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Limited Liability and the Real World

Robert W. Hamilton*
Larry E. Ribstein**

This is not a traditional academic law review article. Rather, this Article describes a personal debate that the two co-authors had through electronic mail in late 1995 and early 1996. Initially, the subject of this debate was the appropriate role of limited liability in the jungle of newly created unincorporated business forms that have appeared in the 1990s, but the debate rapidly expanded into a discussion of contrasting views of the rationality of markets in American society. Because these exchanges were by electronic mail, they are frank and uninhibited and perhaps sometimes wander from the basic issue. However, the exchanges raise basic issues that need to be addressed in any discussion of the future of unincorporated business forms.

Part II of this Article represents the actual exchange of views. By and large, the comments speak for themselves and were left untouched. Some minor editing of this text was made to eliminate obvious typographical errors and to insert footnotes when the authors referenced other published work. The authors also omitted a couple of observations that seemed irrelevant or substantively wrong, but that did not go to the merits of the debate. The selection of the four introductory messages that were placed on the LNET-LLC net was made solely by Professor Hamilton in an effort to give some perspective to the debate that followed. Part III of this Article, the Postscript, reflects comments that each author wished to make about this exchange following the Symposium at Washington

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1. This comment applies only to Professor Hamilton's comments. In one instance, a hypothetical that was hastily thrown together did not prove the point he was trying to make and has been eliminated.
and Lee University School of Law and after reviewing the earlier discussions.

Each communication begins with the name of the writer, the date of the communication, and the audience to which it was addressed.

I. Background

The genesis of this debate was a conference at the University of Colorado in early 1995 entitled "LLCs, LLPs, and the Evolving Corporate Form." During the course of this conference, a lively discussion developed among the participants (and to some extent within the audience) as to the desirable scope of limited liability in these new business forms. Several papers argued that limited liability should be accepted as a reasonable default form. Professor Hamilton had prepared an article on the development of the limited liability partnership (LLP) in Texas for that symposium which defended (or at least accepted) the narrow form shield of limited liability for electing LLP status. At the same time, Professor Hamilton's article criticized the New York and Minnesota statutes that provided a broad form shield of limited liability. At the Colorado conference, several participants strongly took issue with this conclusion and expressed the view that the shield of limited liability should be extended to cover many business relationships.


5. The narrow form shield protects innocent partners only for liabilities incurred as a result of malpractice or wrongful conduct by other partners. The partnership itself and the responsible partners remain liable on those claims, while all partners, innocent and guilty alike, remain liable for all other claims and liabilities, including particularly all claims arising out of breach of contracts.

6. See Hamilton, supra note 4, at 1087-1103. The broad form shield protects partners from all personal liability for partnership liabilities except that individual partners remain liable for tortious or other conduct in which they were directly involved. In the scant period of less than two years, it appears that the broad form shield has become the model for most state statutes.
II. The Debate

Following the Colorado conference, a series of messages that considered the limited liability issue were posted on the LNET-LLC, a bulletin board for persons interested in limited liability companies and a host of interrelated "threads." The first four messages set forth below frame the background for the more personalized discussion that followed. Even though the debate began with a discussion of the effect of changing default rules for general partnerships, the debate quickly turned to more fundamental issues about the kind of society in which we live.

Robert W. Hamilton: September 12, 1995 Broadcast on the LNET-LLC Net

I have been reading with considerable interest the recent dialogue [on this net] about limited liability in LLPs. LLPs were invented in Texas and I was indirectly involved in the enactment of the original statute. Last winter, I gave a talk that considered many of the questions being discussed on this net at the present time. I hope that those of you interested in the LLP problem will take the time to read that article. I might add that I do not agree that it is good policy to extend the limitation of liability in LLPs to general contract claims, as was done in Minnesota, New York, and the prototype statute, and as is now proposed below by Mark Pruner. I do think that some definition is needed as to the scope of "vicarious" liability for law firm managers, and the like, if these statutes are to fulfill their original purpose, which basically was to allow innocent, nonnegligent partners to sleep at night without concern about personal responsibility for someone else's malpractice.

The message from Mark Pruner was as follows:

I believe that limited liability for contractual claims is much more important for law firms than is limiting vicarious malpractice liability. I can name several firms that had "business" problems of one sort or another that led to their liquidation, but cannot think of any firms larger than four attorneys that were put under by malpractice. Does anyone know of such a firm? In small firms, attorneys are likely to be "in-
involved" with a majority of matters handled by the firm, either from a supervisory role or by contributing substantive assistance to the larger matters and hence will find protection from vicarious liability of little use.

The LLP statute in Connecticut only protects firms from vicarious liability for matters "arising from negligence, wrongful acts or misconduct . . . in the course of the partnership business." Since most firms do carry malpractice insurance, the large majority of these claims are covered (excepting the deductible). Firms do not carry insurance for downturns in business. At least in Connecticut, a firm is much better off being a professional limited liability company (LLC) rather than [an] LLP, since the LLC is protected from contract nonmalpractice claims as well as from malpractice torts unless personally involved in the malpractice.  

Robert W. Hamilton: September 20, 1995 Broadcast on the LNET-LLC Net

As I discuss at length in my article, I think that the states that have extended protection to partners against all contract liabilities have created a rule that promises to cause real mischief . . . . More basically, partnerships have involved unlimited liability for centuries; to change the rule quietly, without fanfare and without warning, threatens to injure all the relatively unsophisticated people who deal with LLPs who are unaware that the three little letters mean that the basic rules have been reversed by 180 degrees. If partners want limited liability for contract claims, they should negotiate for nonrecourse terms; they should not be able to compel customers, clients, etc. (most of whom are not sophisticated and will not know that is what they should do) to bargain for unlimited liability, which has been the standard rule since Babylonian times.

In addition, this change is going to be viewed as a lawyers' gimmick to cut their own personal legal obligations. Lawyers as a group are not held in the highest esteem by many facets of society today, and I am afraid that this will be viewed as a sneaky trick that hardly will improve our general reputation.

12. CONN. GEN. STAT. ANN. § 34-53 (West Supp. 1996). Connecticut has subsequently amended this section to provide full limited liability for LLP partners except for liability arising from a partner's "own negligence, wrongful acts or misconduct, or that of any person under [the partner's] direct supervision and control." 1996 Conn. Legis. Serv. 96-254 (West).

