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▶ To cite this version:

Marie-Laure Djelic, Joel Bothello. Limited liability and its moral hazard implications: the systemic inscription of instability in contemporary capitalism. Theory and Society, 2013, 42 (6), pp.589 - 615. 10.1007/s11186-013-9206-z . hal-01891963v2

HAL Id: hal-01891963

https://sciencespo.hal.science/hal-01891963v2

Submitted on 10 Dec 2021

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Theor Soc (2013) 42:589–615
DOI 10.1007/s11186-013-9206-z

Limited liability and its moral hazard implications: the systemic inscription of instability in contemporary capitalism

Marie-Laure Djelic & Joel Bothello

Abstract The principle of limited liability is one of the defining characteristics of modern corporate capitalism. It is also, we argue in this article, a powerful structural source of moral hazard. Engaging in a double conceptual genealogy, we investigate how the concepts of moral hazard and limited liability have evolved and diffused over time. We highlight two parallel but unconnected paths of construction, diffusion, moral contestation, and eventual institutionalization. We bring to the fore 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 systemic instability of contemporary capitalism and, as a consequence, of a pattern of recurrent crises that are regularly disrupting our economies and societies.

Keywords Moral hazard · Limited liability · Systemic instability · Financial crisis

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 behavior generates externalities and the privatization of benefits for some comes at the expense of others (Dow 2012b). We suggest, in this article, that the multiplicity of documented moral hazard-type episodes, before and during the crisis, 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, the inscription of this potent source of moral hazard at the heart of contemporary capitalism is rarely recognized or discussed.

To show the consequential but neglected connection between limited liability and moral hazard, we engage in a double exercise in conceptual genealogy (Foucault 1984; Palonen 2002). In the first section, we present conceptual genealogy as a method, underscoring in parallel the epistemological perspective that grounds such a methodological choice. The second section of the article engages with the concept of "moral hazard." We show the fluidity and plasticity of the concept through time, particularly since the beginning of the nineteenth century. The concept crystallized initially in the insurance domain but over time it diffused to other fields—morphing significantly in the process. We subsequently explore, in the third section, the concept of limited liability, tracing in broad strokes here again an historically fluid notion. Since the nineteenth century, limited liability has gone from being a rare privilege generating distrust to becoming the undisputed regime 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 source of moral hazard. This source of moral hazard is all the more powerful now that it is legally inscribed at the core of contemporary capitalism, within corporations and increasingly even with partnerships (in the form of Limited Liability Partnerships). In conclusion, we propose that this is highly consequential for the dynamics of contemporary capitalism. If limited liability has strong moral hazard implications and is a structural feature of contemporary capitalism, then instability is in fact systemically inscribed in contemporary capitalism. This systemic inscription of instability can help us explain, in turn, the recurrence and regularity of crises.

Conceptual genealogy: epistemology and methods

Conceptual genealogy is a "history of morals, ideals and metaphysical concepts." It is a history of successive "interpretations" pointing to different "systems of rules" and regimes of power (Foucault 1984, p. 86). Conceptual genealogy entails an "historical sociology of concept formation" (Somers 1995a, p. 115; Canguilhem [1966]1978; Foucault 1972; Hacking 1990). The epistemological conviction behind such an approach is not only that human activity is contextual and socially constructed but that activity, language, politics, and values are co-constitutive and co-evolving. Knowledge is not based on "timeless and essential secrets but … [is] fabricated in a piecemeal fashion" (Foucault 1984 p. 78). In this sense, it is decidedly historical, situated, and anthropomorphic (Foucault 1984, p. 90; Nietzsche and Commons 2006[1882]). Accordingly, words and concepts are not mere labels put on the "essence of things" but are "historical and cultural objects," "symbolic systems with their own histories and logics." Those "symbolic logics are themselves modalities of power and authority" (Somers 1995b, p. 232). Concepts are thus complex, multilevel, and multidimensional (Goertz 2005).

This kind of epistemological conviction generates a responsibility for social scientists—that of "turning social science back on itself to examine the often taken-for-granted conceptual tools (and fundamental categories) of research" (Somers 1995a, p. 114). 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. In order really to "understand how we think and why we seem obliged to think in certain ways" (Hacking 1990, p. 362), we need to analyze concepts as being "words in their sites" (Somers 1995a, p. 113). A deeper understanding of concepts—in the Weberian sense of *verstehen*—hence "presupposes knowledge about the alternative interpretations of concepts that the historical agents had in their hands" (Palonen 2002). It consequentially implies the exploration of historical "sites" of meaning and the reconstruction of institutional settings, authority regimes, and meaning systems in which words and concepts form and evolve through time.

Conceptual genealogy (alternatively labeled conceptual history or the historical sociology of concept formation) has been gaining ground in most social sciences over the last two decades (Hampsher-Monk et al. 1998; Skinner 2002; Koselleck 2002; Palonen 2002). Scholars in different disciplines have used this methodological program to explore such fundamental categories and concepts as "agency" and "order" (Alexander 1982), the "person" (Carrithers et al. 1985), "structure" (Sewell 1992),"dependency" (Frazer and Gordon 1994),"civil society" (Somers 1995b),"sovereignty" (Bartelson 1995) or"poverty" (Mitchell 1992). Genealogical perspectives in general belong to the "reflexive" turn in social science (Woolgar 1988). This "reflexive" turn has come in reaction, over the past decades, to the dominance of normative and naturalistic approaches and methods so characteristic of the evolution of social sciences after 1945.

