

A note on Austro-libertarianism and the limited-liability corporation.

A limited-liability corporation is an artificial (“legal”) person whose liability is limited to the assets “owned” by the corporation. This means that the real or natural persons (if there are any) who own the corporation are not liable for the consequences of corporate actions or events originating within the property “owned” by the corporation. Thus, while the limited-liability corporation itself is *fully liable* (i.e., to the full extent of its assets) for such actions and occurrences, its human owners (if there are any) are *not liable at all*. Admittedly, they run a risk of losing all that they have invested in the corporation, but nothing more. This risk may be called an economic liability but it is not a liability in the relevant juridical sense: debtors cannot turn to the owners of the corporation to ask or compel them to pay its debts—it does not matter whether these debts are consequences of the corporation’s contractual obligations (wages, rents, purchases, loans, etc.) or consequences of harmful actions or events (explosions, flooding, contaminations, etc.) caused by the corporation or its property to third parties.

Thus, we have the problem of the standing of the limited-liability corporation in view of the principles of Austro-libertarianism: the limited-liability corporation is a fully liable artificial person that shields any natural persons who are its owners from any liability. This is a problem because we cannot have it both ways. Either the limited-liability corporation is an autonomous (“self-owning”) person in its own right and then no objection can be made to it, as, despite its name, it is fully liable; or it is something owned by natural persons and then these owners must, like all other owners, be held fully liable for what they do (or command or permit others to do) with their property as well as for the consequences of events that originate within their property.

Now, from an Austro-libertarian point of view—which, as I understand it, is committed to a realist philosophy and therefore akin to a natural law position¹—it does not make sense to say that an artificial person can be an autonomous person in its own right. A corporation is a fiat person; in some ways it stands to a natural person as fiat money stands to real or natural (market-generated) money. For instance, corporations can be multiplied at little or no cost without changing the availability of any material economic resource (including labor). A corporation is not an individual person, as it is possible to divide it in many other corporate persons as well as to merge it into another corporation or to combine it with other corporations in a new, larger corporate entity. As an artificial person, it is the intended product of particular decisions and actions of particular natural persons, who create it because they have or expect to have an interest in using it for one purpose or another. In a word, it is a tool, a means of action. As such—and according to the natural law position—it exists in the realm of human action only as something that is owned by human persons.

Therefore, the Austro-libertarian point of view rules out the first alternative, that the limited-liability corporation is an autonomous person in its own right. It rejects the notion that the limited-liability corporation as it exists in modern state-run legal systems is a lawful construction. For, while it is true that in the parlance of the positive law of modern legal systems the shareholders of a corporation are sometimes

¹ Austrian economics regards the laws of economics as natural laws and libertarianism (at least in its Rothbardian tradition) similarly regards the basic patterns of order in the human world as natural rights and natural laws (of justice).

said to be its “owners”, it cannot be denied that their so-called “ownership” is absolutely unlike the ownership of other things, other tools, other types of organization. After all, they are absolved from liability—not by others who for one reason or another waive their right to hold the shareholders liable, but by the unilateral decision of the founders/organizers to set up a limited-liability corporation. Of course, the idea that the founders/organizers can absolve themselves and others (the shareholders) of all liability towards third parties merely by performing the rituals of founding a particular type of organization has no basis in natural law (which, being tied to reality, is what it is); it can only have a basis in positive law (which is what the locally and currently relevant group of powerful and influential people say it is).

If its shareholders do not own a limited-liability corporation in the full and usual sense of the phrase “to own”, the question arises: who owns the corporation? The positive law does not provide an answer. As seen from the point of view of the positive law, the corporation is not owned by human persons; yet it is said to be a person with rights similar to those of a human person. Therefore, the positive law construes the limited-liability corporation as an autonomous person in its own right—which is nonsensical from the point of view of the natural law.

Austro-libertarian principles of law can only accommodate the second alternative: the owners of a corporation are fully liable for its obligations towards others, unless these others have consented to the condition that only the assets of the corporation but no other assets belonging to its owners can be claimed for settling its debts. One could of course argue along legal-positivist lines that the legalization of the limited-liability corporation is a proxy for the consent of all persons—assuming that once something is enacted as “positive law” it has the consent of the governed. However, an argument of that sort is not likely to carry much weight in Austro-libertarian circles.

