WORKING PAPER

Rethinking Limited Liability

Beneficial Ownership Transparency to Reform the Liability System

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Please send feedback to andres@taxjustice.net. Thank you!

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1. Introduction

Limited liability refers to the right to cap a legal or natural person's losses up to their investment in a legal vehicle, shielding the rest of their personal wealth from the entity's debts. Limited liability is two-sided: i) the personal creditors of a shareholder in a limited liability company have no direct right over the company's assets (they can seize the shareholder's shares, but they can't reach into the company to seize its equipment etc.), while ii) the creditors of the company cannot access the shareholder's personal assets. Limited liability is usually obtained simply by creating or incorporating a legal vehicle as a separate entity. It may also be achieved where the law recognises a distinct pool of assets without separate legal personality. This could be, for example, a trust where the law distinguishes the trustee's personal assets from the assets held by the trustee in relation to the trust.

The main problem of limited liability, from a justice perspective, is that it caps investors' losses but not their gains, transferring the risk and costs of any endeavour to the rest of society, but not sharing any of the profits.

In addition, limited liability is one of the benefits automatically obtained by legal vehicles when they are incorporated (eg companies) or created (eg trusts) without requiring that legal vehicle to offer society anything in return. Vehicles enjoying limited liability do not even offer transparency about who is benefitting from the vehicle, unless their country of incorporation has a public beneficial ownership registry. In other words, while limited liability was presented in theory as an incentive for investors to undertake risks which would create employment and economic growth, nothing in the law requires this social benefit to take place. An individual could set up a company to hold their assets (eg house, car, yacht) and such a company would enjoy limited liability even though it creates no benefit for society.

Finally, limited liability is an argument used to justify the need for complexity within corporate structures. When corporate groups create complex structures involving many layers of entities, they can not only create secrecy (because it becomes harder to identify who is ultimately owning or controlling the group), but they also add layers of limited liability to isolate risks from the rest of the group, protecting the corporate group but affecting society at large.

This brief explains why the current system of limited liability is unfair, and it proposes ways to rethink limited liability to make it more aligned with goals of financial justice and equality. This brief proposes that if an entity's assets are not enough to pay for its debts, then the entity's owners should need to respond, at least partially, with their personal wealth.

To enforce this new system, more transparency would be required to ensure the identity of each owner (shareholder or investor) in an entity is easily accessible. Beneficial ownership transparency deals precisely with the identification of the natural persons who ultimately and effectively own, control, or benefit from legal companies and other legal vehicles. Therefore, beneficial ownership transparency is an essential tool to have a fairer liability system.

In addition to knowing the identity of each owner, it is necessary to ensure that they won't be able to protect their personal wealth by transferring it to yet another entity. This proposal to prevent individuals from escaping liability by shielding their assets should not just apply to owners of entities, but to any individual who is liable to a creditor (eg because they ran over someone with a car).

2. The negative consequences of limited liability

The standard justification for limited liability (capping the losses up to the investment in an entity) is that it encourages investors to put their money into new endeavours that will create economic growth and development. If investors were fully liable for losses, they would likely avoid investing at all, or would want to be highly involved in the recipient company's decisions, creating additional costs and preventing diversification (because they would have to closely supervise every company in which they hold interests).

Author Damian Murphy expands on some of the benefits of limited liability, describing that it: "(a) creates an incentive to invest - increasing the level of economic activity; (b) encourages socially desirable high risk projects; (c) permits the functioning of an efficient capital market; (d) enables the promotion of large projects; (e) diminishes agency and social costs and spreads risk efficiently; (f) encourages diversified portfolios; (g) reduces costs of contracting around liability; and (h) avoids litigation and bankruptcy costs."[1]

No law, however, actually requires an entity that enjoys limited liability to invest in risky endeavours, let alone to create jobs. A shell company can still enjoy limited liability despite not doing anything but holding a person's assets. Moreover, there are many negative effects resulting from limited liability itself. For instance, Hansmann describes that *"limited liability encourages overinvestment in hazardous industries. Since limited liability permits cost externalization, a corporation engaged in highly risky activities can have positive value for its shareholder, and thus can be an attractive investment, even when its net present value to society as a whole is negative."*[2]

The financial crisis of 2007/8 has many examples of risky behaviour undertaken by financial institutions (the subprime mortgages) that led to the collapse of the financial system where the government (instead of shareholders and investors) had to bail out many institutions.

As a final note, limited liability was meant to protect an investor (natural person) in relation to an entity. It is now, however, in widespread use as a means to isolate assets between two entities: a parent and its subsidiaries.

[1] Murphy, Damien (1998) "Holding Company Liability for Debts of its Subsidiaries: Corporate Governance Implications," Bond Law Review: Vol. 10: Iss. 2, Article 6.
[2] Hansmann, Henry, and Reinier Kraakman. "Toward Unlimited Shareholder Liability for Corporate Torts." The Yale Law Journal 100, no. 7 (1991): 1879-934.

2.1 Negative effect I: Limited liability between a parent and its subsidiary

Given the argument in favour of limited liability to promote investment and subsequent economic growth, limited liability is usually granted automatically whenever an entity (eg a company) is incorporated. However, this means that limited liability becomes a feature of new (separate) entities, even when there is no individual investor's personal wealth to protect. This is what happens when a holding company incorporates a subsidiary.

