Limited Liability and Moral Hazard Implications – An Alternative Reading of the Financial Crisis.

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Abstract: The principle of limited liability is one of the defining characteristics of modern corporate capitalism. It is also, we argue in this paper, a powerful structural source of moral hazard. Engaging in a double conceptual genealogy, we investigate how the concepts of moral hazard and limited liability were created and diffused over time. We highlight two very similar but parallel paths of emergence, moral contestation and eventual institutionalization, and outline how the two notions have become connected through time, showing clear elective affinities between both concepts and their respective evolution. Going one step further, we suggest that both concepts have come to be connected through time. In the context of contemporary capitalism, limited liability has to be understood, we argue, as a powerful structural source of moral hazard. In conclusion, we propose that this structural link between limited liability and moral hazard is an important explanatory factor of the recent financial crisis and a seemingly intractable characteristic of modern corporate capitalism.

Keywords: *moral hazard, limited liability, financial crisis*

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Introduction

The financial crisis that disrupts our world since 2007 has generated heated debates as to its causes and origins (Mohan 2009, Bernanke 2010, Lounsbury and Hirsch 2010). One of the recurring themes, across ideological divides, has been the role of “moral hazard” (Moss 2004, Dowd 2009; Dow 2012a). “Moral hazard” refers to the opportunity for organizational and individual actors to reap rewards of risky behavior without bearing associated costs. This kind of opportunistic behaviour generates externalities both in terms of risks and costs – the privatization of benefits for some comes at the expense of others (Dow 2012b). The multiplicity of documented episodes of moral hazard-type situations, before and during the crisis, is certainly striking in itself. We suggest, in this article, that this multiplicity does not simply reflect inadequate individual moral standards (Dembe and Boden 2000). Nor does it correspond only to the contingencies of a particular period (Dowd 2009). We propose, instead, that it reveals a consequential structural characteristic of contemporary capitalism. Moral hazard is profoundly inscribed in modern capitalism, we argue, in particular through the widespread diffusion of the limited liability principle. Surprisingly, this potent source of moral hazard within contemporary capitalism is rarely recognized as such.

In order to show the consequential but neglected connection between limited liability and moral hazard, we engage in a double exercise in conceptual genealogy (Foucault 1984, Richter 1995, Palonen 2002). We start with a focus on “moral hazard”, showing the fluidity and plasticity of the concept through time. Then, we explore the concept and legal practice of limited liability, tracing in broad strokes here again an historically fluid notion. In the first section of this paper, we present the conceptual genealogy as a method, underscoring in parallel the epistemological perspective that grounds such a methodological choice. The second section of the paper engages with the concept of “moral hazard” and its evolution through time, particularly since the beginning of the nineteenth century. We show how the concept initially crystallized in the insurance domain and how, over time, it diffused to other fields – morphing

significantly in the process. We then investigate, in the third section of this paper, the path along which the concept of limited liability developed, particularly since the nineteenth century. In the process, limited liability went from being a rare privilege generating distrust to becoming the undisputed definition of responsibility in contemporary capitalism. In the discussion section, we draw parallels between those two genealogical exercises – showing clear elective affinities between both concepts and their respective evolution. Going one step further, we suggest that both concepts have come to be connected through time. In the context of contemporary capitalism, limited liability has to be understood, we argue, as a powerful structural source of moral hazard. In conclusion, we propose that this structural link between limited liability and moral hazard is an important explanatory factor of the recent financial crisis.

Conceptual Genealogy – Epistemology and Methods

Conceptual genealogy is a “history of interpretations, the history of words, ideals and metaphysical concepts” (Foucault 1984: 91-93). The epistemological conviction behind such an approach is not only that human activity is contextual and socially constructed but that activity, language as well as politics and values are co-constitutive and co-evolving. Knowledge is decidedly historical and anthropomorphic (Nietzsche 2006[1882]).

A naturalistic and a-historical use of concepts and notions places major limits on our understanding of social reality, with problems such as theoretical inadequacy, confusion in analysis, and dubious validity of the concepts used. A deeper understanding “presupposes knowledge about the alternative interpretations of concepts that the historical agents had in their hands” (Palonen 2002). Conceptual genealogy (or conceptual history as it is sometimes called) has been gaining ground in most social sciences over the last decade (Richter 1995; Hampsher-Monk et al. 1998; Skinner 2002; Koselleck 2002; Palonen 2002). This can be seen as a reaction to the dominance of normative and naturalistic approaches and methods so characteristic of the evolution of post-World War II social sciences in general.

Conceptual genealogy can be performed backward or forward. A backward approach would start from the current understanding and meaning of a concept to recover, step-by-step, older and more contextualized meanings. We adopt the more classical forward approach. We move from older, contextualized, meanings

towards the dominant contemporary ones and try to uncover, in the process, the key patterns, events and mechanisms that account for conceptual transformation. In the case of moral hazard we go back only to the 19th century even though we make brief references to some earlier developments. In the case of limited liability, we have to go back to Roman times in order to provide a mapping of conceptualizations and meanings at the origins of the concept (Farr 2004). In both cases, however, the 19th and 20th centuries represent the important period because the two concepts grow during that time in societal significance while going through consequential transformation.

Conceptual genealogy implies the use of historical analysis as a methodological tool. The empirical material is most of the time of a textual nature and includes both primary and secondary documents. Primary documents are all those texts produced in the period of a given conceptualization that have contributed in one way or another to shape and stabilize it – legal documents, encyclopedias and dictionaries, textbooks, pamphlets, scientific or technical “bibles” but also newspapers and various kinds of commentaries. Secondary documents are the work of later commentators – historians or other analysts who later on came to discuss and account for a given conceptualization and its context.

In each of our two cases, we identify and focus on key historical moments when meanings can be shown to change (Skinner 2002). Hence, we are not historically exhaustive but instead we select conceptual turning points as deserving more attention. Concretely, doing a conceptual genealogy means that we “seek earlier conceptions” of a particular concept while “remaining attentive to what their authors were doing in using term and conception, in the context and as part of the traditions in which they did so” (Farr 2004: 10). In the end, a comprehensive tracing of the genealogical path of given concepts should

provide us with information about the full range of their meanings, types of documents that make use of them, disciplines in which they originate and disciplines in which they migrate (and) changes they undergo during migration (Cajvaneanu 2011: 35).

On the case of moral hazard, we start from its early conceptualization within the 19th century insurance industry, using some of the key texts to contextualize a particular understanding. We then explore the transfer to monetary policy that took place in the 19th century, paying attention to the associated fluctuation in meaning. The next important step in the history of the concept is its value-neutralization by economists in the mid-20th century and its adoption by and

adaptation to healthcare and welfare economics. With respect to limited liability, we start from its Roman origins and underscore a peculiar and highly contextual meaning then – that differs considerably from contemporary conceptions of limited liability. We then trace the limited revival of the concept in the European middle ages – emphasizing a significant conceptual transformation. We then move closer to our times, to the 19th century, and we identify key turning points that account not only for consequential conceptual transformation but also for a much broader societal impact of the concept of limited liability ever since.

For each of our two conceptual genealogies, the objective is to understand – to borrow from Skinner – if not “all”, at least many of the “various contexts in which the words were used – the functions they served, the various things that could be done with them” (Skinner 2002: 84). Methodologically, the step we then take in our discussion section is more novel. Through systematic comparison of the two genealogies, we are able to underscore the emergence through time of elective affinities between the two concepts. This leads us, in the end, to argue that the two notions have in time become structurally connected in the particular form of capitalism that dominates our contemporary world.

