The recent financial meltdown has generated a lot of talking and writing. We still debate how similar or different this episode has been from previous ones in the history of financial and economic crises. It is not yet fully clear whether the episode of crisis is now already over – or whether we are simply standing right now in the lull between two storms. Another important set of open questions bears upon the root and active causes behind this particular episode.

Different theories have been advanced on the question of causes but a recurrent theme has been the notion of “moral hazard”. The notion of “moral hazard” refers to the opportunity for organizational and individual actors to reap rewards of risky behaviors without bearing the associated costs. It appears, on the whole, that the opportunities for moral hazard-type behaviours have been numerous before but also during the crisis – as national States have then massively bailed out large banks and financial actors. The multiplicity of opportunities for but also of documented episodes of moral hazard-type behaviours is certainly striking in itself. We suggest in this paper that this multiplicity does not simply reflect the contingencies of a particular period. We propose, instead, that it reveals a consequential structural characteristic of contemporary capitalism. Moral hazard is profoundly inscribed in modern capitalism and the argument we put forward in this paper is that an important but neglected source for contemporary moral hazard lies in the widespread diffusion of the principle of limited liability. In order to show this consequential but neglected connection, we engage in a double genealogical exploration. First, we do a conceptual genealogy of “moral hazard”, showing the fluidity and plasticity of the notion through time. Then, we explore the concept and legal practice of limited liability, tracing in broad strokes here again an historically fluid notion and a significant evolution of the role and significance of the legal practice.
Conceptual genealogy is a “history of interpretations, the history of words, ideals and metaphysical concepts” (Foucault 1984: 91-93). The rationale behind such an approach is the conviction that social activity is contextual. 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. A deeper understanding “presupposes knowledge […] about the alternative interpretations of concepts that the historical agents had in their hands” (Palonen 2002). Conceptual genealogy has been gaining ground in social science in general, as a counterweight to the dominance of normative and naturalistic approaches and methods (Skinner, 2002; Koselleck, 2002; Palonen, 2002). Conceptual genealogy implies the use of historical analysis as a methodological tool (Djelic 2008). It is obvious that there is still today a profound epistemological gap between historians on the one hand and organization and business scholars on the other. Historians would reproach business and organization scholars for their disregard of “differences in culture or time”, for “squeeze(ing) phenomena into rigid categories and to top it all” for “declar(ing) these activities as scientific” (Kieser 1994:612). Business and organization scholars in turn “see historians as myopic fact collectors without a method, the vagueness of their data matched only by their incapacity to analyze them” (Kieser 1994:612). This gap, unfortunately, is detrimental to a more accurate understanding of organizational and institutional situations that are unique and historically path dependent but still can be framed in theoretical causality chains (Schneiberg and Clemens 2006). The good news is that such a gap is not a necessary one. It is quite clear today that there is vibrant call for and a revival of interest in historical perspectives and agendas by business scholars (e.g. Booth and Rowlinson 2006).

The first section of this paper proposes a descriptive summary of the evolution through time, and in particular since the beginning of the nineteenth century, of the notion of “moral hazard”. We show how the concept of “moral hazard” developed in the insurance domain and how, over time, it proceeded to diffuse into a variety of other fields. In the second section of this paper, we then investigate the path along which limited liability developed, particularly since the nineteenth century, as a concept and as a legal practice. We show how limited liability, through that period, went from being a marginal, suspicious privilege to becoming the unquestioned, dominant rule of the game (“institution”) that it is today in contemporary capitalism. Through this double genealogical exploration, we are able to show some clear “elective affinities” between limited liability and moral hazard. Hence, in the discussion/conclusion section of the paper, we propose to reinterpret limited liability as a powerful structural source of moral hazard in contemporary capitalism. We suggest that limited liability might in fact be a much more consequential source of moral hazard than monetary policy, which is often identified in the economics literature as a potent driver of moral hazard behaviour.

This structural connection between the contemporary “density” of moral hazard on the one hand and limited liability on the other is an important explanatory factor of the recent financial crisis. Through the limited liability mechanism, managers but also shareholders, investors and bankers have been structurally protected from the costs of risky behaviours and decisions. This systemic protection is now deeply ingrained and institutionalized within contemporary capitalism, including naturally within the financial sector. This systemic source of moral hazard has naturally been reinforced by the persistence and even the spread of a “lender of last resort” principle – which has translated in the recent crisis into large-scale bail-out programs. This double layer of
moral hazard has clearly become a systemic feature of contemporary capitalism, and 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 increasing mechanisms for governance; rather it involves a more fundamental questioning of some of the assumptions undergirding contemporary capitalism.
Moral hazard and limited liability: exploring elective affinities

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OBJECTIVE

Put contemporary CSR in perspective – double contextualization of CSR

- CSR associated with corporate capitalism/neoliberal globalization and governance
- Exploration of alternative understandings of the social responsibility of business

Deconstruct the explicit and implicit political and ethical foundations of contemporary CSR
PUZZLE (1)

- Contemporary financial crisis
- Multiplicity and regularity of financial crises

- Moral Hazard as one of the explanations?