Clearly, if we want to approach limited-liability corporations from an Austro-libertarian point of view, we should be prepared to search for the real owners of such organizations, either by following the trace of full ownership of a corporation from its original founders to their present successors or by identifying those who presently have actual possession or control of the corporation. We should be prepared to do so even though, as noted already, the positive law is particularly unhelpful when it comes to identifying the real owners of a limited-liability corporation. It is understandable why the positive law is so unhelpful: In the perspective of the positive law, there is “normally” no need to identify the owners of a corporation, as it is construed to be a self-owning person, although it is admitted that “occasionally” there may be reason “to pierce the corporate veil” and to find the corporation’s real owners. Note, however, that the positive law does not require a corporation to identify or list its real owners; it is left to the judge to discover the facts of real ownership whenever he decides to look behind the corporate veil. If the real owners had to be identified or listed in any case, they would always be known and the corporate veil would serve little or no purpose. No judge would be able to argue cogently that the corporation is self-owned if it was public knowledge who its real owners are. The real owners could be saddled with full liability for the corporation—and this would deprive the corporation of its single-most characteristic feature, its “limited liability”.

In short, the limited-liability corporation as we know it has no place in an order of law that conforms to Austro-libertarian principles—and, therefore, no place in a truly free market (assuming that a market order has to conform to Austro-libertarian principles to be truly free).

1. One typical defense of the limited-liability corporation is that limiting liability in contracts is acceptable and lawful. This is of course true, but it is a mere consequence of the freedom of contract that, under Austro-libertarian principles, is available to *all persons* and consequently all associations and partnerships of persons, provided only that they are deemed capable or competent to enter into contractual relationships. It has nothing to do with the limited-liability corporation per se, although it is true that the limited-liability enjoys the privilege of not having to take special steps to limit its liability for contractual obligations: it is up to the other parties to the contracts to take steps to get it to remove that limitation of its liability. The economic value of that privilege should not be underrated but it is certainly not the most important privilege of which limited-liability corporations are the beneficiaries.

If limited liability for contractual debts is not the peculiar privilege of limited-liability corporations, it is nevertheless important to them to the extent that they sell bonds to the general public. When banks, other corporations or financially savvy wealthy individuals make a loan to a limited-liability corporation, it is far more likely that it will have to waive its limited-liability prerogative and provide sufficient collateral. In contrast, the general bond-buying public has no occasion to impose conditions. It is fully exposed to the effect of the “Caveat emptor”-principle, even though prices on the bond market may (or may not) adequately reflect the creditworthiness of the corporate borrower.

Even so, the limited liability of the limited-liability corporation is particularly noteworthy only with respect to obligations that do not arise out of its contracts. What sets such a corporation apart from other participants in the market is the privilege of unilaterally limiting its liability for torts (and other sorts of non-contracted obligations) to the assets of the corporation itself rather than the assets of its owners. That privilege is bestowed on those who cloak their actions in the form of a limited-liability corporation, and denied to those who do not do so.

Moreover, current legal systems (systems of “positive law”) impose conditions on incorporation to the effect that not everybody is legally entitled to cloak his actions in the form of a limited-liability corporation. For example, most legal systems forbid the formation of one-man corporations. This prohibition makes sense only with respect to liability for torts, as any person has the undisputed right to insist on limited liability for his contractual obligations.

Why should one-man corporations be singled out? Recognition of the legality of the one-man corporation would mean that any person can set up any number of corporations, assign some asset or other to each one of them, and present any action of his as the “corporate action” of one these fiat persons. Anybody would then be in a position to unilaterally limit his liability for torts as well as contracts. If everybody were to do this, liability would disappear as a significant element in human interaction—and so would every property or attribute of social and economic life that depends on the practice of holding people fully liable for their actions. For example, the coherence of a market economy, its tendency to harmonize diverse interests, depends on the incentive to internalize the costs of one’s actions and to minimize the imposition of harmful external effects on others—but what would become of this incentive if people were free to unilaterally limit their liability for torts? It is therefore with good reason that one-man corporations are made illegal. Nevertheless, it is odd—to say the least—that it is deemed illegal that a person cloak his actions in the form of one or more limited-liability corporations, but legal that two or more colluding persons do so.