Moral Hazard – From Moral Fraud to Rationality

As a general phenomenon, moral hazard can be defined as the “tendency of insurance protection to alter an individual's motive to prevent loss” (Shavell 1979: 541). More specifically, the presence of insurance or other forms of protection creates a disincentive to exercise caution with person and property, while increasing the proclivity to engage in careless or risk-seeking behavior. Regarding etymology, Baker (1996) remarks that the Victorian understanding of the word “hazard” carried a moral implication by definition, as the term was synonymous with a contemporary vice: gambling. Hazard originated as a dice game, but in the sixteenth century transitioned into a more generic term that would describe any venture considered to be risky (Baker 1996: 244-6).

Towards the end of the nineteenth century, the concept of moral hazard would impose itself in two main areas – the insurance industry and monetary policy. In 1862, Arthur C. Ducat, who wrote the first foundational and reference text for the American insurance industry, explicitly inscribed in this text the notion of “moral hazard” (Ducat 1865; Baker 1996: 248). This marked the first occurrence, the creation as it were, of the term. In the same period, moral hazard also became salient in monetary policy, through the spread of the notion of the “lender of last

resort” – a notion initially coined by English banker Francis Baring in 1797. These two parallel paths subsequently converged in the mid-twentieth century, culminating into what can be labelled the “economic neutralization” of moral hazard. This period would also mark the beginning of the neo-liberal mobilization of moral hazard, as a means, in particular, to rationalize policies regarding welfare programs. Hence, the term spread then to areas as diverse as healthcare and philanthropy (Arnott and Stiglitz 1991: 180).

Moral Hazard and the Insurance Industry

With respect to the insurance industry, the intuition of moral hazard (albeit not the label) can be traced back to the eleventh century, when the Charitable Brotherhood of Valenciennes stopped covering losses that resulted from the negligence of claimants (Moss 2004: 38). The Charitable Brotherhood of Valenciennes was a mutual-aid society in Feudal France, where members (local craftsmen) obliged themselves to “assist one another, under any circumstance, with advice, purse, and sword” (Funck-Brentano 1922). The leadership of the Brotherhood realized that the availability of insurance incentivized individuals to exercise less caution in protecting themselves and their assets. Already, this particular behavior was associated not only with an individual’s character but also with the structural situations of “temptation” resulting from the provision of insurance and protection. Although it would remain unlabelled for another century, by the 1700s conspicuous cases of fraud indicated that the behavior we would today call moral hazard had become a pervasive phenomenon (Dembe and Boden 2000).

As commented upon earlier, “hazard” initially carried a negative connotation as a result of its association with gambling. However, the underlying association with risk or chance in general was captured by insurance companies in the early nineteenth century, and hazard was reframed to describe any sort of risk regarding the insured. Physical (and subsequently legal) hazards were well distinguished by these organizations, for example in terms of fire, accident and workers’ compensation (Heimer 1989: 29). Additionally, these hazards were already divided into events that could potentially cause damage (e.g. lightning), and conditions that would further exacerbate the damage (e.g. wood built structures). Such classifications were created in order to better anticipate risk so that premium rates could be adjusted accordingly. Ostensibly, the term “hazard” had shifted from its moralistic origins to encompass a more de-personalized definition, which was better suited for the probabilistic purposes of insurance

assessment. As Baker comments, these calculations became the “intellectual cornerstone of the nineteenth-century insurance enterprise” (Baker 1996: 246).

By the mid-nineteenth century the scope of private and social insurance systems had expanded considerably, with insurance companies then offering coverage for accident and sickness insurance to large numbers of private persons or families. Zelizer observes that this occurred as the result of a number of factors, including economic growth, increasing urbanization, deeper actuarial knowledge, and aggressive marketing techniques and pricing policies on the part of the insurance companies (Zelizer 1979: 10-26). Within the U.S., she notes that there were no more than a hundred policies in place in the entire country at the turn of the nineteenth century, but by 1844 a single company could issue 796 policies in 19 months of operation (Zelizer 1979: 1). Growth of the British insurance industry was even more impressive: by 1859 British firms collected estimated annual premiums of \$30 million, compared to \$7 million in the United States (Zelizer 1979: 35). This expansion also spilled over into Prussia where the British Friendly Society movement was a source of inspiration for a law that passed on April 3rd, 1854. This Prussian law empowered local authorities to require dependent workpeople to join benefit societies (Dawson 1911: 6). One week later, on April 10th, 1854, a second law was passed that made provident funds compulsory for all workers employed in mines, smelting works and salt works throughout Prussia. As Dawson remarks, this was a critical development, aimed at “strengthening [insurance] societies and increas[ing] their efficiency and utility” (Dawson 1911: 4-5). France was the only country during this period that did not experience the growth of the life insurance enterprise, as it was considered to be “repugnant to French sensitivity” (Zelizer 1979: 35).

The astonishing expansion of the insurance enterprise was accompanied by equally remarkable specifications of insurable characteristics, including the notion of “hazard”. The elaboration of this latter notion was particularly important, as more pervasive coverage resulted in a corresponding increase in the amount of fraud being committed (Murphy 2010). This tendency combined with the Christian apprehension at the time about the growth of insurance – and indeed the very idea of it – to explain a focus on the moral dimension of hazard and insurance (Zelizer 1979, Daston 1987, Clark 2002). Insurers introduced the moral dimension into their classifications, labeling explicitly the risks associated with immorality as *moral hazard*. Conscious acts such as fraud, arson, and malingery were classified as *moral hazards*, as were other behaviors that heightened the

probability of loss, such as misrepresentation, negligence, poor business practices and overinsurance (Ducat 1862: 164-65; Campbell 1902; Rubinow 1913). A distinction was made between “character” and “circumstance”. Moral hazard could result from situations of temptation as much as from personal predisposition and, in fact, often resulted from a combination of both (Aetna Guide 1867; Baker 1996). In any case, by the turn of the twentieth century, moral hazard had become a well-defined feature of the insurance industry and literature. More importantly, the incentive dimension of moral hazard remained framed in fundamentally ethical terms even when situations and circumstances seemed to create or increase “temptation”.

In order to assuage a broad based societal preoccupation with the potential for moral hazard, but also the aforementioned Christian concern on the very notion of insurance, the insurance enterprise was then imbued with an almost religious sense of right and wrong (Sumner and Keller 1927; Kimball 1960; Baker 1996). As a result, persons of “questionable character” would not simply be charged a higher premium as with physical hazards, but would be denied insurance outright. Such risks were deemed outside the scope of insurance, and in practice were identified based on “rules of thumb” combined with norms about conventional morality (Griswold 1868; Baker 2000). As a consequence of this practice, by the end of the nineteenth century, assessments of moral hazard had shifted towards a more narrow definition. In his book titled *Risk as an Economic Factor* (1895), John Haynes outlined quite explicitly that moral hazard should only apply to the acts of intention, while excluding the negligent behaviors stipulated by Campbell or Rubinow. Haynes was influential in his work, as insurance texts during the middle of the twentieth century made a subsequent distinction between moral and *morale* hazard, the latter of which was unintentional carelessness (Mowbray and Blanchard 1955; Heimer 1989). Thus, moral hazard became commonly accepted as being the result of *consciously* immoral behaviors.

The value driven conception of insurance persisted from its seventeenth century roots in probability theory (Covello and Mumpower 1985) up until the 1960s, when the concept of moral hazard transformed into a distinctly amoral notion. However, despite the development of the term within the insurance field, the application of moral hazard was arguably even more consequential within the domain of monetary policy. More specifically, the facility of “lenders of last resort” would ensure that moral hazard would become a permanent fixture in

monetarism and government policy, and would also lay the groundwork for the institutionalization of the “economic neutralization” of the term.

Monetary Policy and “Lenders of Last Resort”

While moral hazard was shaping the insurance industry, the notion also developed in parallel within the financial and monetary sphere in England. As with insurance, the notion of moral hazard had already been identified, without being named, as a risk of monetary policy in the early eighteenth century. More specifically, moral hazard was presented as a dilemma arising from government intervention during periods of illiquidity, and it became a subject of study following the occurrence of severe financial crises during this era (Humphrey and Keleher 1984; Moore 1999). Although the term “moral hazard” would not be explicitly coined by insurers for another half century, the financial equivalent of the underlying notion was understood as resulting from the establishment of “lenders of last resort¹” (Bagehot 1873; Baring 1797; Thornton 1802).

