Their gain and your pain: the limitations of limited liability

THE rules of the private equity game favour the big players while imposing risks and costs on the less fortunate

Dan Plesch, Stephanie Blankenburg and **E Elize Sakamoto** hold that private equity firms should not be above the law

PRIVATE equity has become the poster-child for the "unacceptable" face of capitalism. In fact, it is a natural outcome of a distortion of the free market and of a business operation that has caused much of the concern over the negative impact of capitalism for more than a century.

This is the provision of legal immunity for owners as regards any damage caused by the property companies they own. This provision of limited liability came into being only after 1900 and long after the Industrial Revolution. Yet, while breaking the social contract that all shall be equal before the law in a free society, it has attained mythic status as the engine of prosperity.

Consider the case of nursing homes in the United States owned by private equity firms. The *New York Times* looked at more than 1,200 nursing homes bought out by major private equity firms since 2000. It compared them against national averages of multiple indicators of non-financial and regulatory performance based on publicly available data up to 2006.

Even with a reasonable margin of error, the results are clear. While the financial performance of these nursing homes has gone up since the change of ownership, the average quality of life of the residents has diminished. The *New York Times* identified substantial reductions in normal operating expenses and staff, including registered nurses, as restructuring factors that typically lead to such an outcome.

Owners have immunised themselves from legal action if residents suffer ill-treatment by the perfectly legal creation of Russian doll-like company structures. Residents and relatives find that the business managing the nursing home has had its assets removed to a parent company whose only liability is the value of the now nearly worthless shares in the business that has been asset-stripped.

Private equity is not the only trade that takes advantage of this privilege of having to act legally but not responsibly. In fact, almost all businesses have now been given this immunity from being held accountable by law. However, what is notable with the private equity industry is that its spectacular financial gains necessarily draw attention to how these are earned – the processes and costs involved. This is juxtaposed with the institutionalised gap between legality and responsibility in business behaviour.

So it appears there is little wrong with private equity firms, other than that they are very good at ruthlessly but rationally exploiting this legal advantage. Nor are they shy of pushing the limits of legality and irresponsibility.

Limited liability formally limits the liability of a company for the decisions and actions it takes. Business owners (shareholders) are not held liable for any consequences of their company's behaviour beyond the value of their investment. The primary purpose of this legal concept is to encourage innovation and enterprise by reducing the risks and costs of investors. But the consequences of applying this law too liberally have been controversial with serious implications.

First, the provision of immunity from being held fully accountable effectively puts business owners and related executives above the law. This violates the principle of equality before the law which is fundamental to a democratic society. While it is not the case that companies necessarily behave irresponsibly, nor that owners and operators are always able to get away with the damage they cause, the privilege they enjoy disproportionately promotes the power of businesses and accelerates the recklessness of some firms. The law aims to aid the economy, yet it also removes a key incentive from a whole sector of society to curb negligent or destructive impacts on others.

Second, limited liability reduces the risks and costs of investors, that is, the risks and costs involved in maximising efficiency and profits are dumped elsewhere – including on the environment. The successes of companies asserted by their owners and executives are often inaccurate, in that they fail to take into account the full extent of risks and costs of their endeavours. Private financial gains are contingent on costs involuntarily accepted by the public.

Third, as seen with the nursing home example, the law reduces the liabilities of businesses to none as it enables complex corporate structures whereby the individual identities of business owners become very obscure. The principle of limited liability invariably extends to cases in which businesses are the shareholders of other businesses, which, in turn, are also shareholders of other businesses – and so on and on. The people involved in any of these companies are able to change identities and disappear from view simply by selling their shares or closing down subsidiaries.

There are at least two further advantages in businesses adopting a complex ownership structure. First, non-publicly traded private businesses, such as private equity firms, can benefit further from the lack of transparency by contending that certain information is proprietary. Second, if held liable, the owners of both private and public companies are only responsible to the extent of their investment in the specific company in question. Its links to or assets in other firms in the corporate network are irrelevant.

Of course, society needs successful businesses. But it also needs fundamental reforms of the laws that enable a few capitalists to grow staggeringly rich at the expense of the less advantaged – as those running the multi-billion-dollar private equity industry have done.

The rules of the private equity game are guaranteed to minimise the losses of the players while imposing risks and costs on the less fortunate. And there is something wrong with the law if the owners of companies are legally able to walk away from their responsibilities without being held fully accountable for the consequences of their actions.

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