13. CONN. GEN. STAT. ANN. § 34-133.

Robert W. Hamilton: September 20, 1995 Broadcast on the LNET-LLC Net

If parties are sophisticated and transactions are substantial, it really makes no difference what default rule is adopted: the parties presumably will negotiate either for liability or nonliability, depending on relative bargaining power. Default rules affect unsophisticated people and routine transactions. As discussed in my Colorado article, what bothers me is that the states that have broadened the LLP concept have in effect reversed the default rule without in any way considering or justifying that action (except, I suspect, on the basis that a no-liability rule is clearly better than the default rule for lawyers in partnerships). I doubt that reversing the common-law rule leaves very much to be said for it, considering the persons and transactions affected by it. At least the arguments in favor of reversing the default rule that were made at the Colorado symposium largely were based on the argument that everyone is sophisticated and so it really does not matter. If someone can explain why it is a good idea in societal terms, I would appreciate hearing from them.

I also agree that an old rule is not necessarily the best rule. But I would think that the persons seeking to change the old rule should have the burden of explaining why the proposed new rule is better than the old. In fact, so far as I know, that has not happened.

Larry E. Ribstein: September 21, 1995 Broadcast on the LNET-LLC Net

I find it odd that anyone would say at this point that (1) no one has bothered to explain why the new rule is better than the old; and (2) that the arguments for the new rule assume everyone is sophisticated. I and many other writers have argued extensively for broader limited liability and have made many arguments for limited liability that do not assume sophistication. Indeed, I sketched some such arguments in a previous posting. One could in good faith disagree with these arguments and attempt to refute them point by point. Or one could just decide that the arguments are so worthless they are not worth responding to. But saying that the arguments do not even exist is quite puzzling and does not further the debate.

15. Id. at 1095.
Robert W. Hamilton: September 23, 1995 E-Mail
to Larry Ribstein Only

Larry, I am sorry that my posting irritated you; I certainly did not mean to do so. I was of course present at the Colorado symposium and I have read much, though not all, of what you have written about limited liability. I really think that we see the world differently. I view default rules to be highly important because they govern millions of transactions, and I believe that if they have worked well then they should not be changed without really strong justification. I also think the default rule of unlimited liability for partners, which has existed for centuries, is the premise on which a large (but unquantifiable) number of people routinely deal with partnerships. I think you view the world in a much more economic-trained sense, in which presumptively all people not only try to maximize their wealth in all transactions, but also are well informed and act knowledgeably and rationally in their conduct. You dismiss situations in which that is not the case on the theory either that the transaction is too small to justify rationally the cost of doing something, or that the system should protect only those who protect themselves by acting rationally. If this is a misstatement of your views, please let me know. I decided to send this message to you personally rather than over the network because I did not want to misstate your views publicly. I would like to see your reply. We then might agree to post both this message and your reply on the net. Bob.

Larry E. Ribstein: September 23, 1995 E-Mail
to Robert W. Hamilton Only

Bob, I welcome your invitation to a dialogue on this issue. I do think your message misstates my views somewhat. First, I do not think that people are well informed and act knowledgeably. Like most economists, I assume only that people generally act rationally, which means they take into account the fact that they are not well informed and knowledgeable. For example, in my article, The Deregulation of Limited Liability and the Death of Partnership (Death of Partnership), I argue that unlimited liability may be inefficient precisely because smaller creditors are ignorant about the true value of this liability.16

Now that I have spent a summer researching partnership bankruptcy, I am more convinced of this than ever. It follows that in a world of free contracting, smaller creditors with little way to determine the creditworthiness of individual business owners would prefer to contract for limited liability because they more readily can determine its value.

I also have problems with your statement that I think "the system should protect only those who protect themselves by acting rationally." I would qualify that in many ways. First, I think default rules generally should anticipate actual contracts. If people are really irrational, then that is the way default rules should be. The problem is that there is much evidence that markets, which reflect the interactions of real people, are rational. I would like to see real evidence that in a particular market, such as legal services, people act irrationally. Second, even if some people are irrational, markets may protect them without the aid of regulation. For example, if it is irrational for most clients or patients to deal with minimally capitalized limited liability professional firms, then there will not be enough of a market to sustain such firms even if some clients or patients are irrational. Third, even if there would be a few firms who would prey on the irrational, it may be difficult to regulate them such that the benefits of the regulations outweigh the perverse effects on the legitimate firms. That is a problem with minimum insurance statutes.

With respect to your views on changing the rules, I question whether most people do in fact contract in view of any liability rule. Cases in which vicarious liability for malpractice is actually imposed are very rare. Your point about the long-term survival of the rule is one that I generally find persuasive and necessary to deal with. That is why I wrote the Death of Partnership — to show that unlimited liability has survived because of regulation and tax law, and not because of the preferences of individual contracting parties. I am trying to nail that point down further in an article I am working on now on the public choice aspects of liability rules (specifically, their relation to the conflict between large-firm and small-firm practitioners).18

Finally, I would like to emphasize that I welcome your disagreement and respect your views as one who has enormous expertise in business associations. And maybe we are not as far apart as you think . . . .


I do think that we view the world through different lenses. Perhaps our differences may partially lie in the value we place on economic models or in the reliance we prefer to place on such models.

For myself, I do not doubt that economic models using simplifying assumptions permit valuable insights to be obtained about what we should look for in the real world. I know that my own thought and my own teaching have been significantly influenced by the writing of law and economics scholars, even though I have always been skeptical of that approach. Where I leave the train is when a scholar develops a model and then assumes — without examination or explanation — that the model reflects reality and that therefore certain legal or social changes are desirable.

Most law and economics scholars assume at a minimum that people act rationally in order to increase their personal wealth. Many economic models further assume an absence of transaction costs and perfect foresight about things that have not yet occurred. These confining assumptions may be relaxed in some models, though often it is not clear (to me, and possibly to the model builder himself) precisely which assumptions have been relaxed and to what degree. Particularly treacherous are models that assume some degree of foresight of events that may occur in the future; economists like to talk about ex ante analysis by rational people. I believe that real people cannot and do not approach the insights and skill that economists assume they have in such analysis. In effect, the designer of the model inserts his own personal views as to what he thinks a person should do ex ante.

