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Raising the Risk of Business

By Sergey Matyunin

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In 1892, Aron Salomon, a boot maker from East London, set up a company called Salomon & Co., Ltd. Salomon had 20,001 shares in the company, while his wife, daughter and four sons had one share each and were, according to Judge Vaughan Williams, “mere dummies.”

In a way, Salomon was the company and vice versa. He sold his business to the company, and the price he agreed on (with himself) was such that he not only drained cash from the company but became its creditor, securing the loan with the company’s assets. The company folded shortly thereafter. Creditors tried to sue Salmon and reach his personal assets, but they got nothing.

Salomon vs. Salomon is a cornerstone case in modern corporate law. It extended limited liability to the smallest, one-man companies. Though the decision has remained controversial, the legal principle that any businessperson must be allowed to shield his personal assets from the debts created by his business is so entrenched in our minds that few have dared to challenge it.

Last week, the Supreme Arbitration Court published on its web site the new version of the Civil Code proposed by the president's council to improve civil legislation. The amendments to the code are expected to become law in the near future. If this happens, the minimal capital requirement for companies registered in Russia will surge 50 times — from 10,000 rubles ($320) to 500,000 rubles ($16,000).

According to the limited liability principle, a private business owner's financial liability is most commonly limited to his investment in the company. Therefore, if the new amendments are passed, private business owners' liability will essentially increase by 50 times. For many, this will mean a return to the 19th century.

Most people view limited liability for business owners as an innovative result of the evolution of business. Limited liability, the argument goes, was created by the economic necessities of the industrial revolution — a crucial protection to encourage enterprise and entrepreneurial risk taking. In short, it is the alpha and omega of modern corporate law; it is universal, undisputed and indispensable. We take it for granted, therefore, that corporate law everywhere must provide for easy creation of incorporated, limited liability companies.

Yet in reality, the corporate veil was created by political will, not economic demand. The industrial revolutions in Europe and in Russia had little to do with corporations. They were carried out by partnerships where every member was liable to the last ruble or shilling.

Entrepreneurs in Victorian Britain and merchants in late 19th-century Russia were generally opposed to the idea of limited liability. Rewarding success and punishing failure was considered natural, fair and "Darwinian."

"There is no shifting or narrowing of responsibilities," wrote Professor John McCulloch from University College London. "Every man ... [should be] personally answerable to the utmost extent for all his actions." For British philosopher and economist Adam Smith, the apparent disparity in the risks and rewards taken by shareholders in companies with limited liability paved the way to "negligence and profusion."

Although today we cannot imagine our economy without corporations, the rationale for separating a one-man company from its owner remains blurred. There is little economic sense in such structure unless it is adequately capitalized. Banks, as well as most prudent creditors, would only lend if they can reach the personal assets of those behind the corporate veil.

Clearly, Russia's amendments to the Civil Code are an attempt to prevent abuses and crimes committed by fly-by-night companies. But if the reform works out as planned, there will be fewer companies to control, and the army of taxmen — one of the biggest in Europe — will be able to collect whatever is needed. It will mean the end of relatively low taxation in Russia.

The World Bank, which believes that capital requirements should be as low as possible — or even better, abolished entirely — will probably drop Russia from it current 123rd place to an even lower position if the capital requirements are indeed raised to 500,000 rubles. But Russia doesn't seem to care.

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