The concept of “lender of last resort” can be understood as the financial intervention of an institution in reaction to a crisis or panic, and specifically involves injection of liquidity into a market to preserve financial stability within that market (Humphrey 1975). Typically, this function is fulfilled today by a state organization or public agency, such as the Federal Reserve or the Bank of England, although on occasion it has also been fulfilled by private actors (the Bank of J. P. Morgan in the United States before the passing of the Federal Reserve Act in 1913 is a well-known example). In fact, following the financial crisis of 1793 in Britain, the merchant banker Francis Baring argued that organizations independent from government could have been more efficient “lenders of last resort” (Baring 1797: 22). But anti-usury laws (passed in 1660) restricted the interest that private lenders could charge, thus creating a real disincentive for these lenders to provide the required liquidity during subsequent periods of crisis and this until the mid-nineteenth century, when the Usury Act was repealed. It is a historical irony that anti-usury legislation was meant to prevent the perceived moral abuse associated with exorbitant interest rates (Bentham 1787). Yet such laws would inadvertently create another moral dilemma of an entirely different kind.

¹ Francis Baring actually used in 1797 the label partly in French and with a spelling mistake “lenders of *dernier resort*”.

With state sponsored institutions providing almost any required liquidity to private banks with “little difficulty, expence, or delay” (Thornton 1802: 38; Goodhart 1999), the threat of moral hazard became more palpable. As Moore comments,

it has long been recognised that the lender-of last-resort facility provides a form of insurance which tests the moral character of those agents who have an incentive to alter their behaviour once an elastic supply of liquid funds is offered (Moore 1999: 444).

Henry Thornton discussed this issue at length in his seminal work, *An Enquiry into the Nature and Effects of the Paper Credit of Great Britain* (1802). Thornton was primarily concerned with the moral hazard resulting from the Bank of England injecting liquidity into the financial system to prevent bank runs. He remarked that any fiscal support would set a dangerous precedent for future crises, and as such advised against the creation of a formal lending institution by the state.

Thornton’s concern with moral hazard was taken seriously, as evidenced by the passing of the Bank Charter Act of 1844. Among other things, the act was intended to severely impair “lender of last resort” powers for the Bank of England, effectively preventing it from intervening in financial crises (Fetter 1978). However, three ensuing crises in 1847, 1857, and 1866 were of such severity that the government found it necessary to suspend the Bank Act in order to intervene (Humphrey and Keleher 1984). Debates on how to modify the Bank Act remained intense throughout the nineteenth century and certainly the most potent argument was proposed by Walter Bagehot (1873). In *Lombard Street*, Bagehot departed from the “hands-off” approach of Thornton, citing the necessity of formal lending to prevent financial collapse (albeit at a stiff penalty rate to combat moral hazard). *Lombard Street* was so influential that thereafter the provision of liquidity by the Bank during crises “became a near orthodoxy among English financial commentators and economists” (Moore 1999: 449). With freely available liquidity supplied by the Bank of England, it appeared as though English monetarists had succeeded in institutionalizing the practice of “lender of last resort”, and by extension, an accompanying systemic form of moral hazard (Fischer 1999; Kindleberger 1986; Wood 2000).

The idea and practice soon spread to other countries in Europe but also North and Latin America. With respect to the United States, although the Federal Reserve was not established until 1913 (Eichengreen 2008: 47), individual states had provided deposit insurance since 1829 in addition to a number of private

insurance regimes (Golembe 1960). These “self-imposed regulations and mutual monitoring kept members of the privately established coalitions from ‘free riding’ on the collective insurance” (Calormis 1990), and they were quite effective in some states. Yet the subsequent establishment of a central bank eventually legitimized the “lender of last resort” facility and has since become cited as the reason why “no financial crisis² has occurred in the United States since 1933 and none in the United Kingdom since 1866” (Brodo and Levy Yeyati 2003). In fact, with respect to the Great Depression, it has been proposed that the severity of this crisis could in part be attributed to a *lack* of sufficient “lender of last resort” support from a transnational economic regime (Kindleberger 1986).

Despite this institutionalization, some authors have acknowledged that the advent of federal or central systems of “lenders of last resort” have meant an intensification of the moral hazard dilemma (Calormis 1990; Sleet and Smith 2000). The problem is that moral hazard has proven difficult to substantiate empirically, due to its probabilistic nature and focus on forward-looking behavior (Lane and Phillips 2000). However, within the transnational domain there have been empirical studies conducted on moral hazard with respect to the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (IBRD). These studies indicate that acting as a “lender of last resort” facility to nations during times of distress has the demonstrated effect of increasing direct moral hazard³ (Drexel and Vaubel 2004; Vaubel 1983). Nevertheless, such empirical work has hitherto been sparse, while the amount of literature citing the need for such a facility has proliferated (e.g. Fischer 1999; Cordella and Levy Yeyati 2002; Rochet and Vives 2004). It has been observed that there has been very little evolution since Bagehot regarding the discussion about how a lender of last resort should operate (Sleet and Smith 2000). Indeed, this is the result of the institutionalization of the “lender of last resort” policy, and offers a stark contrast to debates waged within the political and social arenas during the latter part of the 20th century.

² This is clearly contingent on the definition of “crisis”, although Brodo and Levy-Yeyati seem to mean full-scale panic akin to the Great Depression. Brodo and Levy-Yeyati (2003) naturally were writing before the more recent episode of financial turmoil.

³ The authors identify “direct moral hazard” as affecting the behavior of the direct recipients of insurance payments—the governments of the member states. This ought to be distinguished from “indirect moral hazard” effects on the lending behavior of their creditors, i.e. the “bail-out” of foreign banks, etc.” (Drexel and Vaubel 2004).

Economic Neutralization and Neoliberal Reinterpretation

In 1963, the economist Kenneth Arrow published an article entitled, “Uncertainty and the Welfare Economics of Medical Care”, which would mark the beginning of a profound transformation in debates around moral hazard.⁴ Arrow argued that insured individuals seeking healthcare would choose their physician based on the doctor’s willingness to use expensive medical services. Drawing upon insurance literature, he thus inferred that this behavior would lead to moral hazard in two respects: an increase in the use of services overall and an increase in price for those services (Arrow 1963). However, Arrow acknowledged that these limitations would not “alter the case for the creation of a much wider class of insurance policies than now exists”, as “the welfare case for insurance of all sorts is overwhelming” (Arrow 1963). In making this argument, Arrow appeared to have drawn inspiration from Bagehot, through his comment that “the government should undertake insurance where the market, for whatever reason, has failed to emerge” (Arrow 1963). In a sense, Arrow’s article represented a convergence of both the insurance and monetary interpretations of moral hazard into a more universal phenomenon.

Following its publication, the article stimulated debate among economists, and was cited as “the single most influential neoclassical treatment” of medical care (Starr 1982: 225, see also Feiwel 1987, Arrow et al. 2011). Arrow also influenced the development of theories related to risk aversion (Pratt 1964), adverse selection (Akerlof 1970; Pauly 1974) and trust (Williamson 1993). However, the most significant contribution of the article was the impact it had on the perception of moral hazard. By legitimizing moral hazard as rational economic behavior, Arrow triggered a paradigm shift that would effectively neutralize the ethical dimension of the term (Dow 2012b). The prominence of this article, combined with the reaction by economists, served to catalyze a transformation of moral hazard into a distinctly *amoral* concept.