I start with a criticism of the assumption that persons act rationally in economic matters. This assumption seems facially plausible when it is stated, and it is difficult to use anecdotal evidence to disprove it. I accept the fact that many people act rationally on most economic matters. There is, however, a tremendous amount of irrational or unthinking behavior in our society, and that includes many actions that might be aptly described as economic activity. Any analysis that tries to deal with what people actually do should take into account this irrationality.

Examples of irrational or unthinking behavior abound in real life:

(1) Some examples may perhaps be eliminated from analysis on the theory that the behavior is not "really" economic behavior. An example is the welfare mother with three hungry children who puts a dollar in the church offering box presumably in order to have heavenly help in improv-
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ing her lot. Other examples include charitable gifts and individual political contributions made as a matter of principle and not to influence actual decisions. Still other examples may be based on the fact that for some people, convenience is more important than dollars over a fairly wide range.

(2) In some instances, irrational behavior is based on one person's idiosyncratic views. Economic behavior does not exist in a box independent of other human motives. I was involved in one case in which one sibling acted economically irrationally toward his brother in connection with the operation of an inherited business; blocking the brother was more important than the decline in value of the business that followed. I have no idea how common that is.

(3) One of the most important causes of irrational behavior is that many people, nay, most people are woefully deficient in understanding the most simple and fundamental economic concepts. I have listened to one of my colleagues comment that he was holding a losing investment until it rose in value to what he paid for it, and then he would unload it. Sunk costs are not recognized for what they are by many people. I have watched apparently sophisticated people place large amounts of retirement funds into money market accounts "because that way I am sure it will be there when I need it." The lessons of the 1970s and 1980s about inflation have simply been forgotten, if they were ever learned. Even though the desirability of diversification of investments seems obvious, people regularly load up on one stock that a friend has recommended or that they think is underpriced. Many investors rely on chartists or stock gurus despite the wide — but not universal — acceptance of the efficient capital markets hypothesis (ECMH). Other common misconceptions involve the failure to recognize or understand either the time value of money or the time value of an option arrangement.

If people with a fair degree of sophistication make such common mistakes in financial analysis, consider what the number of mistakes must be for average persons, roughly one hundred IQ and a high school degree, at best. Then consider the millions of people at the lowest economic end of our society. One might argue, I suppose, that real adversity is a better teacher of the value of money than a college degree, but it sure does not explain why some people with credit cards in their pocket go to pawn shops to raise short-term cash, or why persons with a small amount of equity in their home prefer to borrow on credit cards rather than obtaining a much cheaper home equity loan.

(4) A final major contributor to irrational decisionmaking is a human failing to be optimistic — to assume that someone else will do what he
promised to do. It is an unusually sophisticated person who considers in advance what should happen if the other person does not do what he promised. An average person probably does not consider at all the consequences of what should happen if the other party does not perform, or for that matter, what should happen if he himself does not perform.

In my view, in a world in which there is a large amount of nonrational decisionmaking, fair default rules are really important. The great bulk of people, in fact, rely on default rules in most or all of their transactions. Of course, if people "cut their own deal," that deal should be enforced, and default rules should be ignored. However, when in fact no special deal has been cut, such as in *Donahue v. Rodd Electrotype Co. of New England*19 (a case which I taught again yesterday), I am not troubled by the court adopting a rule of "equal opportunity" on the facts of that case.20

Easterbrook and Fischel suggest not only that the *Donahue* case is terribly wrong, but that the default rules that should be adopted are what the parties would have agreed to had they written a contract resolving all contingencies or that the rule should reflect the operational assumption of successful firms.21 This proposal seems to me to lead to completely indeterminate results. In a negotiation in which one party is to become a minority shareholder in a corporation controlled by the other, there are three possible outcomes: (1) the parties might agree upon a contract that would give the minority shareholder a right to exit on some mutually agreeable terms; (2) the parties might find that they cannot agree on such terms, but the minority shareholder decides to take his chances and agrees to make the investment anyway; or (3) the parties might find they cannot agree, and no investment is made. Each of these alternatives seems equally plausible in the abstract. Easterbrook and Fischel select alternative (2), so far as I can see, simply by asserting that this is the right one.22

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20. *Donahue v. Rodd Electrotype Co. of New England*, 328 N.E.2d 505 (Mass. 1975). *Donahue* is a well-known Massachusetts case in which a controlling shareholder of a closely held corporation redeemed some of his shares (and transferred the balance of the shares by gift to his children) at $800 per share while refusing to redeem shares of a minority shareholder, the estate of a deceased employee. *Id.* at 510-11. The court imposed a partnership-type fiduciary duty on the controlling shareholder and required the corporation to give an equal opportunity to the minority shareholder to sell shares to the corporation at the same price. *Id.* at 519-21.
22. *Id.*
I turn now to the comments in your message of September 23 and your analysis of limited liability for partnerships in your article, *Death of Partnership*.

First, in your communication you state that unlimited liability "may be inefficient precisely because smaller creditors are ignorant about the true value of this liability," and from that you conclude that "smaller creditors with little way to determine the creditworthiness of individual business owners would prefer to contract for limited liability because they can more readily determine its value." I have puzzled over the assumptions that underlie these statements because, to my mind, the conclusion reached is not only counterintuitive, but also insupportable in terms of simple common sense. If asked, smaller creditors would always prefer unlimited liability to limited liability because they will then always have greater security for performance when personal assets as well as business assets are at risk. You apparently assume that smaller creditors may take limited liability into account when they negotiate with a partnership in setting the price for the transaction, and that the price may vary depending on whether there is limited or unlimited liability. That is simply unrealistic. Smaller creditors normally will not be aware of whether or not a specific business has limited rather than unlimited liability — a point you make later on when you state, "I question whether most people do in fact contract in view of any liability rule." Second, smaller creditors are particularly unlikely to consider the consequences of nonperformance at all. Finally, smaller creditors are classic examples of persons without bargaining power — their individual arrangement is not necessary to the survival of the firm, but the services of the firm, even though minor, may be essential to some larger project with which the individual is involved. Hence, typically smaller creditors are quoted a price for the goods or services provided, and they can say yes or no, but they cannot really negotiate.

