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Limited Liability and Theories of the Corporation

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Articles

LIMITED LIABILITY AND THEORIES OF THE CORPORATION

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INTRODUCTION

The limited liability[1] of corporate shareholders is one of the most controversial issues in corporate law. Many lawyers, judges, and academics believe that limited liability is a privilege conferred by the state as a result of the act of incorporating or forming some other type of limited liability business.[2] Some object to this privilege as unfair to creditors and an invitation to reckless behavior by those doing business in limited liability firms.[3]

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1. One who has "limited liability," as the term is used in this Article, risks liability for debts only up to a predetermined sum, usually the party's investment in the business. "Personal liability" refers to a rule by which a party is liable to business creditors to the full extent of her assets, limited only by the dischargeability of debts in bankruptcy. *See, e.g.*, Ribstein, *An Applied Theory of Limited Partnership*, 37 EMORY L.J. 835, 841 (1988) [hereinafter *Applied Theory*].

2. *See, e.g.*, Solomon & Collins, *Humanistic Economics: A New Model for the Corporate Social Responsibility Debate*, 12 J. CORP. L. 331, 338 (1987).

3. *See, e.g.*, Diamond, *Corporate Personality and Limited Liability*, in LIMITED LIABILITY AND THE CORPORATION 22, 42 (T. Orhnial ed. 1983) ("Were Parliament to set about devising means for the encouragement of speculation, over-trading and swindling, what better could it do?" (quoting J.R. McColluch, first professor of political economy in the University of London, 1859)); Halpern, Trebilcock & Turnbull, *An Economic Analysis of Limited Liability in Corporation Law*, 30 U. TORONTO L.J. 117, 148 (1980) ("[I]n the case of small, tightly held companies, a limited liability regime will, in many cases, create incentives for owners to exploit a moral hazard and transfer uncompensated business risks to creditors . . . ."); Mitchell, *Close Corporations Reconsidered*, 63 TUL. L. REV. 1143, 1172-80

More recently, a benign or even productive view of limited liability has emerged from the contractual theory of the corporation.[4] Limited liability can be regarded as a term of the contract among shareholders and creditors[5] which is wealth-maximizing for both creditors and owners.[6] Indeed, one group of commentators has argued that legal rules providing for limited liability, far from conferring a privilege, are "irrelevant" because the parties can contract for limited liability.[7]

This Article rejects the conception of limited liability as a state-conferred privilege. It makes the following general points: First, contracts for limited liability should be broadly enforced even if the parties have not complied with formalities such as incorporation.

(1989) (policy of limited liability suggests that the risk of business failure of an incorporated business is placed on the corporation's creditors).

4. Commentary reflecting this contractual theory includes R. HESSEN, IN DEFENSE OF THE CORPORATION (1979); N. WOLFSON, THE MODERN CORPORATION: FREE MARKETS VERSUS REGULATION (1984); Baysinger & Butler, *Antitakeover Amendments, Managerial Entrenchment, and the Contractual Theory of the Corporation*, 71 VA. L. REV. 1257 (1985); Butler, *The Contractual Theory of the Corporation*, 11 GEO. MASON U.L. REV. 99 (1989); Butler & Ribstein, *The Contract Clause and the Corporation*, 55 BROOKLYN L. REV. 767 (1989) [hereinafter *Contract Clause*]; Butler & Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 WASH. L. REV. 1 (1990) [hereinafter *Opting Out*]; Butler & Ribstein, *State Anti-Takeover Statutes and the Contract Clause*, 57 U. CIN. L. REV. 611 (1988) [hereinafter *Anti-Takeover*]; Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259 (1982); Haddock, Macey & McChesney, *Property Rights in Assets and Resistance to Tender Offers*, 73 VA. L. REV. 701 (1987); Klein, *The Modern Business Organization: Bargaining Under Constraints*, 91 YALE L.J. 1521 (1982); Ribstein, *Takeover Defenses and the Corporate Contract*, 78 GEO. L.J. 71 (1989); Ribstein, *Applied Theory*, *supra* note 1, at 835.

Some of the major contributions on the economics of the firm, which are relied on in the legal literature, include Alchian & Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777 (1972); Cheung, *The Contractual Nature of the Firm*, 26 J. L. & ECON. 1 (1983); Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937); Fama & Jensen, *Separation of Ownership and Control*, 26 J. L. & ECON. 301 (1983); Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976); Klein, Crawford & Alchian, *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J. L. & ECON. 297 (1978); Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965); Manne, *Our Two Corporation Systems: Law and Economics*, 53 VA. L. REV. 259 (1967) [hereinafter *Our Two Corporation Systems*]; Williamson, *Transaction-Cost Economics: The Governance of Contractual Relations*, 22 J. L. & ECON. 233 (1979).

5. For early recognition of this point, see Hohfeld, *Nature of Stockholders' Individual Liability for Corporation Debts*, 9 COLUM. L. REV. 285, 296 (1909).

6. *See* R. HESSEN, *supra* note 4, at 17-18; R. POSNER, ECONOMIC ANALYSIS OF LAW 269-72 (3d ed. 1986); Blumberg, *Limited Liability and Corporate Groups*, 11 J. CORP. L. 573, 615-16 (1986); Easterbrook & Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89, 89 (1985); Halpern, Trebilcock & Turnbull, *supra* note 3, at 144; Manne, *Our Two Corporation Systems*, *supra* note 4, at 262-63; Woodward, *Limited Liability in the Theory of the Firm*, 141 J. INSTITUTIONAL & THEORETICAL ECON., 601, 602-06 (1985).

7. *See* Meiners, Mofsky & Tollison, *Piercing the Veil of Limited Liability*, 4 DEL. J. CORP. L. 351, 364 (1979).

Second, the positive law largely reflects this contractual approach to limited liability. Third, recognition of limited liability as the product of private ordering compels acceptance of the contract theory of the corporation.

This Article extends existing literature by looking beyond the efficiency of limited liability to how limited liability contracts are created in both corporate and noncorporate settings. The existing literature mostly identifies limited liability with incorporation or other formal state filings.[8] Such filings certainly should not be abolished because they provide an inexpensive way of agreeing with creditors that the latter may look for payment only to the assets of the firm. But there is no economic justification for making filing a necessary prerequisite to acquiring limited liability protection.

Recognizing that incorporation or other formalities are not prerequisites to obtaining the protection of limited liability has broad theoretical and practical implications. From a theoretical standpoint, it demonstrates convincingly the contractual nature of the corporation. It is already widely accepted that other "corporate" characteristics, including perpetual life, centralized management, and transferability of shares, are available by private contract.[9] Once it is recognized that state action is unnecessary to create limited liability, there is nothing left of the idea that incorporation is a state-conferred "privilege." From a practical standpoint, if incorporation or other formal filings are unnecessary for limited liability, this would make it more difficult for the states to regulate the terms of business associations than if the firm is regarded as the "product" of state law.

The Article proceeds as follows. Part I discusses the role of limited liability in the regulatory theory of the corporation. This Part shows how regulation of corporate governance is linked both historically and practically with the rule that a state filing is a prerequisite for limited liability.

Parts II and III establish that there are no efficiency-based reasons for regulation of limited liability in cases involving voluntary creditors. Part II shows that limited liability contracts generally are efficient across the spectrum of limited liability firms, including closely held firms. Thus, there is no economic justification for restricting the availability of limited liability to particular types of

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8. *See, e.g.*, Easterbrook & Fischel, *supra* note 6, at 90 (while noting that "[l]imited liability is not unique to corporations," the authors focus their discussion on the corporate setting).

9. *See infra* text accompanying notes 36-43.

firms. Part III shows that formal incorporation, while often useful as a transaction-cost-saving device, should not be a mandatory prerequisite to limited liability. The implication of Parts II and III is that mandating formalities as necessary prerequisites for limited liability can be explained only as the assertion of state power to assist legislative rent-seeking. Since these prerequisites are unjustified, they should be abolished.

Part IV analyzes the law regarding informal limited liability. It shows that informal limited liability in cases of voluntary dealings with creditors is firmly entrenched in the law, and that the few existing constraints on the availability of limited liability by contract are mostly consistent with the contractual theory of the corporation.

Finally, Part V shows that there is no efficiency-based justification for a filing requirement in the case of involuntary creditors. Thus, even here limited liability cannot properly be regarded as a state-conferred privilege.

I. LIMITED LIABILITY AND THE REGULATORY THEORY OF THE CORPORATION

At first blush, legal restrictions on limited liability seem trivial: formal incorporation is cheap and easy and in some cases beneficial. But these restrictions are important because they lie at the heart of the debate over the nature of the corporation.

Contractarians view the corporation as a set of contracts between the participants in the business, including shareholders, managers, creditors, employees, and others.[10] The terms of the corporate contract may be provided by customized agreements or by standard forms provided by state case and statutory law that the parties can draft around or avoid by selecting the state of incorporation.

Advocates of the regulatory theory of the corporation, on the other hand, argue that the terms of corporate contracts should be regulated more extensively than those of "ordinary" contracts.[11]

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10. For commentary discussing the contract theory of the corporation, see *supra* note 4.

11. For examples of anti-contractarian commentary, see generally Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403 (1985); Clark, *Agency Costs Versus Fiduciary Duties*, in PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS (J. Pratt & R. Zeckhauser eds. 1985); Coffee, *No Exit?: Opting Out, The Contractual Theory of the Corporation, and the Special Case of Remedies*, 53 BROOKLYN L. REV. 919 (1988). Other examples include the following papers presented at the Columbia University Law and Economics Center Conference on Contractual Freedom in Corporate Law, December 9-10, 1988: Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Con-*

This Part shows how the requirement of a state filing as a prerequisite for limited liability is a significant basis of the regulatory theory of the corporation.

A. The Concession Origins of the Filing Requirement

The regulatory view is based to a significant extent upon the so-called "concession" theory—that is, the theory that corporations are creatures or concessions of the state rather than wholly the product of private contract. This theory is reflected in Chief Justice Marshall's famous description of the corporation in *Trustees of Dartmouth College v. Woodward*[12] as "an artificial being, invisible, intangible, and existing only in contemplation of [state] law."[13] Early corporations were, indeed, state-created franchises. Later, corporations continued to be created by special legislative acts that preserved the image of state creation.[14]

Special chartering gradually was replaced by incorporation under general incorporation laws.[15] Under these laws, the state filing that technically created the corporation came to be a largely ministerial act rather than something that connoted state "permission." The corporation no longer could be regarded as the product

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straints on Charter Amendments, 102 HARV. L. REV. 1820 (1989); Clark, *Contracts, Elites, and Traditions in the Making of Corporate Law*, 89 COLUM. L. REV. 1703 (1989) [hereinafter *Contracts*]; Coffee, *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618 (1989) [hereinafter *Mandatory/Enabling*]; Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461 (1989); Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549 (1989); Kornhauser, *The Nexus of Contracts Approach to Corporations: A Comment on Easterbrook & Fischel*, 89 COLUM. L. REV. 1449 (1989).

For articles advocating limiting the private ordering of corporate manager duties, see Anderson, *Conflicts of Interests: Efficiency, Fairness and Corporate Structure*, 25 UCLA L. REV. 738 (1978); Branson, *Assault on Another Citadel: Attempts to Curtail the Fiduciary Standard of Loyalty Applicable to Corporate Directors*, 57 FORDHAM L. REV. 375 (1988); DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879; Frankel, *Fiduciary Law*, 71 CALIF. L. REV. 795 (1983).

For commentary criticizing the anti-contractarians, see Black, *Is Corporate Law Trivial? A Political and Economic Analysis*, 84 NW. U. L. REV. 568-70 (1989); Butler & Ribstein, *Opting Out*, *supra* note 4; Easterbrook & Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416 (1989); McChesney, *Economics, Law, and Science in the Corporate Field: A Critique of Eisenberg*, 89 COLUM. L. REV. 1530 (1989); Romano, *Answering the Wrong Question: The Tenuous Case for Mandatory Corporate Laws*, 89 COLUM. L. REV. 1599 (1989).

12. 17 U.S. (4 Wheat.) 518 (1819).

13. *Id.* at 636.

14. *See* Butler, *Nineteenth-Century Jurisdictional Competition in the Granting of Corporate Privileges*, 14 J. LEGAL STUD. 129, 143-46 (1985).

15. This history is traced in Butler, *id.* *See also* Butler, *General Incorporation in Nineteenth Century England: Interaction of Common Law and Legislative Processes*, 6 INT'L REV. LAW & ECON. 169 (1986) [hereinafter *England*].

of state permission or concession.[16]

Although state creation is an historical relic, the concession view of the corporation continues to influence corporate law. For example, the Supreme Court recently repeated the *Dartmouth College* "creature" dictum quoted above.[17] The Court also upheld against a first amendment challenge a state law that prohibited corporations (but not other types of firms) from making certain political expenditures.[18] The Court justified singling out corporations partly on the basis of the "unique state-conferred corporate structure that facilitates the amassing of large treasuries."[19] The Court referred to limited liability as one of these special state-conferred corporate advantages.[20]

The most important remnant of the concession theory is undoubtedly the continued requirement of a state filing.[21] While no one today would argue that filing is tantamount to an application for "permission" to incorporate, the filing appears to involve the state in the incorporation process to a greater extent than it is involved in the formation of other contracts. Some have argued that the long survival of a rule of state involvement in the creation of the corporation lends some normative support to such state involvement.[22]

Concession-based arguments for regulation of the corporation depend, therefore, on the filing requirement. As will be shown, lim-

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16. For recent recognition of this point, see Bratton, *The "Nexus of Contracts" Corporation: A Critical Appraisal*, 74 CORNELL L. REV. 407, 435-36 (1989).

17. CTS Corp. v. Dynamics Corp. of America, 481 U.S. 69, 89 (1987).

18. Austin v. Michigan Chamber of Commerce, 110 S. Ct. 1391, 1401 (1990). *But see* FEC v. Massachusetts Citizens for Life, Inc., 479 U.S. 238, 256 (1986).

19. 110 S. Ct. at 1398. Along similar lines, the Court has held that corporations, by accepting special privileges, submit to the state's "visitatorial" power to compel production of incriminating documents. Wilson v. United States, 221 U.S. 361, 382 (1911); *see also* Hale v. Henkel, 201 U.S. 43, 74-75 (1906).

20. *Austin*, 110 S. Ct. at 1397. Whether there are other reasons for denying certain types of firms first amendment rights, such as the fact that agents representing these firms do not represent the shareholders, is beyond the scope of this Article. The point here is only that regulation of corporations cannot be justified under the Constitution on the ground that corporations receive "privileges" from the state.

21. *See* Bratton, *supra* note 16, at 445 (arguing that corporate formalities represent "[t]races of concession theory"; although the parties easily can comply, the formalities caution the parties that they act subject to the threat of state constraint).

22. *See* Bratton, *The New Economic Theory of the Firm: Critical Perspectives from History*, 41 STAN. L. REV. 1471, 1493 (1989).

Apart from the filing requirement, the state "creates" the corporation in the additional sense that state courts and other agencies recognize and enforce corporate features. But this is no different from state recognition and enforcement of any contract. Thus, it is the state filing that seemingly justifies greater state involvement in corporations than in other types of contracts.

ited liability is the single corporate feature for which filing arguably does remain a requirement.[23]

B. The Filing Requirement as Facilitating Regulation

The continued requirement of a state filing is more than merely a symbolic holdover of the "concession" theory. The filing requirement gives the state control over the corporate terms of firms that comply with the filing.[24] Any firm that files as a "corporation" is subject to all state rules applying to corporations, such as limitations on the form of management[25] or on opting out of fiduciary duties.[26] In other words, firms that want corporate features must accept the limitations on contracting that come with the filing.