One response in particular, authored by Mark V. Pauly, was instrumental in normalizing and neutralizing moral hazard within the economic sphere. Pauly (1968) regarded Arrow’s prescription of government insurance as problematic, and attempted to demonstrate the inoptimality of this proposition. More importantly, Pauly went on to assert that the problem of moral hazard in

⁴ Jacques Drèze (1961) had already applied economic tools to study moral hazard just two years earlier, yet Arrow’s article was clearly the more influential.

insurance had, “in fact, little to do with morality, but [could] be analyzed with orthodox economics tools” (Pauly 1968), and criticized the use of emotional terms such as malingering and hypochondria. Furthermore, in an extension of “prisoner’s dilemma” logic (Baker 1996), Pauly proposed that rational economic agents are legitimated in using excess medical care when the cost of insurance is spread out over a large group. In this manner, the value-neutral language of economics subsumed the moral rhetoric that had hitherto existed for centuries within the insurance literature (Dembé and Boden 2000). As such, the ‘temptation’ of insurance became the ‘incentive’ of economics (Baker 1996). Pauly’s commentary was well received, and became cited as the “single most influential article in the health economics literature” (Nyman 2001: 9). As Baker aptly remarks, “Pauly’s observation that moral hazard has little to do with morality has become the conventional wisdom” (Baker 1996, see also Dow 2012b).

It is worth noting, however, that Arrow retorted with a further comment, praising Pauly for enriching moral hazard while lambasting his suggestion that rational economic behavior and moral perfidy are mutually exclusive categories (Arrow 1968). In an apparent attempt to salvage the value-laden dimension of moral hazard (Laffont and Martimort 2002: 19), Arrow observed that every principal-agent relationship has the potential for agent deviation. However, he argued it would be cumbersome or even unfeasible to always take out insurance against the agent’s ability to perform well. Arrow concluded with the rather noble sentiment that a successful economic system requires a certain amount of trust and confidence between the principal and the agent, so that the agent will not cheat even when it is in her economic interest to do so (Arrow 1968). Despite this poignant response, Arrow’s initial publication and its early interpretations would come to represent a historical turning point in discussions on moral hazard, one that would irrevocably neutralize the term. Subsequent economics research would not simply institutionalize the newly neutralized term, but would also expand the scope to cover any principal-agent relationship (see Jensen and Meckling 1976, Holmström 1979, Stiglitz 1983).

In parallel to this consequential re-interpretation of ‘moral hazard’, the meaning of the term ‘moral’ also shifted. Economists distanced themselves from the strong value-laden notion of ‘moral’, originally connected to religion. To do that, they turned instead to Daniel Bernoulli’s (1738) “Theory of Moral Value” – an answer to the St Petersburg Paradox – where “moral” was representative of the subjective or psychological value of an outcome for a particular risk-taker

depending upon her initial wealth (Jordan 1924). Within this context, moral value was a function of a risk-taker's wealth, and as such became free of the original religious undertones.

Another significant event during the mid-twentieth century was the mobilization of moral hazard within the legal and policy debate (Baker 1996: 267). Arrow had advocated government supplied insurance wherever the market failed to emerge, and as discussed earlier, monetary intervention by the state had already been institutionalized by this period. Yet the universalization of moral hazard would have dramatically different results within the domain of social welfare. More specifically, the rationalization of moral hazard would be mobilized by proponents of neoliberalism, who would argue that state sponsored insurance schemes created unnecessary and unwanted forms of moral hazard (McCluskey 2003). This position stood in stark contrast to the institutionalization of moral hazard within the sphere of finance and monetarism, where it apparently was fine to have state-sponsored "lending of last resort". Yet within the social sphere, neoliberals advocated social welfare restrictions as "a matter of sensible science rather than contentious politics or moral dictate" (McCluskey 2005) and as an "instrument to police moral hazard" (Kvist 2001: 207). In this manner, areas such as social security, healthcare, unemployment insurance, and workers compensation all became important battlegrounds in the debates on moral hazard and policy making (Moss 2004).

When it comes to healthcare and welfare provisions, the mobilization of moral hazard has had significant policy implications. As an example, in the United States, the AFDC (Aid to Families with Dependent Children) was a federal program providing income support for single parent families in poverty during the 1970s. Yet by the end of the twentieth century, it was denounced as a "prominent symbol of social pathology inimical to good citizenship" (McCluskey 2003). By 1996, it was eliminated in favor of a more limited program called TANF (Temporary Assistance to Needy Families). In the same vein, workers' compensation programs became a target for neoliberal policy makers. Ronald Reagan, as a candidate, vowed to eliminate the Occupational Safety and Health Act (OSHA), and two decades later, George W. Bush succeeded in establishing a moratorium on any new "economically significant" regulations (Owens 2004). With respect to healthcare, the concern with moral hazard has played an even more direct role. Gladwell (2004) has remarked that the six attempts to establish a universal healthcare system in the United States during the twentieth century

were all thwarted because of the presumed associated threat of moral hazard. In the 2004 Economic Report of the president, this concern was specifically discussed as a reason for the creation of the “Health Savings Account”, a program that would require consumers to contribute to their own healthcare. In effect, this would aim to reduce moral hazard by making “the insured a little bit more like the uninsured” (Gladwell 2004). As those examples all show, neoliberal economists essentially understood the beneficiary of welfare and health programs to be a rational *homo economicus*, maximizing her consumption of benefits from these programs. The contrast is striking between this perspective in the welfare sphere and the particular take on moral hazard that was dominant within the financial community as the last crisis unfolded.

Limited Liability – From Rare Privilege to Legal Right

Limited liability is today a legal concept used in commercial law, to indicate that a person is personally liable, in the context of a given venture, only to a fixed amount. Although in principle this amount could vary, most of the time it corresponds to the value of the initial investment. As a legal concept, limited liability contrasts with and confronts the concept of unlimited liability. Unlimited liability suggests that involvement in a particular venture comes together with full liability, potentially beyond the value of the initial investment, and in fact to the extent of one’s personal or even family wealth.

In the current legal context, the notion of liability has mostly a financial and rather neutral connotation. Limited or unlimited liability is envisioned in relation to the financial situation of a given venture and more particularly in relation to the debts and obligations it may incur. At least, this is the way we generally think about it in contemporary contractual societies. Not so long ago, though, and still well into the 19th century, debates and discussions around limited or unlimited liability pointed to a broader sense of liability with profoundly moral connotations. Liability – whether limited or unlimited – went well beyond the debts or financial obligations of a venture. There was a sense in which liability was also about a personal moral responsibility connected to the overall behavior and engagement of or with a collective (the firm or society). Hence, the debate between limited and unlimited liability in that context was a debate about whether such personal, moral responsibility could or could not be translated in merely financial and

economic rationality terms; whether it could or could not be split and set within limited bounds.

Limited Liability and Roman Origins

The concept of limited liability first appeared in Roman Law. An old Roman rule prevented dependent individuals (*personae alieno juri subjectae* – “persons subject to the jurisdiction of another”) from owning property. This applied naturally to slaves but also to family members (wives, daughters, dependent sons) and in fact in some cases also to free men who were for one reason or another in a position of dependency (*cliens*). Legal personality was associated with citizenship rights and in fact with full responsibility as well. The *pater familias* was the symbol of such legal personality – being *sui juris* (“under his own jurisdiction”) and registered in the census as full *capita* (head or citizen). This status or condition came with its rights and duties (Duff 1938). It meant in particular full liability in the context of business ventures or initiatives. In fact, under Roman Law, creditors had the right, until the fourth century BC, to kill or sell into slavery a debtor with legal personality who failed to pay. This right, which implied an extreme form of unlimited liability indeed, was finally abolished in 326BC (*Lex Poetelia Papiria de Nexis*). By contrast, those individuals who were not full *capita* – and hence in a sense were, legally, non-persons – could not be legal owners and could not enter into contracts nor be held liable in front of the law. In principle and in law until the second century BC, this would mean that transactions by dependents could not generate “enforceable obligations to the disadvantage of the *pater familias*”. The latter “could only acquire rights but not incur debts from business activities of his family members” (Abatino et al. 2009: 11).