You also state that you do not assume that "people are well informed and act knowledgeably." I have reread portions of your article, *Death of Partnership*, and it seems to me that in fact your entire analysis of limited liability and contract claims in that article is based not only on assumptions that creditors have good information and relevant knowledge, but also that they have foresight and can estimate (ex ante) events that may occur in the future.

You argue that limited liability "may reduce owners' risk-bearing and monitoring costs" and that "its costs to closely held firms in terms of the

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23. Ribstein, supra note 16.
cost of credit may be even smaller." That is because creditors determine the benefit of unlimited liability by "a comparison of the expected value of debt (V) under each rule," which in turn depends on the "creditor's ex ante evaluation of (1) the probability that the firm's wealth will be dissipated or transferred out of reach before collection; (2) the probability that the owners' wealth will be dissipated or transferred out of reach prior to the time of collection; (3) creditor monitoring costs; and (4) collection costs." You then use a hypothetical creditor planning to lend fifty dollars to the debtor when the debtor can adopt either a limited or an unlimited liability form. This seems to me to be a classic example of making up a hypothetical that can never even be remotely approximated in real life because it assumes a degree of knowledge and foresight that a real person could never have.

I do think that your analysis is interesting and theoretically should determine the cost of credit to the firm in a world of perfect knowledge and perfect foreseeability. It should, in such a world, determine whether the firm should choose a partnership or a limited liability form of business with personal guarantees by some or all of the partners (because the firm owners would know the results of the creditors' analysis). However, everything depends on what values and probabilities you assume.

This calculation is impossible to make in real life. It requires some knowledge about the size, type, and probability of liability that may be incurred by the firm, the probability that the firm may distribute assets in fraud of creditors to the owners, and the probability that owners will hide assets from creditors, also in violation of the fraudulent transfer statutes and quite possibly in violation of criminal fraud statutes as well. No matter how sophisticated a creditor is, this is little more than a guess. For someone who only assumes that the firm will perform as expected, it is not even guessed at. Furthermore, it is no help to the owners themselves, because the owners must choose a business form before doing business, and they have no way of knowing how specific creditors, or creditors as a group, will assess those variables.

What also is interesting about your analysis of contract liabilities in Death of Partnership is that the only type of creditors you consider are those rational creditors with 20/20 foresight who can determine, ex ante, what the present value of these future costs are. You do not weigh at all

24. Id. at 428.
25. Id.
26. See id. at 428-29.
27. See id. at 428.
the fact that most partnership creditors would (simplistically) always prefer unlimited liability regimes if they had a voice in the matter. Of course, creditors do not become involved in such matters in real life, because the selection of business form for the firm is determined by the owners, and the creditors must rely on whatever the default rules are for that specific business form.

I also have problems with your analysis of tort liabilities, though I am not intimately familiar with Priest’s arguments about third-party insurance. My own guess is that unlimited liability does in fact increase the monitoring of agents by owners even with the presence of insurance. I doubt whether the presence of insurance reduces significantly the monitoring process. The coverage of insurance is never one hundred percent; some kinds of intentional conduct or claims may not be insurable, and even high policy limits may be exceeded in specific cases. However, this is an area where all I can say is that we do not now have a perfect compensation system for tort victims, and until we do, I suspect that insurance provides more benefits to society than harms or costs.

So far as your analysis of tort cases under limited liability and unlimited liability regimes is concerned, I think your reliance in *Death of Partnership* on Robert Thompson’s data is misplaced. The simple fact is that Thompson’s data are skewed because he uses only appellate cases, and tort cases at that level are relatively infrequent because of settlement practices and the existence of insurance. Tort cases settle much more often than contract cases because most tort liability is insured against, and the third-party payer sets premium rates that permit settlement of most cases. The number of tort cases that reach the appellate level on piercing issues is therefore much lower than contracts cases. Further, the higher success rates of defendants in those cases as compared to contracts cases is also influenced by the high settlement rates in tort cases generally. Settlement is rejected mainly in cases of doubtful liability and very large claims.

I do agree with you that the taxation system encourages general partnerships because the alternatives of C or S corporation taxation are both less attractive. Unlimited liability in partnerships (which may never arise and if it does may be insured against) is not as important in real life


29. *Id.* at 449 (citing Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 CORNELL L. REV. 1036 (1991)).

as tax costs (which inevitably will arise) in many situations. I assume that many general partnerships will adopt limited liability forms as they become available. This is because limited liability is always a benefit to the owners and will be adopted if tax costs do not go up as a result. I do not think that your bargaining model will prove or disprove this assumption. Once one posits nonnegotiating or nonrational creditors, a limited liability regime is always more attractive to owners than an unlimited liability regime because those creditors rely on the default rule, to the extent they rely at all, and thus the choice of a limited liability entity is always preferable, other things being equal. Creditors who consider the possibility that the partnership will not perform may request personal guarantees and may get them if their bargaining power is strong enough. However, most partnership creditors will not realize that they are dealing with a limited liability entity until it is too late. That is why, basically, I am not happy with the quiet change in default rules in the Minnesota type of LLP statute.31

The preliminary data I have seen on LLCs seem to indicate that they are displacing S corporations and limited partnerships more than general partnerships. However, the collection of data on general partnerships is difficult because usually there is no filing requirement ....

Larry E. Ribstein: October 29, 1995 E-Mail
to Robert W. Hamilton Only

The following are some comments in response to your last e-mail.

People maximize their utility, but it may not be clear what this means or that it means increasing wealth in the narrow sense of money. Utility maximization depends on each individual’s utility function, including their belief in God or hatred for their brothers (to allude to two of your examples). In other words, "rational" economic behavior is an extremely broad concept. One who believed in an afterlife and in a God that rewarded good behavior on earth would be irrational if she did not try to appease that God by putting money in the collection box.

You assert as an example of irrationality that "most people are woefully deficient in understanding the most simple and fundamental economic concepts." But people do not have to understand economics for economic theories to work. For example, people have economically wise intuitions. Also, many markets are driven by more sophisticated participants because producers know that even if there is a sucker born every

minute, they cannot successfully price discriminate between the suckers and the sophisticates. In general, there is much evidence that markets perform as if the actors in the market are economically astute, even if they are not, e.g., stock price reaction to takeover defenses.

