2004

Who Bears the Costs of a Lawyer's Mistakes? -- Against Limited Liability

Martin McWilliams

University of South Carolina - Columbia

Follow this and additional works at: http://scholarcommons.sc.edu/law_facpub

Part of the Law Commons

Recommended Citation


This Article is brought to you for free and open access by the Law School at Scholar Commons. It has been accepted for inclusion in Faculty Publications by an authorized administrator of Scholar Commons. For more information, please contact SCHOLARC@mailbox.sc.edu.
WHO BEARS THE COSTS OF LAWYERS' MISTAKES?
—Against Limited Liability

Martin C. McWilliams, Jr.†

I. INTRODUCTION

Who most appropriately bears the costs of the fiduciary failures of a law practice—the owners of the practice, or its clients? While the question seems rhetorical,¹ a tide is running against the traditional and obvious answer. This article discusses the economic and normative implications of limiting lawyers' personal liability to the clients of their law practices. It concludes that the traditional rule of personal, vicarious liability² of residual claimants is superior to a default rule of limited liability.³

† Associate Professor of Law, University of South Carolina. Many thanks to David Owen, Marie Reilly, and Pat Hubbard for their comments and encouragement, and to Brian Hellman, Sarah Montgomery, Fabio Diminich, and Aaron Jophlin for their patient and capable assistance. Errors are mine.


2. Where an enterprise is organized as a jural person, as in the cases of professional corporations and limited liability companies, the enterprise will be vicariously liable for the acts of its employees. By “personal vicarious liability” I refer to assigning second-stage vicarious liability to the residual owners of such enterprises. This assignment is not an instance of “piercing the veil,” because the requisites of that doctrine are not required to be shown. In the case of limited liability partnerships, the analysis is slightly different because, but for the statutory limitation of liability, the partners would be first-stage vicariously liable for obligations of the enterprise.

3. By “limited liability” I refer to de jure limitation of the personal exposure of residual claimants for claims against the firm, beyond the claimants’ equity investment. Law practices organized in limited liability formats are vicariously liable for the professional lapses of their professional employee-agents. By terms, the residual claimants, qua shareholders, members of limited liability companies, or partners in limited liability partnerships, are not vicariously liable; their liability is limited in the sense intended here. In this article, I occasionally refer to “vicarious” liability of the residual claimants, meaning, strictly speaking, the personal liability of the residual claimants for clients’ claims against the firm, in spite of nominal limited liability.
Limited liability enterprises are economically efficient in ways that, for the most part, should benefit law practices without net social cost. For the most part, then, it is probably a good thing for lawyers to be able to organize in limited liability formats. It is important to understand, however, that limited liability as a default rule is designed purposefully to advantage the residual claimants of enterprises relative to external stakeholders. When stakeholders fail to adjust to the limited liability default rule, or are not able to do so, risk and loss will be externalized to them. Among the external stakeholders of law enterprises are the clients. As stakeholders of their lawyers, clients are nonadjusting, and as their lawyers' principals, nonobserving. To the extent that the limited liability formats protect the residual claimants of law practices from clients' claims against the practice, they will typically be inefficient. At the same time, reliance on general organization law to protect the personal assets of the residual claimants of law practices is a significant act of deregulation that is incongruent with the law profession's core fiduciary norms. In this article I conclude that courts should use their powers of lawyer regulation to enforce the traditional default rule of personal, vicarious liability of residual claimants of law firms to the firms' clients.

Part II describes the movement toward limited liability for service enterprises, including law practices, and summarizes the effects of limiting the personal liability of the residual claimants of such enterprises. Part III reviews the origins and history of the limitation of commercial liability. It demonstrates that limiting liability is not an ineluctable characteristic of doing business through artificial jural persons, but was grafted onto the corporate form through the political process as a matter of organization law to serve policy goals of the formation and efficient employment of capital. Part IV reviews the present-day public policy justifications of limited liability. It shows that such justifications are most convincing in the context of widely held enterprises whose equity capitalization is furnished by passive investors and whose creditors are able to adjust to limited liability. Part V discusses limits on the justifications of limited liability. Part VI evaluates the justifications of limited liability in the context of the lawyer/client relationship. This evaluation reveals that protection of the residual claimants of law practices from personal liability to clients results in net social cost by shifting from the owners to the clients both risk of

4. See infra note 147 and accompanying text for the definition of "nonadjusting."
5. See, e.g., Jonathan R. Macey & Geoffrey P. Miller, An Economic Analysis of Conflict of Interest Regulation, 82 IOWA L. REV. 965, 970–71 (1997) (explaining how the "informational asymmetry" between lawyer and client gives the client only a vague idea of how to monitor performance); see also infra text accompanying notes 258–260.
insolvency of the enterprise and fiduciary risk—the risk that the enterprise will under perform the fiduciary obligation owed them by the enterprise. Part VII rebuts the argument that third-party insurance fully accounts for risk externalized to clients.

This article reaches two conclusions. First, protecting the residual claimants of law firms from client claims is not supported by the public policy that justifies limiting liability for general commercial risks. It shifts risk and cost from the residual claimants to nonadjusting, nonobserving clients, resulting in inefficiency. Second, elimination of the regulatory function of vicarious liability is inappropriate in terms of fiduciary norms, subjecting clients to persistent fiduciary risk, and in that respect is costly to clients and to the legal system. There is no social justification for substituting clients as bearers of the consequences of actions authorized by, and directed to the benefit of, the residual claimants of law practices. The traditional default rule of personal vicarious liability—allocating agency costs and commercial risk to the residual claimants of law firms rather than the firms’ clients—is the more efficient and appropriate rule.

II. BACKGROUND: THE ADVENT, AND RISKS, OF THE LIMITED LIABILITY SERVICE ENTERPRISE

Expert service enterprises, such as public accounting and law practices, entail agency costs that are complex in the sense that the enterprise must accommodate the varying and potentially inconsistent interests of the practice, its professional employees, its residual claimants, clients of the practice, and society at large as a consumer of services. When service enterprises become geographically dispersed and diverse in terms of specialist expertise, these agency costs increase. In recent times, service enterprises have made efforts to reduce internal agency cost by limiting the

---

6. Professor David Wilkins posits that lawyer regulation is based upon two related sets of duties: duty to clients, characterized as fiduciary and manifested by what Professor Wilkins calls “agency problems”; and duty to the public, or the legal system, manifested by “externality problems.” The former results in client injuries, and the latter, by and large, in harm to third parties or the legal system. David B. Wilkins, Who Should Regulate Lawyers?, 105 HARV. L. REV. 799, 818–20 (1992).

7. By “agency cost” I refer to the costs of “monitoring, and bonding a set of contracts” among actors, in an enterprise setting, whose interests are not identical, and “the value of output lost because the costs of full enforcement of contracts exceed the benefits.” Eugene F. Fama & Michael C. Jensen, Separation of Ownership and Control, 26 J.L. & ECON. 301, 304 (1983); see also Michael C. Jensen & William H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 J. FIN. ECON. 305, 308–10 (1976).

exposure of the firms’ residual claimants to personal vicarious liability for clients’ claims against the firm. Considerable impetus in this direction was furnished by the accounting profession which, during the 1980s and 1990s, engaged in a lobbying effort to encourage the state legislatures to enact statutory unincorporated limited liability entity formats. The general partnerships in which accountants had traditionally practiced could conveniently be converted into such formats without significantly altering the structural and cultural forms of partnership and without imposing adverse tax consequences on the residual claimants. By terms, these enterprise formats limit the residual claimants’ personal liability for obligations of their practices, including, especially, clients’ claims against the enterprise. The accountants’ lobbying effort was largely successful. Every state now permits professionals, including lawyers, to practice in one or more formats that, by terms, limit the residual claimants’ personal


10. See, e.g., Jan M. Rosen, In Business: Protecting Personal Assets, N.Y. TIMES, Aug. 6, 1994, at A3 (reporting that more than forty states have enacted limited liability legislation: “Eager for such protection, Ernst & Young and several other Big Six accounting firms are preparing to switch from conventional partnerships to limited liability partnerships . . . .”); Jan M. Rosen, The Many Advantages of a Hybrid Company, N.Y. TIMES, June 19, 1993, at A1 (“Accounting firms, for example, are eager to avoid a repeat of ‘the fiasco when Laventhol & Horwath went under’ and partners were personally liable for millions of dollars owed by the partnership . . . .”); Kevin Sack, New Type of Company Stirs Tax Worry in Albany, N.Y. TIMES, June 20, 1992, at A1 (reporting “heavy lobbying by lawyers and accountants” with Goldman, Sachs & Co. as the “most active lobbyists” supporting a limited liability bill to pass in New York). See generally Clark, supra note 9, at 1006 (“The results of [the accountants’] efforts were the enactment of LLC and LLP laws in every state.”); Joseph A. McCahery, Comparative Perspectives on the Evolution of the Unincorporated Firm: An Introduction, 26 J. CORP. L. 803, 803 (2001) (noting that limited liability legislation has passed “in all fifty states and the District of Columbia”); Jonathan D. Glater, Enron’s Many Strands: Accounting; Suits Against Andersen May Test Partners’ Risks, N.Y. TIMES, Feb. 12, 2002, at C6 (reporting that limited liability laws eventually passed in all fifty states in response to auditor suits after the savings and loan crisis). For a general description of such enterprise formats, see generally sources cited infra note 16.

11. See generally Jennifer J. Johnson, Limited Liability for Lawyers: General Partners Need Not Apply, 51 BUS. LAW. 85, 93–94 (1995) (concluding that the statutes, by terms, do not limit lawyers’ liability for their own acts, but do protect them from “the general business obligations” of the practice and from liability for “negligent or wrongful conduct” of lawyers in the practice other than, in some cases, those whom they supervise or control). The residual claimants’ equity investments remain at risk.
vicarious liability to clients. The lobbying effort continues today in other countries.

The legislatures adopted the new limited liability entity formats with minimal inquiry into normative consequences. Generally speaking, the liability limitation provided by the new statutory formats applies, with no effort at rationalization, to businesses of all kinds and sizes.

Many law practices have organized in limited liability formats for precisely the purpose of limiting their residual claimants' personal vicarious liability to clients. Limiting the liability of the residual claimants of service enterprises is said to reduce internal agency cost, thereby facilitating practice in firms that are large, geographically dispersed, and include specialist elements. Agency cost avoided by the enterprise, however, is not

---

12. See Hillman, supra note 8, at 1391–93; McCahery, supra note 10, at 803; Glater, supra note 10, at C6.
14. See J. William Callison, Rationalizing Limited Liability and Veil Piercing, 58 BUS. LAW. 1063, 1063–64 (2003); William J. Rands, Domination of a Subsidiary by a Parent, 32 IND. L. REV. 421, 430 (1999) (“As stimulating as the academic debate has been, state legislatures have paid no attention to it.”).
15. See Callison, supra note 14, at 1067 (“[C]losely held and widely held entities might be sufficiently dissimilar that entities within one class might be afforded different liability protection from entities in the other class.”).
16. See, e.g., Developments, supra note 9, at 1658; Johnson, supra note 11, at 89; Robert R. Keatinge & George W. Coleman, Practice of Law by Limited Liability Partnerships and Limited Liability Companies, 1995 Symposium Issue PROF. LAW. 5, 6–7 (describing that lawyers seek new ways to organize in order to avoid vicarious liability); Thomas E. Rutledge, The Place (If Any) of the Professional Structure in Entity Rationalization, 58 BUS. LAW. 1413, 1418–19 (2003) (noting that limiting the personal liability of the residual claimants is the primary impetus for professional service organizations to incorporate); Ted Schneyer, Reputational Bonding, Ethics Rules, and Law Firm Structure: The Economist as Storyteller, 84 VA. L. REV. 1777, 1794 (1998) (referring to a “virtual stampede” among law firms); Steele, supra note 1, at 626 (“Protection of personal assets from claims for malpractice is the stated motivation for practicing law in a limited liability partnership.”); Michael J. Lawrence, Note, The Fortified Law Firm: Limited Liability Business and the Propriety of Lawyer Incorporation, 9 GEO. J. LEGAL ETHICS 207, 208 (1995) (“[The] impetus for lawyers to incorporate grew out of [vicarious liability of lawyers during] the S & L scandal of the 1980s.”).
17. Cf. Developments, supra note 9, at 1672 (explaining how vicarious liability may detrimentally inhibit law partnerships from practicing “in different geographic locations or that
eliminated but externalized to clients of the enterprise.\textsuperscript{18} This raises troubling issues on several levels. Insurance in the form of a transfer of risk and related agency cost from residual claimants to clients poses moral hazard, encouraging behaviors in the interests of proprietary owners that are risky to clients.\textsuperscript{19} In contractarian terms, such a transfer constitutes "rent seeking" by enterprise members who have persuaded the legislatures to alter ex post the traditional contract between expert agencies and their clients.\textsuperscript{20} In agency terms, such a transfer constitutes displacement of fiduciary norms in favor of the commercial norms of organization law.\textsuperscript{21} Residual claimants of fiduciary service enterprises insulated from vicarious personal liability to clients are, effectively, passive intermediaries,\textsuperscript{22} active in firm management and policymaking, empowered to put forward their own interests, but protected from personal liability by statutory organization law as if they were passive investors. Clients of expert agencies are, generally speaking, unable to self protect, due to high transaction and specification costs,\textsuperscript{23} to a degree suggesting that positivist utilitarian economics is imperfect as a source of justifying rules in the lawyer/client

---


\textsuperscript{19} Limited liability is a means not of eliminating the risks of entrepreneurial failure but of shifting them from individual investors to the voluntary and involuntary creditors of the corporation—it is they who bear the risk of corporate default."). See Poonam Puri, \textit{Judgment Proofing the Profession}, 15 GEO. J. LEGAL ETHICS 1, 16 (2001) ("Limited liability allows the owners of an enterprise to avoid bearing the risk of loss if the enterprise is unable to pay its liabilities. But, the risk of loss does not disappear. It is transferred to those who deal with the enterprise.") (citations omitted).

\textsuperscript{20} Cf Developments, \textit{supra} note 9, at 1672 (noting that vicarious liability can be a harmful deterrent if it deprives "multi-office, multi-specialty firms [of the efficiency derived from] economies of scale"). See generally Tamar Frankel, \textit{Fiduciary Law}, 71 CAL. L. REV. 795 (1983) (describing the history of fiduciary law, the problem of abuse of delegated power, and methods of controlling or regulating the fiduciary to protect the entrustor).

\textsuperscript{21} Cf Richard N. Langlois, \textit{Contract, Competition, and Efficiency}, 55 BROOK. L. REV. 831, 831 (1989) (noting that the Framers predicted that the Contract Clause was intended to prevent accession to "rent-seeking" constituencies).

\textsuperscript{22} See supra text accompanying note 7.

\textsuperscript{23} See infra text accompanying notes 349-350, 352.
LAWYERS’ LIABILITY

A default rule assigning the initial allocation of risk and cost to such clients is highly likely to persist, resulting in private and social cost. At the same time, where an agent takes less than optimal care, product price will not reflect the true cost of the product, resulting in social cost. Vicarious liability, it has been shown, reduces this social cost.

III. THE LEGISLATIVE POLICY ROOTS OF LIMITED LIABILITY

Those who organize their commercial enterprises in certain ways described by statute are permitted to avoid personal liability (beyond their equity investment) for obligations attributable to the enterprise. Creditors’ recourse is limited to the assets of the enterprise. Where such assets are insufficient, the creditors, rather than the residual claimants of the enterprise, bear the loss. So, in a sense, does society at large. This shifts to creditors the cost of entrepreneurial failure in excess of the direct investment of the residual claimants of the enterprise, making society at large, by extrapolation, a bearer of the risk of insolvency. There is no statutory limit, however, on the residual claimants’ access to gains. This

24. The reference is to a group of theories hypothesizing that the most desirable results follow from rational persons making choices, including associational choices, designed to maximize their own benefit under conditions conducive to informed bargaining. See generally, e.g., Scott FitzGibbon, Fiduciary Relationships Are Not Contracts, 82 MARQ. L. REV. 303, 327–31 (1999).


27. There are common law exceptions described as “strict liability” based on public policy and veil piercing. See, e.g., ROBERT CHARLES CLARK, CORPORATE LAW 3, 7 (1986). Plaintiffs can also reach the personal assets of servants of corporations who are tortfeasors. See, e.g., W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS § 70, at 501–02 (5th student ed. 1984).

28. See Stephen M. Bainbridge, Abolishing Veil Piercing, 26 J. CORP. L. 479, 488–89 (2001) (“[Limited liability] allows shareholders to externalize [cost onto creditors] . . . and, in a sense, to society at large.”). This externalization happens in two ways: when the substitute cost bearer spreads the cost (as by raising prices), and when enterprise is not required to bear the full costs of production—resulting in an inefficient allocation of resources.

29. POSNER, supra note 18, at 432 (“Limited liability is a means not of eliminating the risks of entrepreneurial failure but of shifting them from individual investors to the voluntary and involuntary creditors of the corporation—it is they who bear the risk of corporate default.”); see Phillip I. Blumberg, Limited Liability and Corporate Groups, 11 J. CORP. L. 573, 576 (1986); Peter French, Parent Corporation Liability: An Evaluation of the Corporate Veil Piercing Doctrine and Its Application to the Toxic Tort Arena, 5 TUL. ENVTL. L.J. 605, 607 (1992).
asymmetrical\textsuperscript{30} statutory arrangement, colloquially referred to as "limited liability," has been called a "fundamental principle of corporate law."\textsuperscript{31} In the Anglo-American legal system, limited liability in the sense described has been associated traditionally with the corporate form, but recently has been legislatively extended to a variety of unincorporated business forms.\textsuperscript{32}

Limited liability is not an inevitable incident of organizing businesses as discreet jural persons. The history of limited liability shows that government engrafted limited liability onto the corporate personality as a political decision directed toward a policy objective of pooling capital.\textsuperscript{33} This part reviews the history of limited liability in the United States with emphasis on three points pertinent to the present topic. First, from its beginnings, limited liability has been employed as market regulation: a purposeful, policy-based norm of organization law permitting the residual claimants of business enterprise to externalize cost and risk. Second, the success of the corporate form as an economic engine in the United States did not result from limited liability alone, but from the combination of limited liability with free transferability of protected residual claims, perpetual jural existence, and, as Professor Henry Butler has explained, the


\textsuperscript{32} The main categories are professional corporations, limited liability companies, and limited liability partnerships. Robert W. Hamilton, Professional Partnerships in the United States, 26 J. Corp. L. 1045, 1053 (2001); Larry E. Ribstein, Ethical Rules, Law Firm Structure and Choice of Law, 69 U. Cin. L. Rev. 1161, 1170 (2001) ("Virtually every state now recognizes limited liability for law firms in one or more entity formats, including professional corporations, limited liability companies, and limited liability partnerships.") (citing Alan R. Bromberg & Larry E. Ribstein, Bromberg and Ribstein on Limited Liability Partnerships and the Revised Uniform Partnership Act § 7.04 (2001)).