Interestingly, this did not prevent non-*capita* individuals from doing business and entering into different kinds of ventures. This took place through the mechanism of the *peculium* – a sum that the *pater familias* granted to some of his dependents for them to use in a particular venture. This probably was one of the first if not the first instance in history of a “de-personalization” of business. Business was de-personalized by “making a non-person (slave or dependent) the center of attribution for the company” (Abatino 2009: 5). Arguably, the kind of responsibility or liability “void” in this case had a tendency to foster rather the development of business through *peculia*. The *pater familias* was better off divesting his liability through the delegation of business ventures to his dependents – slaves or sons. This legal void did not go long unnoticed and, from the second century BC Roman magistrates worked step-by step, through case

law, to remedy this situation (Micolier 1932; Duff 1938; Aubert 1994; Abatino et al. 2009). Limited liability was born in the process as a mechanism to expand the liability of the *pater familias* to the business undertakings initiated by his dependents through the *peculium* he had granted them. The liability of the *pater familias* was re-affirmed in the process. Quite often, liability was limited to the value of the *peculium*. The *pater familias* became liable for any debts or liabilities incurred through the venture but only to the extent of the *peculium* he had initially granted (Perrot 1982; Hillman 1997). Some provisions, though, increased liability in those situations where the *pater familias* could be shown to be actively involved in a particular venture (Foldi 1996). Hence the degree of liability was connected to the nature and intensity of the involvement in and knowledge about the venture that characterized the “principal”, here the *pater familias* (Abatino et al. 2009: 13).⁵

A legal alternative to unlimited liability was thus born in that period. It is interesting to note, though, that the principle of limited liability was born as a legal mechanism to *increase* overall the liability of citizens to those activities they had chosen to delegate and had placed in the hands of non-persons. With limited liability, the *pater familias* or citizen became liable also for those ventures initiated through the *peculium* – while before the institutionalization of the limited liability principle under Roman law he could use the *peculium* as a way to escape liability altogether. This contrasts sharply with the contemporary role of limited liability as a tool to *reduce overall* the responsibility of entrepreneurs. The combination of delegation with limited liability, characteristic of this evolution of Roman law, proved ultimately quite successful. In the centuries that followed, business ventures through the *peculium* mechanism prospered:

Slaves managed estates and arranged trading and banking transactions on their master’s behalf. Even top managers were typically selected from among slaves, explaining the common phenomenon of Romans placing themselves into slavery. Free men sold themselves into slavery in order to attain a high position in the enterprise of a senatorial house (Malmendier 2010)

Complex combinations then emerged where free citizens would jointly delegate business through (a) co-owned slave(s) who worked through a co-financed *peculium* (Micolier 1932; Abatino et al. 2009). In parallel, the *societas*

⁵ *Ignorantia* or *Scientia* meant that the master’s liability was limited to the *peculium*. In the situation of *Voluntas* (the master consenting to the dependent’s transactions), creditors could go after the master’s wealth beyond the value of the *peculium* (Abatino et al. 2009:14).

publicanorum flourished during the last two centuries BC. These legal collectives carried out different kinds of public or 'common good' tasks and works, such as feeding Roman geese, building and maintaining temples, and collecting taxes. Outside investors could acquire shares in those undertakings that were run by the major partners (*socii*) without becoming partners themselves. Those *participes* or *adfines* had no place or role in management but in counterpart, they were not legally liable beyond the amount they had invested (Malmendier 2009). This integration of a collective legal structure with both limited and unlimited liability could arguably be seen to announce the medieval *commenda* form. But before it could be reborn in different guise, the *societas publicanorum* went through institutional demise, as a legal form, during the Roman Empire (Malmendier 2010; Badian 1972).

Limited Liability and the Commenda Structure

The expansion of trade in early medieval Europe (12th to 13th century) was initially structured under the principle of unlimited liability (Lopez and Raymond 1955; Guerra-Medici 1982). As the trade system reached out to distant territories and diverse constituencies, unlimited liability was used as a strong security signal and mechanism. Trust was the necessary basis for exchange and unlimited liability could be used to build such trust in situations of weak institutionalization and high uncertainty. Origins of the principle of unlimited liability in trade could possibly be traced back to powerful local traditions in the Longobardi regions of Italy (everything but Papal territories). There, all members of a family group were potentially "jointly liable without limits for all debts arising out of contract or crime undertaken by any member of that group" (Guerra-Medici 1982: 123). The *compagna* was the legal form that brought together partners under joint and unlimited liability. The term comes from the Medieval Latin word *cumpanis* that stood for "those that eat the same bread". This term naturally suggests the importance of family and clan connections in the early Italian *compagna* ventures. Connecting economic, social and family honor, the *compagna* was the dominant legal frame for the development of wealth in areas such as Pisa and Firenze before and during the Medici period (Sapori 1955). Later on, the *compagna* would reach beyond close family and client ties and would evolve towards the modern legal forms of partnership.

In coastal towns in Italy, particularly Genoa and Venezia, an alternative form of business association was pioneered in the context of maritime trade as early as the 11th century (Perrot 1982; Guerra-Medici 1982). The "*accomendita*" or

“*commenda*” was a peculiar form of partnership, where one of the parties supplied “capital” and the other “labour” (Renouard 2009[1068]). In the context of maritime trade, the *commenda* contract brought together an investor partner, who stayed home but took the financial risks, and a traveling partner, who did not have to provide capital but took the physical risks. Typically, the investor would receive his capital back and three quarters of the profits upon safe return of the ship while the traveling partner would get the rest of the profit. In practice, the financial risks taken by the investor did not exceed the amount he had brought into the venture. This “limited liability” principle was explicitly established and formalized in the legal statute that introduced, in 1408, the *commenda* form in Firenze (Mitchell 1909).

This form of association diffused with limited success in other European territories in the following centuries. The Napoleon code of 1808 modernized it and gave it a new life, extending its reach to all spheres of economic activity. The “*Société en Commandite par Actions*” created through the 1808 French Code provided for a hybrid legal form, where unlimited and limited liability partners contributed in different ways to the same venture. The “*commandités*” or “*gérants*” (general or managing partners) were under unlimited liability, jointly responsible for the entire debts of the company. They were generally strongly involved in the management and current affairs of the company. The “*commanditaires*”, on the other hand, were “sleeping or dormant partners”, who brought in capital under the limited liability principle and were not to be involved in daily management in any direct way (Saint-Léon 1907). The Napoleon code of 1808 hence introduced limited liability in France quite early on, in a legal form that was then freely accessible to all. The Napoleon code soon had influence in a number of European countries and the “*Société en Commandite par Actions*” was adopted and adapted in countries like Belgium, the Netherlands, Italy and Germany later in the 19th century (Rochat 2008).

Limited Liability as Rare Corporate Privilege

As Kingdoms, Princes and States came of age in early modern Europe, they seized upon the corporation as a useful legal vehicle. Medieval jurists had defined the corporation (in Latin *universitas*) as being both at the same time a collective abstraction (and hence a legal *persona*) and the sum or reunion of its individual members (Canning 1996: 172-3). Initially, this corporation doctrine applied to the Church, to guilds, to cities and to the University in the “narrow” sense of the term (Ekelund et al. 1996; Greif, Milgrom and Weingast 1994;

Canning 1996). As secular authorities managed to impose a monopoly on the use of the corporate form, the history of the corporation became closely associated, from that point on, with national politics and the Prince (Willinston 1888). Incorporation became a regal privilege that the Prince would bestow on given groups of private individuals, in general as they engaged in projects that served the interests of the Kingdom – and of the King – and hence “public interest”. The first corporate charters of that kind were granted for the purposes of overseas trading. In England, the *Russia Company* was incorporated through royal charter in 1555 (Willan 1953). Soon, other states and Kingdoms followed suit, getting inspiration from this early innovation. Charters that were granted by states and Kings were associated with a number of privileges. Many of those corporations were granted different kinds of monopolies and some form of privileged treatment with respect to taxes and duties. As legal persona, they could act in law as a single body. In 1623, the Dutch *East India Company* or *Vereenigde Oost-Indische Compagnie*-VOC was granted the privilege of perpetual existence. This innovation was then soon followed in other parts of Europe and the free transferability of shares generally came along. In 1662, it was the British Parliament this time that proposed an important legal innovation. The 1662 Act granted certain corporations, and in particular the *British East India Company*, the privilege of limited liability. In retrospect, this Act marked a consequential turning point, connecting as it did the corporate form and limited liability, even though as only the expression, then, of a rare privilege.