Because economic "rationality" and human conduct generally are so indeterminate a priori, it is useful to find out how the world really operates. One way to do this is to construct a model based on certain narrow assumptions and then see what implications this leads to or what data it produces. The model can lead to insights if the assumptions are clear, even if the assumptions are unrealistic. For example, Coase assumed a world without transaction costs, not because he really believes there are none, but only to demonstrate the role of transaction costs. For this "unrealistic" model he received a Nobel Prize. Following in his path, most modern law and economics scholarship focuses on the role of transaction and information costs, rather than assuming that such costs do not exist.

You say that default rules are important "in a world in which there is a large amount of nonrational decisionmaking." In fact, default rules are important in a world in which people are rational and budget their time to avoid unnecessary customized contracting.

I disagree with your Donahue example of the law and economics of default rules. Whether that case was right or wrong, it certainly was not applying a default rule. Rather, it was making up a new rule. I am not satisfied with the reasoning of Easterbrook and Fischel either, as discussed in detail in my review of their book and in other places, including my takeover defenses article. For me, the question is simply what the existing default rule is, as Posner reasoned in his Jordan v. Duff & Phelps, Inc. dissent. In Donahue, the default rules were provided by the corporation statute, including the provision that required dissolution by majority vote and in the absence of a buyout provision. If you want to criticize "law and economics," which law and economics are you talking about — Posner, or Easterbrook and Fischel, or me?

With respect to liability rules, you accuse me of unrealistically assuming perfect knowledge and foresight. In the first place, it is not important to my analysis whether creditors know what the deal is or that they negotiate over the price of credit. What matters in determining the efficient default rule is what deal most creditors would make in light of the constraints (including imperfect knowledge and foresight) under which they operate.

Second, to repeat, I do not assume perfect knowledge and foresight. The source of our disagreement is that I assume that in a world of generally free contracting (including the availability of both limited liability and vicarious liability business forms), all else being equal, creditors would pay more for any extra collectibility they get from owners' personal liability. (That does not necessarily mean that credit costs are lower for partnerships than for corporations, since all else is not equal — different types of firms select different forms). On the other hand, you seem to assume that creditors are not paying for unlimited liability since you say they would always prefer it. I will always take a Jaguar over an Escort if that is the only question. If you add that I have to pay $50,000 for one and $10,000 for the other, my answer may change.

My question is whether creditors would want to pay this premium for vicarious liability. I conclude that they often would not because of the difficulty of evaluating what they are getting. If creditors must pay for the liability protection they get, they are in effect investing in business owners as well as firms. They would then care about payoffs from these investments. Given their imperfect knowledge and foresight, the payoff is risky, as illustrated by my hypothetical probabilities. If, as we both say, creditors do not have any idea what the payoffs are, it follows that your rule of compulsory vicarious liability would force creditors to buy a pig in a poke.

Thus, our real disagreement concerning contract creditors is over your assumption that the price of credit does not depend on the personal or vicarious liability rule. Why is your assumption any better than my assumption of costly credit? As I explained above, my assumption does not require that all, or perhaps even most, creditors know what the liability rule is, as long as there are market mechanisms that adjust the cost of credit.

With respect to tort liability, I agree that unlimited liability increases monitoring even with insurance. My point, relying on George Priest, is

that the resulting monitoring is socially excessive. If you have contrary reasoning or data, let me know and I will reconsider my conclusion. But why should your different assumption change my mind? Note for what it is worth that I heard a partner in a large Atlanta firm say that his malpractice insurer was not charging higher insurance rates for LLPs and indeed believed that the LLP was a favorable development because it focused liability and therefore incentives for care on the directly responsible partners. This is exactly the result Priest’s analysis would predict.

With respect to veil-piercing, I rely on Thompson37 only to show that the appellate courts accept limited liability in the cases they decide. This has nothing to do with the actual imposition of liability in tort or contract veil-piercing cases . . . .

Specifically with respect to LLPs, if you are merely saying that people are being fooled by inadequate disclosure, then this is a specific market problem that, perhaps, requires regulation if it can be shown. This argument does not, however, support more general restrictions on the availability of limited liability.

I hope this lengthy reply has helped to clarify some of our differences. I appreciate your taking the time to lay out your criticisms. You have helped me focus my positions a little better.

Robert W. Hamilton: December 22, 1995 E-Mail to Larry E. Ribstein Only

. . . . I’m now free to turn to your very interesting and thoughtful response to my earlier message. I have the following thoughts:

(1) You say that "people have economically wise intuitions." Certainly people know that $50,000 is larger than $10,000, and most people know that their income may be large enough to afford a $10,000 car, but not a $50,000 car. But I really doubt that from these examples one can assume that most people act rationally in economic matters . . . . People without formal economic training often harbor basic misconceptions about what is rational from an economic standpoint. It obviously is difficult to determine whose point of view is more accurate on this fundamental issue; my own anecdotal experiences and observations over some sixty years indicates to me that irrational behavior is much more common than economists like to think.

(2) You also say that "markets are driven by more sophisticated participants because producers know that even if there is a sucker born every
minute, they cannot successfully price discriminate between the suckers and the sophisticates." I find this point more difficult to respond to because some markets — e.g., securities markets — seem clearly to be driven by sophisticated traders. On the other hand, there are many markets in which price discrimination is the name of the game. An obvious example is used cars. Even if there is a "sticker price" and a "blue book" which one can refer to, price discrimination among suckers and nonsuckers occurs all the time in the form of values of trade-ins, cost of credit, cost of credit life insurance, and discounts from the sticker price. I suspect that many people who buy used cars in fact are taken as suckers. In the supplement to my book, Fundamentals of Modern Business, I have some information about the vocabulary of used car dealers. The language is colorful and indicates that a lot of price discrimination does occur: "selling the payments," "slam dunk," "heavy turnover" (pressuring customers by multiple employees), "low balling" (how to screw the comparison shopper), the "Hull-Dobbs maneuver" (taking a down payment or trade-in before the deal is set and then refusing to return them), "stealing the trade-in," and the "puppy dog" (letting the consumer take the car home before the price is agreed upon and then not taking it back). When one rummages around in consumer credit areas, as I have, one has great skepticism about the notion that sellers are unable to price discriminate successfully.

