ABSTRACT. Shareholders of corporations have their liability for actions of the corporation limited by law. Unlike the equity holder in a partnership or proprietorship, the assets that a shareholder has distinct from her holdings in the enterprise can not be taken to satisfy liabilities arising from actions of the enterprise itself. This paper argues that a reasonable principle of fairness argues for an alternative to limited liability, proportional liability. Proportional liability makes a shareholder liable for the same proportion of a corporation’s excess of liabilities over assets that her number of shares bears to the total number of shares outstanding. The key idea is that it is unfair in situations in which explicit agreements can not be reached for shareholders to bear only limited risk when they may receive gains from stock dividends and appreciation that are not limited to any pre-determined amount. Proportional liability has not been much examined in the financial literature. Good utilitarian arguments have been given for limited liability over unlimited liability for corporate shareholders, but these arguments do not clearly support the choice of limited liability over proportional liability.

KEY WORDS: corporate property rights, corporations as moral persons, limited liability, proportional liability, theories of the corporation, unlimited liability

A standard feature of the corporation today is limited liability for investors. Unlike the equity holder in a partnership or proprietorship, the assets that a shareholder has distinct from her holdings in the enterprise can not be taken to satisfy liabilities arising from actions of the enterprise itself. When a corporation’s outstanding debts are in excess of what it can pay, the law allows the corporation to declare bankruptcy as if it were a natural person with no recourse to additional assets that may be in the hands of shareholders. The corporation is in effect treated as an entity separate from the shareholders that have invested in it, even though it has been acting for their benefit. The question arises whether it is morally justifiable for corporate liability to be limited in this way. I will argue that it is not.

In place of limited liability, I suggest proportional liability. Proportional liability and the mechanisms for enforcing it are open to a variety of interpretations. At some points in history, individual creditors have been able to pursue their claims against particular shareholders up to the full amount of their claim. In the version of proportional liability that I support, each shareholder would be liable for the excess of liabilities over the corporation’s assets to the extent of the proportion of her shares to the total number of shares outstanding. In addition, such liability of shareholders would only be to the victims of tort or other so-called “involuntary” creditors. In general, I accept the arguments that creditors who interact contractually with the corporation have the opportunity to adjust their terms to compensate them for expected losses. Thus, the liability to which voluntary creditors are exposed can be altered by contract from the legal default. However, I will assume that a
corporation must be liable for any wrong that it
does, whether or not a contractual relationship
is present. Finally, the focus of this discussion
will be on wrongs for which the victims are seeking
monetary compensation; I will not deal with the
issues of corporate criminal liability and the
forms of punishment suited to criminal liability.

It is difficult to examine the moral justifica-
tions of shareholder liability without touching on
an even more difficult area, the nature of the
corporation as a moral entity. What is the moral
standing of the corporation? A variety of answers
have been proposed. At one extreme, the corpo-
ration has been taken to a moral agent, capable
of directly bearing responsibility and liability. At
the other, the corporation is viewed as an aggre-
gate completely resolvable into its component
parts, suggesting that ascriptions of liability
should not, or perhaps need not, be made to the
corporation itself. Various intermediate positions,
e.g., where natural persons are retained as the
primary bearers of moral standing, while corpo-
rate entities are viewed as having a secondary
moral role, also have been advanced.

Larry May gives one such intermediate
position. May’s theory is multifaceted, con-
cerned with a variety of forms of group behavior
including mobs and ethnic groups as well as cor-
porations; I make no attempt to fully assess it
here. On the one hand, May rejects any form of
individualism which claims that social groups do
not “really” exist, while on the other hand he
opposes any collectivism which asserts that
groups “exist in their own right, perhaps as full
moral agents”. May’s view is that social groups
are best conceived as “individuals in relations-
ships”, stating that:

It makes sense to refer to individuals in relations-
ships, rather than to individuals conceived apart
from their relationships, when there is action or
intent that occurs in the group which could not
occur outside of the group.

Developing this idea, May rejects French’s
view of the corporation as a separate moral
entity. I accept this portion of May’s analysis.
Applying it when the “group” in question is a
corporation, it makes sense to look at individual
persons in their relationships to the corporation.

Although May rejects the idea of a corporation
as a separate moral entity, his treatment of the
question of moral standing of the corporation,
specifically as it relates to corporate property
rights, touches on the issue of limited liability
in an important way.

Although I lean heavily toward the “aggre-
gate” over the “moral person” view, I will not
explicitly deal with this issue here. Rather, I will
argue on independent grounds for a view of
shareholder liability that is consistent with the
aggregate view, proportional liability. At
the same time, proportional liability provides an
answer to a problem raised by May regarding cor-
porate property rights.

§1. A historical sketch of limited liability

The structure of the modern corporation is the
result of a long evolutionary process. In particu-
lar, the role of limited liability in the develop-
ment of the modern corporation is complex, and
the importance of this role is disputed. The
purpose of this section is only to give a high-
level summary.

Commercial associations to provide risk
sharing appear as early as the 12th century with
the Italian “commenda”. This was a partner-
ship in which one partner, the “commendator”,
provided capital while another partner, the “trac-
tor”, conducted the actual business of the part-
nership. The practice of limited liability is also
very old, appearing as early as 1408 in a
Florentine statute that exempted the com-
mandator from any liability beyond the capital
provided. In the addition to its appearance in
Italy, the commenda could be found during the
Middle Ages in England, Germany, and
Scandinavia.

In England, the long common law tradition
makes it possible for historians to disagree over
exactly when limited liability became the law.
The situation is further complicated due to the
side-by-side existence of corporations and un-
incorporated joint-stock companies which were
(governed by the law of partnerships. In a description of the differences between
the law of corporations and of partnerships