The 17th and 18th centuries witnessed a progressive extension of domains where corporate charters could be granted – mining of metals valuable in war, banks, insurance, infrastructure or even manufacturing projects (Hickson and Turner 2005). In certain countries, and particularly in England, this came together with the partial delegation of the monopoly to grant corporate charters – particularly after the English revolutions in the 17th century. Charters could be granted directly by the King or, by power of delegation, through the authority of Parliament. In both cases, the costs associated remained high. And, in principle, petitioners still had to convince the authorities that their project served the public interest. Limited liability could be granted as a privilege but this was rare. On the whole, common law went on prevailing and “the liability of members of even a chartered corporation was unlimited unless their charter specified that it was limited” (Perrott 1982: 91; see also Livermore 1935; Hunt 1936). The same was true everywhere else – limited liability was a rare privilege, granted with parsimony – and this until the mid-nineteenth century.

From the start, the association of limited liability with corporate charters generated strong reactions. Amongst the most vocal critics, we find no less than Adam Smith. Smith, we know was wary of the corporate form as it was bound, according to him, to generate “negligence and profusion in its management” (Smith 1999[1776]: Book V, chapter1: 741). As decision makers were managing “other people’s money rather than their own”, corporate charters were the source of what we would call today an “agency problem”. Things became even worse when limited liability was brought in as limited liability implied a disappearance of the sense of responsibility that could only trigger adventure, risk taking and speculation:

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 (Smith 1999[1776]: Book V, cha. 1).

Limited Liability Revolution in Britain

Well into the nineteenth century, the association between incorporation and limited liability hence was not a necessary one. It was contingent on political fiat and only attributed as a rare privilege. Things would change radically during the nineteenth century, with the U.K. again playing a major role. In 1844, Britain took a major first step as it passed a law that turned incorporation into a legal right. This came after long and heated debates within Parliament as well as outside (Taylor 2006). The Joint Stock Companies Registration and Regulation Act of 1844 created a Registrar of Joint Stock Companies. All partnerships having more than twenty-five members and freely transferable shares were required (and hence de facto allowed!) to register as corporations. Before being conferred full corporate status, though, they had to provide information and appoint auditors to “receive and examine the accounts”. Regular information and publicity demands were furthermore made on corporations (with respect to members and their holdings). In exchange, those companies could function with all privileges incident to corporations (Hunt 1936: 95-8). By then, though, limited liability was not on the list of systematic privileges. The common law principle remained in place that unless otherwise specified in their charter, corporations were operating under unlimited liability.

Right after the passing of the 1844 Act, however, debates started again – but this time the focus was limited liability. Debates were intense and highly divisive between those who wanted limited liability to become a feature associated by

right to incorporation or even to the partnership form and those who thought that a broader diffusion of limited liability would be a dangerous mistake (Djelic forthcoming). On the side of those in favor of limited liability, two groups were arguing from a somewhat different perspective. Social reformers championed the association of limited liability with the Partnership form. This would create, they proposed, safe conditions for workers and middle classes in general to invest their savings in productive ways. Liberals were also fiercely fighting for limited liability but they argued for an association with incorporation. Without limited liability, they claimed, wealthy classes would be deterred from participating in registered companies – as this could potentially imply a high personal liability burden. Hence, those risky adventures, which were so necessary for the industrial development of the country, could come to be thwarted due to a lack of capital (Bryer 1997).

On the other hand, limited liability had its naysayers – often described by the champions of limited liability as boring, diehard conservatives. The arguments on that side were quite powerful, still, and preoccupations were even more political and ethical than economic. In direct continuity to Adam Smith's worries, it was proposed that owners under limited liability would not be so eagerly watching over and controlling managers. This would only further "negligence and profusion", mismanagement if not risky or fraudulent behavior (Shannon 1931; Saville 1956; Amsler et al. 1981). Bankers were, on the whole, violently opposed to a generalization of the limited liability privilege, as this would in fact create strong externalities for their profession – creditors would become in the process the 'responsible actors of last resort'. Conservative politicians and legal scholars argued from a broader moral perspective. According to them, common law embodied the 'natural justice' of individual responsibility that imposed *de facto* unlimited liability. "He, who feels the benefit should also feel the burden" (Royal Commission on ML 1854: 15). British wealth and prosperity rested on the global reputation individual traders and merchants had fought hard to acquire and stabilize. This reputation had been built through a combination of sense of responsibility and personal morality that had then generated trust. This sense of responsibility was much more than a simple 'technical', commercial competence. It was pictured as an essential character trait, reflecting a deeply embedded collective and national ethic. John McCulloch expressed this quite strongly:

In the scheme laid down by Providence for the government of the world, there is no shifting or narrowing of responsibilities, every man being

personally answerable to the utmost extent for all his actions (McCulloch 1859: 321).

Limited liability, from that perspective, was associated with speculation, risk-taking, absence of ethics and fraud. Thomas Baring, of the Baring banking family, expressed a widely held opinion when he proposed that there was no way of preventing fraud “unless the man with the money should be responsible for the character of the business” (Bryer 1997: 41).

As the debate was raging, there was no clearly dominant position (Taylor 2006). The Select Committees and Royal Commissions that worked on those issues from within Parliament were essentially split in half. This apparently also reflected the strong division around this issue within civil society. Final reports did not prove conclusive. The political situation was evolving, though, during that period in England. Soon, leaders of the Liberal movement occupied key positions within the government. Those liberal leaders were also fierce champions of limited liability and their objective was to bring forth a legal association between incorporation and limited liability. Their position of institutional power explains that they finally managed to achieve this (Djelic 2013). The 1855 Limited Liability Act (18&10 Vic. c.133) was essentially an extension of the 1844 Joint-stock Companies Act. Provided that a Company had at least 25 shareholders and shares of no less than £10, it would be granted limited liability on complete registration. Insurance and banking remained excluded. The information requirements present in the 1844 Act were kept in place and those companies had to add “Limited” or “Ltd” in their name, as added information in particular to creditors. One year later, the Joint-stock Companies Act of 1856 (19&20 Vic. c.47) went a step further. It considerably simplified the registration process. The Act extended access to limited liability to all registered companies of seven or more members and it got rid of the £10 share qualification. Rather than having strict legal requirements on information, this Act proposed a set of by-laws with a focus on governance – we would call them “guidelines” – that companies could voluntarily adopt, if they so wished.

A Transnational Phenomenon

In less than ten years, the British legislator hence had managed to bring about a profound (and highly consequential) revolution. In 1843, both incorporation and limited liability had still been a rare privilege granted only through political fiat to a small number of economic actors. Incorporation and limited liability were then, furthermore, only contingently associated. The Act of 1856 marked the formal

institutional inscription, in British law, of the corporation with limited liability as a general statute. Both incorporation and limited liability became broadly accessible by right, while the Act also sealed the 'necessary' association of incorporation and limited liability. In the words of Robert Lowe, then Vice-President of the Board of Trade, and one of the most active champions of limited liability in England during that period:

The process is this – it begins with prohibition, then becomes a privilege, and last of all a right. Till 1825, the law prohibited the formation of joint-stock companies. From that time to the present it has been a privilege; but now we propose to recognize it as a right. So with limited liability. (House of Commons 1856: 129-30).