(3) I do not disagree with your statement that the securities market appears to react pretty rationally to events even though a lot of people in the market really are not sophisticated. On the other hand, there are explanations of stock market activity other than ECMH; I find Lynn Stout's analysis of the stock market to be very plausible even though I gather that her approach is dismissed by true believers in the ECMH as "simply wrong." She believes that the market is primarily composed of "holders" rather than "traders," and that there is a downward sloping demand curve for securities because people have diverse views as to the value of securities. Of course, most of the money put into the market by unsophisticated people today is in fact handled by sophisticated investors, mutual funds, trustees of retirement plans (though some of these

39. Id. at 19-20.
41. See id. at 653.
people are not very sophisticated), and so forth. As a result, the securities markets may be exceptional and unusual types of markets.

(4) I do not disagree with your comment that Donahue was creating a new default rule rather than applying an existing rule. In my view, the new Donahue rule is a desirable default rule because it compels controlling shareholders to consider negotiating with unsophisticated investors (such as Donahue himself, the plant manager of a small business) rather than remaining silent and thereby taking advantage of a default rule that is unfavorable to unsophisticated people who may not be aware of the default rule and its implications.

(5) I think our main disagreement arises from your observation that I assume that the change in default rules of liability when a partnership becomes an LLP does not affect the cost of the services provided by the partnership. It is easiest to talk about a law firm and legal services, though obviously the same argument may be made about many other kinds of service partnerships.

(a) You say that creditors pay a premium for unlimited liability. I agree there may be instances when that is clearly true; whenever parties negotiate for a nonrecourse loan the lender may well add a premium for this kind of desirable loan (if the lender grants the loan at all). Similarly, there are situations when lawyers and accountants in a general partnership (GP) may negotiate for a degree of express limited liability in engagement letters, and the like. However, these are very atypical situations, and I suspect really not very common.

(b) The question whether creditors in effect pay a premium for unlimited liability should be empirically verifiable. If you are right, lawyers and law firms should reduce their rates somewhat when they become LLPs, and the existence of this reduction should be testable using sophisticated analysis. Alternatively, one might compare rates for a firm that is an LLP or an LLC and one that is a GP, though comparability would be difficult. My own guess is that if statistical evaluations of pricing as a GP and as an LLP were made, there would be no detectable differences. If I am right on this, your whole analysis about default rules is based on an assumption that cannot be empirically verified.

(c) One could always ask a law firm, "Are you reducing your rates now that you are an LLP?" My own guess is that the normal response will be, "No, we are not because the LLP election does not reduce our operating costs or the cost of our malpractice insurance." (This is true and sounds really convincing, but is beside the point.) Indeed, I would be astonished, flabbergasted even, if there is any conscious reduction in fees as a result of the LLP election. If I am right on that, then my
statement that creditors will always prefer the unlimited liability regime needs qualification, but is basically correct. I qualify it this way (with the word "basically") because I had not seriously considered the possibility that some clients may be able to negotiate a downward adjustment in the fees they pay as a result of the LLP election. But that is certainly conceivable with respect to a major client.

(d) When I wrote my earlier e-mail, I had the mindset of an "average" law firm, whose clients were drawn from "ordinary folks" — divorce, auto accidents, estate administration, workers’ compensation, criminal defense, social security claims, naturalization problems, and the like. I find it very unlikely that these firms will reduce their fees as a result of the LLP election. And, it is in this area where changing the default rule of general liability is likely to work the greatest mischief.

(e) It is my impression that "ordinary folks," when they hire lawyers, usually do not shop for prices. Rather, they rely on word of mouth, advertising by lawyers, and chance relationships — the next door neighbor who is a lawyer — when they try to find lawyers. That is obviously not true today for large companies that deal with many law firms. They are very price-conscious and may negotiate fees downward before hiring a firm. They may solicit proposals from several law firms. They may negotiate for novel compensation arrangements. However, I do not think that one should generalize from this large company practice with respect to outside legal work to the pricing practices of law firms generally.

(f) I suspect that you view the market for legal services as a single market. The practices of large firms therefore will affect the entire market, and all clients are in fact paying for unlimited liability in GPs. That is conceivable, but there is no obvious mechanism by which fees negotiated with large law firms spill over to smaller firms in smaller cities and towns (or in large cities, for that matter).

(g) I would reconsider my position on this if you could show me instances when firms routinely quote alternative fees, depending on whether or not they waive the protection of limited liability in LLPs or LLCs. I regret that I waited so long to reply to your earlier message. I hope you did not interpret silence as signifying agreement. I will be interested in your reaction to the above. Have a happy holiday. Bob.
Now I have to apologize for taking so long to answer your December 22 message — but here goes:

(1) Are consumers irrational? Anecdotal evidence should not make policy. The evidence is conflicting. Although there is much systematic evidence of irrationality, which is conveniently collected in Eisenberg’s recent article, much of this evidence was collected in experimental settings where nothing rode on the reactions that were measured, and conflicts with evidence collected when subjects did have something riding on the decision. Moreover, it is not as easy as you think to identify irrational behavior as my last message indicated. It also is important to be careful about bounded rationality. Most people know they are imperfect decisionmakers and compensate for this in their agreements.

(2) As I have said, even if individuals are rational, the same does not necessarily follow for markets. See, for example, the interesting work of Schwartz and Wilde, whose work is in consumer markets and not securities markets. They show that it is necessary only to have a few good searchers in a consumer market dominated by form contracts to produce efficient forms.

(3) Even if some markets are irrational, what should we do about it? Regulation is imperfect. Regulators have the same sort of cognition problems that consumers do, but have no property on the line to motivate their decisions. Moreover, public choice theory teaches that legislators and judges have incentives to make perverse decisions that favor dominant players in the industry rather than consumers. You refer to Lynn Stout’s article. This article is a good cautionary example on the role of regulation. She argues that there is too much trading. But what is the prescription — regulate trading? Or should we remove proscriptions on insider trading that encourage even more useless trading by uninformed investors?

(4) Some of these general observations apply to your comments on LLPs:


44. See Stout, supra note 40, at 622-25.
Are consumers or legal services markets irrational? I most certainly do not view the legal services market as one market (my article on the regulation of law firm structure takes a considerably more complex view than that). But I join with you in suspecting that rates have not adjusted down to reflect limited liability. That would follow logically from my conclusion in *Death of Partnership* that unlimited liability does not help clients very much, if at all.* Death of Partnership* extends that notion to conclude that legal regulation of law firm structure generally increases rather than reduces lawyer-client agency costs.

