in the interest of a particular investment. The ‘separation of ownership and control’ is the central preoccupation of the company law of the ‘governance’ of the company, and it is by no means uniformly a positive thing. But the authors tell us that, ‘in a large public corporation … direct investor participation in firm decision making would result in chaos’ and so investors would agree to limited liability in order to make ‘the efficient centralised decision-making … that is the hallmark of modern corporations’, and from which investors overall benefit, possible (p 59). Even those the authors call ‘contract creditors of public corporations’ (p 56), such as trade creditors or debenture holders, would find that limited liability is to their advantage because, under limited liability, ‘the creditor only need concern itself with the creditworthiness of the debtor corporation’, whereas, with unlimited liability, ‘creditors would be obliged to assess and continually monitor the creditworthiness of all shareholders’, which would be ‘burdensome, if not prohibitively costly’ (p 64).

The downside to limited liability on which the authors concentrate (more or less to the exclusion of the others) is that, of its nature, it ‘externalises’ some costs of the company’s actions (p 2). Limited liability does not make liabilities which a company incurs in excess of its own assets disappear into thin air but, as the investors are shielded, those liabilities are borne by others. Trade creditors which supplied goods on credit and so lose goods and payment when a company defaults are the obvious example (but see p 81 n 120). The example which gives the authors most concern (pp 81-82), and in this I think they are representative of US company law academics, are tort creditors of judgement proof companies that have, say, negligently caused personal injury (pp 44, 81-85, 87-89). The bulk of the book (chs 4-6) is taken up with company law’s response to such externalised costs, ‘lifting’ or ‘piercing the corporate veil’, one of the effects of which can be to make those usually shielded by limited liability personally liable. (The authors also discuss ‘enterprise liability’, the other main form of piercing the veil (pp 191-99)). Particularly in the US, a great many complicated doctrines, the number of which is rather disproportionate to the overall efficacy of veil piercing, are gathered under this catholic collective noun. Having described these doctrines as clearly as the subject matter permits, the authors then evaluate them by asking whether they would have been hypothetically agreed, restating the case for outright abolishing veil piercing, which would ‘make limited liability essentially absolute’ (p 40 n 86), which Bainbridge has put forward in some noted journal articles. The authors are surely right to say that the law of veil piercing is overall incoherent – they compare it to a lightning strike rather than a stable electric current (303) – and the reforms in this book would strongly curtail it (18). This is in line with their very approving attitude towards limited liability but it also is a plausible response to the quality of the existing law.

The book is based on ‘contractarian theory’ (p 53). This in the first instance means the ‘agency theory’ or ‘nexus of contracts model’ of company law, in which ‘the corporation is regarded as a legal fiction representing the complex set of contractual relationships between many constituencies providing … inputs for the corporation’s productive processes’ (p 54). Readers of this journal unfamiliar with the literature will initially find it hard to grasp the agency theory. It substitutes for the actual contracts on which a company is based hypothetical contracts like the examples we have discussed. Shareholders, creditors and other parties never, of course, actually enter into these purely hypothetical contracts, but the agency theory has had the rhetorical effect of making it seem as if the company is the result of agreement and so of market ordering. That proceeding in this way does little or nothing to explain the actually existing corporation will impress itself on the readership of this journal, though it evidently is something which has not impressed itself on important strains of economics and law and economics scholarship. At least the central feature of the agency theory, which is to posit contracts between managers and shareholders by which the former, as agents, undertake to promote the interests of the latter, as principals, which contracts, if they actually existed, would constitute fundamental breaches of the real contracts between managers and their company, is not replicated by the authors (but see p 55 n 40). But the quality of fantasy about the contracts hypothetically postulated certainly is.

Behind the agency theory of the corporation lies the methodology of that form of law and economics which, though he was not an important contributor to company law, is rightly identified with Richard Posner, undoubtedly the most influential post–war legal theorist and jurist. Though in his early work Posner did promote the wider use of markets, overwhelmingly his most important idea, wealth maximisation, is itself a ‘hypothetical market’ alternative to actual market organisation, though this is very imperfectly understood. Wealth maximisation is the goal which is to be achieved through laws which have to be devised when the transaction costs of establishing actual markets are too great. Such a goal has an ‘economic’ quality which has led to the widespread belief that welfare maximising laws are ‘market mimicking’, but their very aim is to produce a non-market outcome.

Company law is, as I have said, a topic, one of the few in legal life, indeed in life generally, about which Posner has not said much. But the authors authentically articulate the wealth maximisation view of limited liability, though, unless my reading is faulty, that terminology, unlike the hypothetical bargain terminology, is not used. The typical result is that hypothetical speculation is substituted for consideration of (the possible creation of) actual markets. And this, one is obliged to say, is a grave mistake for a book on limited liability.