\textsuperscript{33} See, e.g., Armund Budington DuBois, The English Business Company After the Bubble Act 1720–1800, at 93–94 (Octagon Books 1971) (1938) ("The evidence at the beginning of the eighteenth century ... demonstrates only somewhat equivocally the existence of a nexus between the corporation and restricted liability."); Blumberg, supra note 29, at 577 ("[I]t is clear that the entity view of the corporation rests essentially on philosophical notions and that this view was firmly established well before the acceptance of the principle of limited liability."); Oscar Handlin & Mary F. Handlin, Origins of the American Business Corporation, 5 J. Econ. Hist. 1, 8–17 (1945) ("Examination of contemporary Anglo-American law ... strikes at the very roots of the common assumption that limited liability was always an essential attribute of corporateeness ... ."). Professor Robert A. Kessler has described the identity of limited liability with the corporate form as "accidental." Robert A. Kessler, With Limited Liability for All: Why Not a Partnership Corporation?, 36 Fordham L. Rev. 235, 237–42 (1967).
development of an unrestricted market in corporate privileges. These points lead to the third point, that limited liability from its inception in the United States enlisted externalization of risk and cost in the service of political goals of aggregation of capital to the benefit of sponsoring political units. Its present-day justifications continue to relate to general, commercial goals and contemplate creditor adjustment. The applicability of these justifications to fiduciary service enterprises, characterized by nonobserving clients, is equivocal.

The liability of a commercial enterprise can be limited de facto as a matter of private ordering, and de jure as a matter of government regulatory intervention. Liability has been allocated de jure in support of government policy goals at least since classical times, far preceding development of the corporate form. While contractarian scholars justify limited liability as an efficient default rule, its origins were experiential. In a sense, de jure limited liability as it is now understood matured fortuitously in company with the development of the concept of the incorporated firm as a vehicle of capital formation and subsequent professional management. Much current understanding of limited liability is ex post analysis of the survivability of the limited liability corporation.

Limited liability was established in the English capital system by the seventeenth century. On a de facto basis, it was far more common among the joint stock companies (not jural persons) than among chartered corporations. By 1800, despite unlimited liability, interests in such companies were transferred as freely as among limited liability corporations.


37. Kessler, supra note 33, at 238.

38. Liability of members of joint stock companies was often limited by private law methods and, as a practical matter, by the inefficiencies of achieving process over a large number of minor owners. See FRANKLIN A. GEVURTZ, CORPORATION LAW 27 (2000).

39. See Handlin & Handlin, supra note 33, at 3. The uncertainty and controversy surrounding de facto techniques of limiting liability persisted in England until clarified by the Limited Liability Act of 1855, granting de jure limited liability generally to shareholders of companies registered thereunder. An Act for Limiting the Liability of Members of Certain Joint Stock Companies (The Limited Liability Act), 1855, 18 & 19 Vict., c. 133, § 7 (Eng.); see also
The corporate form was well established in England by the seventeenth century on a mercantilist model based on a system of charters negotiated between promoters and policymakers of the sovereign. Such charters created, in many cases, monopoly rights and other "grants of state privilege." One such privilege was a de jure charter term limiting liability, but such terms were unusual, difficult to obtain, and have been described as being only of "slight importance." By far, the most likely candidates to be granted limited liability were capital projects of public benefit such as canal companies, toll bridges, financial institutions, and foreign exploration and development.


40. Herbert Hovenkamp, The Classical Corporation in American Legal Thought, 76 Geo. L.J. 1593, 1595 (1988) ("[T]he corporation was a unique entity created by the state for a special purpose and enjoying a privileged relationship with the sovereign.").

41. See, e.g., DuBois, supra note 33, at 105 ("While the heads of a charter were normally presented to the law officers of the Crown by the petitioners, these provisions would be carefully considered by the Attorney General, the Solicitor General, and other officials, and shaped in accordance with the policy of the government."); HERBERT HOVENKAMP, ENTERPRISE AND AMERICAN LAW 1836–1937, at 94–97 (1991).

42. See Langlois, supra note 20, at 831–34.

43. DuBois, supra note 33, at 97 (explaining that the limited liability charter provision was "clearly considered an exception to the usual corporate practice"). According to DuBois:

There is no indication that the idea [of limited liability] was developed or applied when business began to use the joint stock and to acquire corporate status. . . . The evidence at the beginning of the eighteenth century itself demonstrates only somewhat equivocally the existence of a nexus between the corporation and restricted liability.

Id. at 94. See Handlin & Handlin, supra note 33, at 9 ("[Limited liability] was a special privilege included in some eighteenth-century English charters . . . ."). Professor Kessler notes that limited liability was not listed among the attributes of a corporation in the earliest English corporation cases. Kessler, supra note 33, at 240.

44. Handlin & Handlin, supra note 33, at 3 ("Until well into the nineteenth century the corporation was used extensively [in England] only in the organization of canal companies.").

45. See, e.g., Blumberg, supra note 29, at 581 (describing English corporations); id. at 587–89 (describing American corporations). In Professor Seavoy's words:

Before 1820, most incorporated businesses [in the United States] could be classed as public service franchises because they required a grant of one or more special powers from the state in order to perform a service closely linked to public welfare . . . . Limited liability was a means of attracting capital into these . . . enterprises, which could not readily be undertaken by single proprietors or partnerships possessing full liability.
The foregoing discussion suggests that the historical policy basis for de jure limitation of commercial liability in the Anglo-American tradition can be described as a partial delegation of sovereign immunity to private enterprise to encourage the private financing of projects of a quasi-sovereign nature, deemed to be of public benefit and consonant with government financial and political policy. Limiting entrepreneurs’ liability for such enterprises while permitting them to retain the gains of the enterprise without limit encouraged them to accept risk, while allocating enterprise risk in excess of the entrepreneurs’ direct investment to the creditors of the enterprise—and ultimately to society at large. From this point of view, the extension of limited liability from the sovereign to private investors can be seen as a form of indirect tax. The resultant public benefit was financed in part by this tax.

The negotiated-charter corporation and other English-law enterprise forms were inherited by Britain’s American colonies. Public benefit as a policy basis for granting charters generally, and limited liability charter terms in particular, was similarly inherited. In the years following independence, the legislatures of the new states, following the British pattern, “readily” granted limited liability charters for bridges, canals, turnpikes, banks, insurance companies, and similar enterprises of public benefit. Limited liability charters for manufacturing enterprises, by


46. See Bainbridge, supra note 28, at 488–89.

47. For an interesting example showing the analogy to a tax, see Commonwealth v. Blue-Hill Turnpike Corp., 5 Mass. 420, 422 (1809). In that case, a limited liability corporation built a road. Resulting damages were assessed against the corporation, but not its “corporators,” leaving the injured landowner without a remedy should the corporation prove insolvent. The Supreme Judicial Court noted that, by stature, damages caused by county roads built by towns could be paid by a tax: “The funds which towns have, out of which they can pay these damages, is the individual property of the several inhabitants, who may be compelled to contribute by the payment of a tax, to be assessed and collected for this purpose.” To hold the shareholders of the road-building corporation harmless and leave the damages with the local landholder was, effectively, also a tax. Id.

48. EDWIN MERRICK DODD, AMERICAN BUSINESS CORPORATIONS UNTIL 1860, at 364 (1954); see Handlin & Handlin, supra note 33, at 11–12.

49. Following independence, few contested the exclusive power of the state legislatures to form corporations. Butler, supra note 34, at 138; see also LAWRENCE M. FRIEDMAN, A HISTORY OF AMERICAN LAW 188 n.34 (2d ed. 1985) (“It was generally recognized after the Revolution that the legislature was the branch of government that made corporations [as opposed to the executive branch, as in England, where only the Crown chartered corporations].”).

50. Butler, supra note 34, at 138 (“[M]onopoly privileges and police powers [such as eminent domain were granted] in exchange for the financing and construction of quasi-public goods by the private firms.”); accord Blumberg, supra note 29, at 587, 589. Charters for financial institutions, such as banks and insurance companies, “typically” limited investors’
contrast, were unusual.\textsuperscript{51} Indeed, corporate charters of any nature were rarely granted to manufacturing businesses in the early years of independence. According to one account, chartered manufacturing corporations were “practically unknown” in the United States at the end of the eighteenth century, as only eight manufacturing company charters had been granted in the United States by 1800.\textsuperscript{52} The chartering of manufacturing corporations increased slowly thereafter.\textsuperscript{53} Well into the nineteenth century, manufacturing was carried on in the United States largely by cottage industries, with a family or small group of investors providing capital, management, and labor.\textsuperscript{54}

Following the War of 1812, the state legislatures became increasingly interested in achieving industrial self-sufficiency from Europe, especially England,\textsuperscript{55} which industrialized prior to the United States.\textsuperscript{56} Technological

---

\textsuperscript{51} Dodd, supra note 48, at 365. According to Professor Williston, the first business corporation chartered in the United States, and the only business corporation chartered in the United States before the Revolution, was an insurance company chartered in Pennsylvania in 1768. Samuel Williston, History of the Law of Business Corporations Before 1800, 2 Harv. L. Rev. 149, 165 (1888). Only five more were chartered by 1787, only one of which was a manufacturing corporation. Id. About fifty were chartered by 1800, most of which were involved in “insurance, banking, turnpike roads, bridges, canals, and to a limited extent, manufacturing,” of which there were “several” in Massachusetts “but very few in other states.” Id. at 166 n.1. See Handlin & Handlin, supra note 33, at 11–12 (stating that limited liability was not a characteristic of the early corporate form; by the time of the Revolution, “English law [in this regard] had gone no further than to distinguish between individual and corporate obligations”).

\textsuperscript{52} Hugh L. Sowards & James S. Mofsky, Factors Affecting the Development of Corporation Law, 23 U. Miami L. Rev. 476, 478 (1969). According to Professor Friedman, only 335 charters were issued to businesses in what became the United States in all of the eighteenth century, of which a “mere handful” were granted to manufacturing enterprises. Friedman, supra note 49, at 188–89.

\textsuperscript{53} “[S]tate governments in the first third of the nineteenth century were conservative in their initial granting of the corporate form to industrial and business organizations.” Butler, supra note 34, at 139. In the last decade of the eighteenth century, entrepreneurial activity was principally focused on shipping and speculation in land. Bernard Bailyn et al., The Great Republic: A History of the American People 347 (1977). Alexander Hamilton’s proposed policies to stimulate manufacturing were, for the most part, ignored. Id.

\textsuperscript{54} See, e.g., Bailyn, supra note 53, at 455.

\textsuperscript{55} See Dodd, supra note 48, at 366–68, 375 n.15, 398–403; Butler, supra note 34, at 139.

\textsuperscript{56} Cf. Kevin F. Forbes, Limited Liability and the Development of the Business Corporation, 2 J.L. Econ. & Org. 163, 164, 171 (1986) (establishing that England was “the most powerful industrial . . . economy” of the time).
developments and the development of the factory system\(^{57}\) increased the labor and capital requirements of industrial businesses,\(^ {58}\) encouraging use of the corporate form with its capacity to develop pools of capital made up of relatively small contributions from a large number of passive investors.\(^ {59}\)

Expanded use of the corporate form unrelated to projects of public benefit, especially when combined with limited liability, met significant political opposition. In the early nineteenth century corporate privilege, including limited liability, was distributed through a system of favoritism to those with the leverage to obtain it from the state legislatures.\(^ {60}\) Such grants of privilege were strongly opposed, because they were perceived as being antidemocratic.\(^ {61}\) Professor Hovenkamp describes "hostility\(^ {62}\) and a "general legislative and judicial reaction against limited liability" in the early nineteenth century.\(^ {63}\) Jeffersonians "regarded [limited liability] as . . . another of the political favors granted to wealthy entrepreneurs."\(^ {64}\) According to Professor Dodd, Jacksonians "view[ed] corporations and limited liability with alarm both as sinister forms of special privilege and as mechanisms for increasing the economic power of the capitalist class.\(^ {65}\)

The "privilege" aspect of limited liability was diminished when, in 1824, the federal circuit court in *Wood v. Drummer*\(^ {66}\) held limited liability to be

---

57. In contrast to the established British system in which stages of manufacture were performed successively by differing, relatively small, enterprises, a system was devised in America in which all steps of manufacture were performed in a single, relatively large and complex, factory. See Daniel J. Boorstin, The Americans: The National Experience 26–27 (1965).

58. See Butler, supra note 34, at 138–39.

59. Dodd, supra note 48, at 367–68; Sowards & Mofsky, supra note 52, at 479. Unlike England, few capital accumulations existed to finance industrialization. See, e.g., Boorstin, supra note 57, at 250–51 ("In England the large capital required for railroad-building was available in private hands, but in the United States capital was still scarce and the corporation was only beginning to be developed."). Dean Robert C. Clark describes the juxtaposition of the necessity for entrepreneurs to attract investment from a large, dispersed group of moderately wealthy people, rather than a rich few, with acceptance of ownership of investment property as a social norm. Clark, supra note 27, at 3.

60. Butler, supra note 34, at 140 ("[S]tate legislatures granted special charters with less restrictive terms to favored groups.").

61. Dodd, supra note 48, at 393 ("[O]pposition to the corporation and to limited liability as objectionable forms of special privilege was widespread in this country until after the middle of the nineteenth century."); Friedman, supra note 49, at 194 ("The triumph of the corporation as a form of business association was . . . neither painless nor noiseless. The corporation was an object of great controversy in the first half of the [nineteenth] century.").


63. Id. at 1651; Hovenkamp, supra note 41, at 49–50.

64. Hovenkamp, supra note 41, at 50.

65. Dodd, supra note 48, at 394; accord Butler, supra note 34, at 145 ("[Jacksonians] were fundamentally opposed to the granting of limited liability . . . .").

66. 30 F. Cas. 435 (C.C.D. Me. 1824) (No. 17,944).
the default rule governing businesses formed by legislative corporate charter. By 1832, de jure limited liability of corporate shareholders in the United States was deemed "settled" as a matter of common law.

A significant increase in incorporations did not follow Wood, however. Indeed, during the early nineteenth century economic development in states that followed a rule of full liability appears to have kept pace with development in neighboring states that granted limited liability charters to manufacturing enterprises. The failure of Wood to increase the rate of incorporations suggests that de jure limited liability was not the proximate motivator of the rise of incorporation as a tool of capital formation and industrialization. The pieces were not yet in place to enable the emergence of the two inseparable phenomena—the national market in corporate privilege and the national capital market.

By the mid-nineteenth century, the state legislatures fairly uniformly perceived the public benefit of generally encouraging entrepreneurial activity. By that time, the use of limited liability as an inducement to private capital formation through the corporate form appears to have

---

67. Id. at 436.
68. Hovenkamp, supra note 40, at 1651.
70. DODD, supra note 48, at 383 ("[L]egislative acceptance of the limited-liability principle [in Massachusetts] did not result in any immediate acceleration of the rate at which new manufacturing corporations were chartered."); GEVURTZ, supra note 38, at 27; Blumberg, supra note 29, at 594–95.
71. The failure of generalized de jure limited liability to accelerate the rate of incorporation may be accounted for in part by the prevalence of the practice of initial part payment for shares. Even after the advent of fixed-price shares, share subscriptions were customarily not fully paid at issuance. Corporations, and their creditors, were entitled as a matter of contract to make calls on the unpaid portions of subscriptions. Butler, supra note 34, at 139 n.30 (citing DODD, supra note 48); Williston, supra note 51, at 149–50. The practical effect on the subscriber (up to the amount of the subscription) and the psychological effect in making the investment decision would have been little different from unlimited liability. Liability limited to the initial investment, as we think of it today, had to await development of the fully paid share as the rule. Such rules began to appear among the states with Massachusetts, in 1830, and progressively more states during the middle of the nineteenth century. Hovenkamp, supra note 40, at 1653–56. The justifications of limited liability, discussed herein, assume fully paid shares. Although England significantly preceded the United States in industrial development, limited liability as a corporate characteristic appears to have been generally accepted in the United States some thirty years before England. See Blumberg, supra note 29, at 583–94. See generally SEA VOY, supra note 45, at 65–76.
72. BAILYN, supra note 53, at 430 (noting that the United States, handicapped by insufficient cheap labor and insufficient capital, had not successfully industrialized by 1860).
73. DODD, supra note 48, at 368.
become nearly universal among the state legislatures. Following the Civil War, pools of unskilled labor, including many immigrants, aggregated in the cities, and the Civil War-stimulated growth of the national railroad system “triggered a process of large-scale formation of investment capital.” With the stage now set for industrialization, competition among the states for capital gave the advantage to states willing to grant corporate privileges and reduce investor costs, including limiting liability. The states competed in enacting attractive organizational laws to keep local capital at home and to attract investment from other states.

The competition among the states to attract capital through advantageous organization laws was significantly encouraged by the Supreme Court’s decision in 1868 in Paul v. Virginia. Prior to Paul, it was generally considered that a corporation’s operations would be geographically limited to its chartering state. Paul dispelled this supposition, clarifying that “a state could not exclude a foreign corporation from doing interstate business [within its jurisdiction].” This enabled aggressive states to attract not just capital from other states, but also established corporations whose factories, labor, and markets were elsewhere, expanding the market in corporate privileges to a national scale.

Among the devices featured in the competition to attract capital were increased availability of the corporate form, simplification of the processes of incorporation, and advances in the efficiencies of the corporate structure. The cumbersome device of the corporate charter was progressively...

74. See, e.g., Stephen B. Presser, Thwarting the Killing of the Corporation: Limited Liability, Democracy, and Economics, 87 NW. U. L. REV. 148, 155 (1992) ("By the fourth decade of the nineteenth century, . . . virtually all of the state legislatures appear to have arrived at the judgment that the furthering of capital formation could best be accomplished by encouraging shareholders to invest through limiting their liability, [thereby encouraging economic growth]."); cf. In re Appraisal of Ford Holdings, Inc. Preferred Stock, 698 A.2d 973, 976 (Del. Ch. 1997) ("[T]he philosophy that underlies [the Delaware General Corporation Law] is that the public good is advanced by the provision of an inexpensive mechanism that allows all individuals to achieve the benefits that the corporate form provides . . . .").

75. BAILYN, supra note 53, at 831–32.

76. See Blumberg, supra note 29, at 592–95; see also FRIEDMAN, supra note 49, at 197–201. According to Professor Friedman, “[S]tates flocked to the business of chartering business. They cut their prices and vied with each other with liberal laws.” Id. at 458.

77. See Butler, supra note 34, at 142 (“Success in the capital markets translated into the chartering of firms that would build factories and increase the wealth of the state.”). For example, Hovenkamp describes the adoption by the New York legislature of a policy of encouraging manufacturing development through liberal use of limited liability charter provisions. HOVENKAMP, supra note 41, at 51–52.

78. 75 U.S. 168 (1868).

79. See Butler, supra note 34, at 152–55.

80. Id. at 155–56.

81. Id. at 156, 158–59.
displaced, first by "general regulating statutes" that were, in effect, sets of standard charter terms, and later by business corporation statutes making incorporation, with attendant privileges including limited liability, generally available on ministerial terms. This "democratization" of the availability of limited liability incorporation ended political opposition to the limited liability corporation.

The general incorporation statutes with their standardized corporate privileges signaled the advent of the modern public company capitalized by passive residual claimants with limited liability. Professor Hovenkamp describes an evolution from the mercantilist model of the corporation into "a device for assembling large amounts of capital in a manner that could be controlled efficiently by a small number of managers."