Assuming the market is irrational and law firms are able to get something for nothing, what is the legal prescription? It would seem to follow that lawyers should not be able to limit their liability for malpractice — particularly for existing clients. But that is exactly what the law says — and you seem to support it. But lawyers make the rules. My point, above, is that political markets are no better than commercial markets. In other words, your insistence on talking about "real worlds" applies to both commercial and political markets.

I hope this message advances our discussion.

*Robert W. Hamilton: March 13, 1996 E-Mail to Larry E. Ribstein Only*

I am finally getting back to our discussion of the "real world" .... I am returning to our LLP discussion, particularly the proposal to permit law partnerships to change the default rule of joint and several liability for contract claims by filing a public form and adding "LLP" after the firm name.

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(2) As I previously have written, I have little problem with the Texas and Delaware type statutes because they are pure "peace of mind" statutes that deal only with malpractice liabilities and do not change the default rule of partner responsibility except in unusual and rare cases. While this is self-interest legislation on the part of law firms, it is narrow in scope and limited in effect. My concern is with the third-generation statutes that extend the shield of limited liability to all contract and tort claims incurred while the LLP election is in effect.

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(3) Because we are talking about the "real world," it may be helpful to make explicit the real reason why the third-generation statutes are attractive and the malpractice-only statutes are not. In the real world, their attractiveness has nothing to do with the economics of the cost of unlimited liability. Rather, their popularity is a result of the fact that state and national bar committees that develop partnership statutes are overwhelmingly made up of lawyers that are in private practice. And it is this group that benefits economically from the third-generation LLP statute. This is the anecdotal argument I now have heard at least three separate times about why committees recommend enactment of the third-generation form of LLP statute: "You know, these early LLP statutes do not really address the current problems we face in modern law firms. Much more personal liability today is being imposed as a result of improvident leases of office space than malpractice. Besides, the early statutes really do not do anything because we will get insurance against malpractice liability in any case. So, if we really want to do something to protect individual partners we have to go with the third-generation-type statute and give partners protection against crazy leases and crazy promises to give hoped-for rainmakers large draws."

(4) Let's face it, we are talking about basically self-interest legislation that permits persons to escape from improvident contracts. To suggest, as you appear to do, that limited liability is simply not very important is to close your eyes to the real world. Practicing lawyers want limited liability because it is important to them. Now, it may be, of course, that a decision made on personal, selfish grounds without considering the interests of constituencies with adverse interests, may be economically justifiable on theoretical or practical grounds. However, the economic justifications may readily be ex post rationalizations to justify a decision made by other persons on purely selfish grounds.

(5) I want to address your comment about political markets. You suggest that political markets are no better than commercial markets and that the real world applies to both of them. That last comment is true, of course, in the sense that political markets (really political power) obviously may really work in the real world. But that argument logically means that anyone with political power should be free to exact whatever tribute the owner can get, even though the net effect may be that society as a whole is poorer. I doubt if you really mean that. Your political market argument is basically an argument against all government. My understanding of the law and economics approach toward government is that it should provide an atmosphere in which commercial activity should be unconstrained so that it is permitted to find its own level, and that
political power should not be permitted to warp what is essentially a free commercial and economic market.

(6) Next, I would think that default rules of long standing should presumptively be viewed as efficient rules (because if they are inefficient they presumably would have been changed shortly after their introduction). Thus, in order to justify a change in default rules of long standing, the person proposing the change should have the burden to show that society will be better off in some way with the new default rule. However, I must say that neither you nor the various writers that endorse the change to limited liability give a very plausible rationalization for doing so (other than for the self-interest of practicing lawyers in avoiding the consequences of someone’s mistake).

(7) With these comments off my chest, I turn to the remainder of the critical paragraph four of your message of February 1. You first suggest that the legal services market is probably not a single market. I agree with that. You next state that you "suspect" that legal fees have not adjusted down to reflect the change from unlimited to limited liability. I also agree with that. If one looks at the market for legal services, it is clear that there are two broad components: (1) the very sophisticated clients dealing with large law firms (a market which I assume is efficient), and (2) the market for legal services for "ordinary folk." This latter market does not appear to be efficient or rational, since many clients are one-time users of legal services and do not comparison shop before hiring a lawyer. I am a little uneasy about making a sharp distinction of this nature, because obviously there is a gradation of sophistication. However, I think the basic distinction is valid — that the unsophisticated market for legal services is not very efficient because it largely is separate from the influence of the large law firm market and does not obtain the efficiency benefits of that market. The simplest explanation for why legal fees have not come down when firms shift from a GP to an LLP is that there is no incentive for the lawyers to pass on the cost savings to their clientele.

(8) You then justify the stickiness of legal fees by restating your version of the conclusion reached in Death of Partnership that "unlimited liability does not help clients very much, if at all" and then end with a statement that the fact that legal fees have not come down in limited liability states "would be logically consistent" with your conclusion that unlimited liability does not matter very much. At the very best this is a rationalization that a change is OK because it is not very important one way or another. In fact, however, that thesis (which I think is wrong based solely on the widespread interest in third-generation LLPs) tends to prove the opposite, that the status quo should be maintained, for if it is not
very important, there is no reason to reverse a default rule of long stand-
ing.

(9) There is another, more serious problem with your analysis in paragraph four. To justify or rationalize the change in the default rule from joint and several liability to no personal liability, you must look not only at the relationship of lawyer to client, but also at the relationship of law firm to its creditors, many of whom are not clients — for example, landlords, suppliers, creditors, secretaries, paralegals, and so forth. Again, one must not focus solely on the sophisticated creditor (who presumably will respond quickly to the change to LLP status), but also on less sophisticated ones. The shift from the traditional default rule of unlimited liability to a rule that permits partnerships quietly to obtain the benefits of limited liability threatens great mischief to persons in these categories with limited sophistication and limited resources.