Limited liability between a parent and its subsidiary means not only that the natural person investor is protected from the losses incurred by their investments, but also that the different subsidiaries within a group are protected from each other's losses. Griggs posits that

> *"the principle of separate legal entity has remained as the foundation stone, the pillar on which the house of corporate law is constructed. Arguably, because of the law's strong attachment to the concept of separate legal entity, corporate groups and multinationals have flourished—partly due to the desire to achieve managerial efficiencies and tax and finance advantages, but also more importantly for the topic under discussion, the capacity to insulate one card in the house of corporatisation from the collapse of another card. This is the corporate structure anathema to the house of dominos; the fall of one will not lead to the destruction of all. Through this doctrine, multinationals (which at its simplest merely means a group of related entities based in more than one State) utilise the corporate entity doctrine so that the parent is protected from the liability caused by the acts and activities of the subsidiaries."*[3]

An example of the isolation of risks within a group is the way vessel companies organise their structure and the ownership of their vessels to ensure limited liability and to prevent negative consequences from any single vessel's illegal activities from affecting the rest. Greenpeace's publication "Fishy business: How transhipment at sea facilitates illegal, unreported and unregulated fishing that devastates our oceans" described the following ownership structure of the Greek shipping magnate Thanasis Laskaridis, who is alleged to have the single most active fleet of reefers (cargo vessels) involved in transhipments on the high seas [transhipment is considered a high risk activity that enables illegal, unreported, or unregulated fishing because illegal catches and workers can be moved between ships on the high seas, avoiding detection or inspections at port]. According to Greenpeace, "*many of* [Laskaridis'] *vessels are reported to pose an environmental risk and use FOCs [Flags of Convenience] that require lower environmental, labour and safety standards."*[4]

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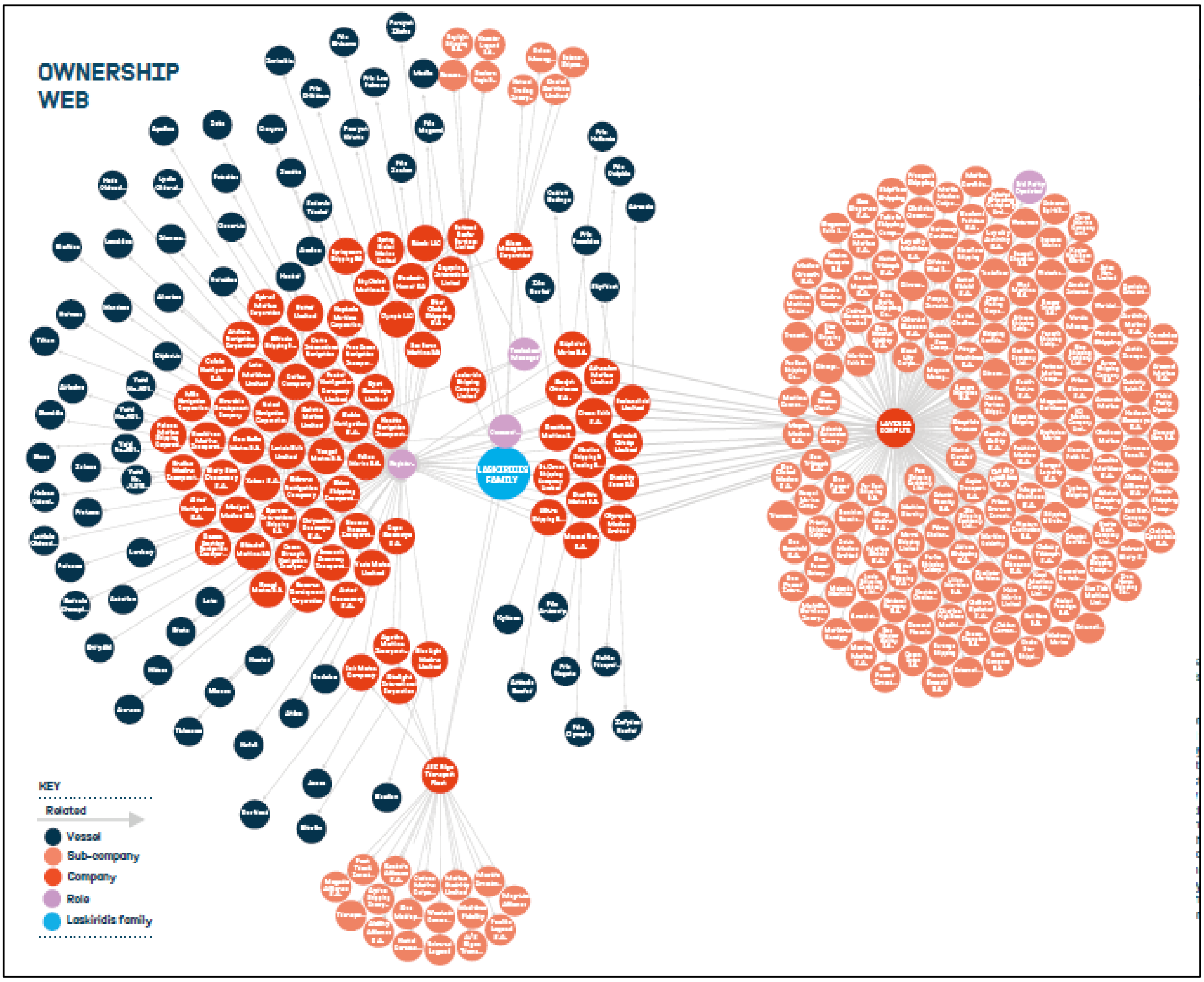
[3] L. Griggs, G. Lugten, "Veil over the nets (unravelling corporate liability for IUU fishing offences)", Marine Policy, Volume 31, Issue 2, 2007