While both are called "corporations," this enterprise model is distinct from the traditional owner-operated model, which now survives as the "close corporation." The present-day statutory model, and the de facto model of the widely held corporation, exhibit separation among equity investors, policymakers, and managers, in which the ability of the equity investor to exercise control is, for the most part, exchanged for low cost entry and exit. Agency efficiencies are manifested in terms of fiduciary

82. Id. at 138–43.
83. See Friedman, supra note 49, at 195. According to Professor Friedman, the early general incorporation laws were addressed to "churches, academies, and library societies." Id. New York enacted the first general incorporation law for manufacturing enterprises in 1811, and other states eventually followed. Id.
86. Such shareholders can be contrasted with "owners" in the conventional sense, who direct enterprise gains out of the enterprise to themselves and their proxies, tending to keep the enterprise closely held. See, e.g., Robert A. Ragazzo, Toward a Delaware Common Law of Closely Held Corporations, 77 WASH. U. L.Q. 1099, 1103 (1999).
87. As Professor Friedman observes, "It was by no means certain that a corporation, as that term was understood in 1800 or 1820, was the best way to raise and manage money for enterprise." Friedman, supra note 49, at 200. The corporate model that evolved in the late nineteenth century owed much to free-form private associations that were used to employ capital (sans limited liability). Id. The essential organizational attributes were borrowed and rationalized in the general corporation laws. Id. By the late nineteenth century, "hardly a stone was left unturned" of the law of corporations of 1800. Id. at 511.
88. See Posner, supra note 18, at 452–53; Langlois, supra note 20, at 836–38 (observing that the investor/residual claimants' participation in control is to elect the board, at most, but more likely to be exercised by selling their shares).
managers employing the capital of passive investors—enabling the investors to take risk with minimal due diligence, to diversify, and to enter and exit investments at low cost. By contrast, the close corporation manifests agency efficiencies in terms of unity of interest among active long-term investors, policymakers, and managers—different models altogether, distinguished in particular by the distinct roles of the residual claimants.

Limited liability, then, developed in tandem with the passively capitalized corporation as a tool of the states’ policy of promoting local capital formation and entrepreneurship. It made the risk of capital investment manageable for members of the emerging middle class, encouraging them to pool surplus assets in passive investments to provide capital for economic development. The cumulative effect of the privileges inherent in the new general incorporation statutes has been described as making investment cheaper—that is to say, more accessible to more potential investors.89 A perceived social benefit of pooling private capital was served by a corporate form made progressively more attractive by a combination of corporate privileges that included limited liability, free transferability of shares, passive equity ownership, agency efficiencies, and perpetual jural existence of corporations.90 To these ends the general availability of the de jure limited liability enterprise was sought energetically, and, ultimately, successfully, through the political process.91

Not all arguments for expansion of the availability of the limited liability corporation were economic. Others included the perceived unfairness of holding passive investors liable for the actions of managers,92 and the democratization of the capital markets—formerly dominated by a wealthy

89. Hovenkamp, supra note 40, at 1656–57.
90. Dean Clark attributes the success of the corporate form to the combination of “(1) limited liability . . . ; (2) free transferability of investor interests; (3) legal personality ([including] entity-attributable powers, life span, and purpose); and (4) centralized management.” CLARK, supra note 27, at 2 (“These four characteristics all serve the positive functions of greatly facilitating the efficient aggregation of very large amounts of capital from numerous investors and the efficient operation of a very large business with numerous owners and employees.”). See Hovenkamp, supra note 40, at 1597 (“[T]he corporation’s ability to raise and mobilize large amounts of capital” was its “most obvious . . . advantage[].”); Meiners, Mofsky & Tollison, supra note 69, at 364.
91. See DODD, supra note 48, at 364–65; HOVENKAMP, supra note 41, at 49–55; Blumberg, supra note 29, at 592–93.
92. Blumberg, supra note 29, at 586.
few. Nevertheless, pooling capital is understood to be the main justification of the limited liability enterprise. Resolution of the political struggle in favor of general access to de jure limited liability reflects a significant broadening of the policy goals to which limited liability was applied. Such goals grew from promotion of individual projects of public benefit to include a generalized expectation of aggregation of capital and resultant beneficial economic activity. The fundamental policy basis remained the same; that is, to encourage the pooling of, and creation of a market in, private capital. Today the logical extension of this policy metamorphosis has been fully realized. Through legislation, limited liability is available in the United States (and England) to any commercial enterprise of any size, organized for any legal purpose, upon meeting ministerial conditions.

The foregoing discussion shows that the expansion of limited liability was a pragmatic exercise in organization law in pursuit of particular public policy goals, especially the competition among the states to attract capital. The recent rapid spread of new forms of limited liability enterprise illustrates the persistence of this political role.

The history of government liability allocation makes clear that limited liability of the owners of the residue is not inherent in conducting commerce through separate jural personalities. The legislative extension

93. Presser, supra note 74, at 155–56; see Ragazzo, supra note 86, at 1102–04.

94. See Easterbrook & Fischel, supra note 31, at 97 (“[I]ncreased availability of funds . . . is the real benefit of limited liability.”); Hovenkamp, supra note 40, at 1597 (discussing that the “most obvious of [the] advantages” that encouraged governmental promotion of the limited liability corporate form was “its ability to raise and concentrate capital more efficiently than other forms of business organization”).

95. General limited liability for certain forms of commercial enterprise was stimulated by the perception that it would contribute to accumulation of capital. Blumberg, supra note 29, at 604. See, e.g., In re Appraisal of Ford Holdings, Inc. Preferred Stock, 698 A.2d 973, 976 (Del. Ch. 1997); Presser, supra note 74, at 155. Another factor in the successful political drive for limited liability was free transferability of shares, resulting in the emergence of a growing class of passive investor shareholders. Limited liability protected such investors, encouraging investment and therefore publicly beneficial capital formation. Blumberg, supra note 29, at 586. Underlying this argument, however, is the effect of relieving such investors from the burdens of due diligence and monitoring, permitting speculation.


97. See, e.g., Blumberg, supra note 29, at 585 (“[T]he extension of limited liability reflected a deliberate political decision in the face of commercial pressures to achieve economic objectives, rather than inevitable conceptual derivation from the separate nature of the entity.”); Kessler, supra note 33, at 238–39 (refuting W. HOLDSWORTH, A HISTORY OF ENGLISH LAW
of limited liability generally to the residual claimants of commercial enterprises expresses a political conclusion that the commercial benefits assumed to follow justify externalizing the insolvency risk of enterprise—the indirect tax on those who must bear the losses the owners of the residual interest need not pay. Whether a concomitant social benefit in fact supports this conclusion across the spectrum of enterprise is a matter of some present debate, and is of direct relevance to the present topic.

That this indirect form of public finance contributes to accumulations of private wealth is recognizable as an asymmetry in the allocation of risk and benefits of enterprise. Indeed it was so recognized from early times, when applications for limited liability corporate charters were individually scrutinized to assure consonance with government policy. The legislated (regulatory) reallocation of risk and cost from the residual claimants of private enterprise to external risk bearers is justified only where the resulting inefficiency is outweighed by social benefit.

This paper approaches this issue in two ways. One is economics, finding social benefit in the efficient application of resources. Most scholars today agree that limited liability is efficient, at least in most cases. In what follows I will argue that limited liability, insofar as it protects the residual claimants from clients' claims against the enterprise, is not efficient in the context of law practice.

The other approach is policy. As this part demonstrates, limited liability took root in the United States to promote a governmental policy of pooling


E.g., EPSTEIN, supra note 30, at 267:
[T]he institution of limited liability creates a radical asymmetry in the distribution of gains and losses from risky operations. . . . The creditors have a disproportionate share of the down side, and the implicit conflict of interest may lead shareholders and corporate officers to prefer riskier financial projects than they would undertake if they did not rely on borrowed capital. It is just this risk that leads [creditors to self protect].

Id.

Cf. Blumberg, supra note 29, at 576–77:
In brief, limited liability, like any other legal rule, serves certain underlying policies that are intended to achieve certain objectives. In circumstances in which the application of limited liability no longer appears to serve such policies or contribute to such objectives, limited liability, like any other legal rule that does not serve its presumed purposes, must be reexamined critically.

Id.
and efficiently managing capital. Certain qualities exhibited by certain forms of commercial enterprise have been posited as appropriately advancing this policy.\textsuperscript{102} As is explained below, law practices, in their relationships with their clients, do not exhibit these qualities. Organization law developed in light of these policies is an inappropriate source of rules for lawyer/client regulation.

IV. THE PRESENT-DAY JUSTIFICATION OF LIMITED LIABILITY

The proposition that the risk of loss of a private enterprise should be borne not by the claimants of the residue but by the voluntary and involuntary creditors, and, by extrapolation, by society at large, warrants (and has received) critical scrutiny.\textsuperscript{103} Before analyzing the propriety of protecting the personal assets of law firms’ residual claimants from clients’ claims, it is important to understand how such protection is justified generally in the commercial sphere. The proffered justifications are largely experiential, as has to some extent already been discussed, and also have a present-day hypothetical basis in economics and a political basis in democracy theory.

The advent of generally available commercial limited liability in the United States and England coincided with dramatic success in capital formation and investment,\textsuperscript{104} cooperative activity harnessing private entrepreneurship for social benefit. Limited liability has been strongly associated with the phenomenal commercial success\textsuperscript{105} of the modern corporate form,\textsuperscript{106} bringing wealth and power to the owners of enterprises and to their sponsoring political units. It is deeply embedded in our economic policy.\textsuperscript{107} Some commentators consider the coincidence to have

\textsuperscript{102} Prentice, supra note 96, at 309 ("Limited liability is seen as an important and legitimate device for encouraging entrepreneurial activity . . . ").

\textsuperscript{103} Cf. Booth, supra note 98, at 141 & nn. 9–10 (assembling relevant scholarship, referring to the phenomenon of cost avoidance through limited liability as a “market failure”).

\textsuperscript{104} See, e.g., Anderson v. Abbott, 321 U.S. 349, 362 (1944) (discussing that “huge sums of capital” have been assembled on the assumption of limited liability).

\textsuperscript{105} Dean Clark describes the advent of the corporate form over its relatively short history as “this amazing historical transformation.” CLARK, supra note 27, at 2.

\textsuperscript{106} The corporate form has been described as “the greatest single discovery of modern times.” NICHOLAS MURRAY BUTLER, WHY SHOULD WE CHANGE OUR FORM OF GOVERNMENT? 82 (1912), quoted in Handlin & Handlin, supra note 33, at 1; Meiners, Mofsky & Tollison, supra note 69, at 351 & n.1. Interestingly, the same words are attributed to another, infra note 108.

\textsuperscript{107} E.g., Easterbrook & Fischel, supra note 31, at 89 ("Limited liability is a fundamental principle of corporate law.").
been cause and effect. Others put forward arguments (discussed below) that limited liability is not essential to efficient capital markets. These arguments question the indispensability of limited liability to efficient enterprise formation. As does the historical account just rendered, they suggest the possibility that limited liability was not the proximate stimulus to the success of the corporate enterprise format but a popular doctrine that has attracted substantial, but ex post, hypothetical economic justification. This suggests a view of limited liability as a concept easily understood on a positive level and attractive in a popular sense, providing a default contractual arrangement that, for the most part, works, with exceptions to be discussed in what follows. The popular accessibility of the concept of limited liability surely has contributed to the survivability of the corporate form as (up to now) the dominant form of business enterprise. Its popular appeal does not mean that in all circumstances it is efficient, or that, as a norm, it is uniformly desirable.

Commentators advance a number of positive economic effects as justifications for limiting liability on a general basis. These include

108. "[T]he limited liability corporation is the single greatest discovery of modern times . . . ." MAURICE WORMSER, DISREGARD OF THE CORPORATE FICTION AND ALLIED CORPORATE PROBLEMS 2–3 (1927), quoted in STEPHEN B. PRESSER, PIERCING THE CORPORATE VEIL § 1:1, at 1–5 (1993). See, e.g., EPSTEIN, supra note 30, at 269 (arguing that the "corporate aggregation of talents and capital" could not have been assembled without limited liability). Others, including Professor Blumberg, take the view that the explosion was well underway before de jure limited liability was established, and that it would have occurred even without limited liability. Blumberg, supra note 29, at 615.

109. See, e.g., Booth, supra note 98, at 147; Henry Hansmann & Reinier Kraakman, Toward Unlimited Shareholder Liability for Corporate Torts, 100 YALE L.J. 1879, 1933 (1991); Meiners, Mofsky & Tollison, supra note 69, at 352 ("[W]e question whether the rule has any significant impact at all."); see generally Robert B. Thompson, The Limits of Liability in the New Limited Liability Entities, 32 WAKE FOREST L. REV. 1 (1997) (suggesting that limited liability formats will not provide protection beyond what is currently provided under the traditional corporate format).

110. Cf ARTHUR STONE DEWING, 1 FINANCIAL POLICY OF CORPORATIONS 14 (5th ed. 1953) (stating that "limited liability is 'not a necessary characteristic' of the corporation," but is attached to it out of "social expediency"), quoted in Meiners, Mofsky & Tollison, supra note 69, at 357; Kessler, supra note 33, at 235–36 (reasoning that the corporate form is successful because it "is universally associated in the popular mind with limited liability," which Professor Kessler describes as a "primitive . . . hypostatization").

111. Cf Steele, supra note 1, at 625 ("[P]ublic investment in corporations is a significant benefit to the national economy. Consequently, the public readily accepted the idea that corporate liability is limited to corporate assets.").

112. See Hovenkamp, supra note 40, at 1658 ("[B]y 1900 any real possibility of liability would have undermined the attractiveness of corporate stock as an investment.").

113. See generally, e.g., RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW § 14.3 (4th ed. 1992); Rands, supra note 14.
incentives to passive investment (and therefore capital formation)\textsuperscript{114} by reducing investor exposure to liability; reduced agency costs (e.g., monitoring and other forms of risk control carried out by investors);\textsuperscript{115} efficiency\textsuperscript{116} and liquidity\textsuperscript{117} in capital markets (due to reduced risk and reduced necessity of due diligence before investing); and encouragement of risk taking, or entrepreneurship.\textsuperscript{118} The resulting liquid market enables investors to vote with their feet, creating incentive for good managerial performance.\textsuperscript{119} The enabling of passive investment permits investors to diversify portfolios—reducing risk, adding value, and enhancing liquidity.\textsuperscript{120} The resulting pools of capital are available to fund technological innovation, which, according to Professor Richard Epstein, would decline in a full-liability regime.\textsuperscript{121} The same pools of capital are said to be available to redress external harms.\textsuperscript{122} The role of limited liability in the capital markets furnishes the small investor with realistic opportunities for diverse, passive investment.\textsuperscript{123} Widely accepted economic arguments posit that “rational, wealth-[.]maximizing owners and creditors” prefer a limited liability regime because under a regime of full liability, investors would lose more than creditors would gain.\textsuperscript{124} In other words, the low-cost market enabled by limiting liability justifies, in social terms, the cost externalized to creditors, creating a net social benefit.\textsuperscript{125} Notably, these justifications, taken as a whole, are most persuasive when limited liability is combined with passive share ownership and free transferability of equity interests.

\textsuperscript{114} See Hovenkamp, supra note 41, at 53–55.

\textsuperscript{115} See, e.g., Blumberg, supra note 29, at 614 (“Numerous economists argue . . . that the elimination of limited liability would lead to substantially increased agency costs.”). See generally Easterbrook & Fischel, supra note 36, at 40–62 (discussing broadly the role of limited liability in the corporate form).

\textsuperscript{116} Limited liability is said to lead efficiency in terms of price sharing, due to liquidity and fungibility of shares. Easterbrook & Fischel, supra note 36, at 42. These effects are theoretical and in specific cases depend upon the existence of a regular market for shares of a particular corporation. From these observations it will be seen that many of the asserted advantages of limited liability apply to publicly traded corporations only.

\textsuperscript{117} Id. at 95–96.

\textsuperscript{118} Blumberg, supra note 29, at 616.

\textsuperscript{119} Easterbrook & Fischel, supra note 36, at 42.

\textsuperscript{120} See id. at 43.

\textsuperscript{121} Epstein, supra note 30, at 270.

\textsuperscript{122} Id. at 273.

\textsuperscript{123} See Presser, supra note 74, at 171–72.

\textsuperscript{124} Gevurtz, supra note 38, at 30–32. After analyzing the issue from the point of view of both investors and creditors, Professor Bainbridge concludes that “limited liability ought to be the majoritarian default rule” of liability. Bainbridge, supra note 28, at 494.

\textsuperscript{125} See Booth, supra note 98, at 143.
Again speaking generally, limited liability provides social benefit not only by encouraging the aggregation of pools of capital (the historical policy justification), but also by reducing the costs of enterprise (the related ex post economic justification). Dean Clark, for example, refers to the "substantial economic advantages" of limited liability, not as a subsidy for enterprise but as a means of achieving net enterprise cost reduction. Professor Oliver Williamson, cited by Dean Clark, explains that much of the evolution of the modern corporation can be accounted for by transaction-cost economizing, both internal and external, tending to an efficient allocation of resources. Dean Clark describes two "distinct reasons" for this. First, when shareholders are numerous, limited liability reduces creditors' transaction costs of due diligence and collection. Second, "limit[ing investor] liability often shifts risk to a better risk bearer." These efficiencies offset the innate inefficiency of externalization of loss, resulting in net social benefit.

A third function of limited liability observed by Dean Clark is to relieve equity investors of "paying the full costs of the enterprise's external effects." Where there is no substitute cost bearer, such as insurance, and the creditor is not otherwise able to adjust, "the loss simply stays on the victims." This result holds obvious normative implications in the present context, as discussed further below.

Contractarian theory views enterprise not as a jural entity but as a "nexus" of contracts defining rights and duties in terms of claims on value. It posits that, hypothetically, best relationships among enterprise members—residual claimants, agents, and creditors—are achieved through default understandings and negotiation. In this construct, limited liability is one of an established pattern of appropriate majoritarian default rules. Such default rules serve either as low-cost relational terms, reducing negotiation costs, or, in particular cases, as starting points for negotiation. This view presumes low transaction and specification costs that enable negotiation and the employment of rational and informed self-protective

126. CLARK, supra note 27, at 35.
127. Williamson, supra note 85, at 1538 ("Since transaction-cost [reduction] is socially valued, it follows that the modern corporation serves affirmative economic purposes.").
128. CLARK, supra note 27, at 8.
129. Id. at 8–9.
130. Id. at 9.
132. See Callison, supra note 14, at 1065 and accompanying authority.
133. See Bainbridge, supra note 28, at 485.
measures. Where transaction costs are high and especially where they lack symmetry, default rules tend to persist, and in this respect the setting of default rules constitutes public regulation.\(^\text{134}\) In such circumstances, the promulgation of organization law, even if intended as a set of majoritarian default rules anticipating contractual adjustment, becomes public regulation. That, as we shall see, is the case when limited liability organization law is extended to law practices.