2. It is often argued that corporations as such cannot commit torts, that torts are always to be attributed to particular natural persons, never to artificial persons such as a corporation. Again, this is true but the question is whether the argument is sufficient to prove the legitimacy of limited-liability corporations. How does one get from “artificial persons cannot commit crimes or torts” to “the owners of a limited-liability corporation are not liable for torts resulting from corporate actions”? (A logically sufficient but realistically speaking unacceptable answer would be that the limited-liability corporation is an autonomous, self-owning person, owned by no natural persons whatsoever.)

Let us grant immediately that in many cases torts are rightly attributed to natural persons who are agents in the employ of the corporation: employees, representatives, managers, directors. Such an attribution may be appropriate when the agents act contrary to corporate rules or instructions given by their superiors in the corporate hierarchy. In other cases, the operative agent whose action is the proximate cause of the unlawful harm to third parties may defend himself by appealing to the “respondeat superior” principle: he acted under and according to the rules or instructions given by his superiors and therefore they (his superiors) should be held answerable and liable for the damages.

Eventually, appeals to the principle of “respondeat superior” may reach the highest levels in the corporate hierarchy: the top-level management, the board of directors or trustees, and ultimately the congregation of the shareholders. Of course, under positive law, the shareholders will normally not be held liable—that is the whole point of being a shareholder of a limited-liability corporation.

In contrast to shareholders, managers and directors / trustees may in some cases be held personally liable for actions committed under their direction or supervision. However, they usually take care to add to their rules and instructions a standing condition to the effect that nothing they command to their underlings should be taken to imply an authorization to commit unlawful or illegal acts or a willingness to condone negligence or carelessness in the execution of corporate policies and actions. Thus, it is a priori uncertain where the liability for a tort will come to rest, as the operators who were directly involved in the harmful occurrence try to shift it upwards and the higher-ups in the hierarchy try to push it downwards again, or further upwards to their superiors, or sideways to other lines of command and supervision (for, typically, several branches of the hierarchy are involved in any particular corporate action). Moreover, the answer to the question where such liability *should* come to rest depends upon the statutes, rules, policies, practices, as well as on actual events and exchanges within the corporation. These are things that an outsider cannot be presumed to know, and it may require a lot of analysis, research and costly litigation to determine just what bearing they have on any particular case.

So where should the outsider who suffered unlawful harm as a result of some corporate activity go to seek redress or compensation? To the operator (a janitor, truck driver, sales clerk), leaving it to him to recover (if he can) the whole or a part of the damages he paid for from his superiors? Or to corporation, leaving it to the corporation itself to recover (if it can) from its operative agents or their more or less immediate superiors? Surely, the latter option is likely the only sensible one, but it implies that the corporation itself is *prima facie* liable, and therefore raises again the question whether its liability extends beyond its assets to the assets of its owners (whoever they may be).

The first option is not sensible except in cases where there is no doubt that the corporation was not involved, neither in the occurrence of the accident itself nor in the

kind and extent of the damage it causes to third parties. Compare, on the one hand, an employee hitting and wounding a pedestrian with his bicycle while on an errand for his employer (say, delivering an envelope to the post office), and on the other hand, an employee losing control of a truck loaded with barrels containing an inflammable liquid and setting fire to a roadside building. Compelling the pedestrian to seek damages from the biker rather than from the corporation that employs him raises fewer questions of remedial justice than would compelling the owner of the building to seek compensation from the truck driver not only for the damage done by the impact of the lorry against the wall of the building but also for the damage done by the explosion of the inflammable stuff owned by the corporation.

It cannot be excluded that employers (be they corporations or not) require their employees to contractually assume all of the risks involved in the work for which they are hired. According to the principle of freedom of contract, if it were considered a valid condition of employment, such a requirement would indeed completely exonerate the employer (who might be a corporation) and liberate him from any liability in tort. However, employment contracts containing such a requirement are rare, as for many sorts of jobs they would be available only to millionaires or billionaires or else would have to include provision for possibly enormous insurance premiums as part of the employee's wage. What if the employee agrees to assume all the risks but does not buy adequate insurance? Should the corporation be allowed to hide behind the contract with its employee, regardless of whether he received a wage sufficient to buy the requisite insurance, regardless of whether he actually bought enough insurance? In any case, the presumption is that unless the employee agrees to (and actually does) assume all the risks attached to his work, the employer is liable. To presume that the employee is liable unless the employer agrees to assume liability for work-related risks would go against the grain of an employment contract, as it would imply that the employee has the last word in deciding whether a particular action is too risky or not. Again, the presumption is that the corporation is fully liable for torts—and we face once more the question why this liability should be limited to the assets of the corporation rather than the combined assets of its owners.