[4] Greenpeace, "Fishy business: How transhipment at sea facilitates illegal, unreported and unregulated fishing that devastates our oceans", 2020.

Figure 1: The complex ownership structure with separate ownership of vessels used by Thanasis Laskaridis as reported by Greenpeace.



Source: Greenpeace, “Fishy business: How transhipment at sea facilitates illegal, unreported and unregulated fishing that devastates our oceans”, 2020

Opposing limited liability between a parent and its subsidiaries

Limited liability is automatically recognised between a parent and its subsidiary because they are separate entities. Author Damien Murphy argues that this automatic recognition (originally intended to apply to a natural person investor in relation to an entity) is wrong when applied to a parent and its subsidiary for four reasons.

First, in the case of a natural person with very small interests in multiple different entities, it could be argued that the individual investor would not be able to supervise each entity into which they invest to make sure they do not engage in unnecessary or high risks that could jeopardise the investor’s personal wealth. This challenge does not apply to the parent company in relation to its subsidiary, given that the parent would have high or absolute degree of information and control over the subsidiary.

Second, even if the parent is liable for its subsidiaries’ obligations, the parent’s shareholders (investors) will keep enjoying limited liability---the individual investors in the parent company will not be responsible for the losses of the subsidiary.

Third (and a consequence of the second point), the limited liability between the subsidiary and its parent adds another layer of protection that was never intended (the arguments were about protecting investors to encourage investment).

Fourth, while individuals with little interest and little control over an entity might be risk averse (and therefore they would reduce their investments affecting economic growth), this does not apply to parent companies. "A holding company, however, is unlikely to be risk averse, rather profit maximising and investing in projects with positive risk-adjusted returns and does not usually separate management or information flows in respect of its operations through subsidiaries."[5]

Along the same line, Blumberg explains that the limited liability between a subsidiary and its parent is different from the one between an entity and its investors because of the disparities in wealth, information, and control over the entity.

"The corporate group analysis does not involve a universe of thousands of shareholders of varying degrees of wealth. Instead, the subsidiary in a corporate group typically involves a single shareholder, its parent… Corporate group analysis does not involve thousands and thousands of shareholders who are widely separated from participation in management of control. Within the corporate group, the parent as sole shareholder is almost invariably engaged in the managerial functions of establishing policy, determining budget, providing administrative support, and participating in the decision-making of the subsidiary corporation… The business of the parent is often integrated economically with the business of the subsidiary; indeed, in many cases the two will be conducting interrelated fragments of a single unit business… [6]"

Blumberg concludes *"in summary, most, but not all, of the suggested arguments for limited liability simply do not apply to corporate groups, or at least are not always fully applicable. The extension of layers of limited liability to the tiers of subsidiaries within corporate groups lacks most of the theoretical justification that has been advanced in defense [sic] of the rule [of limited liability]."*[7]

The author also describes that limited liability between the subsidiary and the parent as something that was never envisioned or discussed as necessary, but was rather an accidental consequence. In fact, at the time when limited liability was first recognised, at least in the United States, corporations were prohibited from owning interests in other corporations. Blumberg explains: *"limited liability triumphed at a time when corporations were simple, when one corporation could not acquire and own the shares of another. Limited liability meant protection for the ultimate investor. Long after corporations were firmly established, corporations generally were first granted the power to acquire and own shares of other corporations… Limited liability no longer meant protection for the ultimate investor alone. It also meant protection for the parent corporation against liability for the obligations of its subsidiaries, even if they were conduction essential parts of a single, unitary business….*

In the simple corporation, the insulation of the shareholder as investor from liability for the debts of the enterprise was accomplished by limited liability for the investor. In the

[5] Murphy, Damien (1998) "Holding Company Liability for Debts of its Subsidiaries: Corporate Governance Implications," Bond Law Review: Vol. 10: Iss. 2, Article 6.
[6] Blumberg, Phillip, "Limited Liability and Corporate Groups" (1986). *Faculty Articles and Papers*. 28.
[7] Ibid.

corporate group, the extension of limited liability to the parent was not necessary to accomplish this result. The parent's shareholders already benefited from limited liability, and insulation of the parent create a second layer of protection. Nevertheless, dazzled by the concept of the corporation as a separate entity, the same rule apparently was applied unthinkingly and automatically to the parent corporation."[8]

2.2 Negative effect II: Limited liability in favour of ultimate investors

The previous section explains that limited liability should not apply between a parent and its subsidiaries because the ultimate investor (of the parent) is already protected by limited liability. This section questions whether even the ultimate investor should be protected through limited liability.