I have said that this book’s chapters on the basic doctrine of limited liability and its history are defensible in themselves. What is, however, questionable, is the way that, having, as it were, got these matters out of the way, the discussion of the detailed law brackets off these matters and proceeds more or less internally to the hypothetical bargain analysis. This is bound to mislead as it does not give proper emphasis to the central fact about the basic nature and history of limited liability, which is that it is not the product of any sort of bargain at all but is the result of arguably the most significant intervention by the state in the history of capitalism. In the UK, limited liability was created by a set of mid-Victorian companies Acts, prior to which the normal legal form of companies was, in the sense relevant to us, based on unlimited liability similar to liability in ordinary partnerships now. The joint stock company based on incorporation and limited liability was an exceptional form granted to, say, the great trading monopolies under a specific charter from the Crown. The companies Acts began the process by which incorporation and limited liability has become the norm for the large companies which now dominate what might therefore be called the corporate capitalist economy.

An adequately functioning market requires that the costs (including risks) of economic activity be taken into account just as much as potential gains. Rational economic calculation *is* the balancing of both. Personal liability is, *ceteris paribus*, essential for such calculation. The proposal of the companies Acts drew an aghast reaction from those committed to market order, who rightly saw that those Acts must undermine personal responsibility and therefore the rational balancing of costs and gains. Such views did not, of course, prevail against the views of those seeking to minimise the risks of investment, who were able to couple their wish to be insulated against responsibility to the powerful argument for accelerated growth. Limited liability not merely was not a feature of market order but constituted the abolition of a central aspect of that order by state intervention. Though the authors are, of course, perfectly well aware of the companies Acts (pp 27-31) and the comparable US law, and of the resistance to limited liability (pp 40-42), the fundamentally non-market nature of the large capitalist company does not emerge from their book. Indeed, in a way comparable to agency theory, the talk of hypothetical bargains seems to make that company a market form.

It is only natural to think, as the authors typically do (pp 56-66), that the alternative to limited liability is unlimited liability. But this is not, as a matter both of theory and history, the choice. For, if the default rule were one of unlimited liability, investors could contract out of the default rule and limit their personal liability. The period of the passage of the companies Acts was one of sophisticated experiment with mixtures of limited and unlimited liability forms. The transaction costs of such contracting are always positive and could be very great indeed. But it is quite wrong to dismiss the possibility of market order simply because the existence of transaction costs makes any possible market imperfect, though, incredibly really, this is the basis of Posner’s thought and is what the authors typically do (p 13). The actual reason investors do not contractually limit their liability is that *general* limited liability makes it unnecessary to do so, and the precise point about the companies Acts is, not that they created specific instances of limited liability, which was possible prior to them, but made limited liability the general default. For it has proven to be the case that bargaining away from limited liability is all but irrelevant to large companies (though it surely is highly theoretically significant that this is by no means the case for the small company even when incorporated (p 53)), and so we have the fundamentally non-market corporate capitalist economy, the central feature of which is that it socialises loss in order to maximise private gain (p 42).

Your reviewer believes that the possibility of abolishing general limited liability should be by far the most important issue in company law and, in a sense, in economic policy as a whole. Your reviewer accepts that the previous pace of capitalist growth would not have been possible without limited liability, but doubts whether a similar pace should now be maintained, and so regards the principal justification of limited liability as questionable in a way it previously has not been. The authors give the possibility of abolition very short shift indeed, rightly observing that its discussion has gone nowhere, certainly outside of the academy, and is going nowhere (p 42). Your reviewer believes that this is the case ultimately because of the exercise of corporate capitalist political power, but to say this is to go far, far beyond the purview of this book, to which such considerations are incidental (p 77 n 112).

The book shows, however, that one cost of not considering actual market order is that, even in the hands of leading contributors, discussion will be based on a fantasy about the market nature of corporate capitalism. It is perhaps significant that Adam Smith does not even have an entry in the index of the book under review. Smith published *The Wealth of Nations* some 70 years before the first of the major companies Acts and his ‘commercial society’ was one of unlimited liability. Though Smith, the most pragmatic of philosophers, conceded exceptional cases for joint stock companies, he viewed joint stock with extreme suspicion as necessarily destroying ‘that natural proportion … between judicious industry and profit … which, to the general industry of the country, is of all encouragements the greatest and most effectual’. It would seem he was wrong about this. The authors paint the commercial society of Smith’s time, not as the miracle of human improvement Smith (and even Marx and Engels) found it to be, but as part of the ‘poverty and disease [and] low … productivity and innovation’ which was humankind’s fate prior to the ‘modern corporation’ (p 1). What is one to say of this when one thinks of Smith’s pride in the, by historical standards, opulence of the ‘the accommodation of an … industrial and frugal peasant’ in commercial society, and in the production of wealth illustrated by the division of labour in a pin factory?

I believe that Smith would have so deplored corporate capitalism as not to regard it as a market economy at all. Even if I am right, this does not, of course, itself mean that economic policy should always adopt unlimited liability. It does mean, however, that a book on limited liability should stress that general limited liability ousts the market. Far from doing this, this book rhetorically creates the opposite impression. This shows just how little actual markets feature in the agency theory of the company and in Posnerian law and economics.