As noted in part III, limiting liability has also been justified as tending to "democratize" the capital markets, lowering entry barriers and giving small-scale entrepreneurs a chance.\(^\text{135}\) Democracy theory suggests that such regulatory devices as limited liability, if available to any, should be available to all similarly situated members of the marketplace\(^\text{136}\)—arguably justifying the general availability of limited liability. Making limited liability generally available as a de jure entitlement, and therebyaffording all enterprises the benefit of the default rule, arguably puts all—large and small—on the same footing by requiring creditors to be the ones to adjust in all cases.

All of these justifying doctrines have limits. Limits relevant to the present topic are discussed next.

V. THE LIMITS OF JUSTIFICATION

A. Economic Limits

Under any justifying theory, cost is externalized in a limited liability regime. This externalization risks inefficiency,\(^\text{137}\) but inefficiency does not always result. For example, externalization lowers the cost of production, and if the substitute cost bearer is superior, efficiency results. Secondly,
externalized cost may be re-internalized, to the extent efficiency requires, if creditors are able to adjust to limited liability, as by negotiating around the limitation or by charging a higher price to extend credit or by obtaining guarantees or other types of de facto economic insurance. In this sense, limited liability stimulates a second-step exercise in private ordering (hence its attractiveness to contractarians) with the burden on creditors to initiate adjustment.

Hypothetically, adjustment to limited liability by external risk bearers acting rationally in informed self-interest, is assumed to ameliorate the adverse social effects of limiting liability and to lead toward efficiency. This assumption in turn is underpinned by the insight of Professor Ronald Coase that, where transaction costs are sufficiently low, an initial assignment of risk does not control the ultimate liability outcome because rational parties will negotiate toward an outcome that is efficient in private and social terms. Hypothetical rational creditors will therefore negotiate around limited liability and for devices tending to align the managers’ interests with their own. Such relationships self-regulate through private ordering. The source of duties and allocation of risk is self-regulation through contract.

By its own terms, the Coase effect is not universally applicable. It assumes low transaction costs and, notably for present purposes, it will not apply where transaction costs are strongly asymmetrical. Asymmetry in transaction costs is often described in terms of inadvertent creditors. Creditors are characterized as “inadvertent” (or “involuntary”) when they have no meaningful opportunity to assess risk prior to becoming creditors, have no opportunity to monitor to avoid or reduce loss, do not benefit from any negotiated devices tending to align managers’ interests with their own, and to whom first-party commercial insurance is not

139. See Callison, supra note 14, at 1071 n.41 (“[F]ew question risk shifting when creditors voluntarily deal with a limited liability entity.”); Debra Cohen-Whelan, Individual Responsibility in the Wake of Limited Liability, 32 U.S.F. L. Rev. 335, 356 (1998) (stating that voluntary creditors “may . . . increase the transaction costs associated with doing business with [a limited liability enterprise] to mitigate the risk of limited liability”).
140. This is what Professor Bainbridge calls a “bargain-forcing” default rule, in which the rule disadvantages one party to stimulate bargaining. Bainbridge, supra note 28, at 502–03.
142. Hansmann & Kraakman, supra note 109, at 1920.
143. See Blumberg, supra note 29, at 620.
144. POSNER, supra note 18, at 435.
As to such actors, initial allocations of risk and cost are unlikely to be adjusted. This describes an externally regulated transaction, in which the default rule becomes the source of duty and allocation of risk. As observed by Professor Blumberg, the economic advantages of limited liability ''disappear'' when substitute cost bearers are inadvertent creditors.\footnote{Blumberg, supra note 29, at 616 ("A shift in focus from voluntary creditors to involuntary creditors . . . causes much of the efficiency advantages of limited liability to disappear."). Accord, e.g., POSNER, supra note 18, at 396 ("The contract analogy breaks down, however, in the case of involuntary extensions of credit, as when a pedestrian is struck by a moving van . . ."); Callison, supra note 14, at 1071 n.41 (discussing that the consensus as to risk shifting through limited liability ends when involuntary liabilities are involved "and there is an increased probability that a business enterprise will not bear all of its costs"); French, supra note 29, at 609 ("[T]he justifications of limited liability are generally less persuasive when involuntary creditors are involved.").}

The principal characteristics of inadvertent creditors are that they have no realistic opportunity to bargain, are not otherwise able to adjust ("nonadjusting"), and are not able to evaluate risk or monitor performance in their relationships with their creditors ("nonobserving").\footnote{Alan O. Sykes, The Economics of Vicarious Liability, 93 YALE L.J. 1231, 1247-52 (1984).} As to the client, information and specification costs are too high—indeed, the expert nature of law practice is why we have lawyers at all.\footnote{See, e.g., Shapero v. Ky. Bar Ass'n, 486 U.S. 466, 488-89 (1988) (O'Connor, J., dissenting) (discussing that lawyers' training "by its nature cannot be made generally available, and it therefore confers the power and the temptation to manipulate the system of justice [to the lawyers'] ends").}

While the inadvertent creditor concept is most often associated with victims of torts,\footnote{See Hansmann & Kraakman, supra note 109, at 1920-21.} the characteristics just described apply to other groups of risk bearers in relationships that are not "truly bargained for."\footnote{See Blumberg, supra note 29, at 618-19 (discussing that voluntary creditors may be only those who enter into "genuinely bargained for transactions"; involuntary creditors are those who cannot negotiate around limited liability or take it into account in price).} One commentator suggests, usefully, that the core issue of adjustment to limited liability is whether a party is "able to build risk into price."\footnote{Callison, supra note 14, at 1071 n.41.} This posits a limit on negotiated or planned adjustment as a means of re-internalizing or otherwise reallocating the costs of limited liability toward efficiency.

As between nonbargaining, nonadjusting, nonobserving, uninsured creditors and their obligors, limited liability seems an unlikely majoritarian
default rule. Who would choose to be struck by a moving van? It is at least possible that Judge Richard Posner's pedestrian may have first-party insurance, which is not available to the law client. As a forced default, limited liability is not justified in the case of lawyer and client, because the default burden is placed on the wrong party. Shifting cost to a superior risk bearer is not an available general justification. Costs of due diligence and collection are not reduced. The owners of the truck, by contrast, can anticipate and evaluate risk in both general and specific terms, can take internal measures to control it, can arrange insurance, and can spread cost. In short, externalization is not rationalized with efficiency in every case. This conclusion is not only true in particular cases. Part VI will argue that it is true in the entire economic sector of law practice, setting the stage for regulation.

B. Normative Limits

The political decision to employ the market regulatory device of de jure limited liability embedded in organization law creates a broad statutory norm of externalization without any particularized basis beyond a very general public policy of aggregating capital and promoting its efficient employment. The breadth of applicability of this legislated norm, and its continued growth, risk subsuming other significant norms directed toward other goals. Put another way, organization law, with its legislated norms, is not necessarily the appropriate source of duty and expectation in all types of commercial relationships. As I will argue in this article, it is not the appropriate source of duty and expectation in the lawyer/client relationship.

The justifications of limited liability discussed above describe a market regulated to encourage capital investment by reducing costs of investment, including relieving the residual claimants of their intuitive burden of exposure to enterprise loss. This system puts the residual claimants into a default position of advantage relative to creditors, in the sense that if creditors neglect, or are unable, to adjust to the limited liability regime, they will bear externalized risk. Hypothetically, this default position will not persist because creditors will be stimulated to negotiate or otherwise make adjustments that will lead toward efficient risk allocations.

152. See Bainbridge, supra note 28, at 503 (discussing that the inadvertent creditor of a close business is "the hardest case in which to justify limited liability").

153. The reference is to Judge Richard Posner's famous example. See infra note 174 and accompanying text.

154. Presser, supra note 74, at 159-60 (stating the economic justifications for limiting liability amount to encouragement of investment by reducing the costs of investing in shares).
Accordingly, this market model assumes that nonequity risk takers in enterprise are able to adjust to the regulation.\textsuperscript{155}

Whether putting the residual owner in the advantaged default position is necessary to produce the desired results in the capital markets has been questioned as a matter of economics. Professors Hansmann, Kraakman, and others have put forward arguments that the present system does not require de jure limited liability.\textsuperscript{156} According to Professors Meiners, Mofsky, and Tollison, “contractual freedom makes a statutory rule of limited liability irrelevant.”\textsuperscript{157} This is not the case, however, where transaction costs are persistently too high to permit adjustment by some creditors. Even seminal proponents of the economics of limited liability, such as Professor Manne\textsuperscript{158} and (then) Professor Posner,\textsuperscript{159} recognized the private inefficiencies of limited liability when applied to involuntary or nonadjusting creditors.

Externalization of cost through limited liability is said to attract investment, perhaps even overinvestment, and in economic sectors where capital formation is desirable, let us assume it to be a useful tool of policy and, in most cases, efficient. Limiting liability de jure through general organizational law, however, draws investment not according to the need to attract capital, but according to the availability of certain advantaged enterprise formats, regardless of economic sector and regardless of the need for capital formation. Thus, the political purpose of limited liability is to attract enterprise, any enterprise, to sponsoring political units that proffer the advantaged formats. Even so, for so long as creditor adjustment is practicable, the inefficiencies of limited liability should be ameliorated. Where there is neither a requirement to form capital nor a practical possibility of adjustment, however, the asymmetry of limited liability is difficult to justify. As observed by Dean Clark, quoted above, loss is simply left with the creditors, with economic and normative negative effects.\textsuperscript{160}

The positions taken by scholars such as Professors Kraakman and Booth,\textsuperscript{161} combined with an understanding of the political origins and

\textsuperscript{155} See, e.g., Hovenkamp, supra note 40, at 1657.

\textsuperscript{156} E.g., Hansmann & Kraakman, supra note 109, at 1933 (“[I]f the case for limited liability turned exclusively on questions of corporate structure or finance, we would conclude without hesitation that this rule ought to be abandoned in favor of the basic policy goals of the tort system.”). See generally Booth, supra note 98; Meiners, Mofsky & Tollison, supra note 69.

\textsuperscript{157} Meiners, Mofsky & Tollison, supra note 69, at 364.


\textsuperscript{160} See supra note 129 and accompanying text.

\textsuperscript{161} See supra note 156 and accompanying text.
continued underpinning of de jure limited liability, suggest that the positive effects of limited liability, while they may accord with certain posited goals under certain circumstances, are not universally appropriate. As a legislated "asymmetry in the distribution of gains and losses," limited liability merits critical evaluation in each aspect of commerce in which it is deployed. Limiting liability produces effects that differ among commercial sectors according to the costs of the necessary adjustments. In some cases, including the lawyer and the client-as-risk-taker in the lawyer/client relationship, the costs of adjustment to external risk takers to limited liability are so high that adjustment is unlikely to occur. As a result, organization law, with its set of norms oriented to capital formation and efficient capital markets, paints with too broad a brush in certain areas of enterprise, occluding other norms proceeding from other value sets.

Accordingly, while limiting commercial liability has, generally speaking, accompanied observable, socially beneficial success in capital formation and employment, its social appropriateness is not without limits. Further extension of limited liability through organizational law into law practice should be evaluated in terms of these limits. This is discussed next.

VI. THE INAPPLICABILITY OF LIABILITY-LIMITING RATIONALES TO THE LAWYER/CLIENT RELATIONSHIP

This part evaluates the validity in the law practice context of the rationales of limited liability. It concludes that such rationales do not convincingly justify the protection of the residual claimants of law practices from the claims of clients. Clients are both principals and creditors of their lawyers. As principals they are typically nonobserving, and as creditors, nonadjusting. The fiduciary duties owed to clients by their lawyers conflict with the corporate duties owed by employees/lawyers, and the firms themselves, to maximize the value of the residue. Limited liability, achieved through general organization law and designed to advantage the residual claimants over creditors, is not an appropriate source of rights and duties in the lawyer/client relationship.

A. The Rationales for Limited Liability Are Not Universally Applicable

Parts III and IV have explained how economic and political goals support the pooling of passive capital and its efficient employment,

162. See Epstein, supra note 30, at 267. Professor Hovenkamp describes limited liability as a "wealth transfer" from creditors to shareholders. Hovenkamp, supra note 40, at 1657.
generally perceived as providing social value, and how limiting commercial liability is justified as a tool of such policy. The social utility of limited liability in this respect must be weighed against the inefficiencies accompanying externalization of loss to substitute cost bearers, including externalization of risk (and the costs of dealing with risk) and loss to substitute cost bearers, with their attendant private and social costs. The economic and political goals served by limited liability are effected by legislatively embedding a norm in organization law. The norm is manifested as a default rule advantaging the residual claimants over external stakeholders, in the sense that it is the creditors who must either adjust or bear the risk and loss externalized by limited liability. Whether the residual claimant or the external stakeholder is assigned, the default advantage is not conclusive so long as adjustment is practicable. The political determination—supported by the economists—has therefore been to advantage the residual claimants, to encourage investment through pooling passive capital, and to promote the capital markets. Creditors are benefited by reduced costs of due diligence and collection. In general economic terms, it is accepted that in social terms more would be lost by a full liability regime than would be gained by eliminating the potential inefficiencies of limited liability. This conclusion applies to law practices substantially as it does to other enterprises, but not entirely. The mismatch can be explained in terms of both the political and economic goals of limited liability.

From the point of view of the political goal of pooling capital, and taking as a whole the justifications for limited liability discussed in part IV, the persuasiveness of the justifications rests largely upon the validity of three general assumptions: (1) that the attractiveness of particular equity investments is materially enhanced by a default rule limiting the investors'


164. See generally, e.g., EPSTEIN, supra note 30, at 266–74 (arguing that the “inconveniences” caused by limited liability are “outweighed by its advantages”); Booth, supra note 98, at 148 (discussing that standard arguments for limited liability posit that “the benefits outweigh these unfortunately distributed costs”).

165. See supra note 141 and accompanying text (discussing Coase).

166. See supra notes 113–124 and accompanying text (demonstrating circumstances in which limited liability inefficiencies outweigh social gains of full liability).
liability;\textsuperscript{167} (2) that the attractiveness of particular enterprises to equity investment is significantly enhanced by opportunities for passive investment accompanied by free transferability of ownership,\textsuperscript{168} and (3) that those undertaking business risk, including creditors, base their investment decisions on rational, informed self-interest, including an opportunity appropriately to evaluate and adjust risk. The latter assumption implies, on one hand, information, specification, and other transaction costs at levels low enough to enable meaningful bargaining, and, on the other, the availability of methods of self protection, insurance, and cost—spreading adjustment to the limited liability regime.\textsuperscript{169}

As service enterprises regulated for the benefit of clients and society as a whole, law practices are not organized upon these assumptions. From a commercial point of view they need not be because, in the legal services sector, limited liability is not required to stimulate enterprise. Indeed, accepting as valid for present purposes the political policy justifications for limiting commercial liability, one looks in vain for any such justification that applies to law practices. They do not require significant capital formation.\textsuperscript{170} Economic barriers to entry in terms of capital formation are not so high as to require pooling passive public investment. For this reason a liquid market in equity ownership is not required. Because net revenues pass through to owners under the prevailing structural and tax regimes, law practices characteristically do not themselves create pools of capital. Judging by the number of entrants annually, entrepreneurship in the profession needs no encouragement.\textsuperscript{171} In law practice, limited liability has

\textsuperscript{167} Booth, supra note 98, at 143 (discussing that the traditional argument for limited liability "amounts to little more than the idea that investors will invest more if they are subsidized by relief from some of the costs" attending investment); id. at 147 (stating that the posited economic benefits of limited liability are "equivalent to saying that investors need to be subsidized in order to induce them to invest").

\textsuperscript{168} Investment is especially attractive in those enterprises whose equity securities enjoy a liquid market based largely on passive investors. See, e.g., William A. Klein & Eric M. Zolt, Business Form, Limited Liability, and Tax Regimes: Lurching Toward a Coherent Outcome?, 66 U. COLO. L. REV. 1001, 1031 (1995) (noting that the economic efficiency arguments "are relevant only to large-scale, publicly held firms"); see Posner, supra note 18, at 423 (discussing that justifications assume a model of motivation and governance limited to widely-held businesses).

\textsuperscript{169} See supra note 151 and accompanying text (discussing adjustments).


\textsuperscript{171} See, e.g., Carrie Menkel-Meadow, Culture Clash in the Quality of Life in the Law: Changes in the Economics, Diversification and Organization of Lawyering, 44 CASE W. RES. L. REV. 621 (1994) (describing the growth and diversification of the legal sector, including entrepreneurial forms of law practice); Andrew M. Perlman, Toward a Unified Theory of
not been a required stimulus to entry. Finally, law clients are typically nonadjusting creditors, and are nonobserving principals in the sense that information costs are too high to permit their meaningful evaluation of their lawyers' performance. In short, none of assumptions (1), (2), or (3) apply to law practices. This makes intuitive sense. An organization law norm designed to serve a political goal of pooling capital for industrialization is incongruent with a service profession that requires little capital.

If law practices sought outside equity investment, the passive outside investors would wish to share control and gains, a disincentive. Law practices don't need to seek external passive equity investment, however, because they are capitalized, in effect, by their clients. Accounts receivable are the major financial asset of any law firm, but clients are capitalists of their lawyers in a more fundamental sense. They provide the raw material, in the form of the need for legal services, that is turned into product by the firms' means of production. They extend credit to their lawyers while production is underway. They provide reputation as well.

Because they are capitalized by their clients, law practices are relieved of the necessity of obtaining external passive equity capital. This enables law firms to operate as close businesses, with the attendant agency efficiencies of identity of interest of residual claimants, policymakers, and managers. Notably, it is those very efficiencies, including the lack of external equity monitors, that enable opportunistic behaviors by residual claimants when their personal assets are shielded. Notably also, it is when law practices get very large, and these efficiencies erode through sheer size, that they begin to be interested in reducing agency cost through limited liability.

Do the political market-capital goals of limited liability apply to law enterprises? The goals of pooling capital and stimulating a liquid market are not applicable. The eagerness of state governments to adopt limited liability formats suitable for service enterprises suggests, however, that the political goal of drawing enterprise, any kind of enterprise, and to protect the ones at home, is a sufficient political goal to justify the states' new formats. In the case of law enterprises, however, as will be seen in what follows, this political determination overlooks both economics and fiduciary norms.

B. The Client as Economic Risk Taker

The client of a law practice is an external stakeholder of the practice both as creditor and, in a sense, as a claimant against the residue. In both respects

---

Professional Regulation, 55 FLA. L. REV. 977, 1015 (2003) ("The profession . . . has never had any trouble attracting talented people to the field.").
the client has little capability to enforce the claim beyond that of an unsecured, nonadjusting creditor. This section describes the posture of the client as stakeholder.

At the most prosaic level, inherent in every legal representation is the probability that the law practice will become financially obligated to the client. Examples include obligations relating to assets held by the practice on the client’s behalf, to refunds of unexpended retainers or other overpayments, to proceeds of judgments obtained by the practice on the client’s behalf, and to civil judgments, including malpractice judgments, obtained by the client against the practice itself. As to clients’ assets in the hands of a lawyer, the lawyer is a trustee. The client is a claimant in respect of services contracted for but not yet provided. Where a client has a claim in these respects, but the defaulting firm is insolvent, and the residual claimants are protected from the claim, the practice has externalized cost to the client, and has not paid the full costs of its production, an inefficient result.