Not all ultimate investors are powerless natural person investors

One of the arguments in favour of limited liability relates to the idea of a small individual investor who would have to use all of their personal wealth to cover a company's debt, despite having a small interest in that company. However, most large shareholders in many public companies are not small individuals. Rather, they are institutional investors (eg pension funds, hedge funds or private equity funds in closely-held companies.)

Institutional investors may have more resources to do more monitoring of the companies into which they invest, and they may have more involvement in the company's board (not only for liability reasons, but mainly for profit purposes). At the same time, given their resources and portfolio, they may already diversify their risk. In other words, just as the arguments that justified limited liability in favour of small individual investors does not apply to the subsidiary-parent relationship, they may also not apply to big institutional investors who would be able to afford the company's debt much more easily than an individual.

Natural person investors are afforded disproportional benefits compared to the rest of society

Unlike a parent and its subsidiary entity, or compared to a large institutional investor, one could argue that natural person investors with little interest in an entity (and little information about and control over the entity) need limited liability to protect their wealth. Otherwise, they may be forced to stop investing in the financial and capital markets. However, one must consider the other side of the coin.

First, it is widely known that "there is no such thing as a free lunch", or in this case, there is no way to make costs "disappear". If investors do not bear the risk (or the cost of that risk when it materialises), it will have to be borne by someone else. In other words, limited liability does not mean that *everyone in society* will be better off. It means that the investors will be. The risks and negative consequences of entities' activities will have to be borne by someone else. One could argue that some parties may already negotiate a

[8] Ibid.

better deal to address the risk of limited liability. For instance, a bank could ask for collateral or a special guarantee from a company before issuing a loan. However, not all stakeholders are able to negotiate with an entity. Some parties are especially vulnerable or less powerful, eg employees, small suppliers or consumers. In other cases, the creditor may be entirely involuntary, such as the victim of an accident. It may eventually even include the State, which will have to pay for the environmental damage or job losses.

The second problem with limited liability is its lack of symmetry and therefore fairness: losses are capped, but gains are not.

Box 1: Limited liability is not necessarily a consequence of the separate entity

Limited liability is usually enjoyed automatically as soon as an entity is incorporated or created. This is based on the assumption that "separate entity" (allowing a corporate vehicle to hold assets or engage in business independently from its creator or owner) equals "limited liability".

As described by Blumberg, the concept of a "separate entity" existed long before the concept of "limited liability" was established, and even when cases of limited liability existed, there were entities that still featured unlimited liability or pro rata liability, as well as double or triple liability. Therefore, it should not be considered that limited liability is an essential part of the separate entity, let alone indispensable for economic development.

To illustrate how establishing an entity was not always related to limited liability, Blumberg demonstrates that *"Substantial industrial development took place both in England and in the United States under legal systems imposing liability on shareholders for corporate obligations before limited liability emerged in the United States around 1825 and in England in 1855. Limited liability is a statutory development that represents the triumph of the rising political power of business interests… Limited liability was not an essential component of the English legal system under which the first one hundred years of the Industrial Revolution flourished. Nor was it an inevitable component of the capitalist economic system. English industrial activity increased enormously under a legal rule imposing liability on shareholders."*

According to the author the same applied in the US where the growth of the corporation was not related to limited liability: *"as the corporate form became available more readily, businessmen used it increasingly, primarily to achieve perpetuity of existence and ready transferability of shares. Except for financial enterprises such as banks and insurance companies, limited liability was still of slight importance."*

Blumberg also describes the inconsistent ways in which limited liability was established in the United States, being adopted in some cases while in many other cases, unlimited liability or even double liability remained until the 20th century: *"Direct shareholder liability thus survived in California from 1849 to 1931…As late as the 1960's, there were as many as six states that by constitution or statute imposed some form of liability on shareholders (or insiders) for unpaid wages of corporate employees….Double liability for bank shareholders was the common pattern under state law for state banks as well. As late as 1926, thirty-five states had statutes imposing double liability (and in Colorado, triple liability) on shareholders of state banks."*

Box 1 (continued)

To sum up, limited liability was both not essential to economic development and there have been many other options used to address liability, including unlimited liability, pro rata liability, double liability, etc. Limited liability became entangled with the separate entity (eg incorporation), not because of a legal or conceptual need, but because of lobbying by industrialists and investors.

3. A fairer liability system

The main problem with the current system of limited liability, apart from the fact that it benefits the wrong people (eg parent entities of large corporate groups or institutional investors), is its lack of symmetry: losses are capped (up to the original investment) but gains are not (the sky is the limit). A fairer system would consider alternative scenarios for owners' liability in the event that an entity is unable to pay its debts. Below is a list of alternative liability options, some of which are already in use by certain legal frameworks (eg unincorporated companies may involve joint liability), and others of which are proposals to be developed further with the aim of achieving a fairer system:

- Fully unlimited liability or joint liability where any shareholder is liable for the full debt of the company.

- Joint several liability, wherein a creditor may collect the whole debt from any shareholder, but that shareholder could then collect the proportional debt from the other shareholders.

- Pro rata, where a shareholder would only be liable for the proportion of their shareholdings (ie if the company owes 100, and the shareholder has merely 1 per cent of the shares, the shareholder would only be liable for 1, not for the whole 100).