(10) Despite your earlier comments about the general unimportance of unlimited liability, we do know that unlimited liability in small business ventures is important in many contexts from our experience with small corporations, where the default rule of limited liability has been in effect for more than one hundred years. Sophisticated creditors routinely refuse to deal with corporations unless the true owners guarantee the performance of the corporation. Why do some people not protect themselves when dealing with marginal corporations? For some sophisticated creditors it may not be worth getting a personal guarantee either because the transaction is so small as not to justify the expense or because the person has a different way of protecting himself from default, e.g., by repossessing property or by being able to set prices high enough in repetitive transactions to cover predictable defaults. However, many creditors lack the economic power to demand anything from the corporation, and they consciously or unconsciously assume the risk of default. Finally, other creditors may lack the basic sophistication to know that there is a credit risk when dealing with a corporation, or they may not even consider the possibility of a default. This last category is definitely not a null set, though it is ignored in the reasoning of most law and economics scholars.

(11) If we transfer these groups of creditors into the LLP context, it is clear that some creditors will protect themselves almost immediately when an LLP election is made while many others will not. Some of those that do not may be indifferent because they have taken independent steps to protect themselves. The remaining groups are always worse off as a result of the LLP election because the market in which they are acting is not efficient and there is no pricing mechanism that compensates them for the loss of protection they have from unlimited liability. What is the
social benefit of allowing lawyers to take advantage of less sophisticated 
or less vigilant creditors in various types of markets? The theoretical 
arguments that there are benefits of limited liability generally are not very 
persuasive in this context because those arguments assume full knowledge 
and rational action by creditors, while the device that is being used here 
is potentially misleading to many people. Also less misleading devices — 
such as personal corporations and LLCs — are readily available.

(12) You may recall that a few months ago there was a discussion by 
primarily practicing lawyers on the LNET-LLC net about what kind of 
otice a general law partnership should give to clients, suppliers, and 
creditors after electing to be an LLP under a third-generation statute. As 
I recall, you contributed an e-mail on that subject. That discussion was 
very revealing to me because lawyers creating LLPs for themselves were 
well aware that there was a real risk that what they were doing was 
 misleading and were struggling to say enough to avoid claims of fraud — 
but not to say too much.

III. Postscript

This ended the original electronic debate. We both had probably 
reached the point where we realized that neither was going to persuade the 
other and concluded that indeed we really did have entirely different 
visions of the real world. Certainly, Larry Ribstein has not had a change 
in heart. His most recent proposal is that the legal system should create 
a "limited liability thing" (LLT) that would permit any individual to obtain 
the benefits of limited liability simply by making a single filing with some 
central authority. This proposal is a rational extension of the views of 
Professor Ribstein set forth above. In effect, his proposal would reverse 
the default rule of personal liability for everyone who bothers to make the 
filing. Presumably, LLTs would relate to businesses or at least to 
property-related transactions (though that is not entirely clear).

Given the views expressed in the above debate, it should be no 
surprise that Professor Hamilton views this proposal as a terrible idea. In 
his view, in a world with many opportunistic people trying to make a buck 
in any way possible, and with many more unsophisticated and not always 
rational people dealing with them, the idea that one could quietly slide a 
limited liability entity into most interpersonal relationships is an open 
invitation for fraud or worse.49 It should be added that the LLT idea has

49. For example, a person might create an LLT with, say, $100 of assets and then 
execute a lease as a tenant which includes a promise by the tenant to pay rent each month. 
If the landlord fails to notice that the tenant executed the lease as an LLT, the tenant could
been extensively aired on the LNET-LLC net and these discussions will eventually be published in some other format. However, this proposal also demonstrates the competing views of the real world expressed here.

As part of the final editing of this exchange, the following concluding comments were added by the authors after the Symposium at Washington and Lee University School of Law.

**Comments of Larry Ribstein**

I want to begin my final comments by responding to two points that I did not have a chance to respond to in the e-mail exchange. First, my comment about political markets is not a call for an end to government, but simply an often repeated point that finding a market failure is not enough to justify government action if the government could not do any better.

Second, I think that Professor Hamilton has misunderstood my proposal for LLTs. This is not a significant extension of limited liability vis-à-vis third parties, but rather is simply a way to obtain limited liability without the baggage of unwanted default rules that apply to the parties to the firm. In Professor Hamilton's example, because the LLT is created by a filing, the tenant's existence as an LLT would be no different from the landlord's standpoint from the tenant's forming an LLC or other type of limited liability business entity.

More generally, it is important to define the issues in this debate. The debate did not deal with whether limited liability should be allowed for some types of firms or whether vicarious tort liability should be mandatory in some settings. Rather, it dealt only with whether the limited liability option should be expanded given the defects of some types of voluntary creditors. My arguments about enforcing such contracts are similar to those in my fiduciary duty waiver article, *Fiduciary Duty Contracts in Unincorporated Firms*, which is also a part of this Symposium. If anything, the arguments against enforcing contracts are even weaker in this setting than those regarding fiduciary duties because it is harder to make norm-based nonefficiency arguments regarding limited liability. Indeed, I do not interpret Professor Hamilton to be making any such arguments.

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live in the apartment without paying rent and then "walk," limiting his responsibility to $100.

50. See generally Ribstein, supra note 42.
Moreover, even if there are reasons for not enforcing contracts, one who makes such arguments must also specify where to draw the line. For example, if law firms must offer their clients vicarious liability, must they also charge a reasonable price for this protection? More broadly, if we will not let people enter into contracts limiting the liability of the people with which they deal, why do we let them do far more important things whose costs and benefits may not be obvious to the unsophisticated — such as getting married, getting divorced, having children, having abortions, joining the military, and voting?

Comments of Robert Hamilton

I agree with the first of Professor Ribstein's points that "finding a market failure is not enough to justify a government action if the government could not do any better."

With respect to Professor Ribstein's second point, his comments simply restate the disagreement between us. I have no problem with parties allocating risks by express agreements to that effect. But what Professor Ribstein is calling a contract is often not an express contract at all; it is a device that permits terms to be imposed by one party on another party without discussion, negotiation, bargain, or awareness.

We should not create devices that make it easy for persons to unilaterally change long-standing liability default rules. If, in my example, the tenant wishes to limit his personal liability under the lease to $100, he can always do so simply by advising the landlord of that fact before signing the lease. The landlord can then decide whether or not to lease to the tenant on those terms. The tenant should not be able to limit his personal liability simply by signing his name followed by the initials "LLT."

Final Comment by Professor Ribstein

Although of course I could have responded to these comments, I decided that it was time to end the discussion and let readers mull the authors' positions.