The work of "reflexivity" is "above all historical." It "challenges us to explore the historicity of our theoretical semantics … usually to discover that they themselves have histories of contestation, transformation, and social relationships" (Somers 1995a, p. 115). Hence, conceptual genealogy offers a particular kind of history, one that does not presuppose constants, uniformity, or unity. Instead, it embraces complexity, discontinuity, hazard, and instability to a great degree:

> … to follow the complex course of descent is to maintain passing events in their proper dispersion; it is to identify the accidents, the minute deviations—or conversely, the complete reversals, the errors, the false appraisals, and the faulty calculations that gave birth to those things that continue to exist and have value for us (Foucault 1984, p. 81).

The empirical material used for a genealogical analysis is the same as that used by the historian. Most of the time, it is 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 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, our analysis is not historically exhaustive but instead we select conceptual turning points or consequential "deviations" 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, p. 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, p. 35).

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 here the more classical forward approach, moving from older, contextualized, meanings towards dominant contemporary ones. In the process, we try to uncover key patterns, events, and mechanisms that account for conceptual transformation. We start from the early nineteenth century insurance conceptualization of moral hazard and then proceed to explore a concurrent emergence in monetary policy, paying attention to the associated fluctuations in meaning. The next important step in the history of the concept of moral hazard is its value-neutralization by economists in the mid-twentieth century and its adoption by and adaptation to healthcare and welfare economics. With respect to limited liability, we start from Roman origins and underscore a peculiar and highly contextual meaning in those times. Then, we brush over a revival of limited liability in the Middle Ages associated with significant conceptual transformation. Moving closer to our times, we identify key turning points in the nineteenth century that account not only for consequential conceptual transformation but also for a much broader societal impact of the concept of limited liability ever since. 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 become structurally connected over time in the particular form of capitalism that dominates our contemporary world and that this is having highly significant consequences.

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, p. 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.

Hazard originated as a dice game and was already mentioned in English texts in the fourteenth century. From the sixteenth century, the term became more generic and described any venture considered to be risky (Baker 1996, pp. 244–246). During the

Victorian era, the word “hazard” came to be associated with strong and negative moral connotations as it was then essentially synonymous with the Victorian vice of gambling (Baker 1996). The two words “moral” and “hazard” only came to be used together in the nineteenth century and by then only in two main areas—first the insurance industry and later monetary policy. Although initially separate, 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 welfare policies.

Moral hazard and the insurance industry

In the insurance industry, the intuition of moral hazard (albeit not the word) 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, p. 38). The Brotherhood was a mutual-aid society in Feudal France, where members (local craftsmen) vowed to “assist one another, under any circumstance, with advice, purse, and sword” (Funck-Bretano 1922). The leadership of the Brotherhood had realized that the availability of insurance reduced the exercise of caution. 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 widespread phenomenon (Dembe and Boden 2000).

In the early nineteenth century, insurance companies appropriated the term “hazard” in its association with risk or chance in general. Hazard was used to describe any sort of risk relative to the insured. Additionally, hazards were already divided into events that could potentially cause damage (e.g., lightning), and conditions that would further exacerbate the damage (e.g., structures built of wood). Such classifications were created to anticipate risk better and thus adjust rates accordingly. Ostensibly, the term “hazard” was being dissociated from morality overtones, with a more de-personalized definition better suited to the probabilistic purposes of insurance assessment. These calculations were becoming, in the nineteenth century, the “intellectual cornerstone of the insurance enterprise” (Baker 1996, p. 246).

By the mid-nineteenth century the scope of private and social insurance systems had expanded considerably, mainly as the result of economic growth, increasing urbanization, deeper actuarial knowledge, and aggressive marketing techniques and pricing policies (Zelizer 1979, pp. 10–26). While there were fewer than a hundred policies in place in the entire United States at the turn of the nineteenth century, by 1844 a single company could issue 796 policies in 19 months of operation (Zelizer 1979, p. 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, p. 35). This expansion spilled over into Prussia and in April 1854, a law empowered local authorities to require dependent workpeople to join benefit (insurance) societies (Dawson 1912, p. 6). France was the only country during this period that did not experience the growth of the private insurance enterprise, as it was considered to be “repugnant to French sensitivity” (Zelizer 1979, p. 35).

The astonishing expansion of the insurance enterprise came with equally remarkable specifications of insurable characteristics, including the notion of "hazard." The elaboration of this latter notion was particularly important, as pervasive coverage resulted in increasing fraud (Murphy 2010). This trend combined with Christian apprehension about the growth of insurance to explain a focus, in the second half of the nineteenth century, 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. In particular, the 1862 text of Arthur C. Ducat symbolized this reorientation. Bringing the two words together, this text de facto created a new compound word—*moral hazard*.[1] Conscious acts including fraud, arson, and malingery were identified and classified as *moral hazards*, as were behaviors that heightened the probability of loss, such as misrepresentation, negligence, poor business practices, and overinsurance (Ducat 1862: pp. 164–165; Campbell 1902; Rubinow 1913). Moral hazard could result from situations of temptation as much as from personal predisposition and, often, from a combination (Ætna Guide 1867; Baker 1996).

By the turn of the twentieth century, moral hazard had become a well-defined feature of the insurance industry and literature. More importantly, moral hazard remained framed in fundamentally ethical terms even when circumstances seemed to create or increase "temptation." Persons of "questionable character" were to be denied insurance outright, not simply charged higher premiums. Such risks were deemed outside the scope of insurance and identified, in practice, by rule of thumb following conventional definitions of morality (Griswold 1868; Baker 2000). This manichean perspective led to an increasingly narrow definition of moral hazard. In his book, *Risk as an Economic Factor* (1895), John Haynes argued that moral hazard should only apply to intentional acts. In contrast to Ducat, he excluded negligence. This book would be quite influential and, in time, insurance texts were using two different terms. Moral hazard implied intentionality while *morale* hazard indicated unintentional carelessness (Mowbray and Blanchard 1955; Heimer 1989). Thus, moral hazard became commonly accepted in the first half of the twentieth century as reflecting *consciously and intentionally* immoral behavior.