- Liability up to the benefits, which is a type of liability proposed by this author. In this scenario, an investor or shareholder would need to respond with the original investment, plus any benefits received. For instance, if shareholder John subscribed $1000 in shares (his initial investment) but throughout the life of the company he ended up receiving $ 1 million in dividends, he should be liable not only for the original investment of $1000 but for all the dividends or other benefits that he received ($1 million). In some cases of management (eg a CEO or CFO), salaries--or at least bonuses-- should be considered part of the liability pool. This would prevent cases in which banks are deemed 'too big to fail'. In these cases, banks did go bankrupt (eg Lehman Brothers) or were saved by the State, yet CEOs still received millions in compensation before or after the financial crisis. Similarly, let us say that John was a shareholder of a company in the year 2018, and in that year, the company's products were found to cause health damages. John might then sell his shares for $1 million in 2019. In this case, he should still be liable up to all benefits, including both the 1 million in dividends and the 1 million in capital gains.

- Corporate taxes as an insurance premium in case of liability. As suggested by Hagai Levi, corporate taxes could be justified for cases where the State may need to pay for company debts (eg an oil spill). In this scenario, the proposal would be that States could use part of the corporate income tax revenue as insurance premiums paid by companies in case they end up having unpayable debts. States could decide to raise corporate income tax rates or establish a new tax, eg for companies engaging in especially risky endeavours.

In conclusion, any new measure has trade-offs. The discontinuation of limited liability may discourage or prevent some investments or developments, but at least it would bring more justice to those that need it the most: involuntary creditors (including those employees or small contactors who were not able to strike a bargain for a better deal). To put things in perspective, when banks were required to ask for more information from clients (eg prove the legal origin of their money) as part of the fight against money laundering, this resulted in excluding informal workers from the financial system. While unintended consequences should be considered, there is a possibility that once the absence of limited liability becomes the norm, investors will get used to investing again.

One word of caution: The absence of limited liability does not mean that shareholders will always lose all their personal wealth. It simply means that if the company is responsible for causing damage and becomes insolvent, or if they did not take out sufficient insurance, only then will someone else – other than the victims –be required to pay the bill. This “someone else” will be a shareholder (eg a large investment fund). How much of their personal wealth will be paid will depend on the applied system of liability, such as pro rata or “investment plus benefits”.

4. Beneficial ownership transparency to enforce a fairer liability system

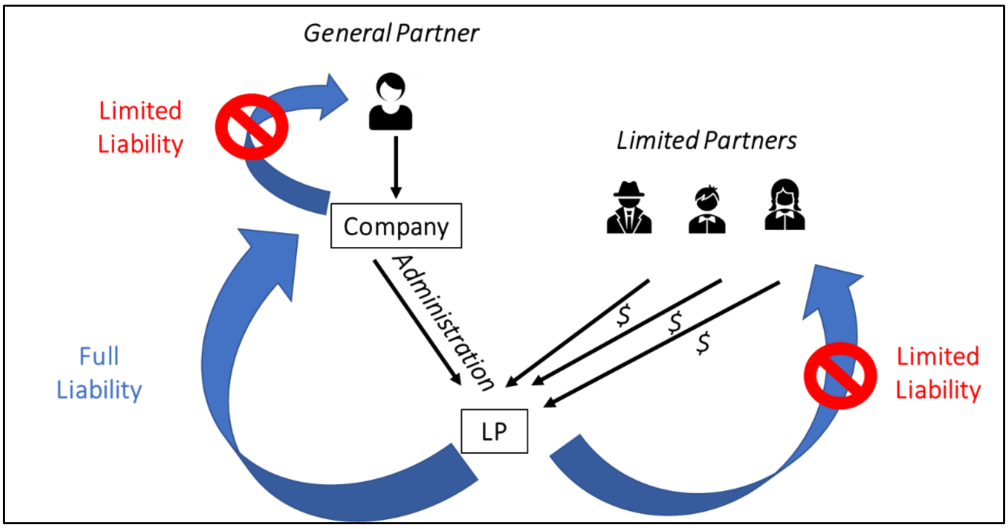
In a system of limited liability, the identity of the investor or owner is irrelevant. That owner will only respond (for the entity’s debts) with their initial investment and nothing else. If that owner was an individual, a nominee shareholder or another company makes no difference. On the contrary, a reform of the liability system towards non-limited liability where owners must respond also with their personal wealth makes identifying the owners an indispensable requirement.

Beneficial ownership transparency refers to identifying the natural persons who ultimately own, control, or benefit from a legal vehicle (company, trust, etc). It is a crucial transparency tool to tackle illicit financial flows such as money laundering, corruption, or tax abuse. Just as beneficial ownership transparency is used to hold individuals to account for any wrongdoing (eg tax evasion), it should also be used for civil liability (when a person owes money to someone else).

Beneficial ownership transparency is essential for a system of non-limited liability. An investor (John) could be investing in hazardous Company A (which transports oil overseas) through a shell company. If Company A suffers from an oil spill and all investors have pro rata liability, the identity and assets of the shell company will probably be irrelevant (a shell company could have a capital of just 1 dollar). It is much more relevant to identify John, the beneficial owner, and his personal wealth.