As claimant against the practice, the law client competes at significant disadvantage for cash flow and residual value with the practice’s residual claimants, who can be assumed to act rationally, seeking to use their managerial control to maximize their own benefit. Indeed, one way in which this is manifested is their inclination to organize in limited liability practice formats. The dominant residual claimants will tend to orient internal divergence control, such as monitoring, to their own benefit, and to reduce agency cost by relaxing internal monitoring as to the interests of external claimants. The simplest manifestation of this divergence of interest will be the residual claimants’ exercise of a direct claim on cash flow and any earned surplus as compensation to themselves or employees. Again, the prevailing enterprise and tax structures facilitate this. Should a law practice be managed in a way that leads to insolvency, then, in a limited liability environment the clients will join any other unsecured, nonadjusting creditors in bearing the loss. Gains of the enterprise previously remitted to the residual claimants will be retained by them. The nonadjusting clients to whom loss is externalized will not be superior risk bearers, as explained below.

In a further sense, as already noted, the clients capitalize the practice. As capitalizers of the practice, clients are passive—as nonobserving principals, they have no voice, either directly or by proxy (no board of directors speaks for them) and their power of exit, being poorly informed, is equivocal. As nonadjusting, nonobserving competitors with the residual claimants of the practice they are severely disadvantaged in gaining access to the cash flow or any residue. Access to the personal assets of the residual claimants gives
them both a manifestation of their residual claim and a voice—the proxy voice of the residual claimants whose interests are now aligned with theirs. It also gives them exit in the sense of access to the residue in the form of earned surplus remitted to the residual claimants. Without such access there is a windfall for the residual claimants, who need not take the clients’ claims into account in investing in precaution to preserve the residue. Inefficiency results when the clients’ claims as capitalists are not accounted for but are captured, in effect, by residual owners who need not recognize the capital cost in the true cost of production.

The financial risks of stakeholders in law practices are hypothetically adjustable. Many clients, no doubt, have sufficient sophistication and leverage to anticipate and negotiate with, and monitor, their lawyers in respect of business risk. These are clients whose day-to-day business activities involve the regular use of lawyers in planning, operations, and litigation. They can be presumed to be sophisticated, motivated to assure receipt of good legal services at good value, familiar with the system, and important to their lawyers. They will be capable of observing their agents, and capable of adjustment. Such clients may also be superior risk bearers. They can be termed wholesale consumers of legal services.

Most clients of law firms do not fall into this category. Data show that most lawyers in this country practice alone or in small firms, and that their typical clients are “nonwealthy individuals,” seeking representation for personal matters. Such clients have minimal sophistication or experience in the legal system. They would likely include most defendants in the criminal justice or social service systems (many represented by appointed lawyers) and the great mass of individual and small business clients. Many would be one-time or occasional users of the legal system, and many would find themselves in the system involuntarily, as criminal defendants, parties to divorce, accident victims, or participants in once-in-a-lifetime civil actions. With respect to finding themselves bearing the risk of their lawyers’ insolvency, these clients will tend to exhibit the qualities of Judge Posner’s pedestrian, struck by a moving van and “not . . . compensated for bearing the default risk created by the moving company’s limited liability.” Judge Posner refers here to transaction costs so high that there is no meaningful opportunity to adjust. Such clients will be incapable of observing their lawyer agents. They can be thought of as the retail consumers of legal services. Relative to their lawyers they can fairly be

172. POSNER, supra note 18, at 432.
174. POSNER, supra note 18, at 435.
presumed to be inferior risk bearers. Shifting risk and cost to such clients represents an initial allocation unlikely to be adjusted. Limited liability as a default rule in law practices fails to assign liability to the cheapest cost avoider.

The duty of managers of an enterprise is to increase the value of the residual claims. Where the residual claimants of the enterprise are owed this duty, and especially where they wield management powers and have direct access to the gains of the enterprise, but are not personally exposed to liability, their incentive is to risk behaviors with possibilities of greater personal gains. If the risk succeeds, the proprietary claimants benefit. If it does not, at the point of insolvency the loss is externalized; the client bears the loss of the failure in place of the residual claimant, whose assets are protected. Accordingly, absent personal vicarious liability of the residual claimants, the client is an insurer as to the residual claimant.

Agency theory leads to a similar conclusion. As postulated by the adherents of limited liability, an employee/lawyer is in a position to incur liability beyond the lawyer’s ability to pay and, indeed, beyond the law firm’s ability to pay. In the words of Professor Sykes, the residual claimants “can use [this] to their advantage” under limited liability because the insolvency of the lawyer and the enterprise increases the profits of the residual claimants (lowering costs they must bear) “by the value of the judgment less the agent’s ability to pay, multiplied by the probability of the judgment.” The limited liability organizational arrangement among lawyer, enterprise, and the residual claimants will likely be Pareto optimal among them but, as can be the case with privately optimal

175. See id. at 8.
177. See infra note 206 and accompanying text.
180. Because the residual claimants themselves are potentially insolvent, clients will always be subject to some externalized cost. Nevertheless, efficiency as a goal, though never perfectly attainable, is enhanced. Further, the goal of suppression of fiduciary risk is advanced.
181. Sykes, supra note 147, at 1241.
182. Id. at 1242.
arrangements,\textsuperscript{183} socially costly: the wealth of the residual claimants will be increased at the expense of full recovery to the client.\textsuperscript{184}

\textbf{C. The Client As Bearer of Fiduciary Risk}

In the immediately foregoing material I described clients as bearers of their lawyers' business risk to illustrate the problem of commercial arrangements that put clients, as one set of risk takers of a law enterprise, at a systemic disadvantage in competing with dominant residual claimants at the same time that clients are unable to make adjustments to the inefficiencies of limited liability. In this part, I will suggest that a further and more striking inefficiency results from the complication of the multiple sets of agency costs inherent in a law enterprise combined with the asymmetry of the capabilities of lawyer and client. The client, as principal, risks the lawyer's failure to fulfill the fiduciary duty of good faith and due care. This concept subsumes the concept of shirking. I will refer to the threat of fiduciary failures as "fiduciary risk," and related injury as "fiduciary harm."

A default rule of limited liability externalizes fiduciary risk and harm to clients in the same way that business risk and cost are externalized, and I think it fair to say that this strikes at the heart of the lawyer/client relationship, as we have traditionally understood it. The lawyer/client relationship as presently understood is underpinned by a core norm of undivided loyalty of lawyer to client.\textsuperscript{185} This norm is strongly promoted both by the lawyers' professional organizations (in justifying the self-

\underline{183.} \textit{Id.} at 1234.

\underline{184.} \textit{Id.} at 1242. Professor Sykes observes that at least three sets of inefficiencies result from the potential insolvency of agents—employees/lawyers in our model. First, because what is risked by the lawyer is less than the potential loss might be, the lawyer will not take optimal care. Second, as described in the text, potential lawyer insolvency increases the expected profitability of the residual claimants (in our model), giving the owners an incentive to forgo efficient internal risk allocation. Third, the insolvency of the lawyer in a limited liability regime will permit the residual claimants to externalize cost, leading to an inefficiently high level of production. \textit{Id.} at 1244.

\underline{185.} See Burdett v. Miller, 957 F.2d 1375, 1381 (7th Cir. 1992) (Posner, J.) ("A fiduciary duty is the duty of an agent to treat his principal with the utmost candor, rectitude, care, loyalty, and good faith—in fact to treat the principal as well as the agent would treat himself."); \textit{MODEL RULES OF PROF'L CONDUCT} R. 1.2(a), 1.7 cmt. 2.1 (2003) [hereinafter \textit{MODEL RULES}] (describing a lawyer's duty to represent the client with professional judgment and undivided loyalty).
This norm is undercut by the organization law norm of limited liability. Because clients as principals are nonobserving, fiduciary risk is insidious. It can reach expression through such actions as minimizing effort or internal monitoring as to some client matters in order to pay more attention to more profitable ones, “borrowing” from client trust accounts, stimulation of overly aggressive billing practices to increase revenues, or of self-dealing by the law practice at the expense of clients. As nonobserving principals, clients may well not be aware of fiduciary harm, as Professor Wilkins suggests. It can take such subtle forms as a general degradation of representation, never rising to a level at which the client both becomes aware of it and finds it practicable to seek recourse in the courts. This states a strong case for ex ante regulation. Less obviously, however, fiduciary risk goes to the normative heart of the lawyer/client relationship. This can be demonstrated in terms of the nature of the relationship as a complex agency.

Where organization law exempts the residual claimants from personal vicarious liability, a passive intermediary—a person interested in enterprise profit and owed duties by the enterprise, but owing no duty, direct or vicarious, to the disadvantaged client—is interposed between the employee/lawyer and the client, and between the practice and the client. Clients are accordingly exposed to the inevitable “divergence of interest” between agent and principal on more than one level. In a recent opinion, a United States District Court applying Massachusetts law took the opportunity to clarify, evidently for the benefit of the lawyers in the case, the meaning of “conflict of interest.” The court wrote, “A conflict of interest is involved if there is a substantial risk that the lawyer’s representation of the client would be materially and adversely affected by

187. See generally EPSTEIN, supra note 30.
188. This is a particular problem for smaller clients of larger firms, on account of the phenomenon of claim dilution. In lender-liability theory, “the greater the amount of debt” owed by a borrower, “the lower the value of [any particular] debt.” Daniel R. Fischel, The Economics of Lender Liability, 99 YALE L.J. 131, 134 (1989). Similarly, in law practices with a great number of clients, an individual client of small stature will experience dilution of its claims on the practice. While claim dilution of law clients is probably unavoidable, vicarious liability of the proprietary owners is a relevant control.
189. Wilkins, supra note 6, at 815–18.
190. See Easterbrook & Fischel, supra note 36, at 9–10.
the lawyer's own interests or by the lawyer's duties to . . . a third person." 192

In a law practice, the "third person," the passive intermediary, is the unregulated residual claimant of the practice to whom the employee/lawyer owes duties such as maximization of the residue of the enterprise, and to whom the practice itself owes similar duties. 193

Law enterprises involve complex agency costs—they involve conflict of interest analysis on multiple levels. The employees/lawyers owe fiduciary duties to their clients at the same time that they owe fiduciary duties to the practice. 194 The employee/lawyer is "essentially trapped" 195 between these duties when the residual claimants require employee/lawyer to the interests of the enterprise rather than clients, or certain clients. The practice itself owes a fiduciary duty to its clients and to its residual claimants and will similarly be trapped between these duties when they conflict. The lawyers/managers of the practice owe a fiduciary duty to the practice itself and to the residual claimants. As Judge Easterbrook and Professor Fischel observe, a manager with duties to two beneficiaries "has been freed of both . . . Agency costs rise and social wealth falls." 196

Unless some other incentive is substituted, the rational objective of the residual claimants, as usual in a business enterprise, is to control the employees' behavior to their own advantage. 197 In a limited liability regime, the residual claimants qua investors owe no one a fiduciary duty, and

192. Id. at 272 (quoting RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 121 (2000)) (emphasis added).

193. A notable example is the billable hours issue. As illustrated by Professor Rhode, activities risky to clients, including over-billing, are stimulated by the corporate emphasis on generating revenues. RHODE, supra note 186, at 168–78. Auditors find demonstrable fraud in up to ten percent of lawyers' bills reviewed, and questionable practices in another twenty-five to thirty-five percent. Id. at 169. Forty percent of surveyed lawyers acknowledge that some of their work is influenced by a desire to bill more time. Id. Also common are overstaffing and unjustified markups of expenses. Id.

194. See, e.g., Kramer v. Nowak, 908 F. Supp. 1281, 1291–92 (E.D. Pa. 1995) (describing the employee/lawyer conflict between duties owed to clients and duties owed to the employer); Deborah A. DeMott, The Lawyer as Agent, 67 FORDHAM L. REV. 301, 309–11 (1998); Leonard Gross, Ethical Problems of Law Firm Associates, 26 WM. & MARY L. REV. 259, 259 (1985); Hillman, supra note 8, at 1388 (discussing that in a professional service firm, such as a law firm, ethics norms create duties running to clients that potentially conflict with agency norms creating duties among the members of the firm).


196. EASTERBROOK & FISCHEL, supra note 36, at 38.

197. Bainbridge, supra note 28, at 501 ("[I]n close corporations[,] it becomes significantly more likely that shareholders will cause the corporation to act in ways that in fact externalize risk onto creditors. . . . [S]hareholders and managers frequently are one and the same [and,] consequently, . . . can cause the corporation to externalize risk and, moreover, have strong incentives to do so.").
rationally will promote their own interests to the extent they are able—and they are able, to a significant extent, in a law practice, where the residual claimants are also the policymakers and managers. This casts the complex duties of a law practice into inherent conflict, risky to clients. Regulating the residual claimants to align their interests with those of the clients rationalizes the conflicting duties by directing them all to the same objective—the clients' best interests. Limiting liability deregulates the residual claimants, putting these duties back into conflict, increasing agency cost, and assigning the increased cost to the client. Accordingly, maximizing the interest of the residual claimants will tend to be at the expense of the nonadjusting, nonobserving client.

The less the residual claimant has at risk, the lower the investment in precaution on behalf of the client, and the more this effect is magnified. The complex agency costs of law enterprises reflect a tension between the goals of statutory, market-regulatory limited liability and the goals of lawyer regulation. Limited liability creates a default rule purposefully advantaging the residual claimants of an enterprise over the creditors of the enterprise, assuming that creditors will adjust, generally leading to efficient resource allocation. In the paradigm of the limited liability enterprise, it is understood that management’s duty is to maximize value for the benefit of the enterprise and its residual claimants. In the words of Dean Clark, "[M]anagers have an affirmative open-ended obligation to increase . . . residual value, rather than the wealth of some other affected group . . ." Law practice doesn't fit this paradigm because of the existence of another affected group—the clients—whose benefit supersedes the benefit of the owners of the residue.

198. See, e.g., Lisa G. Lerman, Lying to Clients, 138 U. Pa. L. Rev. 659, 759 (1990) (positing that money has become the greatest value in large law practices, and that the pressure to perform financially causes lawyers to mislead clients concerning the basis of fees).
199. Cf. Harry T. Edwards, A Lawyer's Duty To Serve the Public Good, 65 N.Y.U. L. Rev. 1148, 1152 (1990) (discussing pressure on partners to increase profit margins and on associates to meet financial goals); Menkel-Meadow, supra note 171, at 629–33 (discussing the increased emphasis on billable hours as a measure of success, for the benefit of law practice owners).
200. See Fischel, supra note 188, at 134 (discussing how under lender liability theory, the incentive to invest in risky projects becomes larger as equity capital becomes smaller relative to debt, so that the equity owners risk less of their own and more of the lenders' capital).
201. REVISED MODEL BUS. CORP. ACT § 8.30 (1985).
202. CLARK, supra note 27, at 18.
203. See Gross, supra note 194, at 303: [. . .] a law firm’s interest is not coextensive with the interest of the client insofar as the firm seeks to maximize its own profit. The associate is essentially trapped between his duty to the firm and his duty to the client. . . . In such a situation, the associate’s duty to the client . . . should override his duty of loyalty to the law firm.
As Professor Richard Epstein has observed, "'agency cost' . . . is the economic equivalent of the conflict of interest question," which is a persistent problem in law agencies.\(^\text{204}\) Devices to assure services commensurate with expectations—in the case of a law agency, undivided loyalty and performance up to an appropriate, expert standard of care—are necessary.\(^\text{205}\) The lawyer "bears the full cost of his own actions," that is to say, the justified expectation\(^\text{206}\) is that the lawyer internalizes the cost of production.\(^\text{207}\) Professor Epstein goes on to explain that "[t]he risks of self-interest are such that the attorney may not undertake actions that work for the benefit of the client because of the high costs of doing them."\(^\text{208}\) This proposition describes an interest divergence that requires regulating.\(^\text{209}\) When the residual owners are protected against clients' claims against the practice, the resulting (and fully intended) shift of agency cost from residual claimant to client illustrates the re-emergence of a conflict of interest.\(^\text{210}\) As Professor Deborah Rhode has noted, to align the interests of lawyers with their clients, the incentive structure within law practices—the organization law of law practices—must be regulated.\(^\text{211}\) Limiting the personal vicarious liability of the residual claimants of law firms has the opposite effect.

The tension between the formats in which law is practiced and the clients' best interests has been resolved, up to now, in favor of the clients. The disciplinary rules, for example, strongly regulate the scope for lawyers to negotiate away their personal liability to clients, "because such an agreement appears to serve the attorney's interests rather than the client's."\(^\text{212}\) The disciplinary rules permit limiting malpractice liability only under conditions that include representation of the client by another

---

\(^{204}\) Id.

\(^{205}\) Id. at 581–83.

\(^{206}\) Id. at 580. One thesis of Professor Epstein's piece is that a powerful aspect of lawyer regulation is customary expectation: "The expectations of ordinary parties may be unexpressed, but at least in this context they are powerful and real." Id.

\(^{207}\) Id. at 580–81.

\(^{208}\) Id.

\(^{209}\) Id.

\(^{210}\) Lawyers organize in limited liability formats for the purpose of shifting agency cost from their residual claimants to their clients. See supra notes 12–25 and accompanying text.

\(^{211}\) RHODE, supra note 186, at 182 (stating that the law firm structure should be designed to complement the ethical norms.). See Burne V. Powell, The Limits of Integrity or Why Cabinets Have Locks, 72 FORDHAM L. REV. 311, 332 (2003) (showing that knowledge and notions of morality are less effective in leading to ethical decisions than is structure-framing "ethical environments").

\(^{212}\) Developments, supra note 9, at 1664.
The requirement that a client be represented in negotiations with the client's own lawyer demonstrates in clear money terms the cost to the client of attempts by lawyers to limit their exposure to personal liability to clients, and is a clear illustration of the rules' recognition of the disadvantages under which clients labor in striking a bargain with their lawyers.

When a class of commercial actors is persistently disadvantaged regarding attempts to regulate commercial relationships privately, a case is stated for some other source of regulation. This must be especially true where the disadvantage is a dilution of the performance of fiduciary duty. The persistent and systemic disadvantaged position of clients relative to their lawyers, in the light of the public interest in the legal system, states a strong case for external regulation of the relationship. Vicarious personal liability of the residual claimants of law firms is a tool of lawyer regulation. This is discussed in the section that follows.