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. In the early eighteenth century already, moral hazard was identified (but not labelled) as a risk associated with monetary policy. The concern was related to infusion of liquidity during periods of crisis. This type of intervention played the role of quasi-insurance and banks would be encouraged to take risks if they were likely to be rescued in periods of crisis (Humphrey and Keleher 1984; Moore 1999). Although the term "moral hazard" would not be coined by insurers for another half century, the underlying notion was clearly associated, in the financial sphere, with the institutionalization of this "lender

[1] Compound words can be closed, hyphenated or open."Moral hazard" is an open compound word (like"ice cream").

of last resort" function, a term attributed to English merchant banker turned Member of Parliament, Henry Thornton (Thornton 1802).

In principle, private actors could be "lenders of last resort" (LLR) and historically they were. Yet the English Usury Act, in 1660, restricted the interest private lenders could charge, thus creating a real disincentive for these lenders to provide required liquidities during subsequent periods of crisis. The function did not disappear, though, but was progressively transferred to state or state-sponsored organizations, in the case of England to the Bank of England.[2] It is a historical irony that anti-usury legislation was meant to prevent the perceived moral abuse associated with exorbitant interest rates (Bentham 1787), as such laws would inadvertently create another moral dilemma of an entirely different kind. In the late eighteenth century in England, the Bank of England provided almost any amount of liquidity to private banks "with little difficulty, expense or delay" (Thornton 1802, p. 38; Goodhart 1999), generating serious moral hazard concerns. Thornton in particular was worried about the moral hazard consequences of an infusion of liquidities by the Bank of England to prevent bank runs (Thornton 1802). He remarked that any state support would set a dangerous precedent for future crises and as such advised against institutionalizing the state as a formal lender of last resort.

The risk of 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 impair the LLR powers of 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 suspended the Bank Act in order to intervene (Humphrey and Keleher 1984). Debates around the Bank Charter Act and its modification remained intense throughout the nineteenth century, with Herbert Spencer warning that "[t]he ultimate result of shielding man from the effects of folly is to people the world with fools" (Spencer 1878). Yet the most potent argument for the LLR was developed by a British businessman named Walter Bagehot. In *Lombard Street*, Bagehot departed from the "hands-off" approach of Thornton (Bagehot 1873), calling for the formalization of lending to avoid financial collapse, albeit at a stiff penalty rate to prevent moral hazard. *Lombard Street* was so influential that thereafter the provision of liquidity during crises by the Bank of England "became a near orthodoxy among English financial commentators and economists" (Moore 1999, p. 449). The practice of a state-sponsored LLR function became institutionalized and by extension moral hazard was systemically inscribed in the financial and monetary sphere. Effectively, this function acted as insurance, "test[ing] 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, p. 444).

The idea and practice soon spread to other countries in Europe but also to North and Latin America. With respect to the United States, although the Federal Reserve was not established until 1913 (Eichengreen 1998, p. 47), individual states and a number of private insurance regimes provided deposit insurance beginning from 1829 (Golembe 1960). These "self-imposed regulations and mutual monitoring kept members of the privately established coalitions from 'free riding' on the collective insurance" (Calomiris 1990), and they were quite effective in some states. Yet the

[2] In the United States, this transfer happened later. During the 1913 panic, before the creation of the Federal Reserve Bank, the Bank of JP Morgan still famously played the role of LLR.

subsequent establishment of a central bank eventually legitimized the LLR facility and has since been cited as the reason why "no financial crisis has occurred in the United States since 1933 and none in the United Kingdom since 1866"[3] (Broda and Levy Yeyati 2003).

Today, the LLR function is typically fulfilled by state organizations or public agencies acting through deposit insurance programs. In the United States, the Federal Reserve Bank acts through the Federal Deposit Insurance Corporation (FDIC) and the Bank of England through the Financial Services Compensation Scheme (FSCS). To benefit from these schemes, private banks have to adhere to a set of capital and liquidity requirements (Calomiris 1990). These requirements generate costs, whether in the form of auditing expenses (Merton 1978) or in the form of opportunity costs associated with maintaining reserves (Laeven and Majnoni 2003). Cumulatively, these form "subscription costs" that are in fact very similar to insurance premiums. Indeed, the entire LLR facility is considered by some to be no different from other types of insurance schemes (Freixas et al. 2000).

The LLR function, though, has a moral hazard potential that goes well beyond that of most classical insurance schemes (Calomiris 1990; Sleet and Smith 2000). This is due, mostly, to the size of financial institutions. During crises, the collapse of a major bank may devastate an economy. This "too big to fail" predicament implies and even requires decisive intervention by the state—even in some cases when deposits are uninsured (Stern and Feldman 2004). Some countries attempt to mitigate the problem by imposing stricter constraints on their deposit insurance programs. The Canadian Deposit Insurance Corporation (CDIC), for example, has stringent policies for subscribers, including strict limits on leverage and even stricter limits on unconventional investments such as subprime mortgages (Brean et al. 2011). Deposits in mutual funds, stocks, and foreign currencies are not covered. These rules are meant to restrict deposit insurance to low-risk investments, and hence to limit speculation and reduce ensuing moral hazard.