States could regulate the terms of the corporate contract by expressly requiring or forbidding certain contract terms even if firms did not have to file in order to obtain corporate features. But the states would have to define the contracts to which such regulations would apply. It would no longer be enough simply to apply the regulation to "corporations," because without the filing requirement firms would not have to identify themselves as corporations.[27] Perhaps the regulation could be applied to all "limited liability" firms. But that would not necessarily cover all variations on limited liabil-

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23. *See infra* subpart IC.

24. The filing requirement may also facilitate *noncorporate* tax and regulatory provisions applying to corporations that may be justified even under the contractual theory of the firm. Among other things, the filing requirement arguably helps provide a mechanism for collecting taxes and for identifying agents of firms who are charged with statutory duties. Full explication of this justification would require a detailed survey of the myriad contexts to which the filing requirement would relate, and accordingly is beyond the scope of this Article. It is enough to note at this point that statutes could be crafted to identify the objects of taxation and regulation without mandating filing.

25. For example, in some states corporations may not dispense with or unduly limit the functions of the board of directors. *See, e.g.*, N.Y. BUS. CORP. LAW. § 620(b) (West 1968) (prescribing circumstances in which director-control agreements are valid).

26. *See, e.g.*, DEL. CODE ANN. tit. 8, § 102(b)(7) (1988) (providing certificate of incorporation may contain provision limiting the personal liability of a director or stockholder of the corporation for monetary damages for breach of fiduciary duty in certain situations).

27. The difficulty of defining "corporation" is demonstrated by the difficulty in the tax context of distinguishing firms that should be taxed as partnerships from those that should be taxed as corporations. *See* I.R.C. § 7701(a)(2), (3) (1988); Treas. Reg. § 301.7701-2 (1990); Larson v. Commissioner, 66 T.C. 159 (1976). The definitional problem is illustrated similarly in the context of federal securities regulations, which apply only to transactions involving the sale of a "security." *See* 15 U.S.C. §§ 77b(1), 78c(a)(10) (1988). The broad statutory definition of this term has given rise to an extensive body of case law.

ity, or companies that have limited liability with respect to only some of their creditors.

The filing requirement facilitates state manipulation as well as limitation of the corporate contract. State corporation statutes commonly give the legislature the "reserved power" to enact amendments that retroactively alter the charter.[28] This leaves filing firms at the mercy of post-filing legislative changes.[29] Recent anti-takeover legislation shows that legislators are willing and able to use their retroactive amendment power opportunistically to make changes that benefit managers at the expense of the shareholders.[30]

The reserved power is a limited exception from the contract clause that applies only to corporations. It is based on Justice Story's concurring dictum in *Dartmouth College* that "rights legally vested in a corporation, cannot be controled or destroyed by any subsequent statute, unless *a power for that purpose be reserved to the legislature in the act of incorporation*."[31] Firms that obtain limited liability or other corporate features without incorporating are not subject to the reserved power and thus are protected by the contract clause from legislation that changes the terms of existing contracts.

The states might try to preserve their power to limit or manipulate the corporate contract by enacting statutes that apply to firms with corporate features whether or not they are incorporated. Again, this would present the problem of identifying which firms these statutes should govern. Moreover, the reserved power exception to the contract clause assumes that the corporation derives rights from the state. Without even a pretense of state involvement in the incorporation process, the state lacks a rationale for exercis-

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28. *See, e.g.*, DEL. CODE ANN., tit. 8, § 394 (1983). For discussions of the reserved power and questions concerning its constitutionality, see Butler & Ribstein, *Contract Clause*, *supra* note 4, at 782-91; Butler & Ribstein, *Anti-Takeover*, *supra* note 4, at 632-34.

29. *See* Bratton, *supra* note 16, at 445 (corporate formalities remind the parties that the state "reserves the right to rewrite the ground rules").

30. *See* Butler, *Corporation-Specific Anti-Takeover Statutes and the Market for Corporate Control*, 1988 WIS. L. REV. 365, 373-77; Romano, *The Political Economy of Takeover Statutes*, 73 VA. L. REV. 111, 113-17 (1987). Such legislative acts may be unconstitutional under the contract clause. *See* Butler & Ribstein, *Contract Clause*, *supra* note 4, at 794-808; Butler & Ribstein, *Anti-Takeover*, *supra* note 4, at 642-45.

31. 17 U.S. (4 Wheat.) 518, 708 (1819) (citation omitted) (emphasis in original). For applications, see Looker v. Maynard, 179 U.S. 46, 51-52 (1900); Miller v. State, 82 U.S. (15 Wall.) 478, 493-94 (1872); Mobile Press Register, Inc. v. McGowin, 271 Ala. 414, 424, 124 So. 2d 812, 821 (1960); Coyne v. Park & Tilford Distillers Corp., 38 Del. Ch. 514, 521, 154 A.2d 893, 897 (1959); Davis v. Louisville Gas & Elec. Co., 16 Del. Ch. 157, 161, 142 A. 654, 656 (1928); Adair v. Orrell's Mut. Burial Ass'n, Inc., 284 N.C. 534, 538, 201 S.E.2d 905, 908 (1974).

ing a reserved power.[32]

In summary, from a practical as well as an historical standpoint, the regulatory theory of the corporation significantly depends on the filing requirement and ultimately must fail if, as shown below, the filing requirement is shown to be without basis.

C. *Limited Liability and the Filing Requirement*

The need to comply with the filing requirement technically applies to all features that are available only to "corporations." But limited liability is now the only feature commonly identified with "corporateness" that is not clearly available to noncorporations.

A fair approximation of corporate features can be derived from the tax definition of "association,"[33] which is the mechanism for distinguishing firms that should be taxed as partnerships from those that should be taxed as corporations.[34] The so-called "Kintner regulations," which govern on this issue, identify four characteristics that distinguish corporations and partnerships: continuity of life, centralized management, free transferability of interest, and limited liability.[35]

In the partnership, the first three of these features are available by contract. As to continuity of life, although a partnership automatically dissolves upon the happening of any of several types of events—including the disassociation of a partner from the partnership by death or withdrawal[36]—section 38(1) of the Uniform Part-

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32. For a critical discussion of arguments for the reserved power, see Butler & Ribstein, *Contract Clause*, *supra* note 4, at 782-91; Butler & Ribstein, *Anti-Takeover*, *supra* note 4, at 632-34.

33. *See* I.R.C. § 7701(a)(2), (3) (1988) (distinguishing the corporation as an association).

34. The tax definition recognizes that firms might want to identify themselves as "partnerships" or "corporations" in order to obtain favorable tax treatment. Unfortunately there is no clearly articulated tax policy basis for distinguishing the two business forms. *See* Ribstein, *Applied Theory*, *supra* note 4, at 871-77. For present purposes, precise tax categorization is unnecessary. The tax definition is being used only to resolve the question of whether incorporation is necessary to obtain "corporate" features.

35. Treas. Reg. § 301.7701-2(a) (1990). A prominent modern corporate law treatise also cites four corporate characteristics, three of which are identified in the Kintner regulations. *See* R. CLARK, CORPORATE LAW, § 1.1, at 2 (1986). For continuity of life Dean Clark substitutes "legal personality," which includes continuity of life as well as other features. But legal personality is not particularly helpful because it is more a way of characterizing corporate features than a feature itself. For a discussion of the aggregate-entity distinction showing that partnerships, like corporations, are regarded as entities for many purposes, see 1 A. BROMBERG & L. RIBSTEIN, BROMBERG & RIBSTEIN ON PARTNERSHIP § 1.03 (1988).

36. *See* UNIF. PARTNERSHIP ACT §§ 29, 31, 6 U.L.A. 364, 376 (1969).

nership Act permits the parties to draft around the nondissolving partners' power to compel liquidation of the business.[37] Under such an agreement, a partner's absolute power to compel dissolution at will reduces to a power merely to withdraw and terminate the agency relationship between the withdrawing and continuing partners. This is comparable to any agent's or principal's power to terminate an agency.[38]

Similarly, the governance rights provided for in section 18 of the Uniform Partnership Act explicitly are made "subject to any agreement between [the partners]."[39] As to centralized management, although subsection 18(e)[40] provides for equal participation of partners in management, the partners can draft around this default provision and place management power in a body resembling a corporate board.[41] Moreover, the partners can provide for transferability of interests by drafting around subsection 18(g),[42] which gives each partner the power to veto admission of a new partner.[43]

Of all the principal "corporate" features, only limited liability is not explicitly made available by agreement to partnerships.[44] If in-

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37. UNIF. PARTNERSHIP ACT § 38(1) provides that the partners are entitled to compel liquidation of the firm "unless otherwise agreed." *Id.* § 38(1), 6 U.L.A. 456. For examples of cases enforcing agreements providing for continuation of the business after dissolution, see Hagan v. Dundore, 185 Md. 86, 43 A.2d 181 (1945); Wilzig v. Sisselman, 182 N.J. Super. 519, 442 A.2d 1021 (1982); Napoli v. Domnitch, 14 N.Y.2d 508, 248 N.Y.S.2d 228, 197 N.E.2d 623 (1964); Hunter v. Straube, 273 Or. 720, 543 P.2d 278 (1975); Adams v. Jarvis, 23 Wis. 2d 453, 127 N.W.2d 400 (1964). For a discussion of continuation provisions in partnership agreements, see 2 A. BROMBERG & L. RIBSTEIN, *supra* note 35, § 7.11(e).

38. *See* RESTATEMENT (SECOND) OF AGENCY § 118 (1958).

39. UNIF. PARTNERSHIP ACT § 18, 6 U.L.A. 213 (1969).

40. *Id.* § 18(e), 6 U.L.A. 213.

41. *See, e.g.*, Day v. Avery, 548 F.2d 1018 (D.C. Cir. 1976), *cert. denied*, 431 U.S. 908 (1977) (law firm executive committee controlled the firm's Washington office under a partnership agreement); Bernstein, Bernstein, Wile & Gordon v. Ross, 22 Mich. App. 117, 120, 177 N.W.2d 193, 194-95 (1970) (exclusive management powers resided in senior partners); McCallum v. Asbury, 238 Or. 257, 393 P.2d 774 (1964) (executive committee of a medical partnership was given general management authority subject to other partners' power to alter or cancel action taken by a majority vote); 2 A. BROMBERG & L. RIBSTEIN, *supra* note 35, § 6.03, at 6:39-6:40.

42. UNIF. PARTNERSHIP ACT § 18(g), 6 U.L.A. 213 (1969).

43. *See* Day v. Sidley & Austin, 394 F. Supp. 986 (D.D.C. 1975), *aff'd sub nom.* Day v. Avery, 548 F.2d 1018 (D.C. Cir. 1976), *cert. denied*, 431 U.S. 908 (1977) (enforcing an agreement that provided for the admission of partners by majority vote). Purely financial interests of partners are freely assignable in the absence of contrary provision in the agreement. *See* UNIF. PARTNERSHIP ACT § 27(1), 6 U.L.A. 353 (1969); Rapoport v. 55 Perry Co., 50 A.D.2d 54, 376 N.Y.S.2d 147 (1975). Note that, as discussed *infra* at text accompanying note 82, transferability of interests, even if permitted by the agreement, is infeasible in the absence of limited liability.

44. UNIF. PARTNERSHIP ACT § 15, 6 U.L.A. 174 (1969), which provides for the part-

corporation is necessary to obtain any corporate feature, this is the one.[45] It has been said:

> Transferable shares and concentration of the powers of management and a small number of necessary parties in suits are minor advantages of incorporation. But limitation or elimination of liability of the shareholders is not merely the chief single advantage of a business corporation but it is the advantage which in the estimation of legislatures and also in the estimation of the public is of more importance than all the other advantages put together. It is the main thing.[46]

Thus, in order to preserve their control of corporate terms states must constrain the parties' ability to obtain limited liability without incorporating or making some other state filing.[47]

II. THE EFFICIENCY OF RESTRICTIONS ON LIMITED LIABILITY: REGULATION OF FORM OF LIMITED LIABILITY FIRMS

In light of the argument in Part I that restrictions on limited liability are critical to the viability of the regulatory theory of the corporation, it is important to determine whether there is any justification for such restrictions. Parts II and III demonstrate that there is no economic justification for these restrictions.

Restrictions on limited liability can be explained as "rent-seeking" conduct by legislators. State control over corporate terms lets legislators benefit (in the form of campaign contributions and other support) from interest groups that can gain from exercise of this control.[48] Historically, legislators reaped benefits by controlling the

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ners' personal liability, is not subject to contrary agreement. A state filing is also required to obtain limited liability in some non-corporate firms. *See infra* text accompanying notes 193-206.

45. Incorporation may be helpful in obtaining the corporate features just discussed because the courts have tended to construe partnership agreements in the light of the standard form, forcing partners who want corporate features to draft explicitly for them. *See, e.g.*, Rapoport v. 55 Perry Co., 50 A.D.2d 54, 376 N.Y.S.2d 147 (1975) (construing an arguably ambiguous agreement against transferability of full partnership status). Like the limited liability story being told here, this approach to contract interpretation may be related to the regulatory theory of the corporation.

46. E. WARREN, CORPORATE ADVANTAGES WITHOUT INCORPORATION 399 (1929).

47. *See infra* note 186 for a discussion of historical precedent for government suppression of privately contracted governance terms in order to retain state control over the corporation.

48. *See generally* Peltzman, *Toward a More General Theory of Economic Regulation*, 19 J. L. & ECON. 211 (1976); Posner, *Theories of Economic Regulation*, 5 BELL J. ECON. 335 (1974); Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. 3 (1971). The conduct discussed here is more accurately characterized as "rent extraction" in that, by enacting

supply of corporate charters.[49] Modern legislators can earn rents by being able to enact, for example, retroactive corporate anti-takeover legislation that benefits corporate managers.[50] Legislative rent-seeking generates costs while doing no more than redistributing wealth to well-organized interest groups. Thus, rent-seeking cannot justify restrictions on the availability of limited liability.

Even if restrictions on limited liability are the product of rent-seeking by legislators, they might also be justified on efficiency grounds.[51] But Parts II and III reject two potential efficiency-based reasons for regulating limited liability arrangements through a filing requirement. Part II considers whether regulation of limited liability might appropriately restrict the types of firms that can adopt this contractual term. As discussed below in subpart A, the filing requirement does, indeed, deter closely held firms from adopting limited liability. But as shown in subpart B, this deterrence is unnecessary: limited liability can be an efficient bargain for both owners and creditors of closely held firms. Thus, regulation of limited liability is not justified as a means of screening the types of firms that can adopt this provision. Indeed, as discussed in subpart C, the law apparently is moving toward lifting these restrictions on the form of limited liability firms.

A. Constraints on Form of Closely Held Firms

A firm that submits itself to a statutory regime in order to obtain limited liability pays a price in terms of accepting any mandatory terms of the statute. The filing requirement might operate to discourage adoption of limited liability by firms for which the mandatory terms are particularly costly. Theoretically, this regula-

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corporate laws, legislators actively are creating rent-seeking opportunities rather than merely brokering law changes instigated by interest groups. *See generally* McChesney, *Rent Extraction and Rent Creation in the Economic Theory of Regulation*, 16 J. LEGAL STUD. 101 (1987) (discussing how legislators can extract rents by threatening to regulate in order to be paid for forbearing from regulation).

49. For discussions of rent-seeking during the special-chartering era before jurisdictional competition and interest group pressure brought general incorporation laws to England and the United States, see generally sources cited *supra* note 15.

50. *See supra* note 30.

51. The restrictions might also accomplish the purpose of ensuring a particular tax classification for a business form. *See supra* text accompanying notes 33-35. *See also* Hamill, *The Limited Liability Company: A Possible Choice for Doing Business?*, 41 FLA. L. REV. 721, 739 (1989) ("limited liability company" statutes increase the certainty of partnership tax classifications by prohibiting full transferability of interests). However, this merely raises the question (which is beyond the scope of this Article) whether restrictive tax rules have an efficiency justification.

tion would be justifiable if limited liability would be wealth-redistributing rather than wealth-creating for those firms.