3. Another line of defense for the limited-liability corporation is that the law—meaning, the positive law—provides sufficient means to alleviate or even eliminate the worst abuses: more or less onerous legal and regulatory requirements concerning capitalization, keeping and publishing records, shareholder rights, auditing and the like. At the very least, drawing attention to these legally mandated safeguards (which may vary considerably from one legal system to another) is to concede the point that limited-liability corporations are not merely contractual arrangements posing no more inherent risks than do other arrangements that do not imply the ability to unilaterally limit one's liability vis-à-vis non-consenting others.

A hard-line free-market stance would reject such imposed requirements and regulations as interventions in the property-and-contract relationships that define the free market. However, with respect to limited-liability corporations this position is difficult to maintain, given that limited liability is itself a privilege that cannot be reconciled with the principle of equality under the law that is implied by the notion of a free market. Indeed, if incorporation were not a special-status privilege then one would have to wonder why not everybody avails himself of its benefits. The usual explanation is that incorporation is costly and that it is by no means certain that the benefits outweigh the costs. However, it appears that a significant part, perhaps most, of the costs of incorporation are imposed by the legal and regulatory system—for

these are the only costs that the founders of a limited-liability corporation cannot avoid or mitigate by specific provisions in the statutes of the corporation or in the contractual conditions of shareholding. In other words, it appears that the legal and regulatory burdens imposed on the limited-liability corporation are needed to prevent incorporation from becoming a general, even universal phenomenon; and needed, therefore, also to prevent the complete erosion of the full-liability requirement implied in personal action and ownership. Without the imposed costs, it is hard to see why a person would neglect to set up a corporation with severely limited, possibly nearly worthless assets, especially when the action he plans to undertake is risky, merely to keep his other assets out of the range of liability claims.

The ultimate safeguard is usually identified as the judges' power "to pierce the corporate veil". Now, it is certainly true that judges have this authority (at least in the jurisdictions and legal systems that I am aware of). However, judges may be more or less reluctant to tear away the corporate veil. On the one hand, if the judges are extremely willing to do so then the corporate form does not provide much of a shield to the people who own the corporation. In that case, the corporate form serves no purpose, as it only implies limited liability for obligations arising out of contract—and, as noted before, everybody can make acceptance of his limited liability a condition for entering into a contractual relationship. If, on the other hand, the judges are extremely unwilling to rip through the corporate veil then the real owners of the corporation have virtually no personal liability, even when they are indisputably *morally* responsible for its actions: only the corporate assets (which may be huge or tiny) are available for indemnification of the victims.

Thus, it appears that the form of the limited-liability corporation is significant only if, and to the extent that, judges adopt a sufficiently deferential policy with regard to the corporate veil. We have to bear in mind that the limited-liability corporation is a creature of legislation, enabled by "general incorporation laws", and that, in this connection, the "judges" are state-appointed magistrates, with an official duty to apply duly enacted legislation as a matter of course. However, the whole point of an Austro-libertarian critique of the limited-liability corporation is to determine whether general incorporation laws or judicial decisions asserting or implying the right of unilaterally limiting one's liability are compatible with the free-market principles that define the Austro-libertarian outlook.

In any case, it should be clear that this whole "corporate veil"-business reveals an inconsistency in the positive law of corporations: normally judges will pretend that the corporation is a self-owned entity that does not entail liability for any other persons, but occasionally judges will drop the pretense and go after the persons behind the corporation, treating them as its owners (in the usual sense of the word).