The LLR dilemma, furthermore, also plays out at the international level. The International Monetary Fund (IMF) or the International Bank for Reconstruction and Development (IBRD), for example, regularly fulfill the LLR function at the international level. Some empirical studies indicate that the possibility of LLR intervention at the international level has the demonstrated effect of significantly increasing direct moral hazard[4] (Dreher and Vaubel 2004; Vaubel 1983). But studies arguing along this line are rare. The dominant discourse, instead, points to an increasing need for LLR facilities at the international level, with little preoccupation for associated moral hazard consequences (e.g., Fischer 1999; Cordella and Yeyati 2003; Rochet and Vives 2004).

[3] This is clearly contingent on the definition of "crisis," although Broda and Levy-Yeyati seem to mean full-scale panic akin to the Great Depression. Furthermore, Broda and Levy Yeyati (2003) were writing before the more recent episode of financial turmoil.

[4] 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. (Dreher and Vaubel 2004).

This profound institutionalization of the LLR function in the financial and monetary sphere, in spite of its dramatic moral hazard implications, stands in stark contrast, as we show below, to what has happened in the welfare and social insurance arena.

Economic neutralization and neoliberal reinterpretation

In 1963, the economist Kenneth Arrow published an article entitled, "Uncertainty and the Welfare Economics of Medical Care," which marked the beginning of a profound transformation in debates around moral hazard.[5] Drawing upon the insurance literature, Arrow inferred that medical insurance would generate two types of moral hazard behavior. First, there would be an increase in the use of services altogether. Second, insured individuals would choose their physician based on his or her willingness to use expensive medical services thus driving up the overall price for those services (Arrow 1963). According to him, though, moral hazard implications did 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, p. 945). To make this argument, Arrow appeared to have drawn inspiration from Bagehot, asserting that "the government should undertake insurance where the market, for whatever reason, has failed to emerge" (Arrow 1963, p. 961). In a sense, this article represented a convergence of the insurance and monetary policy interpretations, turning moral hazard in the process into a more universal phenomenon.

Arrow's article stimulated debate among economists and it was cited as "the single most influential neoclassical treatment" of medical care (Starr 1982, p. 225). The most significant impact of the article, though, was that it contributed to change the perception of moral hazard. By legitimizing moral hazard as rational behavior, Arrow triggered a paradigm shift that would effectively neutralize the ethical dimension of the term (Dow 2012b). The 1963 article and the debates it generated effectively catalyzed 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. Pauly started by asserting that the problem of moral hazard in insurance had, "in fact, little to do with morality, but [could] be analyzed with orthodox economics tools" (Pauly 1968). He further proposed that rational economic agents were legitimated in using excess medical care when the costs were spread out over a large group. His conclusion was that Arrow's prescription of government insurance was non-optimal and highly problematic. In the process, the value-neutral language of economics subsumed the moral rhetoric that had hitherto characterized the insurance literature (Dembe and Boden 2000). 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 2003, p. 9).

Arrow wrote a rebuttal, praising Pauly for enriching moral hazard while lambasting his suggestion that rational economic behavior and moral perfidy were mutually exclusive categories (Arrow 1968). In an apparent attempt to salvage the value-ladden dimension of moral hazard (Laffont and Martimort 2002, p. 19), Arrow observed that every principal-agent relationship had the potential for agent deviation.

[5] 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.

However, he argued it would be cumbersome or even unfeasible to take out insurance always against the agent's ability to perform well. Arrow concluded with the rather noble sentiment that a successful economic system required a certain amount of trust (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 research in economics 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; Hölmstrom 1979; Stiglitz 1983).

Another significant event during the mid-twentieth century was the mobilization of moral hazard within the legal and policy debate (Baker 1996, p. 267). Arrow advocated government supplied insurance wherever the market failed to emerge, and as discussed earlier, state-sponsored LLR had already been institutionalized by then. Yet the universalization of moral hazard would have dramatically different results for social welfare. More specifically, the rationalization of moral hazard was mobilized by proponents of neoliberalism, who argued that state sponsored insurance schemes created unnecessary and unwanted forms of moral hazard (McCluskey 2003). Areas such as social security, healthcare, unemployment insurance, and workers' compensation all became important battlegrounds (Moss 2004). Neoliberals advocated social welfare restrictions all around as "a matter of sensible science rather than contentious politics or moral dictate" (McCluskey 2005, p. 193) and as an "instrument to police moral hazard" (Kvist and Pedersen 2007, p. 207). This position stood in stark contrast indeed to the institutionalization of moral hazard within the sphere of finance and monetarism, where it was apparently acceptable to have state-sponsored "lending of last resort."

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 developed in the 1970s providing income support for single parent families in poverty. By the end of the twentieth century, it was denounced as a "prominent symbol of social pathology inimical to good citizenship" and dismantled in 1996 (McCluskey 2003, p. 800). In the same vein, workers' compensation programs became a target for neoliberal policy makers. As presidential candidate, Ronald Reagan 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. 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 (Gladwell 2005). In the 2004 Presidential Economic Report, 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 2005). As these examples all show, neoliberal economists essentially understood the beneficiary of social welfare to be a rational *homo economicus*, maximizing consumption of benefits. 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 dangerous privilege to legal norm

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. In principle this amount could vary, although it generally corresponds to the value of the investment. This contrasts with unlimited liability, when involvement in a particular venture implies full liability to the extent of one's personal or even family wealth.

In contemporary contractual societies, the notion of liability has essentially a financial and mostly neutral connotation. Liability, whether limited or unlimited, is envisioned only in relation to the debts and obligations incurred through a given venture. Not so long ago, though, and still well into the nineteenth century, debates and discussions revealed a broader meaning of liability with profoundly moral connotations. Liability—whether limited or unlimited—went well beyond the debts or financial obligations associated with a venture. There was a sense in which liability was also about a personal moral responsibility connected to the behavior of a collective (the firm) and its engagement with others (collectives or individuals). Hence, the opposition between limited and unlimited liability was in that context also a debate on whether such personal, moral responsibility could be reduced to simple monetary value.