The principal area in which this rationale appears to operate is with respect to close corporations. Corporation statutes and case law historically have limited the enforceability of variations on the corporate standard form where close corporations are concerned. Most importantly, limits have been imposed on voting agreements that "sterilize" or remove power from the board of directors.[52]

These limits appear to be explicable only as disincentives to adoption of limited liability by close corporations. No other rationale stands up under scrutiny. The function of the agreements is to combine management and control, a structure inherent in most closely held firms. Restrictions on the agreements can hardly benefit creditors because even "unsterilized" directors have legal duties and economic incentives to act in the shareholders' interests. The agreements conceivably might surprise incoming shareholders, who might expect to be protected by, and to be able to be elected to, the board. But even unsterilized close corporation board members presumably are aligned with particular shareholders or factions. Moreover, close corporation shares normally are not transferred in a faceless market, and one buying into a close corporation is likely to insist on disclosure of existing control agreements.

Similarly, the rule that limited partners who participate in control lose their limited liability appears to be based on the theory that the law should regulate the governance form of firms adopting limited liability.[53] The basis of the control rule has been sharply ques-

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52. Early statutes absolutely required that corporations be managed by the board of directors, and these statutes were interpreted to render unenforceable agreements that substantially removed discretion from the board. *See* Long Park, Inc. v. Trenton-New Brunswick Theatres Co., 297 N.Y. 174, 77 N.E.2d 633 (1948); McQuade v. Stoneham, 263 N.Y. 323, 189 N.E. 234 (1934); Manson v. Curtis, 223 N.Y. 313, 119 N.E. 559 (1918).

Corporation statutes also restrict other arrangements that might be made in close corporations. *See, e.g.*, DEL. CODE ANN. tit. 8, § 218(a), (b) (1983) (requiring central filing and other rules regarding voting trusts); Abercrombie v. Davies, 36 Del. Ch. 371, 130 A.2d 338 (1957) (invalidating a shareholder voting agreement on the ground that it was a non-complying voting trust). However, these provisions apply equally to public and close corporations. Indeed, they may be even more applicable to public corporations since they serve to provide notice to incoming shareholders of control arrangements in a regime of freely transferable shares. *See* Lehrman v. Cohen, 43 Del. Ch. 222, 222 A.2d 800 (1966) (purpose of voting trust statute is to protect against "secret, uncontrolled combinations of stockholders formed to acquire control of the corporation to the possible detriment of non-participating shareholders").

53. *See* UNIF. LIMITED PARTNERSHIP ACT § 7, 6 U.L.A. 582 (1969); REVISED UNIF. LIMITED PARTNERSHIP ACT, § 303, 6 U.L.A. 307-08 (1990).

tioned in recent years.[54] Although the rule might be defended on the ground that it ensures that only those who are "bonded" by the risk of liability will participate in control, the rule does not accomplish this purpose because it does not prevent transfer of management responsibilities to nonpartners. Creditors who are misled by a limited partner's exercise of control into thinking she is a general partner will be protected without the control rule by partnership-by-estoppel liability under section 16 of the Uniform Partnership Act.[55]

The only remaining reason for the control rule is that it deters firms in which control and management are not separated from selecting the limited liability form.[56] The basic policy question whether the law should deter certain firms from selecting limited liability by means of the incorporation requirement is discussed next.

B. An Efficiency Analysis of Constraints on Form

This subpart shows that constraints on the availability of limited liability are unjustified because limited liability can be an efficient bargain in close as well as public corporations.

Prior explanations of limited liability have focused on public corporations.[57] This suggests that the benefits of limited liability to closely held firms and corporate groups are insufficient to cover their increased cost of credit. If so, such firms will adopt limited liability only when they can externalize the costs of limited liability. In effect, under this externalities hypothesis, the legal rule permitting firms to adopt limited liability forces creditors to subsidize risky firms.[58] The policy implication is that closely held firms should be blocked or deterred from adopting limited liability.

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54. *See* Basile, *Limited Liability for Limited Partners: An Argument for the Abolition of the Control Rule*, 38 VAND. L. REV. 1199 (1985); Ribstein, *Applied Theory*, *supra* note 4, at 882-86.

55. UNIF. PARTNERSHIP ACT § 16, 6 U.L.A. 195 (1969).

56. This basis of the control rule is defended in Mitchell, *supra* note 3, at 1182-83.

57. It has been argued that this application of limited liability is trivial, because it is not even clear that public shareholders would have sufficient control to be principals or partners in the absence of limited liability. *See generally* R. HESSEN, *supra* note 4.

58. *See* Mitchell, *supra* note 3, at 1178-79. For related arguments that the state should not permit variation of the corporate form to suit small businesses, see generally Fessler, *The Fate of Closely Held Business Associations: The Debatable Wisdom of "Incorporation,"* 13 U.C. DAVIS L. REV. 473 (1980).

Mitchell suggests, somewhat inconsistently, that limited liability burdens closely held firms because trade creditors will charge them high credit rates to reflect their difficulty in obtaining information. Mitchell, *supra* note 3, at 1176-77. This is puzzling because the firms themselves obviously do not have to accept limited liability. Perhaps Mitchell is suggesting that firms incorporate to obtain other corporate features and find

There is no obvious reason why limited liability could result in externalization of risk in contract cases. Whether dealing with closely or publicly held firms, creditors who are not fully informed as to the risks they are taking can always adjust their cost of credit to reflect the lack of information. Indeed, closely held firms generally are less able than public firms to extract monopoly rents by means of uncompensated risk-shifting.

This subpart refutes the externalities argument circumstantially by identifying the benefits of limited liability and showing how both publicly and closely held firms might gain enough from limited liability to offset increased credit costs. To show how limited liability can be an efficient bargain, it is necessary to begin with the default rule of personal liability of principals and partners.[59] The following section explains why parties would seek to contract around this default.[60]

1. The Default Contract: Personal Liability.—Under what circumstances may party *P* who does not deal directly with creditor *T* but who has contracted with *A* be held liable to *T*? Most obviously, *P* is liable where *A*, with *P*'s express or implied authority, explicitly deals with *T* as *P*'s agent. This liability is based on a contract between *P* and *T* in the sense that both parties expect *P* to be bound.

Agency can be viewed as a "standard form" or "default" position that the law supplies in certain situations where the parties have not clearly contracted otherwise. The standard form fills in the contract if *T* is aware of *P*'s affiliation with *A*, or believes that *A* is not acting solely for its own interest, even if *A* does not act explicitly as *P*'s agent. For example, in *Nichols v. Arthur Murray, Inc.*,[61] the plaintiff entered into a contract for dancing lessons. Although the plaintiff dealt with Burkin, the defendant's franchisee, the contract was with "Arthur Murray School of Dancing," which did not exist as a separate organization.[62] The court held that the defendant was

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it expensive to opt out of limited liability. But this is inconsistent with the usual description of close corporations as firms with partnership features.

59. Limited liability could be regarded as the default contract where the party to be charged would not be a principal or a partner even in the absence of incorporation or other limited liability arrangements.

60. The problem of involuntary creditors is deferred until Part V of this Article. Part V also discusses the category of "quasi-involuntary" creditors—those, like taxi passengers and product consumers, who arguably cannot be regarded as having bargained for limited liability in any realistic sense.

61. 248 Cal. App. 2d 610, 56 Cal. Rptr. 728 (1967).

62. *Id.* at 612, 56 Cal. Rptr. at 730.

bound on the ground that there was an agency relationship between Burkin and the defendant.

"Agency" is defined as follows:

> Agency is the fiduciary relation which results from the manifestation of consent by one person to another that the other shall act on his behalf and subject to his control, and consent by the other so to act. The one for whom action is to be taken is the principal. The one who is to act is the agent.[63]

This definition includes three prerequisites for holding a person liable as principal for the acts of another: (1) the acting party must act primarily for the benefit of the party to be bound; (2) the actor must be subject to the control of the party to be bound; and (3) both parties must consent to the relationship. The "benefit" test means that the principal normally is a residual claimant—that is, it receives all net income after fixed claims are paid. "Consent" does not require that the parties explicitly recognize that they have taken on the benefits and burdens of agency, but only that they consent to an arrangement that includes the legal elements of agency—that is, benefit and control.[64]

Partnership law supplies a similar default rule of personal liability. Section 6 of the Uniform Partnership Act defines partnership as "an association of two or more persons to carry on as co-owners a business for profit."[65] This definition includes three elements: (1) intent (implied in "association"); (2) the requisite form of activity ("carry[ing] on . . . a business for profit"); and (3) co-ownership.

As in the law of agency, the intent element can be satisfied by intent to do the acts, or agreement to the elements that in law constitute partnership.[66] The definition's reference to the nature of the activity simply reflects the fact that many of the provisions of the Uniform Partnership Act are designed for profit-making businesses.[67]

The co-ownership element is partnership law's equivalent of the control and benefit tests in agency. Two of the most important elements of co-ownership are profit sharing—the only specific co-

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63. RESTATEMENT (SECOND) OF AGENCY § 1 (1958).

64. *See id.* § 1 comment b.

65. UNIF. PARTNERSHIP ACT § 6(1), 6 U.L.A. 22 (1969).

66. *See* West v. Kerr-McGee Corp., 586 F. Supp. 493, 499 (E.D. La. 1984), *rev'd on other grounds*, 765 F.2d 526 (5th Cir. 1985); 1 A. BROMBERG & L. RIBSTEIN, *supra* note 35, § 2.05, at 2:36.

67. *See* 1 A. BROMBERG & L. RIBSTEIN, *supra* note 35, § 2.06.

ownership element mentioned in the Uniform Partnership Act—and control.[68] Section 7(4) of the Uniform Partnership Act provides that "the receipt by a person of a share of the profits of a business is prima facie evidence that he is a partner in the business."[69] The commissioners' note to section 6 states: "Ownership involves the power of ultimate control. To state that partners are co-owners of a business is to state that each has the power of ultimate control."[70]

The default personal liability imposed in both agency and partnership law rests on elements that relate to *P*'s ability to monitor *A*. Agency or partnership is imposed as a default rule when *P*'s expected loss from *A*'s inability to perform is lower than *T*'s.[71] Expected loss is a function of the amount and probability of loss and the cost of measures that will prevent the loss from occurring. If *P* is a partner or principal under the tests just discussed, it can reduce its expected loss by monitoring *A*—that is, exercising its control over the agent to ensure that it does not become insolvent. Moreover, because of its position, *P* is well-informed about the likelihood of loss. *T*, on the other hand, can reduce expected loss only by learning about or becoming involved in managing a business in which she currently has no role.

P's residual claim, like her control, relates to *P*'s status as a monitor. Armen Alchian and Harold Demsetz observed in a noted article[72] that allocating the residual claim of the firm to the monitor ensures that the monitor will maximize its own compensation by minimizing shirking by other "team members." It follows from this theory that the residual claim is most efficiently allocated to the one who holds the power to monitor the other actors in the business.[73]

The personal liability default position also can be explained in

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68. Other elements include loss-sharing, co-ownership of property and contributions to capital. *See generally* 1 A. BROMBERG & L. RIBSTEIN, *supra* note 35, §§ 2.07(d)-(e). Note that control may be more important in determining agency than in determining partnership because of the various partnership indicia of monitoring status other than control, which are not typically present in agency cases. Thus, "continuous subjection to the will of the principal" is necessary for agency, *see* RESTATEMENT (SECOND) OF AGENCY § 1 comment b (1958), while a mere right to be consulted may be enough for partnership, *see* Shain Inv. Co. v. Cohen, 15 Mass. App. 4, 10, 443 N.E.2d 126, 131 (1982).

69. UNIF. PARTNERSHIP ACT § 7(4), 6 U.L.A. 39 (1969).

70. *Id.* § 6 commissioner's note, 6 U.L.A. 23.

71. *See* Sykes, *The Economics of Vicarious Liability*, 93 YALE L.J. 1231 (1984) (for an explanation of vicarious liability that also relies to some extent on the potential for loss avoidance by the principal).

72. Alchian & Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777 (1972).

73. For a discussion of the relevance of the Alchian-Demsetz theory to the definition

terms of agency cost theory.[74] In this theory, *T* would be the "principal," who is exposed to loss by reason of *P*'s (now the "agent") decisions concerning use of the resources invested by *T* in firm *A-P*. If *P* is not personally liable for *A*'s debts, *P* may cause *A* to use the funds from which *T* is to be repaid in ways that are excessively risky from *T*'s standpoint. While *T* can reduce this risk by directly monitoring *A*'s actions, this may be more costly than giving *P* the incentive to act consistently with *T*'s interest. Thus, personal liability may optimize total agency costs—that is, the total of monitoring expenditures by the principal, bonding expenditures by the agent (including personal liability for the firm's debts), and the residual reduction in the principal's welfare that results despite these expenditures.[75]

Imposing default liability on monitors is consistent with the commonly accepted theory that default provisions give parties the terms they would have drafted if fully informed and in the absence of transaction costs.[76] *T*'s cost of extending credit to or otherwise dealing with the *A-P* business—a cost that is ultimately borne by *P* as residual claimant—depends on whether *P* stands behind *A*'s debts. If *P* can learn about and protect against the risk of *A*'s insolvency more cheaply than can *T*, personal liability reduces *P*'s credit costs more than it increases *P*'s monitoring costs.[77]

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of partnership, see 1 A. BROMBERG & L. RIBSTEIN, *supra* note 35, § 2.07(a), at 2:51-2:52, 2:54-2:55.

74. For other commentary suggesting an agency cost explanation for personal liability, see Halpern, Trebilcock & Turnbull, *supra* note 3, at 143-45; Woodward, *supra* note 6, at 607.

75. For the seminal statement of this definition of agency costs, see Jensen & Meckling, *supra* note 4, at 308.

76. *See, e.g.*, R. POSNER, *supra* note 6, at 372; Baird & Jackson, *Fraudulent Conveyance Law and Its Proper Domain*, 38 VAND. L. REV. 829, 835-36 (1985); Easterbrook & Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698, 702 (1982).

77. The standard form rule is a hypothetical bargain in the traditional sense and not a "penalty" default under the analysis recently proposed in Ayres & Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 97-100 (1989). Under the Ayres-Gertner analysis, a contract may be incomplete not because of transaction costs, but because a more informed party might take strategic advantage of the other party. But monitoring principals do not gain strategic benefits by refusing to come forward and bargain around the default because this would result in increased credit costs.

Compare this to the situation in Hadley v. Baxendale, 156 Eng. Rep. 145 (1854), in which a miller sued a carrier for profits lost when the carrier delayed delivery of a new crankshaft. Ayres and Gertner conclude that the low-damage default rule is appropriate in *Hadley* because millers who might suffer high consequential damages because of nonperformance by carriers might not identify themselves under a default rule that provided for recovery of these damages. Low-damage millers might not gain enough in contract price to justify the costs of negotiating around the high-damage rule. As a result, the

The default rule of personal liability applies not only where *T* does not explicitly contract for *P*'s liability, but also where *T* explicitly contracts with *A* on the basis that *P* will be liable, but *P* has not consented to being bound by *A*'s actions. In this situation, the rule is nominally that *P* is bound only where he has done something to cloak *A* in "apparent authority."[78] In fact, proceeding on the theory that *P* is in a better position to control *A*'s acts than *T* is to determine the scope of authority, the courts have gone quite far toward holding *P* liable based on the appearance of authority alone.[79]

2. Efficiency of Limited Liability in Public Corporations.—In light of the preceding discussion, the limited liability contract initially seems puzzling. Contracting for limited liability is necessary only if *P* would otherwise be exposed to personal liability under the default agency or partnership rule. But this would mean that *P* is a principal or partner, and therefore a monitor who can avoid the risk of *A*'s insolvency more cheaply than can *T*. In other words, in order to explain limited liability on efficiency grounds,[80] it is necessary to identify benefits to *P* of limited liability that outweigh *P*'s increased cost of credit. This section states the principal efficiency rationale for limited liability in the public corporation, while section 3 shows how limited liability can be efficient for close corporations as well.