Beneficial ownership transparency is necessary to hold the ultimate investor accountable and to prevent said investor from escaping liability by hiding behind other legal vehicles. To understand how an investor could escape liability even if they are "held liable" consider the following example of limited partnerships (LPs). This legal vehicle contemplates two different types of partners: limited partners who only offer capital and enjoy limited liability because they have no control or decision-making power over the LP, and general partners who may have little or no capital in the LP but oversee its administration and are thus fully liable for the LP's obligations. Crucially, if nothing prevents a general partner from being a legal person, then limited liability (rather than full liability) will be achieved in practice. While the corporate general partner would be fully liable, its shareholders would enjoy the corporate entity's limited liability. Therefore, the general partner would enjoy limited liability in practice, as the next figure describes.

Figure 2: Escaping liability



Without beneficial ownership transparency, any investor or shareholder could equally escape liability like the general partner of an LP, by operating through other entities. For this reason, liability should be in the hands of the beneficial owner, rather than in the hands of the investor. (The investor and the beneficial owner would be the same person if the investor directly owns an entity under their own name).

In addition to preventing an investor from escaping liability by holding their investment through an insolvent shell company or through another entity with limited liability (like the general partner of an LP), simplifying the debt collection process is another reason in favour of holding the beneficial owner liable at the same time as the investor (for the creditor to choose to go against whoever is more solvent). Otherwise, creditors will first have to hold the first corporate investor to account, and if it is insolvent, they could then go to the owner of the corporate investor, which may be another entity. This process could go for ever if the beneficial owner keeps adding layers of entities. A fairer system would be for the creditor to choose. It may make more sense to go against a wealthy investor (eg a hedge fund) but in the case of an investor that is just a shell company, it may be better to go directly against the company's beneficial owner.

Although the law may determine that the beneficial owner is to be held liable, ensuring the identification of the beneficial owner may pose several challenges. These challenges are beyond the scope of this paper, but we have written several papers on the importance of beneficial ownership transparency, the loopholes affecting their identification, and the accuracy of reported information. One of the most relevant points refers to the definition of a beneficial owner, which may involve thresholds such as "a beneficial owner is anyone with more than 25 per cent of the shares." The proposed system of liability, however, where all shareholders have to respond (eg in a pro rata basis) means that beneficial owners should be identified without thresholds so that information on all shareholders' beneficial owners is available, instead of having information on the beneficial owners of shareholders holding more than 25 per cent of the company (which may involve no beneficial owner identification, if the company has for instance four shareholders). In other words, the reform of the liability system presents another argument in favour of identifying beneficial owners of all shareholders (without thresholds).

5. Preventing individuals from escaping liability through asset protection trusts

Even if the natural person ultimate investor (the beneficial owner) is identified and held liable for any type of liability (debt) originating in the company where they hold interests (eg pro rata liability), it is just as important to ensure that they won't be able to shield their personal assets from creditors. In other words, it is not enough to reform limited liability and to ensure that a natural person (beneficial owner) rather than a corporate shareholder will be held liable. It is just as important to ensure that this natural person won't pretend to be insolvent to avoid paying their debts. In essence, to make the liability system work, beneficial owners should not be able to shield their assets from creditors. (Individuals should not be allowed to escape liability in general, not just in case they are shareholders. A man who runs over someone in the car should also be prevented from escaping liability).

Most, if not all, countries have fraudulent conveyance (anti-fraud) legal actions, through which transactions such as an individual donating or selling all their assets at a bogus price to a relative right after becoming insolvent would be rendered void. Some individuals, however, may be savvier and shield assets long before insolvency takes place (anti-fraud actions usually go back between two or five years since the debt or damage occurred, not beyond that). They may also shield their assets in sophisticated legal vehicles such as asset protection trusts, making it much harder for creditors to obtain their money.

Trusts create secrecy risks because they are more complex than companies for two main reasons. First, trusts do not have "owners" (eg shareholders). Instead, they have different parties, each with specific roles, rights and duties. Second, trusts usually do not need to register or incorporate in order to exist. In recent years, however, some countries have been requiring trusts to register with government authorities if they are subject to tax, if they had immovable property, or if they have a local trustee.

While the secrecy afforded to trusts allows their users to engage in illicit financial flows without alerting authorities, the special features of trusts also allow trust users to shield assets from legitimate creditors (including tax authorities or victims of embezzlement) even when there is information on the trust's existence and on all of its parties.

As the Tax Justice Network's paper "Trusts: weapons of mass injustice?" describes, some types of trusts shield assets by putting them in "ownerless limbo". An excerpt from a Harvard Law Review paper on trusts describes the effects of this: "Trusts can also pass use and enjoyment of wealth on to beneficiaries while shielding the wealth from the beneficiaries' creditors and from judgments in divorce. *'If you don't own it,' the saying goes, 'nobody can take it away from you.' All of these benefits can be coupled with essentially complete control allocated according to the grantor's wishes. (…) This makes the total package effectively indistinguishable from property owned outright in terms of the benefits provided, but without important downsides property ownership entails, such as greater exposure to taxes, creditors, and vengeful ex-spouses."*

In essence, trust assets become ownerless on paper (and thus unreachable by personal creditors of the trust parties) because they do not belong to the wealth of any of the trust parties:

- The trustee, the obvious party under whose name the trust assets are held, is merely a legal owner. Trustees cannot benefit from trust assets but must administer them in favour of beneficiaries based on the indications given by the settlor in the trust deed. Trust assets do not belong to the trustee.
- Beneficiaries, who are supposed to have beneficial or equity rights to trust assets, will only become entitled to trust assets depending on some conditions. In the best case, at a determined time (when they turn 18 years old, when they graduate, when they have children, etc). In other cases, especially in discretionary trusts, only when the trustee decides - based on its own discretion - to give a distribution to a beneficiary.
- The settlor, or the original owner of the assets, is not the owner any longer, just as any person who sold an asset to someone else no longer owns that asset.