4. Another irrelevant defense is that the limited-liability corporation offers the great advantage of allowing huge amounts of capital to be raised by issuing shares that shield the buyer of shares from liability for the corporation's actions. This is true, but does it provide an argument for the compatibility of the limited-liability corporation with Austro-libertarian principles of law? Any person who, and any association or partnership that, owns an enterprise can issue (i.e. sell) titles to *profit sharing* under a contractual arrangement that entitles the profit-shareholder to a share of the profit (if there is any, and to the extent that it is not re-invested in the enterprise) and to a share of the residual positive value of the enterprise when it is terminated. Under a regime of freedom of contract, such profit-shares may, of course,

be sold with any or no further conditions attached to them, according to the agreement between the seller and the buyer.

Note, however, that owning such a profit-share does not per se imply being an owner or co-owner of the enterprise. Although being entitled to the profits of an enterprise and to its residual value when it is terminated is normally a mark of ownership, it is not a sufficient mark. One cannot presume that the buyer of a profit-share has agreed to buy the burdens (liabilities) of ownership of the corporation merely because he has bought a share to its profits and residual value. In fact, the profit-shareholders of a limited-liability corporation have bought their shares with the specific proviso that they will not have any liability arising out of a corporate action or possession. They know of the risk that the value of their shares may dwindle or even vanish, but unless a judge rips through the corporate veil, they have the assurance that no claim against the corporation will ever reach them.

Therefore, the liability that comes with the ownership of the enterprise does not pass automatically to the holders of profit-shares. Even profit-shares that come with the promise of periodic meetings of the shareholders, periodic information about the enterprise's activities and results, voting rights in certain matters (such as electing profit-shareholder representatives, confirming executive managers, approving particular plans, etc.) cannot be construed automatically as ownership-shares.² Even when the contractually stipulated rights attached to the profit-shares are co-extensive with the *rights* of ownership, the buyer cannot be presumed to have acquired an ownership-share in the enterprise. That is so because he has bought a bundle of rights from the owners; but he has not agreed to buy a bundle of liabilities from them. In fact, the owners, who normally unilaterally determine the conditions under which they will sell shares, have explicitly stipulated that the buyer will only buy a profit-share without being burdened with any liability arising from the actions of the enterprise. But this can only mean that the ownership of, and therefore the full liability for, the enterprise remains with the original owners. They have willingly and knowingly diluted their rights without diluting their liability for the explicit purpose of attracting more capital to their enterprise than they otherwise would be able to attract. To assume otherwise is to hold either the view that ownership of a corporation (which implies rights as well as liabilities) can be transformed into ownership of profit-shares (which implies rights but no liabilities) by a unilateral decision of the owners of the corporation, or the view that the corporation owned itself from the moment it came into existence—in short, that it is not owned by any natural person. In any case, conceptually, and in view of the application of libertarian, free-market principles of law, the owners of profit-shares, no matter how extensive their rights, are not to be considered the owners of the corporation. Thus, the fact that profit-shareholders are exempt from liability for corporate actions is not objectionable from an Austro-libertarian point of view. What is objectionable is that no one else should be held fully liable.

As a device for raising capital, as distinct from a device for transferring real ownership of a corporation, the sale of profit-shares should have no consequences for the liability of the issuer of the profit-shares (the owner of the corporation). This is the crux of the matter. Can selling profit-shares extinguish the liability of the original

² The decisions of the shareholder's meeting are collective decisions, meaning that those who did not vote with the majority are nevertheless bound to accept the decision and to suffer its consequences. Thus, it is in any case incorrect to say that the shareholders own the corporation. At most one could say that an ephemeral collective body, the "congregation of shareholders", which is itself an artificial ("legal", "statutory") person, owns the corporation.

owners of an enterprise? Those who answer ‘No’ must acknowledge that the original owners remain fully liable, and hence that there is no such thing as a limited-liability corporation that conforms to libertarian, free-market principles of law. Those who answer ‘Yes’ must acknowledge that in their view people can unilaterally limit their liability with respect to their own property, and hence that the balance of rights-and-liabilities that underlies our understanding of the “harmony of interests” of the free market can easily be avoided by those who have legal access to the method of incorporation.