The principal explanation for limited liability in public firms is that it is necessary for an efficient capital market in which share prices quickly adjust to new information about traded firms and therefore provide the best available unbiased estimate of future returns.[81] Limited liability is a necessary condition of market effi-

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price charged by carriers would be somewhere between the high-damage and the low-damage price. Ayres & Gertner, *supra*, at 101-04. This is not only a break for high-damage millers, but leads to suboptimal precautions by carriers. In the agency setting, it would also be inefficient if *T*s bore the risk rather than monitoring *P*s. But because *T*s would charge the higher price based on bearing the risk of *A*'s default unless *P* negotiated around, monitoring *P*s would have the incentive to negotiate around the limited liability rule unless the benefits to them of limited liability outweighed the costs.

78. *See* RESTATEMENT (SECOND) OF AGENCY § 8 (1958).

79. *See* Croisant v. Watrud, 248 Or. 234, 432 P.2d 799 (1967) (explicitly placing liability on this ground). This case applies the principle of "inherent agency power," defined in RESTATEMENT (SECOND) OF AGENCY § 8A (1958). This is similar to apparent authority and can arise from the general power the principal has conferred on the agent.

80. Unless otherwise noted, efficiency is used in the Pareto superiority sense; that is, enforcement of the contract is efficient if it makes at least one party better off and does not make any party worse off. Enforcing contracts can be assumed to be Pareto superior if it is assumed that the contracting parties are fully informed and acting voluntarily. Therefore, inefficiency in this sense circumstantially indicates that the parties are uninformed or coerced.

81. This is a rough statement of the Efficient Capital Market Hypothesis. The Hy-

ciency because it facilitates free transferability of shares and pricing of shares according to expected cash flows.

As to transferability, a personal liability regime could be enforced only by either restricting transfer to low-asset holders in firms nearing insolvency or providing that liability of sellers continues despite the transfer.[82] If liability continues despite the transfer, sellers would be in the unfortunate position of having to continue monitoring the firm after the sale. Moreover, even in solvent firms transfer would be costly from the standpoint of both purchasing shareholders who must determine the risk associated with their guarantees, and the non-transferring shareholders whose exposure depends on the wealth of the transferee.

Efficient markets cannot exist without the trading volume made possible by free transferability of shares.[83] First, efficiency depends on frequent trading to establish a recent trade price. Second, if stock is traded relatively infrequently, this reduces investor demand for information about the stock and, in turn, the incentives for producing information. As information becomes more scarce and investors must pay more for it, trading prices will convey less information.[84]

As to pricing of securities, under an unlimited liability rule what investors will pay for securities depends partly on the cost of their guarantee which, in turn, varies according to the investors' wealth.[85] As a result, a given security could not have a single quoted price—a prerequisite of an efficient market.

Market efficiency benefits publicly held firms in several ways.[86] First, by reducing investors' information costs efficient market pricing decreases a firm's cost of capital. Second, because efficient markets impound information about expected investment payoffs into stock price, they make it easy for investors to realize expected cash flows by selling their stock. This means that firms can pursue optimal investments without being concerned about investors' individ-

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pothesis is conventionally divided into three "forms," which reflect various tests of the hypothesis: the "weak form," the "semi-strong form" and the "strong form." *See* Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383, 383 (1970).

82. *See* Woodward, *supra* note 6, at 602.

83. *See id.* at 601-02.

84. *See generally* Gilson & Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984).

85. *See* Easterbrook & Fischel, *supra* note 6, at 96; Halpern, Trebilcock & Turnbull, *supra* note 3, at 130.

86. *See* Ribstein, *Applied Theory*, *supra* note 4, at 845-47 for a more detailed discussion.

ual consumption preferences.[87] Third, an efficient market provides the essential condition of a market for control of the firm by permitting purchase of control at a price reflecting the expected cash flows under current management.[88] The existence of this market can benefit creditors as well as shareholders by reducing managers' incentive to shirk or consume on the job.[89]

3. Efficiency of Limited Liability in Closely Held Firms.—It has been argued that limited liability is inefficient in closely held firms because of its higher agency costs,[90] and because there is no offsetting efficient capital market benefit.[91] However, as discussed in the following subsections, there are explanations for limited liability that apply to closely held firms as well as to public firms.

a. Risk-Bearing Capability.—Imposing personal liability on shareholders makes it costly for them to hold diversified portfolios because each additional holding increases the potential for a disastrous insolvency.[92] Without diversification, owners must bear "unique" (that is, diversifiable) risk as well as "market" (that is, nondiversifiable) risk.[93] Limited liability does not merely shift risk from shareholders to creditors, but rather reduces the total cost of

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87. *See* Fama & Jensen, *Organization Forms and Investment Decisions*, 14 J. FIN. ECON. 101, 107 (1985); Woodward, *supra* note 6, at 602. A related point is that, by facilitating diversification of risk, limited liability encourages a firm's owners to make value-increasing investments that would be too risky for them under an unlimited liability regime. *See also* Easterbrook & Fischel, *supra* note 6, at 97.

88. *Id.* at 96.

89. However, the market for control can also hurt creditors to the extent that it causes managers to increase shareholder wealth at creditors' expense.

90. For an agency cost explanation of personal liability, see *supra* text accompanying notes 74-75.

91. *See* Halpern, Trebilcock & Turnbull, *supra* note 3, at 148; Woodward, *supra* note 6, at 609.

92. *See* Manne, *Our Two Corporation Systems*, *supra* note 4, at 262. Richard Posner has proposed another risk-bearing explanation for limited liability contracts: they efficiently transfer risk to the party best able to bear them. *See* R. POSNER, *supra* note 6, at 370. Posner argues, first, that large lenders such as banks are better able to appraise business risks than individual shareholders. *Id.* Second, he says that shareholders usually are individuals who are more likely to be risk averse than corporate creditors, whose shareholders hold diversified portfolios and who own diversified loan portfolios. *Id.* at 370-71. However, Posner's general characterizations of shareholders and corporate creditors are not universally true. For example, unsophisticated trade creditors and employees who hold nondiversified portfolios are likely to be more risk averse and less able to appraise business risks than are institutional shareholders.

93. R. BREALEY & S. MYERS, PRINCIPLES OF CORPORATE FINANCE 131-33 (3d ed. 1988).

risk borne by shareholders and creditors.[94]

Diversification is not usually an important consideration in closely held firms because investors generally invest most of their assets in a single firm even under a limited liability regime. But one may invest passively in a portfolio of closely held firms, as by providing "seed" money for start-up high-technology ventures. Also, a trademark owner can diversify by franchising outlets and risking only the loss of revenues from the failure of an outlet rather than personal liability as a principal.[95]

b. Monitoring.—It has been observed that limited liability facilitates the separation of ownership and control by making passive ownership feasible.[96] Without limited liability, all owners would be forced either to take an active role in management or to suffer severe consequences from poor management decisions. The specialization of ownership and management functions makes it less costly for the firm to attract capital than under an unlimited liability regime because investors need not have any special management expertise.[97]

Monitoring explains the limited liability contract because in

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94. *See* Easterbrook & Fischel, *supra* note 6, at 101.

The diversification benefit of limited liability is reduced when limited liability is compared with a regime in which investors are held personally liable only for a portion of the debt that reflects the percentage of their investment in the firm—the so-called "pro rata" system. *See* Halpern, Trebilcock & Turnbull, *supra* note 3, at 137. But a pro rata system would be only a second-best solution because it would be costly to administer. For example, it would be necessary to value non-cash contributions, and to adjust liability through costly actions for contribution. *See* Manne, *Our Two Corporation Systems*, *supra* note 4, at 262.

A risk-bearing theory of limited liability seems inconsistent with the evidence that the lack of limited liability protection did not impede economic development of risky enterprises during the early stages of the industrial revolution. *See* Blumberg, *supra* note 6, at 594 (no discernable difference in economic development between states that adopted, and those did not adopt, limited liability). *See also* Meiners, Mofsky & Tollison, *supra* note 7, at 362 (change to limited liability rule had no effect on the granting of charters in Massachusetts). However, this might be explained by the fact that tort liability of enterprises was not well developed by this time. For example, the privity rule of Winterbottom v. Wright, 152 Eng. Rep. 402 (1842), still protected companies from product liability claims to remote consumers.

95. Note that limited liability is provided in this situation not only by incorporation of the franchisor, but also by recognition of a franchise agreement as a contract around the default agency rule, similar to "protected relationships" under partnership law. *See infra* text accompanying notes 101-105. *See also* McLaughlin v. Chicken Delight, Inc., 164 Conn. 317, 324, 321 A.2d 456, 460 (1973) (holding that franchisees are not agents of their franchisors).

96. *See* Easterbrook & Fischel, *supra* note 6, at 94.

97. *See* Fama & Jensen, *Agency Problems and Residual Claims*, 26 J. L. & ECON. 327, 330 (1983).

some situations limited liability reduces total monitoring costs rather than simply shifting monitoring costs from shareholders to creditors. First, under a limited liability regime creditors need not increase their monitoring to offset reduction in monitoring by the shareholders because they can rely to some extent on shareholders' continued monitoring to protect their residual claims.[98]

Second, the costs of limited liability imposed on creditors depend on the firm's capital structure. For example, limited liability imposes a relatively low monitoring burden on secured creditors who monitor individual assets rather than the firm as a whole.[99] Also, there is a free rider problem associated with monitoring by dispersed claimants who each hold relatively small claims and therefore are not in a position to recoup the benefits of their monitoring. The coordination problems associated with monitoring may be less for creditors than for shareholders where the creditors hold relatively few large claims or employ an indenture trustee.

The monitoring explanation of limited liability somewhat overlaps the risk-bearing explanation because the degree to which the parties will incur monitoring costs depends on the amount of risk-reduction they expect to obtain through monitoring. But the two explanations are separate because diversification, particularly in closely held firms, may be incomplete and in any event does not eliminate systematic risk. Limited liability reduces monitoring costs that remain after risk diversification is taken into account.

The monitoring explanation might seem to apply only to public firms where ownership and control are separated. But the following points present monitoring-based explanations for limited liability in closely held firms.

(i) Defining Borderline Monitoring Situations.—The limited liability contract raises efficiency concerns only to the extent that a monitor shifts responsibility for the firm's debts. Agency and partnership law impose unlimited liability only approximately in those situations in which *P* is a monitor. Like all legal rules, the generalizations of

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98. *See* Easterbrook & Fischel, *supra* note 6, at 99-100. However, limited liability increases creditors' need to protect against excessively risky investments by limited liability owners. *See supra* text accompanying note 75.

99. For some monitoring-oriented theories of secured credit, see generally Jackson & Kronman, *Secured Financing and Priorities Among Creditors*, 88 YALE L.J. 1143 (1979); Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 YALE L.J. 49 (1982); Scott, *A Relational Theory of Secured Financing*, 86 COLUM. L. REV. 901 (1986). *But see* Buckley, *The Bankruptcy Priority Puzzle*, 72 VA. L. REV. 1393 (1986) (criticizing these theories).

the control, benefit and "co-ownership" tests may be applied imprecisely—in this case, to impose liability on nonmonitors. For example, a profit-sharing manager may or may not have a partner's "ultimate" control. The limited liability contract clarifies that the party seeking the benefit of limited liability is not, in fact, a monitor.

This explanation for limited liability agreements can be illustrated by "protected" relationships in partnership law. Section 7(4) of the Uniform Partnership Act provides that profit sharing is prima facie evidence of partnership unless profits were received pursuant to one of five relationships described in subsections 7(4)(a)-(e).[100] These relationships include payment of a debt, wages, rent, or interest.

Although section 7(4) says that proof of a protected relationship merely removes the presumption of profit sharing rather than refuting partnership,[101] some courts appear to hold that parties may be either partners or in a "protected" relationship.[102] Under the latter approach, a *P* who has some of the attributes of partnership (such as profit sharing) may be able to clarify nonpartnership status by entering into a contract that adopts the standard features of a protected relationship. For example, in *Martin v. Peyton*,[103] the court, in holding that profit-sharing parties were not partners, relied to some extent on provisions of a credit agreement that stressed standard credit terms over partnership-type co-ownership.[104]

By clarifying her "protected" status, *P* can be viewed, particularly in light of section 7(4), as providing notice to outside parties that she is not a partner.[105] In other words, a contract clarifying

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100. UNIF. PARTNERSHIP ACT § 7(4), 6 U.L.A. 39 (1969).

101. *See id.*

102. *See generally* Cutler v. Bowen, 543 P.2d 1349 (Utah 1975); 1 A. BROMBERG & L. RIBSTEIN, *supra* note 35, § 2.08(c), at 2:76-2:77.

103. 246 N.Y. 213, 158 N.E. 77 (1927).

104. Among other things, as quoted by the lower court in *Martin*, the agreement provided that the creditors "shall not be interested in 'profits' as such," that their profit share "shall be construed merely as a measure of compensation for loaning . . . securities to [the] firm," and that the creditors shall not "in any way be deemed or treated or held as partners." Martin v. Peyton, 219 A.D. 297, 302, 220 N.Y.S. 29, 34 (1927). While this could be characterized as a limitation on the application of the default personal liability rule, it is better regarded as a limited liability contract because it turns on contracting around personal liability that would have been imposed in the absence of the contract.

105. *See* 1 A. BROMBERG & L. RIBSTEIN, *supra* note 35, § 2.09(b)(5), at 2:87-2:88. *See infra* text accompanying notes 106-109 for a discussion of other considerations, relating to the substance rather than the form of the agreement, that contributed to the nonpartnership characterization in *Martin*.

"protected" status may have the effect of opting out of partnership liability that would have existed but for this contract.

(ii) Specialization of Management Functions in Closely Held Firms.—Because management and investment functions may be specialized in closely as well as publicly held firms, limited liability may be efficient even where shareholders are monitors and therefore would be liable under the default personal liability rule.

Martin v. Peyton illustrates specialization of management in closely held firms. In *Martin* a group of creditors loaned marketable securities to a financially troubled broker to enable it to continue in business.[106] The creditors were entitled to a share of the broker's profits as consideration for the loan, and had substantial power, including a general veto power and the power to accept the resignations of any of the members of the firm.[107] Despite the creditors' control and interest in profits, the court held, consistent with explicit provisions in the creditors' agreement, that they were not partners.[108] The court stressed, among other things, that the creditors had only a negative veto rather than an active role in the brokerage firm.[109] In other words, the creditors had left active management to the experts—which made sense because the creditors apparently knew nothing about the brokerage business. In this situation, limited liability may have reduced the cost of monitoring more than it increased the cost of credit.

(iii) Creditor Information and Monitoring Costs.—Limited liability may reduce creditors' and shareholders' monitoring costs in both closely held and public firms by eliminating the creditors' and shareholders' need to monitor shareholder wealth.[110] The cost of credit under personal liability depends on the principals' wealth and the likelihood that the wealth might be dissipated.[111] Creditors must investigate these facts and, perhaps, negotiate constraints on opportunistic conduct by shareholders. These additional monitoring and information costs may prevent the price of credit under unlimited liability from being lowered sufficiently to compensate the shareholders for their increased liability risk.