Trusts: abusive provisions

In addition to the aforementioned discretionary element, different features protect trust assets from outsiders. These features include spendthrift provisions that prevent distributions to indebted beneficiaries, and secrecy jurisdictions that offer non-recognition of foreign laws (eg forced heirship) and non-recognition of foreign judgements. Moreover, trusts can be made to last in perpetuity (or for 1,000 years) so that distributions are never made, allowing the capital (principal) to be kept in the family for generations. Lastly, some secrecy jurisdictions offer limitations on fraud action, reducing the statute of limitations to initiate a fraud action or increasing the burden of proof to invalidate a transfer of assets to a trust.

Consequently, trusts differ from other entities, contracts, and relationships for the following reasons:

- **Companies**: While corporate assets are also unreachable by the shareholder's personal creditors (based on the other side of limited liability which protects corporate assets from shareholders' creditors), the personal creditors could, upon insolvency, obtain the shareholder's shares and thus benefit from, control, or access the corporate assets. In the case of a trust, neither the settlor nor the beneficiaries "own" anything, and, especially in the case of discretionary trusts, beneficiaries only have contingent rights which depend on the trustee giving a distribution in their favour. In other words, for a well-structured asset protection trust, no personal creditor of the settlor or beneficiary would be able to reach the trust assets.

- **Donation**: A settlor could donate assets to beneficiaries instead of settling a trust. In good times, or based on secret agreements, beneficiaries could then donate the assets back to the settlor, and back and forth. While donating assets may sound like an effective way to escape liability, the problem is that the recipient of the donation will become the owner and will have to respond with those assets if they become insolvent. (In a trust, while the settlor is also no longer the asset owner, the beneficiary is not yet the owner either, unlike in the donation). In addition, each donation would re-start the statute of limitations for fraud actions, rendering the process ineffective.

- **Wills**: A settlor may decide who will inherit each of their assets in a manner similar to distributions from a trust. The main difference between wills and trusts is that the will shall only become effective after the settlor dies and as long as the settlor retains those assets. In other words, a millionaire settlor may write a will to give all their money to their only child, but if by the time the settlor dies all the money has been lost, the child will inherit nothing.

Separating the wheat from the chaff

While trusts are usually portrayed as private family matters and used to protect vulnerable people, nothing in trust law requires that beneficiaries be vulnerable. The settlor may very well be one of the beneficiaries, or even the only one. Additionally, there are other methods for succession planning, including donating ownership over business lines for each heir or deciding this in a will to take effect after the settlor dies.

While courts may at times address unfair situations or abuses, it would be more effective to fix potential abusive effects through law. The court system can be unpredictable, and most importantly, extremely expensive and time consuming for some legitimate creditors (eg those injured due to the recklessness of others). As one lawyer put it: *"it is widely acknowledged that one of the essential ingredients of an asset protection plan is to build obstacles that a creditor must overcome before collecting on a claim. The multiple lawsuits and related time and considerable expense that would accompany pursuit of a claim against a DAPT [Domestic Asset Protection Trust] present a considerable obstacle to creditors and with no guarantee of success."*[9]

A recent article entitled "A Creative Way to Divorce-Proof Your Premarital Assets" also suggests creating a trust instead of signing a 'pre-nup': *"Paul can form an irrevocable trust for his assets for the benefit of his children or other designated beneficiaries in one of the favourable states that have "no exception creditors", such as Nevada, Alaska or South Dakota. Paul can even use an offshore jurisdiction to get "suspenders and belt" protection,*

[9] Bove, A.A. 2017 - Asset Protection in the United States: What's the Attraction? in IFC Review 2017/18 The Definitive Guide to Global Wealth Management and International Financial Centres

where the trust can be drafted to provide the trustee with the power to add future beneficiaries, including – but not limited to – Paul. When Paul signs his prenup, he would literally not own the assets previously given to his irrevocable trust, and thus, does not need to disclose them. Should Paul later need or want some or all of the assets held by the trust, the trustee may add him as a beneficiary."