D. The Regulatory Function of Vicarious Liability

A free market in a good or service implies that, at some point or in some cases, transaction costs will rise to the point that gain on exchange is not worth trading and the development of a market is prevented. Where the market is not free but oligopolistic, as in the law business, the consumer is forced to enter the market in spite of transaction and agency costs that, in many cases in an unregulated environment, would exceed the benefit of the relationship. Such conditions state a case for regulation. Our polity has long recognized the likelihood that clients will be nonadjusting and nonobserving (unable to control interest divergence in their relationships with their lawyers due to high information and specification costs), and has

213. MODEL RULES, supra note 185, at R. 1.8(h).
214. Such costs have been described as "potentially prohibitive," justifiable only if exchanged for reduced fees. Developments, supra note 9, at 1671–72.
215. POSNER, supra note 18, at §§ 4.1, 4.7; cf. e.g., The National Labor Relations Act, 29 U.S.C. § 151 (2)(d) (1988) (asserting in its statement of purpose that regulation is necessary to "restor[e] equality of bargaining power between employers and employees").
216. See Williamson, supra note 85, at 1541.
217. Cf. Henningsen v. Bloomfield Motors, Inc., 161 A.2d 69 (N.J. 1960). In Henningsen, the court, describing adhesive contracts, observed that freedom of contract does not exist in cases in which a party advantaged as to information and market power dictates contract terms not just to a disadvantaged individual, but to "an undetermined multiple." Id. at 86. The court observed that such contracts exhibited the qualities of mandatory laws rather than arms-length allocations of risk and cost, and accordingly should be subject to regulation. Id. at 86, 95. Default rules in a context in which adjustment by one party is impracticable are similar.
recognized as a norm that such risks should not be included among the clients' reasonable expectations.\textsuperscript{218}

The previous section described benefits to the residual claimants of law firms derived from limiting their liability, at the expense of clients.\textsuperscript{219} This benefit to the residual claimants at the expense of the client is suppressed by the regulatory effect of vicarious liability of the owners, requiring them to internalize the full costs of the enterprise, resulting in levels of precaution by lawyer and proprietary owner that are efficient socially and privately.\textsuperscript{220}

Accordingly, the relationship between lawyer and client is externally regulated in a variety of ways.\textsuperscript{221} Professor David Wilkins posits four major forms of lawyer regulation: Disciplinary controls, including implementing the disciplinary codes promulgated by the self-regulatory agencies; liability controls, including malpractice; institutional controls, implemented by courts or regulatory agencies (such as the Securities and Exchange Commission) over those who practice before them; and legislative controls, proposed administrative agencies similar to medical boards.\textsuperscript{222} Of primary significance for present purposes are the disciplinary rules and liability controls, or civil liability.

Commentators advocating limited liability for lawyers suggest that the disciplinary rules permit, in effect, protecting the personal wealth of the residual claimants from client claims against the enterprise.\textsuperscript{223} This appears to suggest that the rules subsume all other forms of lawyer regulation, and in particular have abandoned second-level vicarious liability as a regulator, but I do not agree. The disciplinary rules constitute a description of duties owed by lawyers to clients, but are not intended to be comprehensive in regulatory scope.\textsuperscript{224} The argument that the disciplinary rules are dispositive overlooks the discreet regulatory functions of the disciplinary rules and civil liability.\textsuperscript{225} Disciplinary rules identify public wrongs. They are intended to provide to the court system, as regulator of lawyer behavior, a vehicle to vindicate public interests in certain described aspects of lawyer

\textsuperscript{218} See FitzGibbon, supra note 24, at 322–23 (quoting Burdett v. Miller, 957 F.2d 1375, 1381 (7th Cir. 1992) (Posner, J.)) ("[A lawyer's client] is in no position to supervise or control the actions of his principal on his behalf; he must take those actions on trust; the fiduciary principle is designed to prevent that trust from being misplaced.").

\textsuperscript{219} See supra Part VI.C.

\textsuperscript{220} Sykes, supra note 147, at 1246.

\textsuperscript{221} See Wilkins, supra note 6, at 802–03.

\textsuperscript{222} Id. at 805–09.

\textsuperscript{223} See, e.g., Lawrence, supra note 16, at 212–13.

\textsuperscript{224} See, e.g., Ribstein, supra note 17, at 1714 ("[A]n ethical code is a blunt instrument that leaves much self-interested conduct untouched.").

\textsuperscript{225} Id. at 1708.
misbehavior. Civil liability, by contrast, is private lawyer regulation, vindicating the private order between a particular client and lawyer upon a showing, not that rules have been broken, but that the lawyer has harmed the client. As Professor Wilkins has observed, the disciplinary machinery is not likely to redress client injury and, further, may not have a high interest in individual cases.\(^{226}\) Accordingly, a client can be harmed, even severely, without attracting the attention of the disciplinary machinery. Professor Wilkins regards as "dubious" claims that discipline will enforce lawyers' duties comprehensively.\(^{227}\) He concludes that liability controls will address claims that will not be addressed through discipline.\(^{228}\) Elimination of the liability control represented by vicarious personal liability of the residual claimants is deregulation.

Civil liability to clients, as a regulatory device, is designed to internalize the production costs of law practices.\(^{229}\) It operates ex ante to align the interests of lawyers with those of their clients, discouraging divergent acts and stimulating internal monitoring on behalf of clients. It also offers the possibility of an ex post corrective feature in the form of damages for injury.

The corrective feature of civil liability is inefficient as a regulator. For a client, determining that they have been harmed is problematic (costly, in economic terms) and bringing a lawsuit is costly. Information costs are high and litigation's inefficiencies are discouraging.\(^{230}\) The cost of correction may well exceed detected harm. Clients often lose such cases, but even if successful, the client remains subject to insolvency risk—the risk that available resources will not be sufficient to pay the judgment.\(^{231}\) A civil

\(^{226}\) Wilkins, supra note 6, at 815–16.

\(^{227}\) Id. at 829. "[T]he bar's assertion that disciplinary controls can effectively address the full range of lawyer misconduct is unpersuasive in light of the clear compliance gains that can be achieved through liability and institutional controls." Id. at 848.

\(^{228}\) Id. at 830. "[L]iability controls appear likely to address a broad range of claims that would otherwise fall outside the present disciplinary system." Id. at 835.

\(^{229}\) Id. at 833.

\(^{230}\) See, e.g., id. at 815–16 (discussing the inefficiencies of civil remedies as a regulatory device); Keith N. Hylton, Litigation Costs and the Economic Theory of Tort Law, 46 U. MIAMI L. REV. 111, 113–14 (1991) (discussing that where litigation is required to internalize social cost, losses suffered by those who do not sue and litigation costs of those who sue and prevail will not be internalized, resulting in under-deterrence).

\(^{231}\) Generally speaking, corporate and LLC statutory rules limit distributions to the residual owners beyond the point at which the enterprise would be able to satisfy obligations incurred in the ordinary course of business. See, e.g., REVISED MODEL BUS. CORP. ACT, supra note 201, § 6.4. Such rules do not accommodate events outside the ordinary course, such as an insolvency-inducing malpractice judgment. They also do not control the disbursement of law practice revenues in the form of compensation and benefits to the residual claimants and their
judgment against the enterprise, vindicating the client's fiduciary status, perversely converts the client from beneficiary of fiduciary duty to an unsecured, nonadjusting creditor of the enterprise, competing at a severe disadvantage with adjusting creditors and the residual claimants for cash flow and the residue, and subject to insolvency risk. Corrective justice is, therefore, not the purpose of civil liability as a regulator. The main purpose of civil liability as lawyer regulation is deterrence.

Where (as is typical in law practices) enterprise resources are limited and the residual claimants' personal resources are veiled, civil liability's deterrent qualities are muted. Civil liability of the enterprise alone does not eliminate the client's exposure to either insolvency or fiduciary risk.232

Because exposure of the enterprise alone has insufficient deterrent force to cause law practices to internalize their costs of production, clients' risk in their lawyers has traditionally been regulated through a default rule of personal vicarious liability of the residual claimants of law practices.233 This will tend to suppress ex ante the risk of loss externalization by moderating divergence of interest between the residual claimants of a law practice and the firm's clients.234 Part VI concludes that this rule is more efficient than a rule protecting the residual claimants' assets from client claims. Professor Sykes concludes that, overall, vicarious liability is more efficient than limited liability in a context of potential agency insolvency,235 especially where creditors—clients of the firm—are unable to anticipate risk of loss in forming the relationship.236

Compensatory goals are also served by personal vicarious liability of the residual claimants. Ex post, it permits the clients' rights to follow the profit of the enterprise to the personal assets of the residual claimants, where the earned capital of a law practice is retained.237 This reflects the traditional

proxies, such as family members. LLPs, as general partnerships, have no such capital-preservation rules.

232. See Leubsdorf, supra note 1, at 141–44 (observing that "most law firms are thinly capitalized" so that vicarious liability is "important to ensure internalization of the full costs of malpractice" as well as to bolster the fiduciary principle that all lawyers in a firm take responsibility for the firm's practice).


235. Sykes, supra note 147, at 1250–51.

236. Id. at 1256.

237. Are law practices undercapitalized when the residual claimants are protected? If so, why would creditors do business with them? In the case of usual commercial creditors, of course, the creditors will be able to adjust—unlike clients. Further, the usual notion of "undercapitalization" relates to ability to pay judgments in the ordinary course. Third-party
normative conclusion that the residual claimants of the practice, not the client, should bear the risk of insolvency or misfeasance of the practice.

Where one party to a transaction is nonadjusting, default rules are regulatory. Contractarian theory, which is generally supportive of limited liability, is based in part on the proposition that "society is generally better off when law facilitates private ordering . . . ."238 A default rule that fixes high transaction costs on a persistently disadvantaged class of parties, however, does not "facilitate" private ordering, but impedes it. In the words of Professor Bainbridge, "when transaction costs are very high, bargaining around the [default] rule becomes wholly impractical, forcing the parties to live with an inefficient rule. In such settings, we cannot depend on private contracting to achieve efficient outcomes. Instead, legal rules must function as a substitute for private bargaining."239 Regulation, in other words, substitutes for the private bargaining that is prevented by unavoidable asymmetries in relationships. In the asymmetrical lawyer/client relationship, the better result would be the traditional one—to give the client the benefit of the default rule—stimulating the better informed party to instigate negotiations and disclose pertinent information to which only it has access.240

The traditional default rule of vicarious personal liability allocates the default advantage to the client, but this allocation is not fixed. Unlike most clients, lawyers are able to negotiate with clients for self-protective devices, such as limited personal liability. The disciplinary rules contemplate such negotiation, within client-protective regulatory parameters reflecting the lawyers' transaction cost advantages.241 The traditional vicarious liability rule allocated the cost of information and negotiation to the residual

---

238. Bainbridge, supra note 28, at 493. Professor Bainbridge goes on to acknowledge that "contractarianism does not claim that private ordering trumps all other considerations." Id.

239. Id. at 486.

240. Cf. id. at 502–03 (discussing the concept of the "bargain-forcing" default rule, in contrast to majoritarian default rules).

241. Under the traditional rule, lawyers are free to negotiate with their clients to limit their liability, but must make full explanation, full disclosure, and recommend that the client obtain counsel. See MODEL RULES, supra note 185, R. 1.8(h)(1) ("A lawyer shall . . . not make an agreement limiting the lawyer's liability to a client for malpractice unless permitted by law and the client is independently represented in making the agreement . . . ."); cf. MODEL CODE OF PROF'L RESPONSIBILITY DR 6-102(A) (1980) ("A lawyer shall not attempt to exonerate himself from or limit his liability to his client for his personal malpractice.").
claimants of law practices, performing a regulatory function correcting the asymmetries of the lawyer/client relationship. Again, this reflects the traditional norm, assigning to the residual claimants of the practice, not the client, the cost of reallocating the initial assignment of risk, as well as the risk of the insolvency or misfeasance of the enterprise.242

Departing from the traditional default rule both shifts the cost of information and negotiation from the advantaged residual claimants to the disadvantaged client, and suppresses the ex ante regulatory effect. As Professor Booth suggests in a different context, “Bargaining power, like other assets, is valuable and should not lightly be reallocated.”243 Professor Booth further observes that the party advantaged by the default rule is relieved of the costs of planning because the other party must initiate and quantify negotiation.244 This is an appropriate result in the lawyer/client relationship, where the client has little way of quantifying, or even identifying, risk. Making the disadvantaged party (the client) the beneficiary of the default rule requires the advantaged party (the lawyer) to educate the disadvantaged party as to risk,245 a result congruent with a lawyer’s duties.246

E. The Agency-Cost Argument

Proponents of limiting lawyers’ liability couch their arguments largely in economic terms, suggesting that efficiencies can result from reducing internal agency cost, especially monitoring.247 According to this argument, exposing the residual claimants to personal vicarious liability incurs an internal interest-divergence cost that is cumulative and excessive. According to one version of the argument, the practice’s inclination to protect its reputation would stimulate appropriate “institutional pressures” to monitor.248 In addition, according to this argument, lawyers will self-

242. See Hillman, supra note 8, at 1388 (“[T]he professions are regulated [to protect] the public and the consumers of the professional services, not to maximize the income of those practicing the professions.”).
244. Id. at 158.
245. See id.
246. See MODEL RULES, supra note 185, R. 1.4; DeMott, supra note 194, at 317 (describing the lawyer as “the guardian of the relationship,” required by duty “to identify the client’s interests and to educate the client”).
247. See, e.g., supra note 15 and accompanying text; see also Johnson, supra note 11, at 89 n.14 (discussing the perceived impracticability of internal monitoring and other agency costs); Lawrence, supra note 16, at 220–21; Ribstein, supra note 17, at 1709–10.
monitor to avoid personal liability, and malpractice insurers will perform an external monitoring function enforced through the cost of such insurance.\textsuperscript{249} With these factors in the picture, vicarious personal liability of the residual claimants, with its further stimulus to monitor, is inefficient. The net reduction in agency cost assumed to follow from limited liability enhances efficiencies, and fees may be reduced.\textsuperscript{250}

In its most superficial iteration, the agency-cost argument assumes that agency costs consist largely of monitoring, and that such cost can be "saved" or avoided by law firms if the stimulus to conduct it is reduced. This line of reasoning overlooks, first, that agency cost is not limited to monitoring; second, that it is not eliminated by excusing law firms from practicing it but shifted to clients; and, third, that when shifted to clients, the agency cost to clients is greater than that avoided by the law firm.

Agency cost is not limited to monitoring. Included are the inefficiencies inherent in the impossibility that the interests of agent and principal will ever be perfectly aligned, despite the application of monitoring, bonding, and other divergence-minimizing devices.\textsuperscript{251} In a lawyer/client relationship such agency cost may reach expression in a number of ways, from the malpractice judgment that cannot be paid in full, at one extreme, to subtle, even undetectable, degradations in the quality of performance of lawyers' duties.\textsuperscript{252} The client is persistently at risk of interest divergence resulting in undetectable cost, and, where loss is manifested, limited liability assigns it to the client.

When a law firm's internal agency cost is reduced, the cost does not disappear. It is shifted to the client.\textsuperscript{253} Law clients as nonobserving, nonadjusting stakeholders in a law practice have no voice in the enterprise. Unlike the residual claimants, they benefit from no organization law structural device (such as a board of directors) charged with monitoring on their behalf from within the enterprise.\textsuperscript{254} Internal monitoring for clients must be performed by employees/lawyers (who owe duties to the residual claimants) and the residual claimants themselves. Limiting liability reduces the residual claimants' incentives to monitor internally on behalf of clients.

\textsuperscript{249} Johnson, \textit{supra} note 11, at 89 n.14.
\textsuperscript{250} See \textit{Developments, supra} note 9, at 1672.
\textsuperscript{251} See \textit{supra} note 7.
\textsuperscript{252} See, \textit{e.g.}, \textit{supra} note 7; Lawrence, \textit{supra} note 16, at 226; Ribstein, \textit{supra} note 17, at 1709–13.
\textsuperscript{253} See Bainbridge, \textit{supra} note 28, at 493.
\textsuperscript{254} \textit{Cf.} Posner, \textit{supra} note 18, at 452–53 (explaining that shareholders can “fire the existing managers and hire new ones who will be more attentive to the shareholders’ interests” through the corporate board).
The result is a shift of the cost of divergence control from the residual claimants onto the clients.

This shift has significant implications in efficiency terms. Agency cost is not fixed. It can be larger or smaller depending upon who bears it. Efficiency analysis must take into account whether the marginal agency cost avoided by the law practice is greater or less than the total cost of divergence control to clients, including malpractice cost, avoided in a vicarious liability regime.\(^{255}\)

The efficiency assessment should take into account that agency cost within law practices, including large, geographically dispersed law business composed of a number of expert departments, does not by any means entail the monitoring of every lawyer by every other lawyer, as the literature seems to assume. The decomposition of functions and employment of multidivisional management in complex enterprises\(^{256}\) suggests that internal monitoring would most efficiently occur within expert divisions of the firm. Management should encourage expert monitoring of expert, and geographic-sector monitoring of geographic sector. Thus, the required marginal divergence control under vicarious liability would likely be carried out not so much by universal direct observation as by such other counterdivergence measures as the setting of appropriate policies and incentives. Vicarious liability might not encourage excessive monitoring so much as stimulate careful internal governance, and capitalization and insurance adequate to insulate the residual claimants’ assets.\(^{257}\)

Decomposition of functions has significant implications for the ramifications within a law practice of vicarious personal liability of the residual claimants, and especially of the proprietary owners. Professor Alan Sykes, in evaluating the economics of vicarious liability, observes that when an agent’s actions are unobservable, the agent’s performance may decline.\(^{258}\) The first ramification of this observation is that, as to clients, lawyers’ performances are almost always unobservable in the sense that high information costs prevent the client from evaluating the lawyer’s

\(^{255}\) Efficiency analysis requires consideration of “the totality of social costs created by a given legal regime.” Bainbridge, supra note 28, at 493. Such costs include the relative costs to each party, the social cost of administering the rule, and externalities. Id.

\(^{256}\) See Williamson, supra note 85, at 1555–60.

\(^{257}\) Kraakman, supra note 98, at 868–76.

\(^{258}\) In economic reality, taking into account the nature of the closely held enterprise, employees/lawyers are the agents of the residual claimants. The employee/lawyer’s duty is to enhance the residue, and the owners of the residue enforce this duty as policymakers and managers of the enterprise. Sykes, supra note 147, at 1237.

\(^{259}\) Id.
performance. Accordingly, some other source of observation is required to stimulate investment in precaution and alignment of the interests of the residual claimants with those of the client. A similar result will occur where the lawyer is internally unobserved, as is encouraged by the limited liability statutes.

Decomposition of function suggests, however, that employees/lawyers are not unobservable, even in a geographically dispersed, highly specialized firm. Appropriate management should ensure that all lawyers are properly supervised—that is to say, the enterprise should invest in cost-justified monitoring, making an adequate investment in precaution. To argue that it is inefficient to supervise everyone is simply to argue that the cost of appropriate management should be shifted to clients. Where an agent’s actions are cheaply observable (that is, where appropriate management steps are taken), according to Professor Sykes, “inexpensive and straightforward incentive devices” should serve to align the agent’s interests with the principal’s. He further explains that ex ante incentives have efficiency advantages over ex post penalties. Appropriate enterprise management, then, lowers internal agency cost, ameliorating the increase in cost resulting from specialization and geographic dispersal.

Does the saved-cost argument succeed in efficiency terms? Stimulus to self-monitor has been described as likely to reduce behavior risky to clients. This stimulus can lead to inefficiency, however, where the cost of internal monitoring is greater than client injury avoided. Excessive internal monitoring cost might inappropriately discourage growth, mergers, specialization, or other developments in law firms that could create efficiencies and, hypothetically, lower fees. It might also create inefficiencies by discouraging actions by a law practice that would maximize its own wealth, or even the wealth of the client. To justify vicarious liability on a social benefit basis, the internal monitoring and other costs of divergence control stimulated by vicarious liability must not exceed malpractice cost and costs of external divergence control avoided.