Personal liability not only increases the information and moni-

106. *Martin*, 219 A.D. at 300, 220 N.Y.S. at 32.
107. *Id.* at 302, 220 N.Y.S. at 33-34.
108. 246 N.Y. at 223, 158 N.E. at 80; *see supra* note 104.
109. 246 N.Y. at 219, 158 N.E. at 79-80.
110. *See* Easterbrook & Fischel, *supra* note 6, at 99; Woodward, *supra* note 6, at 602.
111. *See* Halpern, Trebilcock & Turnbull, *supra* note 3, at 127-28.

toring costs of creditors dealing with principals through agents, but also of creditors dealing directly with principals. These creditors must, under a personal liability regime, assess the risk that the agent's insolvency will trigger the insolvency of the principal.[112]

While the monitoring and information cost problems just discussed are inherent in personal liability, they are likely to be more severe in closely held than in publicly held firms. First, the fewer the owners that creditors rely on, the more important becomes the wealth of each owner. Second, creditors are more likely to rely on the owners' wealth when dealing with a relatively thinly capitalized, closely-held unlimited liability firm than with a large, publicly traded unlimited liability firm.

4. Summary.—Limited liability therefore may be an efficient bargain in closely as well as publicly held corporations. Although limited liability usually is explained in terms of publicly held firms, it also serves important functions in closely held firms, including facilitating diversification of risk and separation of ownership and control, and reducing creditors' need to monitor shareholder wealth. Because there is no a priori basis for believing that limited liability in close corporations externalizes costs, limited liability should be available by private ordering in both contexts.

C. Legal Recognition of Private Ordering by Limited Liability Firms

Modern legal trends support the theory that the law should not force limits on the form of limited liability firms. Close corporation statutes now commonly permit close corporations to adopt director control agreements.[113] The limited partnership statutes have been loosened to provide wide safe-harbors for agreements permitting control by limited partners.[114] Indeed, one statute has dropped the control rule entirely,[115] and some states offer limited liability forms that do not include this restriction.[116]

But the law is in transition. The control rule, although watered down, still restricts private ordering in most limited partnership statutes. And close corporation statutes do not clearly move in the direction of greater private ordering. For example, the statutes

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112. *See* R. POSNER, *supra* note 6, at 370-72.

113. *See infra* note 117.

114. *See* UNIF. LIMITED PARTNERSHIP ACT § 303, 6 U.L.A. 307-09 (1985 & Supp. 1990).

115. *See* GA. CODE ANN. § 14-9-303 (1989).

116. *See infra* note 196 and accompanying text.

limit the availability of director control agreements to "close corporations" that formally elect coverage by a certificate provision, or that meet a statutory definition of a "close corporation," or both.[117] By preventing publicly held corporations from adopting certain types of terms,[118] the statutes reinforce the idea that the legislature should be able to dictate the governance terms that firms adopt.[119] These statutes also make it costly for closely held firms to adopt the corporate form. For example, technical filing requirements may frustrate the parties' expectations by causing an agreement to become unenforceable.

Thus, even while ostensibly loosening state control of corporate terms, the legislatures have maintained their grip. However, the courts are completing the transition toward private ordering in close corporations by enforcing director sterilization agreements despite noncompliance with the disclosure requirement.[120]

III. REGULATION OF METHOD OF FORMATION OF LIMITED LIABILITY FIRMS

Part II showed that restrictions on limited liability contracts are not justified on the ground that this form of contract should be readily available only to publicly held firms. This Part critically analyzes and rejects some possible efficiency-based reasons for mandating formality—in particular, central filing—for the creation of limited liability contracts.[121]

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117. For a prominent example, see DEL. CODE ANN. tit. 8, § 350 (1983) (permitting certain agreements in firms that both elect close corporation status by certificate provision (*see id.* § 343) and that meet certain qualifications, including 30 or fewer shareholders and adoption of share transfer restrictions (*see id.* § 342)).

118. For example, these statutes may prevent publicly held firms from adopting arbitration provisions. *See* Shell, *Arbitration and Corporate Governance*, 67 N.C.L. REV. 517, 553-54 (1989).

119. *See* Karjala, *An Analysis of Close Corporation Legislation in the United States*, 21 ARIZ. ST. L.J. 663, 690 (1989), stating, "[a]t best, [close corporation] statutes send a legislative message to courts in those jurisdictions that have continued to adhere stolidly to formalistic 'statutory norms' analysis." *Id.*

120. *See* Zion v. Kurtz, 50 N.Y.2d 92, 405 N.E.2d 681, 428 N.Y.S.2d 199 (1980) (holding that a corporation that did not formally elect close corporation status pursuant to a statute nevertheless could take advantage of a statutory provision applying to close corporations); Penley v. Penley, 314 N.C. 1, 332 S.E.2d 51 (1985) (enforcing, on other grounds, an oral agreement that did not comply with a North Carolina statute validating shareholder agreements); Coffee, *Mandatory/Enabling*, *supra* note 11, at 1644-45 (discussing *Zion* as an example of a judicial interpretation of the corporate statute favoring private ordering).

121. That is not to deny that private parties might favor central filing to clarify their limited liability status in some situations. By analogy, central filing of security agreements can be regarded as a sort of private ordering. Indeed, even if such filings have

A. *Identification of Recourse Assets*

The law might insist on formalities because creditors need to identify a particular set of assets against which they can seek recovery. The fact that a firm has not been formally incorporated does not mean that the creditor has no recourse if she is not paid, because assets can be identified to informally organized, as well as to formally organized companies. According to the rules set forth in the Uniform Partnership Act,[122] creditors who contract with a partner and agree to look only to the partnership for payment can collect against assets determined to be owned by the partnership, including property "acquired in the partnership name."[123] Any company that has not been formally organized under a nonpartnership statute could be considered a partnership.[124]

B. *Filling Contracting Gaps*

An important function of corporate law is providing a standard form contract, including terms relevant to the firm's creditors. The corporate standard form obviously does not apply to a noncorporation. This may leave gaps in the parties' contract. It does not, however, justify refusing to recognize the limited liability of the firm's owners.

To begin with, an informally organized firm would be considered a partnership, and the partnership standard form would fill any gaps in the contract.[125] Assuming the limited liability term is enforced, this would mean that the creditor would have all the rights of a partnership creditor, including the right to recover against the partnership assets, but not including the right to sue or recover against the partners individually.[126]

It is true that the partnership standard form terms, which as-

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very little benefit, their cost is so low for most firms that requiring such filings may be regarded as trivial. However, the filing requirement is important for those firms that, for any reason, intentionally or inadvertently neglect to file. Moreover, whatever the direct costs and benefits of filing, establishing that there is no justification for mandating filings is, as discussed in Part I, a critical step toward full recognition of the contractual theory of the corporation.

122. *See* UNIF. PARTNERSHIP ACT § 8, 6 U.L.A. 115 (1969).

123. *See id.* § 8(3), 6 U.L.A. 115.

124. Partnership is the "default" form of business association in the sense that any firm that fits within the definition of partnership and that has not been formed under some other statute is a partnership. *See id.* § 6(2), 6 U.L.A. 22.

125. *See supra* note 124 and accompanying text.

126. As to whether the parties can contract around this rule under current partnership law, see *infra* note 142.

sume the partners' personal liability, may not be suitable for creditors who enter into a limited liability contract. Limited liability increases the creditors' agency costs because owners who share in any upside outcomes but are protected from downside outcomes have the incentive to gamble with the firm's assets at the creditors' expense. Because these agency costs are reflected in the firm's cost of credit it may be in all parties' interests to contract for limits on the owners' use of the assets in order to minimize agency cost.[127] However, these contracts may be costly. Incorporation provides a cheap standard form.

But this argument neither justifies nor explains incorporation as a necessary prerequisite for limited liability. The transaction-cost-saving function of incorporation does not justify mandatory incorporation as a prerequisite to limited liability because there is no reason why the parties should not be able to choose to forego selection of the corporate standard form. The firm's owners might be willing to pay a higher cost of credit as the price of greater freedom of operation within the firm or of entering into a customized contract with the creditors. Alternatively, the private sector might develop alternative limited liability standard forms that offer a better mix of terms for both creditors and owners with transaction cost savings comparable to incorporation. Whether the contract is customized or standardized, it could be either delivered to creditors or publicly recorded without the necessity of incorporation. Incorporation may be useful, but it is not essential.

Moreover, corporate law cannot be explained as cheap standard form protection for creditors. Corporation statutes offer little resistance for owners who wish to injure creditors through misuse of the firm's assets. There is no meaningful statutory minimum capitalization requirement. Traditional "legal capital" and "earned surplus"-type statutes, while purporting to limit distributions of assets to owners, are actually subject to nearly limitless manipulation.[128] The Revised Model Business Corporation Act has rejected the idea of requiring the maintenance of a cushion, and conditions the power to give dividends on the firm's solvency.[129] This adds little to the

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127. For an important review of some of these devices, see generally Smith & Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. FIN. ECON. 117 (1979).

128. *See generally* B. MANNING, LEGAL CAPITAL (3d ed. 1990).

129. REVISED MODEL BUSINESS CORP. ACT § 6.40 (1984), prohibits distributions if, giving effect to the distribution, the corporation is either insolvent in the "equity" sense (cannot pay its debts as they become due) or its total assets would be less than its liabilities (plus preferred shareholders liquidation rights unless varied by the articles).

protection investors would have under fraudulent conveyance statutes.[130]

What is left for creditors under corporate law is the highly uncertain protection found in the veil-piercing cases and based on "inadequate capitalization" and other grounds. For present purposes, the important point about the veil-piercing remedy is that it is not only not conditioned upon incorporation, but is granted despite incorporation.

The small protection offered creditors by corporate law is not surprising. The protection creditors want varies so widely by type of creditor and type of firm that one-size-fits-all terms would be virtually useless. Some creditors prefer security,[131] while others rely on terms like those in standard form indentures. While baseline standard-form terms might be useful for some very small creditors where transaction costs of customized provisions are high in relation to their benefits, most such creditors are very short term and are therefore relatively indifferent to the risk of opportunistic asset manipulation by owners.

C. *Formalities as a Mechanism for Signalling and Compelling Disclosure*

It has been argued that refusing to enforce corporate charters that have not complied with formalities forces incorporators to disclose such facts as the number of authorized shares, the registered address of the corporation, and the state of incorporation. In effect, personal liability in this situation is a "penalty" default intended to force disclosure by the more informed party.[132]

There are several problems with this rationale for formalities as a prerequisite to limited liability. First, many of the disclosures required under state law are neither very important nor related in any obvious way to limited liability. For example, disclosure of authorized shares is relevant to potential dilution of shareholders' interests but has no bearing on creditor interests. Disclosure of owner contributions to the firm, which arguably does have some bearing on creditor interests,[133] normally is not required in the filed certificate.

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130. UNIF. FRAUDULENT CONVEYANCE ACT § 4, 7A U.L.A. 474 (1918), permits creditors to nullify conveyances made without fair consideration (which would include a distribution of a dividend) by firms whose assets are less than their liabilities. *Id.* Section 5 extends this protection to conveyances that left the firm with "unreasonably small capital." *Id.* § 5, 7 U.L.A. 504 (1918).

131. For explanations of secured debt, see sources cited *supra* note 99.

132. *See* Ayres & Gertner, *supra* note 77, at 97-98.

133. Even this is debatable. *See* B. MANNING, *supra* note 128, at 50-57.

Second, even if these disclosures may be important to creditors, or if for most firms their trivial cost is outweighed by a very small benefit, it does not necessarily follow that they should be legally compelled. Creditors could demand the disclosures and adjust their cost of credit to reflect whether the disclosures have been made. The arguments for mandatory disclosure of information relevant to limited liability are not as strong as those justifying mandatory disclosure in the federal securities laws.[134] Penalties for misrepresentation are not important for ensuring the veracity of the straightforward facts that are relevant to limited liability. Also, the firm's agents are unlikely to have private reasons for refusing to disclose information that minimizes the firm's credit costs.[135]

A related argument for mandatory filing rules is that a state filing signals the existence of certain contract terms, thereby minimizing creditors' information costs. For example, a state filing would assure creditors that the debtor firm has obtained a minimum level of insurance required for all firms incorporating in the state. But here, too, the costs of not filing are internalized, so that firms should not be required to file in order to obtain limited liability. Moreover, statutes providing for limited liability in fact do not provide significant protection for creditors that would be signalled by the state filing.[136]

D. Misrepresentation

If a firm calls itself a "corporation" or a "limited partnership," creditors justifiably expect that the firm is subject to the provisions of a corporation statute, and that the firm has made a public filing containing certain basic information.[137] Thus, it might be appropriate in this situation to refuse to enforce the limited liability contract on the grounds of material misrepresentation or nondisclosure.

However, this result should obtain only if the misrepresentation was material and if the creditor was injured by it. Materiality is

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134. For discussions of mandatory rules in this context, see generally Coffee, *Market Failure and the Economic Case for A Mandatory Disclosure System*, 70 VA. L. REV. 717 (1984); Easterbrook & Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669 (1984).

135. The costs of mandatory incorporation are likely to be far less for most firms than those of securities disclosures. However, in view of the trivial benefits from mandating filings and the absence of any indication of market failure that might justify regulation, regulation probably has insufficient benefits here to outweigh even very small costs.

136. *See supra* notes 128-130 and accompanying text.

137. *See* Manne, *Our Two Corporation Systems*, *supra* note 4, at 268-69; R. POSNER, *supra* note 6, at 384.

questionable. First, creditor protections under corporation statutes (relating, for example, to dividend payouts) do not go much further than fraudulent conveyance statutes applicable to all firms.[138] Second, the creditor's contract could always be enforced according to its terms by applying the corporate provisions to firms that represent themselves to be corporations.

Moreover, even if the misrepresentation could be characterized as material, most creditors are not injured by it. If *T* never seeks the supposed record that would be provided by incorporation, *T* has not been injured by the nonexistence of a record; and *T* has not been injured if the firm actually incorporates soon after the transaction, or at least prior to the time of collection.

E. Summary

There is no justification for requiring compliance with filing requirements as an absolute prerequisite to enforcing limited liability contracts, except perhaps to the extent that the parties' dealings would lead creditors to expect that a filing had been made. Even in this situation, the justification for an incorporation requirement is weak. In other words, limited liability contracts generally should be enforced even absent state filing.

IV. LEGAL RECOGNITION OF LIMITED LIABILITY WITHOUT INCORPORATION

This Part shows that the courts have recognized limited liability by informal contract in many situations. Case law restrictions on limited liability can be explained on efficiency grounds rather than by any general judicial hostility to informal limited liability. Thus, the positive law supports the normative conclusion of Parts II and III that there is no justification for mandatory rules restricting the availability of limited liability.

A. Nonrecourse Contracts

Suppose *A* Company, an unincorporated business, borrows money from *T* under a note specifying that *T* can collect the note only from all or certain assets of *A* Company, and may not collect from *A* Company's owner, *P*.

At one time even such an explicit nonrecourse agreement might not have been enforced on the ground that personal liability under

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138. *See supra* notes 128-130 and accompanying text.

partnership law is absolute short of incorporation.[139] In *Fisheries Co. v. McCoy*,[140] the court held the trustees of a business trust liable for personal injury to an employee although as consideration for his employment, the employee had agreed in writing to look only to the company's assets for any debts or damages. The court said: "In this case there is no corporation, so [the trustees] were masters personally, regardless of how explicitly they might have expressed an intention to employ only in a representative capacity. They could not change their legal status by contract."[141]

Refusal to enforce explicit nonrecourse agreements, however, can be rationalized only on the basis that the corporate privilege must be conferred by the state rather than by private agreement. Accordingly, modern cases support enforcement of these agreements.[142]

B. Signalling, Knowledge and Notice of Nonrecourse Agreements

Even if explicit nonrecourse agreements are enforced, incorporation arguably remains useful as a cheap way of contracting for limited liability. It is important, therefore, to consider legal impediments that might raise the costs of contracting for limited liability without incorporation.

A firm's residual claimants clearly cannot obtain limited liability merely by specifying in their agreement that they are not personally liable for debts.[143] Nor does the limited liability agreement neces-

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139. For a discussion of the English law, see Butler, *England*, *supra* note 15, at 181.