  - "The notion of ‘moral hazard’ refers to the opportunity for organizational and individual actors to reap rewards of risky behaviours without bearing the associated costs"
Moral hazard – a deeply ingrained characteristic of human nature?

Or performativity dimension with incontemporary capitalism – structurally greater occurrence of ”moral hazard” type behaviours?
Indeed we argue that such performativity is at work…

Through a defining feature of contemporary capitalism that has rarely been connected to moral hazard:

**Limited Liability**

We want to explore this “missing link”
APPROACH AND STRUCTURE

- Double and parallel “conceptual genealogy” (Foucault 1984)
  - Evolution of the notion of “moral hazard” particularly since the beginning of the 19th century
  - Development since the 19th century also of the concept and legal practice of “limited liability”

- Identification of elective affinities

- Reinterpretation of limited liability as a powerful structural (and performative) source of “moral hazard” in contemporary capitalism – within and beyond the financial sphere
MORAL HAZARD

- Defined as the “tendency of (insurance) protection to alter an individual's motive to prevent loss” (Shavell, 1979: 541)

- Observed as early as the 11th century in France, but became conspicuous throughout 17th century Europe. Identified in particular with the development of the insurance industry
Mid-19th century. Increasing urbanization, aggressive marketing: considerable expansion of the insurance enterprise in the U.S., Britain and Prussia

In parallel, increasing fraud. But also Christian concerns about insurance per se.

Incorporation of moral hazard risks into insurance classifications (including fraud, arson, malingery)

Persons of “questionable character” denied insurance outright
Mid-1900s – state intervention during crises to preserve financial stability ("lender of last resort” function)

Provision of liquidity becomes institutionalized in Europe by the early 20th century, spreads to North and Latin America

Subsequent moral hazard acknowledged as having a role in late 20th century crises, especially the sub-prime mortgage meltdown (Dowd, 2009).

“Large financial gains [would be] private, while losses in the crisis [would be] socialized”.

State interventions have been equivalent to a “lender of last resort” situation.
Economic neutralization

- 1963 – Kenneth Arrow and the “Welfare Economics of Medical Care”
- The term “moral” shifts to represent psychological instead of ethical value; becomes endemic to any principal-agent relationship (“rational maximization or free-riding”)

Spreading to legal and policy debate

- With a focus on welfare institutions
- AFDC, OSHA, universal healthcare

Sharp contrast to “lender of last resort” function
Two treatments of moral hazard
A legal concept, used in commercial law to indicate that a person would be financially liable, in the context of a given venture, only to a fixed amount – generally the amount of his/her investment.

Before the 1850s, limited liability was rare in the business world. The dominant "regime" was characterized rather by unlimited liability

- A rare privilege granted selectively to certain corporations
- An extension at the margins of unlimited liability firms (Various "Commandite" forms)

The last 150 years correspond to a radical "regime" change where limited liability has become the rule and unlimited liability increasingly the exception.
Roman origins

Hybrid trajectory – commend a
in the middle ages to
contemporary commandite
Regal privilege and the corporation

- Regal monopoly over the corporation
- Limited liability as a rare privilege
Re-Privatization

- When incorporation becomes a legal right and limited liability becomes formally associated with it
- Parallel developments, diffusion, imitation – a transnational phenomenon
- More recent association with partnership acts
Comparison

- A profound transformation of the two concepts over more or less the same time frame
- The widespread diffusion of both notions and associated practices during the same period
- From (negatively) morally laden notions to be kept marginal to morally neutral widespread realities
- Both paths do not appear to meet historically
The missing link: limited liability as moral hazards

- Traditional Assumptions:
  - Shareholders are *risk-neutral* (diversified portfolio)
  - Managers are *risk-averse* (firm-specific human capital investment)

- But is this true for large limited liability corporations?

- Two sources of moral hazard shift risk preference:
  - Separation of ownership and management
  - ”Lender of last resort” in the case of financial institutions

- Results in *risk-seeking* behaviour (potential for large gains with risk of relatively small losses)
The missing link – limited liability as a structural source of moral hazard

Introduction of limited liability as a potent form of “insurance” for the beneficiaries

Responsibility is outsourced and diffused in the process

- First to the state in the early corporation
- Second to the owner/manager in the commandite
- Then to the bankers/creditors when limited liability became legally associated with incorporation
- To “society” when bankers/creditors themselves as well as partners come to enjoy LL as well…
CONCLUSION (2)

• We have come, through time, to takelimitedliability for granted as a structuringdevice of contemporarywealth production

• Forgetting (or not realizing) the otherside of Janus – itspotent moral hazard implications

• In order to seriously face the contemporarycrisis, we argue thatitisimperative to assess the performative moral hazard implications of limitedliability and to weigthem (politically) against the associatedwealthgeneration/benefits