261. The statutes render observers liable, creating an incentive not to observe. See Johnson supra note 11 and accompanying text.
262. Sykes, supra note 147, at 1238.
263. Id.
265. Developments, supra note 9, at 1672.
266. See id.; Ribstein, supra note 32, at 1170.
In assessing relative agency cost in law practices under regimes of limited versus vicarious liability, we can begin by noting that the limited liability argument itself posits that lawyers are potentially insolvent agents. That is, their breaches may result in loss that they cannot pay in full. At some level, their law firms are potentially insolvent, too. Insolvent agents and enterprises will not have an incentive to invest in a level of care adequate to avoid loss in excess of their personal exposure. A second result is a perverse advantage to the residual claimants, because it enhances their profits by the amount of the loss borne by the client, which the enterprise need not pay. For these reasons, Professor Sykes concludes that, where agents are potentially insolvent, vicarious liability is the more efficient rule. As Professor Steven Shavell observes, “[I]mposition of vicarious liability will always lead the principal to consider the full liability cost of the actor’s activity in deciding whether to have the actor engage in the activity.”

In a regime of vicarious liability, the marginal cost to law practices to protect the assets of their residual claimants should be markedly less than the cost externalized to clients. The practice will have, in place and operating, internal controls designed to protect itself. Compared to passive equity investors of commercial businesses, the residual owners of law practices are more likely to understand the business and the associated risks and, if personally liable, more likely (and more cheaply able) to monitor the activities of the business and its employees. The firm has direct access to and control over those being monitored. Information and specification costs will be very low compared to external divergence control; the very purpose of the agency is, after all, to supply to nonobservant clients the expert capabilities of the agent. Under “least-cost-avoider” analysis it would be “wasteful,” to use Professor Shavell’s word, to assign the cost of insuring against externalization of risk and cost to clients. In the lawyer/client context, the social benefit of limited liability as a tool of efficient

268. Where an employee’s harm might lead to significant losses, well in excess of the employee’s ability to pay, “one suspects that their incentives to take care would often be seriously inadequate.” STEVEN SHAVELL, ECONOMIC ANALYSIS OF ACCIDENT LAW 172 (1987).
269. Sykes, supra note 147, at 1241–42.
270. SHAVELL, supra note 268, at 172; see also Leubsdorf, supra note 1, at 142–43 (suggesting that vicarious liability “ensures” that the residual owners of law practices will institute measures that control malpractice).
271. Cf SHAVELL, supra note 268, at 176.
272. Cf Epstein, supra note 204, at 580 (“As long as the gathering . . . of information is costly, it often pays to hire someone else to do your work for you . . . .”).
273. See SHAVELL, supra note 268, at 17.
employment of capital is reversed. The efficiency disparity will increase as
the level of sophistication of the client decreases.

Thus, marginal precaution cost incurred by a law practice on account of
personal liability of residual claimants should be far smaller than the cost
shifted to clients under limited liability. Indeed, shifting agency cost from
the residual claimants of law practices to clients should inefficiently
increase, not decrease, the net agency cost of the relationship. In cost-
avoider analysis, limited liability as a default rule is inferior to the
traditional regime of vicarious liability. Contractarian scholars posit that
"the basic guiding principle for picking default rules should be transaction
cost minimization." In the lawyer/client context, a default rule of limited
liability increases transaction costs.

Next, it should be taken into account that a law firm's internal agency
cost would be similar under both regimes. A law firm's inclination to
preserve its professional reputation, posited by advocates of limiting
liability as a substitute ex ante stimulus to self-monitoring, will entail
monitoring and other agency cost under a regime of either vicarious or
limited liability. Similarly, preservation of the firm's financial assets will
entail costs under either regime. Preservation of the personal assets of
lawyers (including their personal reputations) exposed to liability through
active representation or supervision will entail costs under either regime.
Where supervising lawyers have negotiated for indemnification in case of
liability, costs will be entailed in protecting the indemnifiers. Toward these
ends, under either regime the firm will perform internal monitoring and
other methods of divergence control.

Given the comprehensive divergence control undertaken in a law firm
under a limited liability regime, the marginal additional cost under vicarious
liability would be only the cost of extending protection to the personal
assets of the residual claimants. The marginal increment should be very
small, probably approaching zero. The difference would be the orientation
of the monitoring, as the residual claimants' interests are brought into
alignment with those of the clients.

If the marginal cost of vicarious liability is so low, has the enterprise not
already achieved a near-optimal level of precaution? As just noted, the
orientation of precaution is the important point. Limited liability is, in any

274. See id. at 170–75.
276. See Ribstein, supra note 17; infra notes 277–82 and accompanying text (discussing
reputation as an ex ante regulator).
277. Steele, supra note 1, at 630 ("Lawyers know how to impose proactive malpractice
prevention practices directly on the personnel of the firm.").
event, inefficient relative to vicarious liability. Typically clients will be inferior substitute cost bearers, and they will be nonadjusting so that the limited liability enterprise will not internalize its costs, leading to an inefficiently high level of production.\(^\text{278}\) Effectively, the residual claimants will increase their profits at the expense of clients.\(^\text{279}\)

The marginal precaution cost of protecting the personal assets of the residual claimants should consist almost entirely of opportunity cost. The forgone opportunities would be ones risky to clients. The implications of this, from the viewpoint of fiduciary norms, are manifest\(^\text{280}\) and are discussed in the next section. In terms of efficiency, the incentive to the injurer in a vicarious (strict) liability regime would be to elect a measure of precaution no greater in cost than the expected liability. Because events resulting in judgments exceeding the available assets short of the residual claimants’ personal assets are rare across a firm’s general experience,\(^\text{281}\) expected liability should be very low. Optimal precaution cost at the margin should be similarly low—much lower than the cost would be to the client to self-protect against opportunistic behaviors of a law firm’s proprietary owners. This is especially so when litigation costs (including the information cost of discovering and understanding the tort, and the possibility of a wrong result in court) are added to the client’s cost.\(^\text{282}\)

Any increased investment in precaution stimulated by vicarious liability would also reduce personal risk to the employees/lawyers and reduce risk to the enterprise as a whole. Viewed from within a law practice this should encourage investment—that is to say, should be preferred by members of the enterprise. This proposition should be true so long as the cost at the margin is not excessive in the sense of costing more than it saves. Rationally, however, internal monitoring should never reach the point of excessiveness, even under a vicarious liability regime. Law firm liability events, including malpractice judgments, that exceed all available assets, short of the personal assets of the residual claimants, are of very low probability, and low probability events have little effect on perceived risk even if their magnitude would be large.\(^\text{283}\) Precaution cost, including internal monitoring, would not rationally be incurred beyond the point at which its

\(^{278}\) See Ribstein, supra note 17, at 1711.

\(^{279}\) See id. But cf. Sykes, supra note 147, at 1240–41.

\(^{280}\) Discussed infra Part VI.F.

\(^{281}\) If such events are not rare as to a particular firm, that firm externalizes significant cost to its clients, and merits a higher degree of regulation.

\(^{282}\) See generally CALABRESI, supra note 176.

\(^{283}\) See Leebron, supra note 31, at 1572 ("[A] call [on shareholders’ wealth is] an event of very low probability . . . [and] events of such small probability have relatively little effect on the expected value of an investment, even if the magnitude of any call would be fairly large.").
cost would exceed its benefit in lowering perceived risk. This point, as just shown, should be very nearly the same under a regime of either vicarious or limited liability. Indeed, up to this point, were vicarious liability to tend to reduce risk to the enterprise and reduce individual lawyers’ exposure to direct liability, lawyers on the whole should prefer vicarious liability. This would not be true only in firms in which malpractice or other significant liability events are most likely, which are the same limited liability firms most likely to externalize cost. This shows that limited liability is sought by law firms chiefly as insurance to protect the residual claimants of law practices from poor management. The insurers are the clients.

As noted at the beginning of this section, proponents of limited liability argue that law practices and their constituent lawyers accumulate capital in the form of reputation, and that, in a limited liability regime, preservation of reputation capital provides adequate incentives to take due care and limit opportunistic behavior. This argument is limited, however. First, reputation is far from comprehensive in its contribution to lawyer regulation. As Professor Milton Regan observes, the beneficial effect of reputation bears principally on purposeful wrongdoing. The disciplinary rules themselves reflect that even the best motivated lawyers sometimes make mistakes, and that controls should be in place to protect clients.

The reputation argument must also take into account that reputation capital works in much the same way that financial capital does, so that the less of it there is, the less investment there will be in precaution and the riskier the actions of the practice will be. Accordingly, under limited liability, reliance on reputation as a stimulus for divergence control assures that the firms that most need regulating (those with the lowest reputations) will be least internally regulated.

Finally, the reputation argument must take into account that enterprise reputation is made up of many parts, including the personal reputations of

---

284. A socially optimal level of precaution, or of deterrence, would not be reached, but this is characteristic of the deterrence function of a tort system based on litigation and its inherent inefficiencies. See Hylton, supra note 230. The level of precaution and deterrence experienced by the best cost avoider would approach socially optimal levels, however. Cf. CALABRESI, supra note 176.

285. As Professor Schneyer observes, “by accepting monitoring responsibilities, partners can minimize the risk that doomsday will ever arrive.” Schneyer, supra note 16, at 1796.

286. See generally Ribstein, supra note 32, at 1189 (positing the functions of reputation in lowering agency cost in law practices).


288. Id.
its constituent lawyers. This recognition undercuts the firm-reputation argument. A lawyer's personal reputation is portable. The residual claimants know that if they preserve their personal reputation capital intact, they can take it with them elsewhere. Lawyers can preserve personal reputation by avoiding personal involvement in risky strategies, and indeed the limited liability statutes encourage this. Where vicarious liability to clients is limited to those in the practice who participate in the breach of duty, fiduciary risk could take the form of experienced lawyers' rational personal decisions to avoid monitoring or other involvement in order to avoid exposure to liability. In such an environment, clients lose the benefit of the collective wisdom of the practice as lawyers seek to reduce personal exposure. Rationally, those client matters that need the most monitoring or other participation by seasoned members of the practice will be the matters that are most likely to be avoided. In effect, the limited liability statutes provide a path for limiting the risk of reputation capital. Risk of reputation capital is at least as significant as risk of financial capital in aligning the interests of the proprietary owners with clients' interests. Preservation of personal reputation capital in the context of the limited liability formats discourages internal monitoring and cooperation, permitting behavior risky and costly to clients.

Under a limited liability regime, with its default rule of shifting agency cost to clients, information and specification costs thus allocated to the clients should, in most cases, be so high that the client has no practicable means to evaluate risk. Client performance of external divergence control would also be so costly as to exceed benefit. Because clients are nonadjusting creditors and nonobserving principals, there is little likelihood that the client would in fact attempt to perform external divergence control. Instead, the clients would bear the shifted cost—as described by Dean Clark, the cost would simply be left with the clients. The cost would manifest itself in two ways: At one extreme, the unrecognizable degradation of representation proceeding from the partial deregulation of the proprietary owners, and at the other, judgments against the firm exceeding accessible

289. In a critique of Professor Ribstein's article, Ethical Rules, supra note 32, Professor Ted Schneyer notes that "a provider of legal services does not so much have a reputation as a set of interlocking reputations," and that sophisticated clients are more likely to choose particular lawyers within firms rather than the firms themselves. Schneyer, supra note 16, at 1786–87.

290. See, e.g., Schneyer, supra note 16, at 1787 ("[S]ince portable, individual reputations are now likely to count for much more than firm reputations, large firm lawyers have become more mobile.").

291. See supra note 10.

292. See supra note 130 and accompanying text.
assets. This dichotomy brings analysis back around to the central issue: As between client and residual claimant, who most appropriately bears these costs? In striving to come to grips with this question, promotion of limited liability as a source of informing rules shifts the normative focus from fiduciary duty to contract and organization law.

F. Arguments for Limited Liability Inappropriately Shift the Focus from Fiduciary Duty to Contract

To this point this article has endeavored to show that protection of the personal wealth of law firms’ residual claimants does not lead to efficiencies. For similar reasons, in contractarian terms, it does not lead toward the parties’ understandings of their respective welfare in the context of their relationship. In important ways, however, normative evaluation of the fiduciary relationship between lawyer and client should not be limited to economics and contract. In the lawyer/client relationship, what is the appropriate source of the norm? I conclude that the appropriate source is fiduciary duty, and that from this point of view the elimination of vicarious liability for clients’ claims against the firm is inappropriate. Even if limited liability were efficient in terms of enhancing lawyers’ outputs and lowering net agency cost, in the context of law practice, limited liability imposes social cost beyond that demonstrable by unembellished economics. As Professor Bainbridge has written, “contractarianism does not claim that private ordering trumps all other considerations.”

Arguments in favor of limiting the vicarious liability of the owners of law practices emphasize the agency costs to the law practice and the inefficiency in terms of suppressing growth and specialization. As just discussed, the former can be viewed in terms of net social benefit—do the costs of “production” saved by limiting liability exceed the cost of malpractice avoided? The latter can be viewed in terms of the loss of the efficiency advantages found in the theory of the firm, which are the contracting advantages of sourcing within an enterprise. When a fiduciary relationship is at issue, such approaches emphasize maximizing the efficient

---

293. See discussion infra Part VI.F–G.
294. As Professor Walter Steele has written, “[O]ne hopes that there is more at the heart of the legal profession than economics.” Steele, supra note 1, at 624.
296. See supra note 17 and accompanying text.
297. See, e.g., Steele, supra note 1, at 624 (“Examples abound of instances where lawyers could benefit economically were it not for the impediment of a rule of ethics.”); Williamson, supra note 85, at 1540–41.
output of the fiduciary rather than the "appropriate distribution of . . . value" between the fiduciary and the beneficiary of the fiduciary's duty.\textsuperscript{298} What, then, is the appropriate distribution of value between residual claimant and client, both being stakeholders in the enterprise? What is the appropriate source of duty, or of the norms that inform the relationship? In approaching these questions, one point to keep in mind is that the informing principle of contract is selfishness—the rationally acting person maximizing personal benefit—while fiduciary duty requires one party to act not in their own self-interest, but in the best interests of the other.\textsuperscript{299} The effect on the lawyer/client relationship is manifest. Further, fiduciary duty is not based on sentiment or paternalism, but rather has an efficiency function.

Professor Scott FitzGibbon has recently catalogued the known characteristics of the fiduciary relationship.\textsuperscript{300} Prominent in the catalogue are "good faith,"\textsuperscript{301} avoidance of adverse interests,\textsuperscript{302} a duty of "undiluted loyalty,"\textsuperscript{303} avoidance of "profiting from transactions with the [fiduciary's] beneficiary,"\textsuperscript{304} and "an especially high duty of disclosure."\textsuperscript{305} These aspects of duty come into effect upon formation of a fiduciary relationship, such as a lawyer/client relationship. They need not be bargained for, because they are relational duties rather than contractual duties. Nor, in important respects, can they be contracted away.\textsuperscript{306}

In the case of lawyers and clients, Professor FitzGibbon observes that "fiduciary duty" describes "a set of practices and understandings about lawyers, about trust, and about fairness and justice which are instantiated in the social order as a whole."\textsuperscript{307} Professor Epstein makes much the same observation about the regulatory content of the lawyer/client relationship:

\begin{itemize}
  \item \textsuperscript{298} Brudney, \textit{supra} note 267, at 622.
  \item \textsuperscript{299} Fiduciary duty is often described as a type of contract, and it is so in the sense that parties exchange sets of rights and duties. Unlike the usual concept of contract, however, the fiduciary owes duties of exclusivity and due care to the beneficiary based on the duty from the relationship. \textit{See \textsc{Restatement (Second) of Agency} § 39}. This does not mean that the fiduciary cannot act out of self interest—lawyers are permitted to charge fees at whatever rate the market will pay—but that contract, in the usual sense, is relegated to issues that are disclosed by the fiduciary and those which the client is observant and adjusting. Fiduciary duty is a set of duties inherent in the relationship that account for the non-observant and nonadjusting nature of the law client. They are mandatory bonds. The point made in this material is that they are not appropriately limited by efficiency analysis. \textit{Cf.} discussion \textit{supra} Part VI.F.
  \item \textsuperscript{300} FitzGibbon, \textit{supra} note 24, at 308–11.
  \item \textsuperscript{301} Id. at 309.
  \item \textsuperscript{302} Id. at 310.
  \item \textsuperscript{303} Id. (quoting Birnbaum v. Birnbaum, 539 N.E.2d 574, 576 (N.Y. 1989)).
  \item \textsuperscript{304} Id. at 309.
  \item \textsuperscript{305} Id. at 308.
  \item \textsuperscript{306} See, e.g., \textsc{Model Rules}, \textit{supra} note 185, at R. 1.
  \item \textsuperscript{307} FitzGibbon, \textit{supra} note 24, at 315.
\end{itemize}
"The expectations of ordinary parties may be unexpressed, but at least in
this context they are powerful and real."308

Legislated changes in organization law that eliminate the personal
liability of the residual claimants for clients' claims against the firm alter
the fiduciary understanding just described. The transfer of risk and cost
from residual claimant to client is itself a modification of traditional,
mutually understood expectations; a compromise of loyalty; and a profit for
the lawyers at the expense of the client. By adding terms, the organization
laws also reduce the controls on the conflict between the employee/lawyer's
duty to the client and the duty to the residual claimants. The contractarian
solution is ineffective because organization law sets the default rule to the
advantage of the lawyer, which fatally disadvantages the client who is
burdened by transaction costs typically too high to overcome. As Judge
Posner has written:

The reason for the [fiduciary] duty is clearest when the agent has a
broad discretion the exercise of which the principal cannot
feasibly supervise, so that the principal is at the agent's mercy.
The agent might be the lawyer, and the principal his client .... If
the agent has no discretion and the principal has a normal capacity
for self-protection, ordinary contract principles should generally
suffice.309

The duties inherent in the fiduciary relationship are the norm.310 Indeed, the
traditional normative view has been that agency cost should be fully
internalized to account for the client's characteristic inability to observe or
adjust.311

Professor Victor Brudney observes that unembellished economics is not
the only stimulus to the rules informing fiduciary duty—that is, that wealth
maximization is not the only value served by fiduciary duty. He refers to
"richer normative values [other] than monetary wealth-maximization,"
posing as an example a notion of trustworthiness, or reliability, with its
"moral underpinning and richer, more complex view of humans and their
societal relationships ...."312 This observation is particularly apt in the

---

308. Epstein, supra note 204, at 583.
310. See Brudney, supra note 267, at 601–02 ("At least as between the fiduciary's interest
and the beneficiary's interest the fiduciary is to serve only the latter .... the theme of exclusive
benefit informs the [fiduciary's] obligations."); Gross, supra note 194, at 267–70.
311. See DeMott, supra note 194, at 317 (describing the lawyer as "the guardian of the
relationship," required by duty to "identify the client's interests and to educate the client"),
Epstein, supra note 204, at 582–83.
312. Brudney, supra note 267, at 604 ("In short, the fiduciary relationship and its
obligations serve functions not addressed by 'mere' contract ...."). See also FitzGibbon, supra
lawyer/client relationship.\textsuperscript{313} The profession has not traditionally been organized primarily for the commercial advantage of its residual claimants, but for the benefit of its customer base and the public.\textsuperscript{314} As Justice Cardozo wrote, “Membership in the bar is a privilege burdened with conditions [into which a lawyer is admitted] for something more than private gain; [a lawyer is] an instrument or [agent] to advance the ends of justice.”\textsuperscript{315} Those who are uncomfortable without a way to account in efficiency terms for the benefits suggested by Professor Brudney and Justice Cardozo could view them as a nonpecuniary offset to any inefficiency,\textsuperscript{316} either standing alone or as factors enabling reliance on an expectation, with the attendant efficiencies.\textsuperscript{317} When the default rule is set to advantage the client—stimulating the law firm with its informational advantages to negotiate—and is combined with a norm of undivided loyalty to the client—with the concomitant informational duties—transaction costs are minimized, and the relationship tends to efficiency. Judge Easterbrook and Professor Fischel vouch for the imposition of regulatory rules in order to change internal incentives in enterprise to “alter its behavior at least cost.”\textsuperscript{318}

Where fiduciary duty is imposed upon one party to a relationship, the duty of exclusivity informing the fiduciary’s duty of loyalty arguably “impose[s] costs of over-prohibition on the beneficiary [possibly including suppressing activity that would be advantageous to the beneficiary] and the fiduciary [including suppressing value-enhancing incentives to the fiduciary]” as well as social costs.\textsuperscript{319} As Professor Brudney has observed, however, where agency cost to the beneficiary, such as monitoring and specification, is so high as to be “insurmountable,” such overprohibition is presumably justified.\textsuperscript{320} This statement suggests that where efficiency requires that an actor obtain certain capacities (such as legal representation) which are obtainable only by proxy, then to enable the actor to proceed efficiently requires a system in which an expert, for agreed compensation,
stands in the shoes of the undercapacitated actor. The expert agent’s costs will be far lower than the quantum of cost externalized to the client in a limited liability regime. The fiduciary structure therefore lowers net agency cost and approximates what the parties would have agreed had transaction costs been negligible. The efficiency calculation, then, must take into account the private and social value of low-cost agency.