140. 202 S.W. 343 (Tex. Civ. App. 1918).

141. *Id.* at 348.

142. *See* E. WARREN, *supra* note 46, at 367; Blumberg, *Limited Liability and Corporate Groups*, 11 J. CORP. L. 573, 582 n.35 (1986) (citing early cases enforcing limited liability clauses in insurance policies). Indeed, the courts have enforced nonrecourse contracts even where the effect was to avoid liability that otherwise would be imposed on corporate principals by statute. *See* Preston v. Howell, 219 Iowa 230, 257 N.W. 415 (1934); Continental Corp. v. Gowdy, 283 Mass. 204, 186 N.E. 244 (1933). Both of these cases involved nonrecourse against directors. For a discussion tracing English recognition of informal limited liability contracts, see Butler, *England*, *supra* note 15, at 181-82.

It is true that any firm that conforms to the definition in § 6(1) of the Uniform Partnership Act arguably would be a partnership unless, pursuant to § 6(2), it is formed under some other statute. UNIF. PARTNERSHIP ACT § 6(1), (2), 6 U.L.A. 22 (1916). If the firm is a partnership, the members arguably would be personally liable under § 15 of the Uniform Partnership Act, which is not qualified by any opting-out language. *Id.* § 15, 6 U.L.A. 174. But opting-out language in the Uniform Partnership Act generally refers to the partners alone, and the lack of such language in a provision applying to creditors should not be interpreted to invalidate a contrary agreement to which creditors consent.

143. Similarly, an agreement among parties to a firm that they are not partners does not bind third parties. *See* 1 A. BROMBERG & L. RIBSTEIN, *supra* note 35, § 2.05(c), at 2:38-2:39.

sarily become binding if it has been recorded publicly because the plaintiff may not know of the need to check the record.[144]

But a plaintiff who has contracted with knowledge of the limited liability agreement is generally bound by the limitation of liability.[145] Thus, if a creditor extended credit to "*P* Company, a Limited Liability Company," there is authority supporting limited liability for the principals of *P* Company even absent any further agreement with *T*.[146]

Moreover, the agreement can be signalled other than through explicit reference to the limited liability nature of the company. This is arguably the function of the listing of "protected relationships" in Uniform Partnership Act section 7(4):[147] by adopting clear indicia of a debtor-creditor, employee-employer or other relationship listed in that subsection, *P* serves notice to those contracting with the firm that she is not a partner.

C. Undisclosed Principals

One method of entering into a limited liability contract might be for the principal to remain behind the scenes so that the creditor could be said to be contracting only with the agent. Nevertheless, the well-established legal rule is that the principal *P*, although undisclosed at the time of the contract, is liable to the creditor.[148] The

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144. *See* Allegheny Tank Car Co. v. Culbertson, 288 F. 406 (N.D. Tex. 1923).

145. *See* McCarthy v. Parker, 243 Mass. 465, 138 N.E. 8 (1923). This is consistent with the established principle in partnership law that a third party is bound by limitations on a partner's or agent's authority of which she has knowledge. *See* UNIF. PARTNERSHIP ACT § 9(1), (4), 6 U.L.A. 132-33 (1916); 1 A. BROMBERG & L. RIBSTEIN, *supra* note 35, § 4.02(c), at 4:22-4:24. *But see* Thompson v. Schmitt, 115 Tex. 53, 274 S.W. 554 (1925). The *Thompson* court held that plaintiffs could recover against the holder of a beneficial interest in a business trust despite their knowledge of the provisions of a publicly recorded trust instrument providing that the holders shall not be held individually liable. The concession approach appears to explain the result: the court noted the state policy requiring formation of a limited partnership in order for partners to limit their liability. *Id.* at 68, 274 S.W. at 559.

146. *See* Bank of Topeka v. Eaton, 100 F. 8, 9 (1900), *aff'd*, 107 F. 1003 (C.C.D. Mass. 1901); East River Sav. Bank v. Samuels, 284 N.Y. 470, 478, 31 N.E.2d 906, 910 (1940).

147. *See* UNIF. PARTNERSHIP ACT § 7(4), 6 U.L.A. 39 (1916); *see also* text accompanying note 105.

148. *See* RESTATEMENT (SECOND) OF AGENCY § 186 (1958); Barnett, *Squaring Undisclosed Agency Law with Contract Theory*, 75 CAL. L. REV. 1969 (1987); Lewis, *The Liability of the Undisclosed Principal in Contract*, 9 COLUM. L. REV. 116 (1909); Mechem, *The Liability of an Undisclosed Principal*, 23 HARV. L. REV. 513, 515 (1913) (describing rule as "well settled"). For some cases recognizing liability of an undisclosed principal, see Davis v. Childers, 381 So. 2d 200 (Ala. Civ. App. 1979); Bertram Yacht Sales, Inc. v. West, 209 So. 2d 677 (Fla. Dist. Ct. App. 1968); Amortibanc Inv. Co., Inc. v. Rampart Assoc. Mgt. Inc., 6 Kan. App. 2d 227, 627 P.2d 389 (1981). For a comparative law approach showing that differ-

rule has been described as an "anomaly."[149] The rule is interesting for present purposes because, in the absence of other apparent explanations, it seems to be based on the theory that limited liability is a state-conferred privilege.

The explanations of the rule that have been proposed so far are unsatisfactory. The *Restatement* rationalizes the liability on the basis of the principal's right to control the agent.[150] While this theory makes sense as a default bargain,[151] it should not prevent the parties from contracting around the default.

The liability of the undisclosed principal was explained by Randy Barnett on the basis of a "consent" theory of contract.[152] Professor Barnett argues that *P*'s liability makes sense because *P* has consented to the transfer of rights to *A*, who is then empowered by virtue of this consent to transfer the rights to *T*.[153]

The problem with the consent rationalization is that it mistakes what *P* has consented to. *T* arguably has agreed to look only to *A* for collection and to charge an interest rate that reflects the risk of looking to *A*'s assets. This interest rate may be higher than the rate *T* would charge if *T* could look to *P*'s assets for collection.[154] *P*, as the residual claimant, ultimately bears this higher rate. Thus, *P* has consented only to a particular tradeoff of a higher cost of credit[155] for immunity from liability—just as in any limited liability contract. *P* has not consented in any realistic sense to a liability to *T*. In short, *P* should not be held liable, because liability is inconsistent with any contract between *T* and *P*.

Professor Barnett rejects what he calls the "bargain" theory of contract,[156] and argues that the failure of the bargain theory to explain the undisclosed principal cases shows the "weakness" of this

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ent legal systems have reached similar results, see Mueller-Frienfels, *Comparative Aspects of Undisclosed Agency*, 18 MOD. L. REV. 33 (1955).

149. RESTATEMENT (SECOND) OF AGENCY § 186, comment a (1958).

150. *Id.*

151. *See supra* section II(B)(1).

152. *See* Barnett, *supra* note 148, at 1978-84.

153. *Id.* at 1980-84.

154. If *T* had contracted with *A* acting on behalf of a disclosed principal, *T* could look only to *P* for collection. *See* RESTATEMENT (SECOND) OF AGENCY §§ 320-321 (1958) (liability of an agent for a disclosed or partially disclosed principal).

155. *P* may have gotten more favorable terms from *T* by virtue of being undisclosed if, for example, *T* would have increased its price had it known it was dealing with *P*. This alone does not justify imposing liability on *P* contrary to its contract with *T*. *See infra* note 165.

156. *See* Barnett, *A Consent Theory of Contract*, 86 COLUM. L. REV. 269, 287-89 (1986).

theory.[157] While the bargain theory may be correct and the undisclosed principal cases wrong, Barnett argues plausibly that a well-entrenched legal rule should be accorded some weight by legal theorists.[158] The question is whether there is some other explanation for undisclosed principal liability than Barnett's constricted consent theory.

In fact, a strong efficiency-based argument can be made for undisclosed principal liability. First, it is important to note that in the usual undisclosed principal case, the agent is liable to the third party.[159] If the agent's acts were authorized, the principal ordinarily would have a duty to indemnify the agent or the agent's bankrupt estate.[160] Thus, where the agent is authorized, the undisclosed principal's liability avoids a circularity of action.

An argument for liability also exists in some cases where *A* is unauthorized. Liability cannot necessarily be explained here by the "circularity" argument because the principal probably has no duty of indemnification.[161] Nor can it be explained by application of apparent authority, since the agent is not acting "professedly as agent" for another,[162] or on the basis of the principal's consent.[163] But liability may be justified as what Ian Ayres and Robert Gertner call a "strong" default, in which the principal has the burden of ex-

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157. *See* Barnett, *supra* note 148, at 1977. Barnett also shows how other contract theories he has rejected—will, reliance, and substantive fairness—fail to explain undisclosed principal liability. *Id.* at 1974-77. He notes how an efficiency theory might explain undisclosed agency law on the basis of overcoming "hold-out" problems arising out of *T*'s seeking to exploit its leverage in dealing with *P*. *Id.* at 1976-77. This dubiously assumes that it is efficient to permit nondisclosure or misrepresentation by one party to a contract to overcome the other party's bargaining leverage.

158. *See id.* at 2001. *See also* Clark, *Contracts*, *supra* note 11, at 1737 (rules supported by "tradition" are entitled to respect). For theories of why the common law can be expected to produce generally efficient outcomes, see generally Priest, *The Common Law Process and the Selection of Efficient Rules*, 6 J. LEG. STUD. 65 (1977); Rubin, *Why is the Common Law Efficient?*, 6 J. LEG. STUD. 51 (1977).

159. *See supra* note 154.

160. *See* RESTATEMENT (SECOND) OF AGENCY § 438 (1958) (giving the agent a right of indemnification where it is "fair" that the principal should bear the loss, subject to contrary agreement).

161. *See id.* § 440 (no duty to indemnify for a loss that does not benefit the principal and that results from the agent's "fault").

162. *See id.* § 8.

163. Professor Barnett justifies liability where *P* has received possession of the goods through *A*, and has a duty to make restitution because of his consent to an agency relationship. *See* Barnett, *supra* note 148, at 1997-99. But this does not explain the broader rule, which would hold *P* liable for breach of *A*'s contract to buy goods that were not delivered, or where *A* used the goods for his own benefit. For an example of liability in the latter situation, see Morris Oil Co., Inc. v. Rainbow Oilfield Trucking, 106 N.M. 237, 741 P.2d 840 (1987).

plicitly contracting with the third party agent around the personal liability default in order to force the principal to reveal information to the third party.[164] The strong default is needed because parties extending credit to agents of undisclosed principals lack critical information relevant to assessing the risk of nonrepayment of the debt: a party who has the power to control the agent's use of the funds has incentives to take risks that are excessive from the third party's perspective.[165]

To see why a strong default is justified, consider the effect of a rule limiting the liability of undisclosed principals. *T* could charge *A* based on the increased cost of debt attributable to *P*'s limited liability *unless A* identified itself as *not* acting for an undisclosed *P*. But it is more likely that *T*s would charge *all A*s the same cost of credit because of the high cost of determining the truth of *A*'s representation. This would deter some dealings with parties who might be agents, as well as permit some undisclosed *P*'s to externalize costs. The undisclosed principal rule avoids these problems by giving undisclosed *P*'s the incentive to identify themselves.[166] Thus *T* can charge a cost of credit that is based on the assumption that parties in control are personally liable for the debts of the firm.

A possible problem with this rationale is that it seems anomalous that *A* would tolerate control by the undisclosed principal if *A* bears the risk of personal liability. This explains why *P*'s liability for

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164. *See* Ayres & Gertner, *supra* note 77, at 123-29. Ayres and Gertner cite other reasons for strong defaults—forcing the parties to define terms in order to save judicial resources, and discouraging contracts that generate externalities. The information-revealing rationale is the only one that appears applicable to the present situation.

165. The strong default is not, however, justified to compel *P* to reveal its identity where *T* might refuse to deal with *P* or charge more if it knew it was dealing with *P*. For cases refusing to redress any injury to *T* arising out of this fact pattern, see Kelly Asphalt Block Co. v. Barber Asphalt Paving Co., 211 N.Y. 68, 105 N.E. 88 (1914) (contract enforceable against *T* despite *T*'s argument that it would have refused to deal with *P*, its competitor); Senor v. Bangor Mills, 211 F.2d 685 (3d Cir. 1954) (*T* could not recover against undisclosed *P* for *A*'s unauthorized contract; *P* deliberately hid its identity because *T* would have charged more if it had known it was dealing with *P*). In this situation, because *T* is aware of the ubiquitous possibility of assignment of the contract to a third party, and because sellers generally bear the risk that their buyers might have paid more, there is no material nondisclosure. *See* Barnett, *supra* note 148, at 1989-92. Also, requiring *P* to disclose its identity would reduce *P*'s incentive to acquire the resources that made its bargaining position advantageous, as where a noted mining engineer seeks to buy land with suspected mineral resources. *See* Ayres & Gertner, *supra* note 77, at 128. Thus, forcing disclosure relevant to bargaining position, unlike forcing disclosure relevant to the agency costs of debt, may be inefficient.

166. The rule would probably not force disclosure by purchasers who are hiding in order to secure a favorable price (*see supra* note 165) because such a buyer would not be concerned about exposure to liability.

unauthorized acts is limited to the situation where the agent has been placed in apparent charge of a business actually owned by the principal, and has acted generally within the scope of the business.[167] *P*'s liability makes sense because the agent in apparent charge and without a stake in the business has little incentive to avoid risk. These facts are hidden from *T* who therefore does not take into account the increased riskiness of the debt when setting the price of its credit. Thus, the rule imposing liability gives *P* the incentive to minimize risks to the third party. Without explicitly contracting with the third party, *P* cannot limit its duty by placing narrow limits on the agent's authority.

The theory of undisclosed principal liability articulated here also explains the seemingly peculiar rules regarding election of remedies. *T* cannot obtain joint judgments against both *A* and *P* even if *T* collects only a single inadequate recovery from *A*. If *T* proceeds against *A* after *P* is identified, *T* is barred from later proceeding against *P*, even if *T* fails to obtain satisfaction from *A*.[168] Although the rule has been sharply criticized,[169] it is sound. *P* is liable only because it has not contracted around the default rule. *P* has the burden of contracting around this rule because otherwise *T* erroneously assumes that it is contracting with a principal. *T* may reject the benefit of this rule and recover on the basis of the apparent contract binding *A*. But *T* should not get a better bargain than it thought it had made by being permitted to proceed against the assets of both *A* and *P*.

In summary, the undisclosed principal's liability accords with general contract policies. It does not indicate judicial support for

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167. *See* RESTATEMENT (SECOND) OF AGENCY § 195 (1958). *See also id.* § 194 (liability of undisclosed principal for unauthorized acts of general agent). For a leading case involving liability in this situation, see Watteau v. Fenwick [1893] 1 Q.B. 346. *A* was placed in apparent charge of a hotel and tavern with his name above the door, but with instructions to buy only beer and ale. Principal was bound by *A*'s purchase of other supplies reasonably related to operation of the tavern.

168. *See, e.g.*, Wilkerson v. Stevens, 16 Utah 2d 173, 397 P.2d 983 (1965). The rule has been qualified in several states: *T* must elect only after the agency issue has been determined, and then only if *P* has not waived its right to compel election. *See* Davis v. Childers, 381 So. 2d 200 (Ala. Ct. App. 1979); Amortibanc Inv. Co., Inc. v. Rampart Assoc. Mgt. Inc., 6 Kan. App. 2d 227, 627 P.2d 389 (1981).