Limited liability and Roman origins

The principle of limited liability first appeared in Roman law. Dependent individuals (*personae alieno juri subjectae*—"persons" subject to the jurisdiction of another") could not own property. This applied to slaves, family members (wives, daughters, dependent sons) and in some cases also to free men who were in a position of dependency (*cliens*). In Roman law, only citizens had legal personhood and this came with full and unlimited responsibility. The *pater familias* was the symbol of legal personhood—being *sui juris* ("under his own jurisdiction") and registered in the census as full *capita* ("head" or "citizen"). This condition came with its rights and duties and meant, in particular, unlimited liability in business undertakings (Duff 1938). Until the fourth century BC, creditors could even 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 326 BCA. By contrast, those individuals who were not full *capita* – and hence were, legally, non-persons—could neither own property nor enter into contracts. Neither could they be held liable. In principle and in law until the second century BC, this meant 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. 2011, p. 11).

Interestingly, this did not prevent dependents from doing business. The mechanism allowing this was the *peculium*—a sum that the *pater familias* granted to dependents for them to use in a particular venture. This 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 et al. 2011, p. 5). Arguably, the responsibility "void" made business through *peculia* an attractive alternative. The *pater familias* was better off divesting his liability through the delegation of business ventures to his dependents—slaves or sons. This responsibility 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. 2011). Limited liability was born in the process as a mechanism to expand the liability of the *pater familias* to business undertakings initiated through the *peculium* mechanism. In this sense, it is interesting to note that the principle of limited liability was born as a legal mechanism to *increase overall* the liability of citizens. Although in most cases, liability was limited to the value of the *peculium* (Perrott 1982; Hillman 1997), some provisions increased liability in those situations where the *pater familias* could be shown to be actively involved in the venture (Földi 1996; Abatino et al. 2011, p. 13).[6]

The combination of delegation with limited liability, characteristic of this evolution of Roman law, proved ultimately quite successful. In the following centuries, business ventures through the *peculium* mechanism prospered (Malmendier 2010). Complex combinations 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. 2011). In parallel, the *societas publicanorum* flourished during the last two centuries BCA. 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 c*ommenda* structure

The expansion of trade in early medieval Europe (twelfth to thirteenth century) was initially associated with unlimited liability as a useful mechanism for building trust in distant territories (Weber 2003[1891]; Lopez and Raymond 1955; Guerra-Medici 1982). This liability principle could be traced back to resilient local traditions in the Longobardi regions of Italy (everything but Papal territories). There, all members of a family group were "jointly liable without limits for all debts arising out of contract or crime undertaken by any member of that group" (Guerra-Medici 1982, p. 123). The *compagna* was the legal form bringing partners together under joint and unlimited liability.[7] Connecting economic, social, and family honor, the *compagna* was the dominant legal frame for the development of wealth in areas such as Pisa or Firenze before and during the Medici period (Sapori 1955). Later on, the *compagna* would

[6] In situations of *ignorantia* (ignorance) or *scientia* (simple knowledge) the master's liability was limited to the *peculium*. In the situation of *Voluntas* (the master consenting willingly to the dependent's transactions), creditors could go after the master's wealth beyond the value of the *peculium* (Abatino et al. 2009, p. 14).
[7] The term comes from the latin word *cumpanis* that stood for "those that eat the same bread."

reach beyond close family and client ties and evolve towards modern legal forms of partnership (Weber 2003[1891]).

In coastal towns of Italy, particularly Genoa and Venezia, the development of maritime trade generated an alternative form of business association (Weber 2003[1891]; Perrott 1982; Guerra-Medici 1982). The *commenda* was a peculiar form of partnership, where one of the parties supplied "capital" and the other "labor" (Rénouard 2009[1968]). 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 provide capital but took physical risks. Typically, the investor received 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 put into the venture. In 1408, a legal statute in Firenze explicitly formalized the *commenda* form, including the "limited liability" principle (Mitchell 1909).

This form of association diffused with limited success in other European territories in the following centuries. The Napoleon code of 1807 modernized the form, 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 debts of the company and strongly involved in management. The "*commanditaires,*" on the other hand, were "sleeping or dormant partners," who brought in capital under the limited liability principle and were not involved in management (Saint-Léon 1907). The Napoleon code hence introduced limited liability in France quite early on, in a form easily accessible to all. It also had an influence across Europe and the "*Société en Commandite par Actions*" was adopted and adapted in countries like Belgium, the Netherlands, Italy, and Germany later in the nineteenth century (Rochat 2008).

Limited liability as rare corporate privilege

Medieval jurists had defined the corporation (in Latin *universitas*) as being both a collective abstraction (and hence a legal *persona*) and the sum of its individual members (Canning 1996, pp. 172–173). This doctrine initially applied to the Church, guilds, cities, and the University (in the "narrow" sense of the term). As Kingdoms and States came of age in early modern Europe, they appropriated the corporation as a useful legal device (Williston 1888; Greif et al. 1994; Canning 1996; Ekelund et al. 1996). Incorporation became a regal privilege that the Prince could bestow on certain groups of individuals engaging in projects serving the "public" interests of the Kingdom (and of the Prince). 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, granting charters that bestowed a number of privileges—particularly monopoly rights and preferential tax treatment. In 1623, the Dutch *East India Company* was granted the privilege of perpetual existence. In 1662, the British Parliament went one step further with an important legal innovation, granting certain corporations, and in particular the *British East India Company*, the privilege of limited liability. Free transferability of shares was not immediately granted, however, and former shareholders were still potentially subject to continued assessments in order to satisfy company debts (Carruthers 1996). Nevertheless, by the late seventeenth century the shift in power from Crown to Parliament gave way to legal changes allowing private debts to become freely alienable (Carruthers 1996). In retrospect, the 1662 Act marked a consequential turning point, connecting as it did the corporate form and limited liability, even though only as the expression of a rare privilege.