As the British debates were raging, references were often made in the British press and Parliament to those transformations that were happening in parallel in the United States. The different American states opened access to the corporate form essentially in the period from 1843 to 1913. Connecticut was the first American state to allow general incorporation in 1843. Then it spread first to other states in the north during the 1840s and 1850s but only moved to the south during the last decades of the century. By 1913, all American states had a general incorporation act (Cohn 2010). In the United States, the story of limited liability proved a bit different from what had happened in Britain. American colonies had inherited from Britain the tradition of special incorporation – where state legislatures had the power to grant (or not) corporate charters as a special privilege. In the United States, the fight around the extension of limited liability and its association with the corporate charter took place even before the move to general incorporation acts. Some states, like New York in 1822, associated their corporate charters with the right to limited liability. The New England states, on the other hand, fought to preserve unlimited liability. They finally had to relent, though, under mounting competitive pressure. The intense competition between American states was soon driving homogenization on this issue (Carney 2000). After 1930, limited liability had become the general rule in the United States, as it was systematically associated with the privilege of incorporation – with only very marginal exceptions (Livermore 1935; Carney 2000).

Elsewhere in the world, the British revolution often turned out to have a consequential influence. The British incorporation and limited liability revolution naturally applied immediately and directly in most Commonwealth countries (Lipton 2007). Its impact, though, went well beyond the borders of the Commonwealth. By the last quarter of the nineteenth century, most continental

European nations had followed the British exemplar – passing general incorporation acts and associating them systematically with limited liability (Hickson and Turner 2005). The rest of the world would follow in due course and by the mid-twentieth century, incorporation was understood everywhere to be a general right and not a special privilege, becoming permanently associated, *de jure*, with limited liability.

This was not the end, though, of the progress of limited liability in the history of contemporary capitalism. As indicated above, France had pioneered in 1807 the partial introduction of limited liability in a hybrid legal structure (*Société en Commandite*). This tradition lived and even diffused, as we argued above, in other countries. The German GmbH (*Gesellschaft mit Beschränkter Haftung* – Company with limited liability), a legal structure introduced in 1892 followed along the same route. It was constructed as a legal innovation with a view to propose a hybrid between the partnership and the corporation. The GmbH was constituted to be a partnership – a contract among specific persons with characteristically illiquid shares. This allowed the share holders to retain significant power and control. On the other hand, ownership in the GmbH was associated *de jure* with limited liability, which since 1870 in Germany had been connected to a general incorporation act. As a legal structure, the GmbH was rapidly very successful in Germany and many entrepreneurs and companies adopted it at the turn of the twentieth century (Guinnane 2008). It would also come to have an influence and be imitated elsewhere. The French SARL structure, introduced in 1925, is in its broad features a direct copy of the German GmbH. The Private Limited Liability form that appeared in Britain in 1906 was less directly related but still pertained of the same process. The Limited Liability Company only came to the United States in the late 1970s and early 1980s and the filiation there with the German GmbH was clear (Guinnane, Harris, Lamoreaux, and Rosenthal 2007). Following its transfer to the United States, it appears that the LLC (Limited Liability Company) or LLP (Limited Liability Partnership) forms have experienced rapid success. Limited liability partnership acts have since spread quickly throughout most countries of the world during the 1990s and the first decade of the twentieth century (McCahery 2001).

In the process, Limited liability has become a broadly available right – for corporations but also for those firms choosing to keep a partnership form. This right has notably been exercised in professional service organizations, and in particular, accounting firms. For most of their history, accounting firms adopted a

partnership structure with the associated feature of unlimited liability, mainly because employing such a form signaled a high standard of client service (Greenwood and Empson 2003). Given the inherent uncertainty surrounding audit quality, partners would traditionally assume joint responsibility for torts, potentially putting their entire wealth at stake in delivering a service (Van Lent 1999). However, following the “litigation explosion” that began in the 1970s (Miller 2003), these partnerships became highly exposed to claims of malpractice by their clients, leading to an era characterized by a “liability crisis” (Winter 1988). Between 1985 and 1994, malpractice premiums quadrupled, while deductibles increased six-fold for accounting firms other than the “Big 6” (Pratt and Stice 1994). The crisis highlighted a particularly acute vulnerability of unlimited liability partnerships to litigation, and it has been argued that recognition of this fact led to a shift towards other forms of governance (Greenwood and Empson 2003). The result has been the consequential transformation of the partnership form and the generalization of limited liability partnerships (LLPs) (Johnston 1995).

LLPs were initially employed in the US as a means to avoid taxes but quickly gained legitimacy through state legislation, mainly because of the form’s ability to limit the liability of professionals (Alberta Law Review 1998). The U.K. legislated this new corporate structure shortly thereafter in 1996, coerced by the threat of offshore relocation posed by the major accounting firms of Ernst & Young and Price Waterhouse (Sikka 2008). Since then, the new form has quickly spread to other countries such as Japan, India and Singapore (Reyes and Vermeulen 2011). Since this proliferation, it has been demonstrated that LLP accounting firms are favoring riskier clients as compared to before the switch to limited liability (Lennox and Li 2011). Furthermore, recent work has identified this form of governance as having significant moral hazard implications (Defusco, Shoemaker and Stara 2011).

The case of accounting firms is not the only situation where limited liability and moral hazard have conspicuously converged. One of the more prominent cases has occurred with Lloyd’s of London, the iconic British insurance market. While not a company *per se*, Lloyd’s has retained its “corporate body” structure for over three centuries, as a means to regulate transactions of insurance contracts (Corporation of Lloyd’s 1871; Hodgson 1986). For most of its history, Lloyd’s mandated that individual underwriting members, known as “Names”, accept unlimited liability for their policies. This obligation, coupled with a structure that facilitated underwriting unusual risks, distinguished Lloyd’s as an “underwriter of

last resort” (Fields et al. 1998). However, in the late 1980s/early 1990s, the organization experienced multi-billion dollar losses that resulted in the resignation of approximately 13,000 Names (Fields et al. 1998). Faced with the loss of nearly 40% of its members, Lloyd’s moved in 1992 to establish limited liability for its members (James 2007). Existing unlimited liabilities were spun off into a separate reinsurer called Equitas. This change not only prevented new unlimited liability Names from joining the organization, but also had the consequence of encouraging corporations to participate in the market. Less than a decade later, corporations comprised 90% of Lloyd’s membership, with Names accounting for the remaining 10% (James 2007). This dramatic change had very symbolic and material consequences. Since its inception in 1688, Lloyd’s had built a reputation as a venerable institution within the insurance industry, accounting for half of London market business alone (James 2007). With such an influential position, the organization’s shift to limited liability after three centuries sent a strong signal to the market, namely that limited liability had become the name of the game (Fields et al. 1998). The symbol of an industry that had theorized and fought against moral hazard had come to appropriate, by the turn of the millennium, a limited liability structure that was bound to generate, within its own ranks, risk without costs – moral hazard in other terms!

Discussion: The Missing Link – Limited Liability as Moral Hazard

In the second section of this paper, we have explored the coming of age of the concept of moral hazard during the second half of the nineteenth century and the profound transformation that concept has gone through during the twentieth century. Moral hazard was a concept mobilized initially to suggest the moral fraud or villainy associated with particular individuals in situations of insurance protection. Conceptualizing moral hazard in this way suggests its own remedies and solutions – the problem was not the structure but particular individuals. The insurance schemes, hence, were to be coupled with sophisticated control mechanisms. The ultimate solution was selection on the basis of character. Acknowledged ‘moral villains’ were simply excluded from insurance schemes. As the concept of moral hazard spread through time, and in particular from the insurance field to the fields of finance or welfare, it was integrated in broader economic discourses and was partially ‘neutralized’ in the process. Moral hazard then became nothing more than rational ‘free riding’ in the context of a particular set of constraints and incentives. Character, hence, was not good enough as an

explanatory mechanism. The issue was more structural and should be connected to the existing incentive schemes. The most direct way to get rid of moral hazard, from such a perspective, was to dismantle the incentive system that generated moral hazard in the first place. Interestingly, this type of argument was mobilized broad and wide to propose the reduction or even the end of welfare benefits. But it was much more rarely applied to the 'lending of last resort' situation, where the dynamics at work were nevertheless quite similar.