169. *See* Richmond, *Scraping Some Moss from the Old Oaken Doctrine: Election Between Undisclosed Principals and Agents and Discovery of Their Net Worth*, 66 MARQ. L. REV. 745 (1983); Sargent & Rochvarg, *A Reexamination of the Agency Doctrine of Election*, 36 U. MIAMI L. REV. 411 (1982). There seems to be a trend toward rejection of the election rule. *See* Grinder v. Bryans Road Bldg. & Supply Co., 290 Md. 687, 432 A.2d 453 (1981); Engelstad v. Cargill, Inc., 336 N.W.2d 284 (Minn. 1983); Crown Controls, Inc. v. Smiley, 110 Wash. 2d 695, 756 P.2d 717 (1988).

the theory that limited liability is a state-conferred privilege that is unavailable by private contract.

D. Promoter Liability

A promoter of a new venture who contracts on behalf of a corporation to be formed is not personally liable if the creditor agrees to look only to the corporation-to-be either from the time of the contract or from the time that the corporation is formed.[170] Thus, the limited liability contract is enforced even without a state filing.

More surprising and troubling from the standpoint of the contract theory of limited liability are the many cases holding promoters liable.[171] While these cases reason that the parties did not intend to limit the promoters' liability, the contract language often clearly reflects that the promoter was acting for a corporation-to-be and thus apparently did not intend to take on personal liability exposure. Liability therefore seems to be based on the theory that limited liability is a corporate privilege that can be obtained only by incorporation.[172]

In fact, the courts' reluctance to exonerate the promoter is consistent with the parties' intent. A contract entered into by the promoter for a "corporation-to-be" is ambiguous both as to whether there is a present obligor and as to what happens when the corpora-

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170. For some cases holding that the promoter is not personally liable, see Quaker Hill v. Parr, 148 Colo. 45, 364 P.2d 1056 (1961); Stap v. Chicago Aces Tennis Team, Inc., 63 Ill. App. 3d 23, 379 N.E.2d 1298 (1978); Isle of Thye Land Co. v. Whisman, 262 Md. 682, 279 A.2d 484 (1971); Sherwood & Roberts-Oregon, Inc. v. Alexander, 269 Or. 389, 525 P.2d 135 (1974); Company Stores Dev. Corp. v. Pottery Warehouse, Inc., 733 S.W.2d 886 (Tenn. Ct. App. 1987); Aloe Ltd., Inc. v. Koch, 733 S.W.2d 364 (Tex. Ct. App. 1987); Betchard-Clayton, Inc. v. King, 41 Wash. App. 887, 707 P.2d 1361 (1985).

171. *See* Surovcik v. D & K Optical, Inc., 702 F. Supp. 1171 (M.D. Pa. 1988); Stanley J. How & Assocs., Inc. v. Boss, 222 F. Supp. 936 (S.D. Iowa 1963); *In re* Olsen, 6 Bankr. 255 (M.D. Fla. 1980); Malisewski v. Singer, 123 Ariz. 195, 598 P.2d 1014 (1979); Coopers & Lybrand v. Fox, 758 P.2d 683 (Colo. Ct. App. 1988); LeZontier v. Shock, 78 Mich. App. 324, 260 N.W.2d 85 (1977); Jacobson v. Stern, 96 Nev. 56, 605 P.2d 198 (1980); Skandinavia, Inc. v. Cormier, 218 N.H. 215, 514 A.2d 1250 (1986); Smith v. Morgan, 50 N.C. App. 208, 272 S.E.2d 602 (1980); RKO-Stanley Warner Theatres, Inc. v. Graziano, 467 Pa. 220, 355 A.2d 830 (1976); Herbert v. Boardman, 134 Vt. 78, 349 A.2d 710 (1975); Goodman v. Darden, Doman & Stafford Assoc's, 100 Wash. 2d 476, 670 P.2d 648 (1983).

172. For an article criticizing the courts' unwillingness to limit the promoter's liability as contrary to the parties' expectations, see Kessler, *Promoters' Contracts: A Statutory Solution*, 15 RUTGERS L. REV. 566 (1961). Ayres and Gertner, *supra* note 77, at 120-21, note that the *How* case exemplifies the difficulty of negating the personal liability default, but they do not give a rationale for the difficulty. The case does not seem to fit any of their explanations for "strong" defaults: externalities, incentive to disclose information, or conserving judicial resources.

tion is formed. If the corporation is formed prior to plaintiff's claim, this would seem to resolve the first ambiguity. But plaintiff probably does not intend to accept *any* firm—regardless of how it is capitalized and when it is formed—as a substitute for the promoter.[173] In fact, the probable reason why there was no incorporation at the time of the contract despite the fact that incorporation is a simple formality is that the business had not been formed. Unconditional limited liability for the promoter therefore significantly differs from recognizing limited liability of a firm that exists, and consequently can be appraised by the creditor, at the time of the contract. Accordingly, it is not surprising that the courts have insisted on strong evidence[174] that the plaintiff intended to look only to the corporation.[175]

The problem of determining the parties' intent is illustrated by the often-cited cases of *Stanley J. How & Associates, Inc. v. Boss*[176] and *Quaker Hill, Inc. v. Parr*.[177] In *How*, the plaintiff architect contracted to furnish plans for a hotel. The contract was with "Owner: . . . Edw. A. Boss By: Edwin A. Boss, agent for a Minnesota corporation to be formed who will be the obligor."[178] Despite this seemingly clear language, the court held Boss individually liable. The court stressed that the contract called for plaintiff to begin work and to begin receiving payments soon after the contract was entered into.[179] Moreover, only an Iowa corporation named "Minneapolis-Hunter Hotels Co." was formed—there was no evidence that this corporation had a charter or bylaws, and it had no assets at the time of plaintiff's action.[180] On the other hand, in *Quaker Hill*, the court

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173. Thus, assumption of liabilities by a partnership's successor—including by a corporate successor—usually does not relieve the partners of liability. *See* UNIF. PARTNERSHIP ACT § 36, 6 U.L.A. 436 (1969); 2 A. BROMBERG & L. RIBSTEIN, *supra* note 35, § 7.14 (continuing liability of partners after dissolution); *see id.* § 7.21 (effect of incorporation on existing liabilities).

174. *See, e.g.*, Goodman v. Darden, Doman & Stafford Assocs., 100 Wash. 2d 476, 480, 670 P.2d 648, 651 (1983) (finding a "strong inference" that plaintiff intended to contract with an existing party).

175. In RKO-Stanley Warner Theatres, Inc. v. Graziano, 467 Pa. 220, 355 A.2d 830 (1976), Judge Manderino dissented from a decision holding the promoter liable, opining that the rationality of plaintiff's bargain was not at issue and that plaintiff could have protected himself. *Id.* at 225, 355 A.2d at 835 (Manderino, J., dissenting). *See also* Kessler, *supra* note 172, at 574. Nevertheless, if the agreement is ambiguous, the rationality of a particular interpretation bears on the parties' intent. In fact, the RKO dissent may have been correct given the circumstances of that case. *See infra* note 182.

176. 222 F. Supp. 936 (S.D. Iowa 1963).

177. 148 Colo. 45, 364 P.2d 1056 (1961).

178. 222 F. Supp. at 938.

179. *Id.* at 941.

180. *Id.* at 939.

held against promoter liability where *T* had clearly insisted on an immediate contract with a corporation-to-be, despite the fact that, as in *How*, a corporation with a different name was formed and it never functioned.[181]

These cases suggest that there is more ambiguity in the contract than might first appear from the "corporation-to-be" language, and that the cases involve a fact-specific inquiry as to the parties' intent. While there are occasional aberrations[182] the cases holding promoters liable do not support the state-privilege theory of limited liability.

E. Corporation by Estoppel

Suppose *T* enters into a contract with *P* Corporation, unaware that *P* Corporation has not yet been incorporated. While this is often referred to as a "corporation by estoppel," it is more accurately characterized as a contract for limited liability between *T* and the principals of *P* Corporation. This contract is less ambiguous than the promoter contracts because *T* clearly intended to contract only with a corporation. Nevertheless, the rule persists today by statute in many jurisdictions that those "assuming" or "purporting" to act in the name of a corporation that they know has not been formally incorporated are personally liable to creditors with whom they contract.[183] This rule has led to results that were surprising

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181. 148 Colo. at 51, 364 P.2d at 1059 (1961).

182. A prominent example is RKO-Stanley Warner Theatres, Inc. v. Graziano, 467 Pa. 220, 355 A.2d 830 (1976), in which the promoter was held liable although the contract clearly provided that upon formation of the corporation, the contract should be construed to have been made with the corporation and subsequently the corporation was formed. *Id.* at 227, 355 A.2d at 834.

183. *See, e.g.*, REVISED MODEL BUSINESS CORP. ACT § 2.04 (1984), which provides: "All persons purporting to act as or on behalf of a corporation, knowing there was no incorporation under this Act, are jointly and severally liable for all liabilities created while so acting." For examples of cases applying this theory, see Keene v. National Medical Care, Inc., 700 F. Supp. 458 (E.D. Ark. 1988); Booker Custom Packing Co., Inc. v. Sallomi, 149 Ariz. 124, 716 P.2d 1061 (1986); Robertson v. Levy, 197 A.2d 443 (D.C. 1964); Ratner v. Central Nat'l Bank of Miami, 414 So. 2d 210 (Fla. Dist. Ct. App. 1982), *review denied*, 424 So. 2d 762 (1982); Echols v. Vienna Sausage Mfg. Co., 162 Ga. App. 158, 290 S.E.2d 484 (1982); Minich v. Gem State Developers, Inc., 99 Idaho 911, 591 P.2d 1078 (1979); Timberline Equip. Co., Inc. v. Davenport, 267 Or. 64, 514 P.2d 1109 (1973); Sterling Press v. Pettit, 580 P.2d 599 (Utah 1978).

For the analogous theory in the limited partnership setting, see UNIF. LIMITED PARTNERSHIP ACT § 304, 6 U.L.A. 317 (1985 & Supp. 1990) (providing one who invests in a business erroneously believing it is a limited partnership may be liable under certain circumstances).

Note that the purporting-to-act provision arguably applies even in the promoter situation, where plaintiff knows no corporation has been formed. The official comment

and clearly contrary to the expectations of both parties.[184]

Refusal to enforce the apparent limited liability contract is not justified on the ground that *T* has been injured by the misrepresentation of *P* Corporation's status, because the misrepresentation is probably immaterial and rarely harmful.[185]

This leaves the explanation that refusal to enforce the contract in the absence of compliance with statutory formalities is based solely on state's assertion of monopoly power to create corporate terms. Indeed, this explanation is reflected in the official comment to section 2.04 of the Revised Model Business Corporation Act, which imposes liability on those who act as a corporation without incorporation: "[T]o recognize limited liability in this situation threatens to undermine the incorporation process, since one then may obtain limited liability by consistently conducting business in the corporate name."[186]

The refusal to enforce the limited liability contract in this situation has been criticized by commentators.[187] Moreover, the courts have interpreted the statute narrowly, recognizing limited liability

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to § 2.04 suggests that defendants may not be liable only in the specific situation where the plaintiff has urged defendant to contract in the name of the nonexistent corporation, and cites as an example *Quaker Hill v. Parr*. REVISED MODEL BUSINESS CORP. ACT § 2.04 official comment (1984). *See also supra* text accompanying notes 177-181. However, this ignores the limited liability contract that may exist in other situations. *See supra* notes 137-138 and accompanying text. For a case holding that the predecessor to REVISED MODEL BUSINESS CORP. ACT § 2.04 does not apply to promoter cases, see Sherwood & Roberts-Oregon, Inc. v. Alexander, 269 Or. 389, 395, 525 P.2d 135, 138 (1974) (reasoning that the statute did not unambiguously reverse the common-law rule enforcing the contract).

184. *See* T-K Distrib., Inc. v. Soldevere, 146 Ariz. 150, 704 P.2d 280 (1985) (defendants held personally liable for debt incurred during brief period of revocation of charter for failure to file a report and pay a fee, where neither party was aware of the revocation); Thompson & Green Machinery Co., Inc. v. Music City Lumber Co., Inc., 683 S.W.2d 340 (Tenn. Ct. App. 1984) (both parties believed the company was incorporated, and in fact it was incorporated the day after the promissory note was signed).

185. *See supra* subpart III(c).

186. REVISED MODEL BUSINESS CORP. ACT § 2.04, official comment, illustration 4 (1984). *See also* Dodd, *Partnership Liability of Shareholders in Defective Corporations*, 40 HARV. L. REV. 521, 551, 557 (1927). Dodd also noted that partnership liability in defective corporations is compelled by the "fundamental principle" that liability follows ownership rights—a clear rejection of the contractual nature of the owners' liability. *Id.* at 550.

There is also an historical precedent that supports this explanation: The English Bubble Act was passed in 1720 specifically to protect the South Sea Company from competing joint stock companies and to protect Parliament's monopoly on corporate privileges. *See* E. WARREN, *supra* note 46, at 329; Butler, *England*, *supra* note 15, at 171-73.

187. *See* LATTIN, CORPORATIONS 197 (1971) (estoppel accords with the parties' expectations, and the state lacks a "vital interest in having exact specification of corporate existence complied with"; but incorporation by general act was originally treated suspiciously); Magruder, *A Note on Partnership Liability of Stockholders in Defective Corporations*, 40

consistent with the parties' expectations whenever such a result was not specifically precluded by statute.[188] Indeed, one exhaustive survey of cases concluded that corporation-by-estoppel was a dominant approach in the case law prior to the general emergence of statutory provisions outlawing the theory.[189]

It is significant that nonrecognition of limited liability is supported solely by statute: there is no long common-law tradition that might lend some normative support to the rule.[190] Nor does the state competition for charters demonstrate the efficiency of the purporting-to-act statutes. The states' competition for chartering business, viewed in light of capital market and other constraints on firms to adopt efficient governance terms, generally helps filter inefficient terms out of state corporation statutes.[191] But the chartering market may not effectively discipline purporting-to-act provisions. The statutes do not encourage paying customers (that is, incorporators) to incorporate elsewhere because the statutes do not penalize those who unknowingly fail to comply.[192] Moreover, these provisions have an anti-competitive effect in that they help preserve the states' monopoly over corporate terms by preventing competition by pri-

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HARV. L. REV. 733, 744 (1927) (noting that the sole basis of refusing to enforce the contract is that limited liability is a jealously guarded privilege).

188. *See, e.g.*, Cranson v. International Business Machs. Corp., 234 Md. 477, 200 A.2d 33, 39 (1964); Harry Rich Corp. v. Feinberg, 518 So. 2d 377 (Fla. Dist. Ct. App. 1987) (interpreting an assuming-to-act statute as not imposing liability where defendant did not know of the failure to incorporate); H.F. Phillipsborn & Co. v. Suson, 59 Ill. 2d 465, 322 N.E.2d 45 (1974); Sherwood & Roberts-Oregon, Inc. v. Alexander, 269 Or. 389, 525 P.2d 135 (1974) (holding that promoters were not liable on a note despite an assuming-to-act statute); Molander v. Raugust-Mathwig, Inc., 44 Wash. App. 53, 722 P.2d 103 (1986).

189. *See* Frey, *Legal Analysis and the 'DeFacto' Doctrine*, 100 U. PA. L. REV. 1153, 1162 (1952) (finding that courts often refused to impose liability on the owners of defective corporations where the parties dealt on a corporate basis, although they often rationalized this result in terms of the "de facto corporation" doctrine).

190. *See supra* note 158.

191. *See* R. WINTER, GOVERNMENT AND THE CORPORATION 6-11, 69-70 (1978). For data supporting this view, see Dodd & Leftwich, *The Market for Corporate Charters: "Unhealthy Competition" Versus Federal Regulation*, 53 J. BUS. 259 (1980).