The seventeenth and eighteenth 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. After the English revolutions of the seventeenth century, charters could be granted either by the King or by Parliament. In both cases, the costs associated remained high and petitioners, in principle, 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 [otherwise]" (Perrott 1982, p. 91; see also Livermore 1935; Hunt 1936).

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 was wary of the corporate form as he believed it generated "negligence and profusion in … management" (Smith 1999[1776]: Book V, chapter1, p. 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 got even worse under limited liability as this principle 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).

A 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, to be used sparingly. In 1844, after long and heated debates within and outside Parliament, things changed radically when Britain passed a law that turned incorporation into a legal right (Taylor 2006). All partnerships having more than twenty-five members 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, pp. 95–98). 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—this time with a focus on 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 dangerous (Djelic 2013). On the side of those in favor of limited liability, two groups argued from different perspectives. Social reformers championed the association of limited liability with the Partnership form, arguing that it would create safe conditions for workers and the middle class to invest their savings productively. Liberals also fiercely fought for limited liability but to associate it with incorporation. Without limited liability, they claimed, wealthy classes would be deterred from participating in corporations—as this could 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).

Limited liability also had naysayers offering powerful arguments based on political and ethical rather than economic preoccupations. 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 tended to oppose a generalization of limited liability, as they themselves would become, in the process, "creditors 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 ML 1854, p. 15). Furthermore, British wealth and prosperity rested on the global reputation and trust individual traders and merchants had gradually built through a combination of sense of responsibility and personal morality. This was seen as an essential character trait, reflecting a deeply embedded collective and national ethic:

> 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 1856, p. 321).

Limited liability, from that perspective, was associated with speculation, absence of ethics and fraud, a greater proclivity to engage in careless or risk-seeking behavior—what we would call today moral hazard in other words.

As debates raged, no clearly dominant position emerged (Taylor 2006). The Parliamentary Select Committees and Royal Commissions working on those issues were essentially split in half, reflecting the strong division around this issue within civil society. The political situation was evolving, though, and leaders of the Liberal movement soon occupied key positions within the government. Those liberal leaders were fierce champions of bringing forth a legal association between incorporation and limited liability. Their position of institutional power explains how they finally managed to achieve this (Djelic 2013). The 1855 Limited Liability Act (18&19

Vic. c.133) was essentially an extension of the 1844 Joint-stock Companies Act. Provided that a Company had at least twenty-five shareholders and shares of no less than £10, it would be granted limited liability on complete registration. Insurance and banking remained excluded. One year later, the Joint-stock Companies Act of 1856 (19&20 Vic. c.47) went a step further, considerably simplifying registration. The Act extended limited liability to all registered companies of seven or more members and removed the £10 share qualification. Rather than having strict legal requirements on information, this Act proposed a set of governance by-laws—we would call them "guidelines"—that companies could adopt, if they so wished.

In less than 10 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. 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:

> 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, pp. 129–130).

A transnational phenomenon

As the British debates were raging, references were often made to events in the United States. Connecticut was the first American state to allow general incorporation in 1843. Other states soon followed and the legal competition between states meant that by 1913, all American states had passed a general incorporation act (Cohn 2010). An interesting parallel emerges between the United States and Britain with respect to limited liability: In both countries, the fight for limited liability started through a democratization narrative. The introduction of limited liability would remove a barrier to "universal participation in the economic life of the nation" (Kahan 2009, p. 1092). Critics, though, underscored the dangerous *un*democratic implications of a general reduction of responsibility. Arguing from the perspective of justice, critics interpreted limited liability as a mechanism triggering inequalities:

> Men cannot be allowed to escape their obligations … for if they could, an aristocracy of wealth and means would spring into existence at once,bearing omnipotent sway to the ruin, beggary and slavery of thousands of our industrious mechanics and laborers (as quoted in Kahan 2009, p. 1092).

In contrast to Britain, though, discussions on limited liability in the United States happened together with discussions on general incorporation. Adoption was gradual and at the state level (Chausovsky 2007). The New England states inscribed limited liability in their incorporation acts between 1816 (New Hampshire) and 1847 (Rhode Island). In California, though, a full regime of limited liability did not come along before 1931 (Carney 2000). For the banking sector, limited liability was only introduced in the 1930s, as a reaction to the collapse of that industry (Carney 2000). Interestingly, unlimited liability was replaced in that industry, following a major collapse, by a combination of limited liability and deposit insurance schemes; arguably, this created a powerful incentive for generalized moral hazard. After 1930, limited liability became the dominant norm in the United States and was systematically associated with the privilege of incorporation (Livermore 1935; Carney 2000). It is interesting to note the two main mechanisms driving the diffusion of limited liability in the United States—intense competition between states but also the succession of economic and financial crises (Carney 2000).