In the third section of the paper, we have then looked in turn at the extraordinary fate of limited liability. Over more or less the same period, limited liability went from being a rare and highly contested privilege associated with certain corporate charters to becoming a taken-for-granted feature of contemporary capitalism, both in its corporate and non-corporate forms. Initially, debates around limited liability and its possible extension and generalization were highly morally charged. As limited liability imposed itself and spread through time, the concept was "neutralized" in the process. The moral association progressively waned, and only the financial measure or translation of liability and responsibility remained. Arguably, liability and responsibility were commodified in the process.

The two paths we have traced in turn in this paper do not appear to meet historically. Yet they are strikingly parallel in a number of ways. They share a relatively similar time frame. Similar also is the successful expansion of the core concept well beyond its original field of emergence. We have also underscored the striking similarity in the partial neutralization of the strong moral undertones initially associated with both concepts. Despite the importance of those parallelisms, we believe that the "missing links" between these two stories should be brought much more to the forefront. Limited liability and moral hazard have rarely met conceptually but we propose that they should be brought together if we are to better understand our contemporary world.

Ever since the seventeenth century, an argument that was systematically mobilized in favor of limited liability was the enticement it represented for those investors wary of risky endeavours (Perrott 1982). The limitation of liability was clearly a device that would encourage risk-taking. Without limited liability, it was feared, wealthy individuals – who had the most to lose – would not invest in risky ventures (Bryer 1997: 40). But increased risk-taking has two sides to it. On the one hand, it can encourage growth, the extension of markets and industry (Loftus 2002). On the other hand, it can be a potent source of de-responsibilization. Hence, the extension of limited liability has historically had a *janus* face. On the

one hand, it has been hailed as a positive development, freeing capital, industry and the progress of markets by allowing risk-taking on a larger scale. On the other hand, it could be seen as a worrisome development, precisely because it encouraged large-scale risk-taking in a context of ever expanding de-responsibilization. Limited liability, in other words, could be interpreted if we follow the debates in the second section of this paper as a major source of moral hazard in modern capitalism.

A traditional assumption in the contemporary economics and finance literature has been that shareholders are relatively risk-neutral, resulting from the premise that rational investors have a diversified portfolio (Gray and Cannella 1997) but also from the existence of limited liability. In a situation of limited liability, the amount of loss that might be potentially incurred is limited by the initial investment, which reduces the risk-aversion of investors as compared to a situation of unlimited liability. Ostensibly, this strengthens their risk-neutrality by making them less liable to any given investment (Mendelson 2002). Managers, on the other hand, have typically been considered to be risk-averse, owing to the fact that they have invested their own “nondiversifiable and nontradable human capital in the firm” (Beatty and Zajac 1994). Furthermore, any compensation structure that mandates managerial investment in the firm is viewed as problematic. In forcing “managers to reduce their cash compensation [by mandating] a larger investment in their own firm, you're asking them to bear more risk-risk that cannot be diversified away by holding other stocks and bonds” (Scholes 1992).

However, this view dramatically understates the extent through which moral hazard pervades modern corporations. Although it has been already been identified that limited liability constitutes a form of moral hazard (Okamoto 2009), we argue that the contemporary affinity between the two dramatically transforms the risk preferences of both owners and managers. This has been amply illustrated in the wake of the recent crisis, and especially within large financial establishments. We argue that these entities in particular contain a double layer of institutionalized limited liability as moral hazard that has significant implications for risk preference. First, managers enjoy limited liability in the sense that they do not bear the full costs associated with unfavorable performance. The magnitude of investments managed by financial institutions is immense, with the potential for very large gains. However, in an environment of limited liability, the largest risk for managers is that they will lose those “nondiversifiable and nontradable”

human capital investments in the firm (i.e. they will be fired); this threat is far outweighed by the potential gains of risky bets. Secondly, moral hazard becomes equally salient with the institutionalized 'lender of last resort' facility, meaning that in the event of adverse outcomes, the large financial institutions will be protected from the most severe effects. These two sources of moral hazard indicate quite acutely that managers of large limited liability firms are not risk-averse, but do in fact have significant incentives to seek risk.

Conclusions: Moral Hazard, Limited Liability and the Financial Crisis

While the neoliberal mobilization against moral hazard dramatically reshaped the social and welfare sphere during the latter half of the twentieth century in the U.S. as well as in a number of other countries, the financial sector was surprisingly unscathed by those debates. As argued above, the existence of a state-sponsored system of 'lending of last resort' could easily be presented as a major factor of moral hazard. If that were not enough, the international financial community generated over the last twenty years a succession of 'innovative' financial instruments that accelerated the growth of financial markets and in the process exacerbated the risk of moral hazard (Duffie and Garleanu 2001; Colander et al. 2009; Crotty 2009). All this happened in the context of banking deregulation in the late 1980s and the lack of regulatory reactivity as financial "innovations" were crowding the market (Leibold 2004). Lucid commentators made it quite clear that, all in all, moral hazard was a major cause of the savings and loans crisis of the 1980s (Kane 1989; Demirgüç-Kunt and Detragiache 2002) as well as of the Asian economic crisis of the 1990s (Chang 2000) and more recently of the sub-prime mortgage meltdown of the late-2000s (Goodhart 2008; Dowd 2009; Crotty 2009). This has not yet led, though, to policy making of the type that had been vigorously championed in the healthcare and welfare benefits sphere.

Dowd (2009) explicates clearly how moral hazard played a role in the latest financial crisis. Originally, banks granted mortgages with the intent of holding them until maturity, and if a mortgage holder defaulted, then the bank would risk running a loss. However, once these mortgages became securitized (i.e. with the view towards selling them), the risk of default dissolved, as the bank would only be concerned with the short-term return from the sale of the loan. As Dowd remarks, this "absence of deferred remuneration thus institutionalize[d] short-

termism and undermine[d] the incentive to take a more responsible longer-term view” (Dowd 2009). Such a game of ‘hot potato’ (Shin 2009) was acknowledged to implode inevitably, yet the promise of intervention by the Federal Reserve (acting as a lender of last resort) served as a safety cushion for continued risk-taking behavior. In essence, moral hazard resulted from bankers’ understanding that the “large financial gains of the boom [would be] private, while losses in the crisis [would be] socialized” (Crotty 2009).

While the sources of moral hazard in the financial sphere are naturally quite significant, we propose here that another potent source of moral hazard has been neglected. Through the limited liability mechanism, managers but also shareholders, investors and bankers have been structurally protected from the costs of risky behaviours and decisions. This systemic protection is now deeply ingrained and institutionalized within contemporary capitalism, including naturally within the financial sector. This systemic source of moral hazard has naturally been reinforced by the persistence and even the spread of a “lender of last resort” principle – which has translated, during the recent crisis, into large-scale bail-out programs. Arguably, the moral hazard opportunities associated with those bail-out programs stem, here again, from an institutional inscription of limited liability but this time at the macro-level (national and international). The sectors that have been bailed out, and in particular the financial sector, have been the beneficiaries of limited liability on an hitherto unprecedented scale.

This double layer of moral hazard/limited liability – both at the firm and societal level – has become a systemic feature of contemporary capitalism. It is appropriately addressed as a pervasive phenomenon rather than as an anomaly that can only be attributed to specific individual or organizational failures. As such, it cannot be solved simply by punishing the wrong doers or by improving the quality of governance mechanisms; rather it involves a more fundamental questioning of some of the assumptions undergirding contemporary capitalism.

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