192. *See* REVISED MODEL BUSINESS CORP. ACT § 2.04, official comment (1984). Interestingly enough, Delaware does not provide for purporting-to-act liability. Title 8, section 106 of the Delaware Code simply specifies when the corporation comes into existence, and says nothing about noncorporate limited liability contracts. DEL. CODE ANN. tit. 8, § 106 (1983). As the national leader in the state chartering competition, Delaware has fashioned what is predominantly an enabling statute that accommodates rather than restricts private ordering. Accordingly, Delaware has least to fear from competition by noncorporate forms. It may also be significant that Delaware attracts larger-capitalization firms in which problems concerning formalities and pre-incorporation transactions are least likely to arise.

vate ordering alternatives. Those who seek corporate features, particularly including limited liability, must pay franchise taxes and deal with state legislators for changes in the statutes.

Thus, the purporting-to-act restriction on limited liability contracts is an attempt by state legislatures to guard their franchises and demonstrates the regulatory theory of the corporation in action. However, even here the overall dominance of the contract theory is evident: these restrictions have no case law support independent of the statute and can easily be avoided by firms that seek limited liability other than by doing business as a "corporation."

F. Formal Noncorporate Limited Liability Firms

State statutes provide for several different types of noncorporate limited liability firms. The most prominent variations are the limited partnership,[193] the business trust,[194] and the limited liability company.[195] Some statutes providing for limited liability companies are similar to limited partnership statutes except that they loosen some of the restrictions of that form, for example, by allowing limited partners to participate in management without losing their limited liability status.[196] In all cases, the statutes provide that the firm may be formed only by a state filing rather than solely by private contract.

These statutory limited liability forms illustrate three important points about regulation of limited liability. First, they show that filing requirements persist—in the absence of any possible efficiency justification—merely to maintain the fiction of state control over

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193. Most states have adopted the REVISED UNIF. LIMITED PARTNERSHIP ACT, 6 U.L.A. 226 (1976 & Supp. 1990). For a listing of these states, see *id.* at 226-27. The original 1916 version of § 6 of the Uniform Limited Partnership Act is still in effect in a few states. For a listing of these states, see UNIF. LIMITED PARTNERSHIP ACT, 6 U.L.A. 179, 179 (1916 & Supp 1990).

194. *See* DEL. CODE ANN. tit. 6, §§ 3801-15 (1983); FLA. STAT. § 609 (1977); MASS. GEN. L. ch. 182, §§ 1-14 (1987).

195. *See* COLO. REV. STAT. § 7-80-101 *et. seq.* (Supp. 1990); FLA. STAT. § 608 (1990); 1990 Kan. H.B. 3064; WYO. STAT. §§ 17-15-101 to -136 (1977). *See generally* Hamill, *supra* note 51; Comment, *The Limited Liability Company Act*, 11 FLA. ST. L. REV. 387 (1983). Limited liability statutes have been proposed in several other states, and are being studied by an American Bar Association subcommittee.

As discussed *supra* note 51, limited liability company statutes are also more restrictive in some respects than limited partnership statutes—as by mandating nontransferability of interests—in order to ensure compliance with mandatory tax classification rules.

196. *See* FLA. STAT. §§ 608.424, .436 (1990); WYO. STAT. §§ 17-15-113, -116 (1977). For discussions of the control rule applicable to limited partnerships, see *supra* text accompanying notes 53, 114-116.

corporate terms. Delaware's statutory filing requirement for business trusts cannot be explained as providing for gap-filling, disclosure or signalling.[197] Nor does the statute restrict the form of the business in any material way or include creditor-protection provisions such as limits on distributions.[198] In other words, creating a Delaware business trust is virtually identical to simply contracting with third parties as a "limited liability company." And yet a state filing nevertheless remains a prerequisite to limited liability for beneficiaries of a business trust.[199]

Second, the noncorporate standard forms illustrate the relationship between the common law and legislation in the preservation of the state legislative monopoly on corporate features. There might be no demand for these statutes or filings under them if the courts recognized the enforceability of private limited liability contracts.[200] While the courts have gone a long way in that direction,[201] statutes that provide for partnership liability as a residual term,[202] or impose liability for purporting to act as a corporation,[203] impede full recognition of private ordering. Until the courts finally and clearly interpret these provisions as not precluding enforceability of limited liability forms that are both noncorporate and nonstatutory, compliance with state filing remains a prudent course.

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197. *See* DEL. CODE ANN. tit. 6, § 3801-15 (1983). *See also supra* subparts III(B),(C).

198. *See* DEL. CODE ANN. tit. 6, § 3803 (1983). Under the common law, beneficiaries of a business trust are entitled to limited liability only if they do not participate in management. *See* Greco v. Hubbard, 252 Mass. 37, 44, 147 N.E. 272, 275 (1925); A. BROMBERG, CRANE & BROMBERG ON PARTNERSHIP 174 (1968); E. WARREN, *supra* note 46, at 384-98.

199. *See* DEL. CODE ANN. tit. 6, § 3801 (1983) ("business trust" defined to include only firms that have filed a certificate); Hausam v. Ticor Title Ins. Co., 99 Or. App. 533, 783 P.2d 39 (1989) (trustees of business trust held personally liable for debts where no statutory filing was made). Indeed, the beneficiaries may be even worse off under the statute than they were under the common law, since they might be held liable for failing to file even if they lack partnership-type control.

200. There is also a possible federal tax explanation for the statutory forms. The tax distinction between corporate and noncorporate firms (*see supra* text accompanying notes 33-35) creates a market for noncorporate state statutory forms that clearly differentiates between the two. This raises the interesting question whether the tax distinction can be explained at least partly as a mechanism for maintaining the state monopoly on corporate features. It is noteworthy that, although the first limited liability company act was passed in Wyoming thirteen years ago, Internal Revenue Service rulings in the last two years classifying as partnerships for tax purposes companies formed under the Wyoming (*see* Rev. Rul. 88-76, 1988-2 C.B. 360) and Florida (*see* Priv. Ltr. Rul. 89-37-010 (June 16, 1989)) limited liability company acts suddenly have spurred action by bar groups seeking statutes in several other states.

201. *See supra* subparts IV(A)-(D).

202. *See supra* note 124.

203. *See supra* subpart IV(E).

Finally, the noncorporate standard forms show that an evolutionary process, operating through the common law and the state competition for franchise business, is breaking down barriers to private ordering. Judicial enforcement of private contracts providing for corporate features[204] provides an incentive for private parties to develop forms like the business trust. This creates a constituency pressing for legislative authorization. One result is a business trust statute in Delaware that leaves virtually no mandatory terms to be controlled by the legislature. Such a statute now gives other states the incentive to offer competing statutes so as not to lose franchise revenue.

The proliferation of noncorporate statutory forms like the Delaware business trust statute and limited liability company statutes that include few mandatory governance rules sets the stage for a test of the viability of the filing requirement. Courts may be persuaded to enforce nonfiled contracts absent any showing of efficiency reasons for the filing requirement. This would be similar to judicial recognition of private ordering in the close corporation following adoption of special close corporation legislation.[205] Thus, the business trust and limited liability company statutes may be intermediate steps on the road to full recognition of private ordering, just as special chartering was an intermediate step toward the development of general incorporation statutes.[206]

G. Summary

This Part has shown that the law widely recognizes limited liability without incorporation. The consensus of many courts that limited liability contracts should be enforced supports the normative conclusions in Parts II and III. The only significant departure from enforceability is the statutory prohibition of corporations-by-estoppel. These provisions have limited applicability, and can be explained as an attempt to preserve a shred of the state-privilege approach to incorporation. Increasing common law recognition of noncorporate limited liability firms is breaking down legislative control over corporate features. The recent Delaware business trust

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204. For a discussion of judicial recognition of contracts providing for corporate features other than limited liability, see *supra* notes 36-43 and accompanying text. Judicial recognition of private limited liability contracts is discussed *supra* at subparts IV(A)-(D).

205. *See supra* note 120 and accompanying text.

206. For a discussion of the history of the change in method of incorporation from special chartering to general incorporation statutes, see generally Butler, *England*, *supra* note 15.

statute demonstrates that the states are approaching full-fledged recognition of the contract theory of the corporation.

V. LIMITED LIABILITY AND INVOLUNTARY CREDITORS

Thus far, the discussion has assumed that the creditor voluntarily contracts with the corporation. This Part discusses limited liability with respect to involuntary creditors. It shows that limited liability in this situation, while obviously not the product of a contract with the creditor, is also not a state-conferred privilege. Subpart A discusses pure involuntary "tort" creditors such as taxi passengers and product consumers. Subpart B deals with "quasi-involuntary" creditors who technically have dealt with the firm but arguably have not bargained for limited liability.

A. Pure Involuntary Creditors

Suppose T^1 is hit by a speeding truck. The driver, A, is negligent and clearly is the "servant" of P^1.[207] By the law of agency, P^1 would be liable to T^1, and would have to use her personal assets to satisfy T^1's claim.[208] But if T^2 is hit under identical circumstances except that P^2 has incorporated his business, T^2 can claim only against the (perhaps minimal) assets of P^2's corporation.

P^2 seems to be the beneficiary of a state-conferred privilege of incorporation. But the following discussion shows that, as with restrictions on limited liability to contract creditors, the incorporation requirement in the tort context is merely a means to preserve the state's monopoly over corporate features.

First, the state filing is inconsequential to tort creditors. The filing does not ensure that the firm has adopted creditor-protection provisions,[209] and any disclosures resulting from the filing are useless to tort victims.

Second, there are efficiency reasons why the law should recognize limited liability to tort creditors solely on the basis of formation of a limited liability business even without a state filing. By virtue of taking on the status of a limited liability firm, the company must pay higher credit costs or undertake monitoring of its activities, or both, as a result of the firm's dealings with voluntary investors. This

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207. This means that A's physical conduct is subject to P's control or right of control, as distinguished from the more general power of control sufficient to create an agency. *See* RESTATEMENT (SECOND) OF AGENCY § 2 (1958) (distinguishing "servant" and "independent contractor").

208. *See id.* § 219 (liability of master for torts of servant).

209. *See supra* subpart III(B).

shows that tort risk will be sufficiently internalized that the benefits of limited liability outweigh its costs to involuntary creditors. In other words, it is the contractual relationship within the firm, and not the state filing, that justifies not holding the owners liable for torts.

Third, the law widely recognizes limited liability in informal noncorporate contractual relationships. An important example is the rule that principals are not liable for the torts of their agents who are "independent contractors" rather than "servants."[210] The independent contractor exception to tort liability rests not only on the substantive aspects of the degree or kind of control exercised by the principal, but also on a case-by-case review of the details of the contract between the principal and the independent contractor, including whether the agent has a "distinct occupation or business," the "method of payment, whether by the time or by the job," and "whether or not the parties believe they are creating the relationship of master and servant."[211] In other words, the structure of the private contract among the parties to the firm is controlling. The same reasoning would justify not extending tort liability to those who have contracted among themselves to be members of limited liability firms.

It is a separate question whether limited tort liability of corporate shareholders—with or without formal incorporation—is justifiable on efficiency grounds. The efficiency argument for limited tort liability is that the benefits of limited liability discussed in Part II—facilitating the development of an efficient market, separation of management and control, and risk diversification—offset costs imposed on tort creditors.[212] As suggested above, limited liability firms can be expected to internalize tort risks to some extent. Voluntary creditors, managers who have made human capital investments, and owners have the incentive to minimize exposure of their investments to liability risk by monitoring the use of these assets and by insuring themselves (thereby delegating monitoring functions to insurers).[213]

On the other hand, letting firms select limited tort liability by incorporating may be inefficient. Perhaps all limited tort liability

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210. *See* RESTATEMENT (SECOND) OF AGENCY § 220 (1958).

211. *Id.*

212. In other words, there is arguably efficiency in the Kaldor-Hicks sense. The parties in an "original position"—that is, not knowing whether they will be tort victims—arguably would favor a rule in which society as a whole is better off.

213. *See* Easterbrook & Fischel, *supra* note 6, at 107-09.

should be abolished on the ground that parties to firms are in a better position to insure than are potential tort victims. Maybe limited liability should be denied to firms that adopt limited liability only with respect to tort creditors or that have less than a minimal amount of capitalization or insurance. Otherwise, owners of these firms may have little incentive to insure or monitor. While some of these firms are one-employee operations whose owners would be personally liable for their own torts, many are not. The paradigm is the taxi cab firm consisting of several one-or-two-cab corporations all under common ownership.[214] Finally, tort creditors might be adequately protected by giving their claims super-priority in bankruptcy.[215]

The point here is not that tort claimants should not be protected, but rather that they gain nothing by requiring the cab-owner to incorporate rather than simply to organize the business as a nonstatutory limited liability firm. Indeed, even under the current rule that formal incorporation is a prerequisite to limited liability, tort claimants are protected primarily by case law rules that enable them to "pierce the veil" of formally incorporated firms.[216]

Thus, limited tort liability should be available without formal incorporation. It should not be regarded as a state-conferred privilege or as a basis for state regulation of corporate governance terms.

B. Quasi-Involuntary Creditors

Some creditors deal voluntarily with limited liability firms but do not bargain for limited liability. The extreme case is the injured taxi passenger who obviously did not negotiate credit terms on the basis of the liability rules, and indeed often could not because taxi fares normally are regulated. The characterization arguably extends to product purchasers, short-term trade creditors, and unsophisticated employees.

The argument for distinguishing creditors on the basis of their

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214. *See* Walkovszky v. Carlton, 18 N.Y.2d 414, 223 N.E.2d 6, 276 N.Y.S.2d 585 (1966).

215. *See* Buckley, *supra* note 99, at 1415-19.

216. Even these rules provide little protection for tort creditors. In *Walkovszky*, the court refused to "pierce the veil" on the basis only of allegations of inadequate capitalization. 18 N.Y.2d at 420, 223 N.E.2d at 10, 276 N.Y.S.2d at 590. In the few cases in which the courts did pierce the veil on this ground, the corporation was arguably a complete sham. *See, e.g.*, Wallace v. Tulsa Yellow Cab Taxi & Baggage Co., 178 Okla. 15, 61 P.2d 645 (1936) (veil pierced because corporation organized for purpose of operating a taxicab business which was found to be the "mere instrumentality" of an older corporation). *Id.* at 649.

sophistication or the quality of their dealings with the firm is weak for policy reasons. The uninformed or unsophisticated creditor is as likely to overvalue as to undervalue the risk, and this gives the firm an incentive to reduce the creditors' information or negotiation costs. If the argument is based on the creditor's bargaining position, the question is whether this situation differs from others in which the courts have enforced the bargain despite claims of "unconscionability."

The important point for present purposes, though, is not whether the contract should be enforced, but that recognizing limited liability in this situation should be regarded as a matter of contract rather than state privilege. Requiring formal incorporation does not affect the supposed plight of the nonbargaining creditor. Indeed, the creditor's bargaining position has been an important factor in veil-piercing cases where the firm did formally incorporate.[217]

CONCLUSION

Limited liability should be regarded as a product of private agreements, and not a state-conferred privilege. Private contracts for limited liability should be enforced in closely as well as publicly held firms and without regard to whether the parties have complied with a filing requirement. This has been recognized by many courts in a wide variety of circumstances. Understanding the contractual nature of limited liability is the last important step toward full recognition of the contractual nature of the corporation. With this understanding, the corporate contract can be analyzed like other contracts and not subjected to special regulatory burdens.

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217. *See* Brunswick Corp. v. Waxman, 459 F. Supp. 1222 (E.D.N.Y. 1978), *aff'd*, 599 F.2d 34 (2d Cir. 1979); Bendix Home Sys., Inc., v. Hurston Enters., Inc., 566 F.2d 1039 (5th Cir. 1978); Bartle v. Home Owners Cooperative, 309 N.Y. 103, 127 N.E.2d 832 (1955); Angus v. Air Coils, Inc. 567 S.W.2d 931 (Tex. Civ. App. 1978); Hanson Southwest Corp. v. Dal-Mac Constr. Co., 554 S.W.2d 712 (Tex. Civ. App. 1977)