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Abstract

In 1931, California became the last U.S. state to adopt limited liability. Prior to that, from its inception as a state in 1849, stockholders of California corporations faced *pro rata* unlimited liability. California's unique liability rule during 1849-1931 provides a natural experiment for testing Woodward's (1985) and Alchian and Woodward's (1987, 1988) hypothesis that limited liability reduces transaction costs and facilitates the transferability of shares. Using a small sample of publicly traded California firms and a corresponding sample of benchmark companies, we find that trading volume and share turnover were significantly lower for California firms when California had unlimited liability. After California adopted limited liability, trading volume and share turnover increased significantly for California firms relative to non-California firms. In addition, bid-ask spreads were significantly higher for California firms during the period of unlimited liability and they declined for California firms relative to non-California firms after California adopted limited liability. The results support Alchian and Woodward's hypothesis that limited liability reduces transaction costs and promotes the transferability of shares.

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