Limited Liability

- Limited Liability New York State 1811
- Divide up an enterprise into shares, and no shareholder is liable for more than he or she put in
- Other states were very skeptical
- New York produced many failed corporations, a few spectacular successes

The Corporation

- David Moss points out that a law requiring that all corporations have limited liability was tried as an experiment in New York State in early 19^{th} Century.
- Moss points out that limited liability was not obviously a good idea: it created agency problems for stockholders, who might pursue risky strategies at bondholders' expense. Moreover, in fact unlimited liability hardly ever caused serious problems in practice.
- But, New York experiment was obviously successful, and eventually all states copied it.

Moss' Theory why Limited Liability Corporations were so Successful

- Investor overestimation of miniscule probability of loss beyond initial investment discouraged investment (weighting function)
- Lottery effect: with limited liability, an investment in a corporation was a throwaway item, like a lottery ticket (prospect theory)
- Allowed for investors to hold a highly diversified portfolio (not a concept that framers of corporate law were comfortable with then).