Elsewhere in the world, the British legal revolution had consequential influence and provisions of the 1855 Act were directly transferred to most Commonwealth countries (Lipton 2007). By the end 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 dubious privilege), 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 diffused in other countries. The German GmbH (*Gesellschaft mit Beschränkter Haftung*—Company with limited liability), a legal structure introduced in 1892 followed the same route. It was constructed as a hybrid between partnership and corporation. The GmbH was a partnership—a contract among specific persons with characteristically illiquid shares. This allowed the shareholders to retain significant power and control. But ownership in the GmbH was also associated *de jure* with limited liability, which since 1870 had been connected to a general incorporation act. The GmbH was very successful in Germany and would soon be imitated elsewhere (Guinanne 2008), most notably with the French SARL (*Société à responsabilité limitée*) structure introduced in 1925. The Private Limited Liability form that appeared in Britain in 1906 was less directly related but still pertained of the same logic. The Limited Liability Company only came to the United States in the late 1970s and early 1980s and the filiation with the German GmbH was clear (Guinnane et al. 2007). Since their transfer to the United States, the LLC (Limited Liability Company) or LLP (Limited Liability Partnership) forms have experienced rapid success, spreading across the world in the last two decades (McCahery 2001; Reyes and Vermeulen 2011).

In the process, limited liability has become a broadly available right—for corporations and partnerships alike. 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 unlimited liability, mainly as a signal of responsibility and quality (Greenwood and Empson 2003). Given the inherent uncertainty surrounding audit quality, partners would traditionally assume joint and unlimited responsibility for torts (Van Lent 1999). However, following the "litigation explosion" beginning in the 1970s (Miller 2003), these partnerships became highly exposed (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 the vulnerability of unlimited liability partnerships to litigation, and this led to changes in governance and to the generalization of LLP forms (Johnson 1995; Greenwood and Empson 2003). Recent studies show that LLP accounting firms tend to favor riskier clients (Lennox and Li 2011), highlighting the significant moral hazard implications of this form (DeFusco et al. 2011).

The accounting industry is not the only case where limited liability and moral hazard have conspicuously converged. One of the more prominent illustrations is 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 (The Corporation of Lloyd's 1871; Hodgson 1986). For most of its history, Lloyd's mandated that individual underwriting members, known as "Names," act under unlimited liability. 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). In reaction, Lloyd's moved in 1992 to establish limited liability (James 2007), with existing unlimited liabilities 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 corporate participation. Less than a decade later, corporations comprised 90 % of Lloyd's membership, with Names accounting for only 10 % (James 2007). This shift after three centuries was the final nail in the coffin for unlimited liability (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-taking with limited costs—moral hazard in other terms!

Discussion: the missing link—limited liability as moral hazard

We began by exploring the coming of age of the concept of moral hazard and its profound transformation during the twentieth century. Initially, the concept was coined to suggest the moral fraud or villainy of some individuals in situations of insurance protection. Such a conceptualization suggested its own remedies and solutions—the problem was not the structure but particular individuals. Insurance schemes included sophisticated control mechanisms and "moral villains" should be excluded. As the concept of moral hazard spread, it was integrated in broader economic discourses and partially "neutralized," becoming nothing more than rational "free riding" given particular constraints and incentives. "Character" evaporated as an explanatory variable and the issue was re-interpreted as essentially structural. The most direct way to address moral hazard, from that perspective, was to dismantle the incentive system that generated it in the first place. Interestingly, this type of argument was mobilized broadly to propose the reduction or even the end of welfare benefits. But it was rarely applied to the "lending of last resort" situation, where the dynamics at work were nevertheless quite similar.

We then turned to the extraordinary fate of limited liability. Over more or less the same period, limited liability went from being a rare and contested privilege to becoming a taken-for-granted feature of contemporary capitalism. Initially, debates around limited liability and its possible extension were morally charged. As limited liability imposed itself and spread through time, however, the concept became "neutralized." The moral association waned and only the financial expression of liability remained. Arguably, liability and responsibility were commodified in the process.

The two conceptual paths we have traced in this article are parallel in a number of ways even though they rarely appear to meet historically. First, they share a relatively similar time frame. Similar also is the successful expansion of the concept beyond its original field of emergence. We have also shown striking similarity in the neutralization through time of moral undertones. While those are important parallels, they do not reveal the extent to which those two conceptual paths have become intertwined through time. There are "missing" or rather "hidden" links between those two stories that need to be brought 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 understand our contemporary world better.

Ever since the seventeenth century, arguments were mobilized in favor of limited liability citing benefits of growth, innovation, and democratization. Without this practice, it was feared that wealthy individuals—who had the most to lose—would not invest in risky ventures conducive to nation-building (Bryer 1997, p. 40). Limited liability reduced risk exposure without compromising prospects for large financial gains, thus providing the right incentive structure for innovators (Rosenberg 1994). This plea for an "enfranchisement of capital" was from time to time coupled with a democratization argument. Limited liability would create safe and profitable investment conditions for everybody (Loftus 2002; Kahan 2009; Johnson 2010). Hence, proponents of a limited liability regime staunchly defended it as an essentially positive development, freeing capital, industry, innovative energies and making possible the progress of markets by allowing risk-taking on a large scale. At an even more fundamental level, Max Weber proposed that limited liability belonged to those legal devices necessary for a "stable and continuous system of capitalist production" (Kronman 1983, p. 126).

We have illustrated, however, that the extension of limited liability has historically been *janus*-faced. The other face of limited liability, we argue here, is moral hazard. Many of the worries expressed in the debates around the legal inscription of limited liability in the nineteenth century had to do with its moral hazard potential. The term moral hazard, however, was rarely if ever mobilized to talk about and describe the impact of limited liability. The extension of limited liability encouraged risk-taking (and hence innovation and possibly growth) *because* it created a situation of expanding de-responsibilization. Individuals would take more risks precisely because they could reap rewards without having to bear the full costs. Limited liability played, in other words, the role of a powerful insurance scheme, in the process creating a systemic incentive for moral hazard at the core of modern capitalism. From that perspective, the increased risk-taking associated with limited liability could also be seen as a worrisome development that was likely to bring about great instability and regular crises and failures (Chang 2000).