Further, shifting risk and cost away from a law firm’s residual claimants to clients may entail unquantifiable systemic costs. The legal system is based on a perception of undivided loyalty of lawyer to client, and only in this way can lawyers justify their monopoly of practice in the courts. To support this perception, the commercial inefficiencies of law practice proceeding from its complex agency cost have been internalized to the practice. The interposition of proprietary owner as passive intermediary undercuts this perception. A traditional goal of lawyer regulation has been to avoid the interposition of the interests of passive intermediaries in the fiduciary relationship between lawyer and client. The profit orientation of residual claimants, who are not exposed to personal liability, to most of the clients of a law practice will tend to distract the firm itself, as a jural person, and its employees/lawyers, from the duty of undivided loyalty. When lawyers act opportunistically to promote their own interests at the expense of clients, as by externalizing risk and loss to nonadjusting clients, they tend, in the words of Justice Powell, to “promote distrust of lawyers and disrespect for” the justice system. Such a result directly injures lawyers and the legal profession, providing incentive for lawyer regulation, including internalization of costs.

The legislated shift of agency cost from the proprietary owners of law firms to the firm’s clients would appear to be a nonnegotiated windfall for
the practice, profiting (by reduced costs and free insurance for the residual claimants) at the expense of the client who must bear the risk and cost avoided by the practice’s residual claimants. Such a transfer of cost and risk is in the nature of a transaction between lawyer and client, to the lawyer’s advantage. As Professor Walter Steele asks, “What is the justification for visiting [lawyers’] private contract upon the rights of innocent clients?”

G. General Organization Law as an Inappropriate Source of Lawyer/Client Rules

The traditional normative conclusion that, as to their clients, law practices should internalize their business and fiduciary failures was at one time highly visible in organization law. Recent legislative changes have largely eliminated the presence of fiduciary norms in organization law, and state courts in recent cases have acceded to these changes. General organization law, however, is an inappropriate source of norms to control the relationship between lawyer and client. The courts’ accession to the norms of organization law reallocates risk and cost from lawyer to client, a windfall for lawyers at their clients’ expense.

The traditional regulatory limitation of law practices to the full-liability format of general partnership has been described as historical coincidence, and criticized as professional self-interest and barrier-raising, but, as described above, the traditional rule of vicarious liability, at least, has normative and economic value. When nominally limited liability forms became available to lawyers in the professional corporation movement of the 1960s, efforts were made to preserve essential elements of normative value in the new organizational forms. The limitations of liability included by terms in such statutes received mixed results in the cases, based upon state constitutional reservations to state courts of the power to regulate lawyers, and in state disciplinary rulings.

During the 1990s the state legislatures enacted a variety of new limited liability enterprise forms, which, in addition to the professional corporation

327. Steele, supra note 1, at 630.
328. See, e.g., UNIFORM PARTNERSHIP ACT § 306 (1997) (making all partners jointly and severally liable for breaches of trust and torts attributable to the partnership).
329. See, e.g., RHODE, supra note 186, at 208 (“Regulation of the legal profession has been designed primarily by and for the profession, and too often protects its concerns at the public’s expense.”); Ribstein, supra note 32, at 1169–71.
330. See, e.g., McWilliams, supra note 233, at 371–73, 378–79. The organizational metamorphosis of the professional corporation and its successors has recently been summarized at Rutledge, supra note 16, at 1415–19.
331. See, e.g., Hillman, supra note 8, at 1390–92; McWilliams, supra note 233, at 379–94.
format, are now generally available to law practices in the United States. For the most part, these forms recede from organizational regulation of service enterprises, including law practices. The deleted regulatory effects are accordingly relegated to state supervisory agencies—the courts, in the case of lawyers.

Professor Hillman observes that "[j]udicial acceptance of limitations on lawyer liability is tentative at best," but he goes on to describe a gradual movement toward acceptance by the courts of limiting lawyers' vicarious liability for one another's professional lapses. Among the decided cases, the most striking example is the Georgia Supreme Court's unexplained reversal of First Bank & Trust Co. v. Zagoria. In Zagoria, the Georgia court refused to give effect to a professional corporation statute to the extent that it purported to limit lawyers' vicarious liability for their co-shareholders' malpractice. The opinion was a clear statement of implementing vicarious liability as lawyer regulation over which the courts, not the legislature, exercised the dominant controlling powers. Three years later, the Georgia court overruled Zagoria in Henderson v. HSI Financial Services, Inc. The brief opinion is devoid of analysis other than to cede to the legislature the power to determine, through statutory organization law, the exposure of lawyers to personal liability to their clients.

In this article, I do not make a case for vicarious personal liability for all obligations of law practices, but only for claims of clients against the practices. Enforcement of statutory limitations of liability in favor of the residual claimants of law practices, as in Henderson, however, shifts the regulatory emphasis and informing normative structure from fiduciary law to general organization law. The result is a shift in default rules away from those developed to advantage the nonobserving, nonadjusting law client to

332. See Rutledge, supra note 16, at 1420–21 (stating that some states do require third-party insurance).
333. Cf. id. at 1423–24.
334. Hillman, supra note 8, at 1396.
335. Id.
336. 302 S.E.2d 674 (Ga. 1983).
337. Id. at 676.
338. Id. (indicating that the ethical rules for the jurisdiction were adopted by the court, but making no reference to any statutory assertion). For a discussion of Zagoria and its place in the jurisprudence of lawyer regulation, see McWilliams, supra note 233, at 382–94.
340. Id. at 886.
341. Cf. Leubsdorf, supra note 1, at 143–44 (suggesting that the professional principle underlying vicarious liability does not require extending vicarious liability to "a firm's commercial transactions," such as rent).
those developed to advantage the residual claimants relative to creditors to encourage the aggregation of capital for nonfiduciary commercial enterprises. Results such as Henderson represent confusion of a generalized, commercial, organizational rule with rules designed for particular, normative purposes. They represent court abandonment of the role of guardian of the norms of law practice.

The traditional structuring of law enterprises to avoid the influence of the passive intermediary has been criticized as inefficient and inhibitive of the commercial development of the profession. The recent empirical record described in the introduction strongly suggests, however, that where enterprise owes duties to external risk takers—investors in public corporations, clients of law enterprises—there is a need for internal structure based on proximate monitors who do not personally benefit from the manner in which they monitor, while bearing no personal risk. As Dean Burnele Powell has demonstrated, structure is central in providing a sort of practical guidance toward ethical decisionmaking. Rather than encourage law practices to rely upon limited liability structures designed for the purpose of disadvantaging the external stakeholder—which in law firms includes clients—it is more congruent with the central norm of undivided loyalty to design structures directing lawyers toward protecting clients in terms of both financial and fiduciary risk. In a recent article, Professor Booth suggests that one reason people join firms is to obtain the benefit of internal discipline. "[T]he recent spate of corporate scandals," he observes, "suggests we should focus more on internal controls than we have in the past. . . . External monitors may not be nearly as important as we have made them out to be." In this light, certainly irony is to be found in the movement to dilute internal regulatory controls in the context of the fiduciary law enterprise.

342. This point has been made previously. See supra notes 142–148 and accompanying text.
344. E.g., Ribstein, supra note 17, at 1743 (stating that ethical rules prevent law firms "from adopting more efficient law firm governance arrangements, including non-lawyer ownership of firms, full limited liability, and noncompetition agreements").
346. Powell, supra note 211, at 332.
347. Booth, supra note 343, at 1435, 1439.
348. Id. at 1439.
VII. **SHIFTING RISK AND COST TO CLIENTS IS SIGNIFICANT AT PRACTICAL AND NORMATIVE LEVELS**

Advocates of limiting lawyers' vicarious liability propose that the hypothetical shifting of risk and cost to clients does not state a problem of practical significance. This proposition rests on an assumption that third-party commercial insurance, combined with law firm assets and the personal assets of those lawyers whose assets can be reached without vicarious liability, should be adequate to make injured clients whole in almost all malpractice and other civil claims, barring a "doomsday scenario." It would follow that the absence of vicarious liability subjects clients to no meaningful marginal insolvency risk. Especially where insurance is in place, this viewpoint has attained some acceptance. Under scrutiny, however, this viewpoint breaks down in several respects.

Most obviously, the "made whole" argument cavalierly discounts the interests of those whose judgments exceed the available assets (including third-party insurance), that is, presumably, the clients suffering the most severe injury at the hands of the firm, who are not made whole. Further, the "made whole" argument assumes that a client's only injury is financial and that the client will understand that it has been harmed, will be motivated to seek a remedy in court, can afford to do so, will win, will be awarded a reasonable judgment by the court, and will be able to collect the judgment. Under these circumstances, all of these assumptions are wrong, on account of high information costs on the front end right through to high collection costs on the back end. First, and most importantly, client risk and harm are not limited to demonstrable financial injury, especially in cases of fiduciary risk. Discouragement of internal monitoring and cooperation among members of a practice may well result in persistent subtle, even undetectable, degradation of the quality of legal work. In addition, it has been shown that overly energetic profit seeking by owners of law practices also degrades the quality of the work.

Positing that, short of a "doomsday" event, clients will be made whole, overlooks the fact that clients, who in most cases are nonobserving

---

349. Regan, *supra* note 287, at 551 (setting the issues and citing authorities for both sides).
350. *E.g.*, Steele, *supra* note 1, at 629 ("No doubt insurance in an adequate amount does ameliorate or totally alleviate the adverse effect [of limited liability] on a client claimant.").
352. *Id.* at 628 (asserting that assigning limited liability to supervisors may create a "disincentive to supervise firm employees").
principals of their lawyers, most often do not know that they have been
injured. Studies show that very few clients become aware that they have
been injured, and most of those do not bring an action. 354

Few jurisdictions require law practices to carry malpractice insurance. 355
As of this writing only one state requires lawyers to carry insurance, 356
and in other states movements to require legal malpractice insurance have
failed. 357 An attempt at client protection by mandatory insurance is reflected
in the American Bar Association's movement toward a Model Rule on
Financial Responsibility. 358 The prospective rule would require each
practicing lawyer to certify annually to their state’s highest court that they
have in place third-party insurance or other proxy capital (such as letters of
credit) at certain levels. Failure to comply timely would lead to
administrative suspension pending compliance. 359 The prospective rule
recognizes the characteristically low capitalization of law practices and
seeks to require proxy capital against which injured clients could proceed.
The primary effect of such insurance would be to protect the assets of
lawyers and their firms. Only secondarily would such insurance make it
more likely that injured clients successful in court would be made whole,
presumably making clients feel better about their lawyers. 360

Where there is insurance, the client is at risk for the insurability of the
malpractice event. Insurance policies are drafted to avoid liability for the
most egregious examples of malpractice. 361 The client also remains at risk
for the ability of the insurance company itself to pay a substantial judgment.
Within the insurance regulatory scheme this surely is not a substantial

354. See generally RHODE, supra note 186, at 143–83.
355. See, e.g., RHODE, supra note 186, at 167–68; Susan Saab Fortney, Seeking Shelter in
the Minefield of Unintended Consequences—The Traps of Limited Liability Law Firms, 54
356. As recently as 2000, only one state, Oregon, required lawyers to carry professional
liability insurance. RHODE, supra note 186, at 167.
358. MODEL RULE ON FIN. RESPONSIBILITY (Proposed Draft, Dec. 2, 2003) (circulated by
Robert D. Welden, Chair, ABA Standing Comm. on Client Protection, on file with author).
359. Id.
360. Id. ("The Committee believes that whether a lawyer maintains professional liability
insurance . . . is a material fact that may bear upon a client's decision to hire a lawyer.").
361. Developments, supra note 9, at 1653–54 (listing exclusions for risky or unpredictable
events; fraud and other deliberate harms; and intentional wrongdoing). If the lawyers
themselves are the cheapest insurers of "egregious" harms it means that the client is subjected
to precaution deficiencies and insolvency risk.
problem, but we must ask ourselves why the client should be the one to bear even this small risk.\textsuperscript{362}

Positing insurance as a panacea for agency failures raises the interesting prospect of dealing with one form of moral hazard through another. Use of third-party insurance as proxy capital diminishes the deterrent feature of liability at all levels. This can be shown in at least two ways. First, insurance is a well-understood source of moral hazard; the less the lawyers, or their firm, have at stake the lower will be their investment in precaution.\textsuperscript{363} Of possibly greater importance, however, is the regulatory preference for ex ante, not ex post, compensatory effects. Making an injured client whole is not the primary objective of regulation, as many proponents of limited liability appear to believe. Compensation as a goal assumes that every client who suffers from malpractice will know it, sue, win an appropriate award, and collect. Comprehensive lawyer regulation should include positive ex ante effects on lawyer behavior that falls short of anything for which a lawyer is likely be found liable for malpractice. Third-party insurance actually mutes these regulatory effects. Finally, the injured client is never made "whole." Bringing a lawsuit to redress agency shortcomings is by far the least efficient manner of controlling agency costs,\textsuperscript{364} considering the private and social costs and delays involved. That unusual injured client who wins and collects a judgment fully redressing their injury must then pay a lawyer out of the proceeds.

Reliance on insurance poses public policy issues. Courts have noted that insurance frustrates the tort goals of punishment and deterrence, and other regulatory goals, by removing the liability burden from the perpetrator.\textsuperscript{365} To substitute insurance for the regulatory effects of unlimited liability would have a questionable public policy result in this respect.

Finally, the "made whole" argument is undercut by lawyers' very eagerness to limit their liability. As Professor Steele has put it:

\begin{quote}
Obviously lawyers, themselves, are qualified to evaluate the likelihood of a malpractice claim that will consume the firm insurance, the firm assets, the assets of the responsible partner(s), and still remain unsatisfied. Apparently lawyers believe that such
\end{quote}

\textsuperscript{362} The problem is of insufficient significance to attract the attention of Easterbrook and Fischel, who pose the question "who will insure the insurer? . . . This risk must be borne by someone." Easterbrook & Fischel, supra note 31, at 103.

\textsuperscript{363} See, e.g., Dorsey D. Ellis, Jr., Fairness and Efficiency in the Law of Punitive Damages, 56 S. Cal. L. Rev. 1, 74 (1982) ("Insurance reduces incentives to engage in loss avoidance and, in the case of wrongs falling within the categories of malice and reckless conduct . . . increases moral hazard.").

\textsuperscript{364} Wilkins, supra note 6, at 830–33.

\textsuperscript{365} See Developments, supra note 9, at 1654–56.
catastrophic claims are likely. That is why they are abandoning historic general partnerships for the haven of limited liability partnerships.\textsuperscript{366}

Reorganization of an active practice into a limited liability format, and shifting risk and cost to present clients, presents its own special difficulties and threat of breach of duty. These difficulties have been thoroughly discussed elsewhere.\textsuperscript{367}

\section*{VIII. CONCLUSION}

Limited liability practice formats hold commercial efficiency advantages for law firms, as they do for other businesses. But the vicarious liability feature of the traditional full-liability rule should be preserved. It is a significant regulatory device in the context of clients unable either to observe their lawyers’ performance or to adjust to their lawyers’ limited liability. Protecting the residual claimants of law practices from client claims against the enterprise puts the residual claimants of law practices into a default position of advantage that their clients cannot overcome, shifting risk and cost from the residual claimants to the clients. The result will be inefficient, the externalization of risk and cost.

The limited liability norm is imported into the lawyer/client relationship through legislation not rationalized with the core norms of law practice.\textsuperscript{368} The courts’ accession to such a rule permits legislated general organization law, designed to advantage residual claimants over creditors in a nonfiduciary commercial context, and founded on general commercial policy, to subsume the courts’ own authority over lawyer regulation.

The duties inherent in the fiduciary lawyer/client relationship supply what clients would bargain for had they the sophistication, information, and bargaining leverage.\textsuperscript{369} They are default duties based on the nature of the relationship and the importance of the relationship in the social fabric.\textsuperscript{370} In light of the clients’ stature as nonobservant principals, nonadjusting creditors, and inferior substitute cost bearers, they are efficient. Retention of vicarious liability preserves a key control on lawyers’ opportunistic behavior and a key structural incentive to lawyers’ ethical behavior. Writing

\begin{itemize}
\item \textsuperscript{366} Steele, \textit{supra} note 1, at 626.
\item \textsuperscript{367} See, e.g., Fortney, \textit{supra} note 355.
\item \textsuperscript{368} Cf. Steele, \textit{supra} note 1, at 630 ("Fiduciary duty to clients is the crux of the legal profession.").
\item \textsuperscript{369} FitzGibbon, \textit{supra} note 24, at 325 (quoting Mkt. St. Ass’n v. Frey, 941 F.2d 588, 593–94 (7th Cir. 1991) (Posner, J.)).
\item \textsuperscript{370} See Epstein, \textit{supra} note 30, at 153–54.
\end{itemize}
elsewhere I have concluded that the courts possess the power to set aside the inappropriate statutory, commercial norm protecting residual owners of law practice from client claims in favor of the traditional default rule of personal, vicarious liability. In the interest of efficiency and preservation of the fiduciary norms of the lawyer/client relationship, this is what they should do.