Unfortunately, trusts are not just promoted by 'enablers' as useful tools. They are also validated by courts, even under circumstances that are extremely unfair. Here are some excerpts from the Tax Justice Network's paper "Trusts: Weapons of Mass Injustice? A response to the critics":

- **Trust prevails despite the settlor-beneficiary engaging in embezzlement of millions of dollars**

In this case, Sheikh Fahad Mohammed Al Sabah settled a trust. Later he embezzled millions of dollars from a company. The company obtained a judgment to collect 800 million from him. In principle, a person would have to respond with all their assets, regardless of when those assets were acquired. However, given that "clean" assets were settled in the trust, and despite the fact that the Sheikh was the settlor, a beneficiary and also controlled the trustee, a court in Jersey considered that the trust was valid, and the affected company was unable to access the trust assets to pay their debt.[10]

- **Trust prevails despite sexual abuse against minor**

Kyle Krueger was charged on 90 counts of sexual assault based on videotape depicting the defendant, over the course of twenty-five minutes, lying on a bed with a two-year-old child using various phrases or implements designed to coax the child to perform oral sex upon him.[11] A civil court also ordered the abuser to pay $500,000 in damages to the victim. The mother of the victim tried to satisfy the tort judgement of $500,000 against the abuser. The abuser was the beneficiary of a spendthrift trust settled by his grandmother. Based on the trust's deed, the abuser was even allowed to require trust distributions by writing to the trustee. However, the New Hampshire Supreme Court decided that the trust was a spendthrift trust and that the spendthrift provisions barred it from satisfying a tort creditor, so the mother was unable to satisfy the judgement against the abuser.[12]

Proposals to address trust abuses

Reinforcing or extending fraud actions is usually not enough to address trust abuses. Asset protection trusts are advised to be settled early on, decades before a settlor may become insolvent, rendering any fraud action inapplicable.

Discretionary trusts seem not to make sense from a fairness perspective. While on paper discretionary trusts may pretend that another party (trustee) has discretion, it is obvious that in practice this is not the case, and that discretion often remains with the settlor. Otherwise, why would settlors not donate assets directly? Discretion, however, is not

[10] http://jmvlaw.com/recent-decision-concerning-asset-protection-trusts/
[11] https://casetext.com/case/state-v-krueger-25#p542
[12] https://casetext.com/case/scheffel-v-krueger

even the primary concern. Even if settlors did relinquish all control over assets and gave a robot or an alien full independence and discretion to manage assets on behalf of beneficiaries, the result is still unfair. Why should those assets remain excluded from personal creditors when things go bad, but fully enjoyable by beneficiaries in good times?

Prohibiting discretionary trusts would help eliminate the idea of relinquishing power and control, but this could still be achieved by non-discretionary trusts, where the settlor retains control through the ability to change trustees, to force the trustee to appoint the settlor as a beneficiary, or to give a distribution in favour of the beneficiary. For this reason, a better proposal to avoid the ownerless limbo created by trusts is to require trust assets to always have an owner (regardless of who manages the assets). In other words, while a trustee may still hold legal ownership and management duties over trust assets, they should be considered to belong to the settlor for liability purposes (if the settlor has personal creditors). Once the beneficiaries are entitled to receive distributions, trust assets should be considered to belong to them, for insolvency purposes.

Box 2: Preventing abuses of private interest foundations

Private interest foundations are foundations that, instead of working for the public good (eg education, sports, religion), concentrate wealth to benefit a family or individuals. They have very similar structures to trusts: a founder (similar to a settlor), a foundation council (similar to a trustee), and beneficiaries. Unlike trusts, however, foundations are usually considered legal persons and have to register, so they tend to be subject to more transparency requirements than trusts. However, from an asset protection perspective, foundations are potentially just as abusive as trusts, shielding assets from the rest of society because the founder no longer owns the assets and the beneficiaries have not yet received them. For this reason, the proposals on the "ownerless limbo" should also apply to foundations, where the founder should be considered the owner of the foundation's assets until they are distributed to the beneficiaries.

6. Conclusion and Proposals

Although limited liability is invoked as a tool to promote economic growth, this paper explains that limited liability has evolved such that it is automatically awarded upon the creation of a legal vehicle, often in situations where it was never meant to apply (eg between a parent and its subsidiary). In addition, this paper describes the unfairness of a system which caps losses but not gains, by transferring the losses to the rest of society. From a financial justice perspective, the system of liability should be completely reformed. For reforms to be effective, however, it is necessary to hold the beneficial owner liable and to prevent them from shielding their assets through the creation of trusts or private interest foundations.

Although the issue of reforming limited liability deserves much more research and development, this brief explains why the current situation is unfair and proposes alternatives which would improve the situation.

In summary, this paper proposes to consider and further develop measures to:

I. End limited liability between a subsidiary and its parent.

II. End limited liability for investors who are especially wealthy and have considerable information and control over an entity (especially large investment funds).

III. For natural person small ultimate investors, alternatives to limited liability should at least be considered. Alternatives include pro rata liability, or bringing all of the benefits received to the liability pool including dividends and capital gains (rather than just the original investment).

IV. Liability should be held by the beneficial owner (to prevent the ultimate investor from escaping liability or being unidentified, including by recourse of a complex ownership chain to hold the shareholdings).

V. To prevent the beneficial owner from shielding assets from creditors (to escape liability), asset protection trusts or private interest foundations should be disregarded by considering that the settlor or founder is still the owner of the trust/foundation assets until they have been distributed to the beneficiaries.

VI. If all of the above proposals are considered too radical, then limited liability should, at the very least, apply only to "active" entities that engage in business, hire employees, and undertake risks (thus creating some benefit for society at large). It should not apply to "passive" or holding entities which merely hold assets but do not engage in any type of risk or value creation

Figure 3. Decision tree on the application of non-limited liability