If the holders of profit-shares are not the owners of the limited-liability corporation, who are its owners? Judging by the criteria of the positive law of modern legal systems, the answer must be that the limited-liability corporation has no owners in the ordinary sense of the word ‘ownership’ (which implies full liability). It has owners of profit-shares, managers, directors, employees, and agents of various sorts, all of whom are supposed to be linked to the corporation by contracts of one kind or another (employment contracts, sale-of-profit-shares contracts)—but there is no separate category of people who own the corporation itself rather than merely a collection of shares that entitle them to a dividend. Clearly, the managers and directors also have a mere contractual link to the corporation; they are not its owners, as it is nonsense to say that an owner is under contract to his property. Nevertheless, by piercing the corporate veil, setting aside all the legal fictions of positive law, and engaging in a realistic investigation of property relations within the corporation (starting from the fact that its founders, before they started to sell profit-shares, were without question its first owners), we may well be able to identify fairly easily who its current owners are, and therefore who should be held liable for the corporation’s debts. What the judges acting on the fictional premises of the positive law do only occasionally, when they see a reason for tearing away the corporate veil, a judge acting on the premises of the natural law should do as a matter of course.

5. Corporate wealth and liability insurance provide other lines of defence for the limited-liability corporation. It is certainly true that rich corporations can afford to pay compensation for relatively minor torts or to buy liability insurance covering substantial damages. However, not all corporations are equally rich—and my comments concern the essential legal form of the limited-liability corporation, not its incidental wealth. Moreover, insurance protecting the corporation’s assets against liability claims is not the same thing as insurance protecting the shareholders’ assets against such claims. Even if *corporations* were required by law to take out liability insurance, this would do nothing to remove the anomaly of the unilateral limitation of one’s own liability. To remove that anomaly, one would have to require that the shareholders (or whoever the real owners of the corporation turn out to be) collectively take out liability insurance for the full value of their combined assets, whether these have been labelled as belonging to the corporation or not.

6. From the Austro-libertarian point of view the so-called Berle-Means critique of the limited-liability corporation as institutionalizing “a separation of ownership and control” is not quite on target. That criticism assumes that the shareholders are the owners and the managers the controllers, but, as noted here, that assumption is not germane. The value of the Berle-Means critique resides primarily in the fact that it helps to explain the considerable leeway managers enjoy vis-à-vis the shareholders, which is a legitimate concern, whether or not one wants to belittle it by pointing to the real or supposed efficiency of capital markets and labor markets for managers, which

tend to ensure that after a while the shareholders will get the managers they want (or vice versa).

However, from my point of view, the heart of the problem is the elevation of an artificial, conventional means of action to the status of an autonomous, self-owning person, assumed to be fully liable to the extent of its assets, capable of owning property (either directly or as a shareholder of other corporations), making contracts, and so on, although it is in effect no more than a cloak or veil thrown over the actions of individuals. The problem is “the separation of ownership and liability”, which allows the limited-liability corporation to exist as an anomalous device for reaping the profits of ownership without having to face the full burden of liability.

If this is accepted, it should provide an interesting angle for an analysis of the corporate economy, its corporate elite, its systemic problems of moral hazard, and the vital role that monetary and financial institutions (banks and insurance companies, themselves almost without exception limited-liability corporations) play in it. The opportunity to invest in limited-liability corporations is bound to lead people to invest less of their savings in full-liability enterprises than they otherwise would, thereby creating large pools of capital that enhance the attractiveness of limited-liability corporations to purveyors of credit and insurance, and allowing corporations and complex overlapping and interlocking corporate structures to acquire ownership of huge quantities of real resources as well as real power over men and women. Because of the imbalance between ownership and liability, limited-liability corporations can become really big and, depending on their more or less central position in the corporate economy, acquire a “too big to fail”-status (which in itself is a source of moral hazard).

However, an analysis of that sort lies well beyond the scope of this note and miles beyond the boundaries of my competence. My primary purpose here was to sketch some lines of argument for criticizing the legal form of the limited-liability corporation that might be of interest to readers of an Austro-libertarian persuasion. It is amazing that many Rothbardian libertarians on the one hand like to insist on the fundamental difference between property-based philosophical and economic analysis and the bland contractarianism of mainstream "free market" thinking, and on the other hand unquestioningly buy into the "nexus of contracts" theory of the corporation. It should be obvious that the big innovation of the corporate form was in what it did to property relations and in its extension of the concept of a rights-holding person.

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