Strangely enough, the moral hazard side of limited liability has only rarely been identified—let alone explored (but see Chang 2000; Dowd 2009). In the contemporary period, though, the moral hazard potential of limited liability has proven particularly consequential, dramatically transforming the risk preferences of owners, managers, and firms. 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 triple layer of institutionalized limited liability, which profoundly inscribes moral hazard at the heart of the system. First, shareholders benefit from liability fixed only to their initial investment. Second, 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 their "nondiversifiable and nontradable" human capital investments in the firm (i.e., they will be fired); arguably far outweighed by the potential gains of risky bets (Kotlikoff 2010). A third layer of limited liability, for many financial firms, comes with the institutionalized "lender of last resort" facility, where large financial institutions will be protected from the most severe effects during crises. It is easy to understand why, with these three layers of insurance-like protection, all actors in the system are incentivized to take more risks.[8] In such a context, de-responsibilization is not an individual moral failure; rather it is a general systemic feature.

If limited liability is *janus*-faced—with innovation and growth on one side and moral hazard and instability on the other—we are left wondering about the balance in the long run. There is obviously no empirically-based answer to that question—at best we can point to different types of arguments. Its democratization potential, along with perceived benefits such as large scale, long term investments, more innovation, and financial stability have all been arguments used as support for the spread of limited liability (Chang 2000). These advantages, as a whole, are seen to be "greater than the social costs arising from the moral hazard they create" (Chang 2000, p. 777). To put it more provocatively, "capitalism has [seemingly] developed on the basis of moral hazard" (Chang 2000, p. 777).

This optimism could be questioned by showing that, historically, the expansion of limited liability has often been triggered by the desire to reduce liability. We could probably show, with respect to contemporary financial capitalism, that the mobilization of capital, innovation, and growth have not always been—far from it—the drivers of the expansion of limited liability. The search for insurance-like protection and partial de-responsibilization have been other highly important motivations. It is also interesting to highlight, in the context of the current crisis, that liability never disappears. Rather, it is transferred to, and socialized by, the nearest collective—in most cases, the state. Any resulting punitive or austerity measures are then "imposed on the millions of people who just helped [investors] survive to speculate another day" (Peet 2011, p. 284). This is a disquieting reminder of Barlow's concern during

[8] Non-FIRE (finance, insurance and real estate) firms will in general have only a double layer of limited liability except in the rare situations when they might be bailed-out.

the American incorporation debates, that limited liability is not necessarily a tool of democratization. Rather, it is potentially one of the concrete mechanisms explaining increasing inequalities in contemporary capitalism.

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 United States and many other countries, the financial sector was surprisingly unscathed by those debates. A possible explanation for this disparate treatment lies in the different salience of outcomes. When a financial crisis occurs, a "too big to fail" warning can be deployed that spells out the grave economic consequences if no intervention is taken. This warning spurs LLR action irrespective of the precedent set for future moral hazard. However, no such argument can be mobilized for the social welfare sphere. There, the absence of coverage will mean the reduction or the absence of care—no "lender of last resort."[9] Negative externalities become manifest only in the long-term (Gladwell 2005; Sered and Fernandopulle 2007).

The disparity in moral hazard treatment has become even more evident with the acceleration of financial market growth over the last 30 years. During this time, the international financial community generated a succession of "innovative" financial instruments that exacerbated the risk of moral hazard (Duffie and Gârleanu 2001; Crotty 2009). Securitization in particular pooled together contractual debt from other domains (including mortgages and automobile loans) to create new opportunities for investment, expediting the financialization of the economy (Krippner 2005; Montgomerie 2009). The increased economic dependence of other sectors on finance would only reinforce the "too big to fail" argument in subsequent crises. All this happened in the context of banking deregulation in the late 1980s and a subsequent lack of regulatory reactivity as financial innovations crowded 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) 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 (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.

While the sources of moral hazard in the financial sphere are 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 behaviors and decisions. This systemic protection is now deeply ingrained and institutionalized within contemporary (financial) capitalism. This systemic source of moral hazard has been reinforced by the persistence and even the spread of a LLR 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

[9] The full coverage welfare state used to play that function before neoliberal reforms of the health sector in many countries.

have been bailed out (particularly the financial sector) have been the beneficiaries of limited liability on an hitherto unprecendented scale.

In the case of the latest financial crisis, this affinity between moral hazard and limited liability is particularly visible. Banks historically granted mortgages with the intent of holding them until maturity, and if a mortgage holder defaulted, then the bank would risk running a loss. Once these mortgages became securitized (i.e., with the view towards selling them), the risk of default practically 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 short-termism would not have been possible without the introduction of limited liability (in particular the free transferability of shares), as an investor could completely divest himself of ownership without any lingering responsibility. Rochet notes that this is particularly pertinent to banking. If one takes into account limited liability, banks' behavior towards risk is transformed and, in some cases, "banks may become risk-lovers." (Rochet 2009, p. 229). Further exacerbating this issue was the potential for intervention by the Federal Reserve, acting as a safety cushion for continued risk-taking behavior. In essence, the combination of limited liability, short-termism, and the lender of last resort resulted in significant moral hazard during the crisis: Bankers understood, at least implicitly, that "large financial gains of the boom [would be] private, while losses in the crisis [would be] socialized" (Crotty 2009).

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 deep assumptions undergirding contemporary capitalism.

Acknowledgments We thank the Academy of Management History Division for selecting an earlier version of this article as the 2013 Winner of the Halloran Award for the Best Paper in Business Ethics. We also thank the *Theory and Society* Editors and reviewers for highly helpful comments.

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