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Organizational law as asset partitioning

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Abstract

Organizational law – comprising the bodies of law that govern standard legal entities such as business corporations, partnerships, cooperatives, nonprofit organizations, trusts, limited liability companies, and marriages – serves many functions of an essentially contractual character. These contractual functions – which include most matters involving the allocation of authority and earnings among the participants in the firm – could, however, be performed relatively easily by private contracting even in the absence of organizational law. A far more important function of organizational law, we argue, is its role in partitioning property rights between creditors of a firm and creditors of the firm's owners and managers. In particular, organizational law plays a crucial role in permitting the formation of a separate pool of assets that can be pledged to bond the contracts of which the firm is the nexus. While the law's role in partitioning off these bonding assets is seldom remarked, it is far more significant than the better-studied rule of limited liability that characterizes many, but not all, legal entities. © 2000 Elsevier Science B.V. All rights reserved.

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1. Introduction

The law and economics revolution of the past several decades, which has brought the systematic application of economic analysis to the study of basic

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legal rules and institutions, has had a particularly strong impact on the study of corporate law, and of organizational law in general. One conspicuous consequence has been an increasing tendency to view organizational law in contractual terms. More particularly, the economic analyst is inclined to see nearly all aspects of organizational law as terms in an explicit or implicit contract among the affected parties.

As a consequence, we are naturally led to ask what is it that organizational law adds to contract law? Why does the law establish a set of basic organizational forms for organizing enterprise, rather than leaving the whole field to contract? What would we lose if we were to eliminate all of organizational law, or any part of it, and simply rely upon the general rules of contract law to fill the gap?

In the United States, for example, the law provides for a variety of distinct standard forms for organizing economic activity, including the business corporation, the cooperative corporation, the nonprofit corporation, the municipal corporation, the limited liability company, the general partnership, the limited partnership, the private trust, the charitable trust, and marriage. Other countries with developed market economies typically provide for a roughly similar set of forms, though with some variations in both number and nature. What function is served by these forms? Are they simply convenient standard form contracts that supply off-the-rack contractual terms for the most common types of organizational arrangements, serving only to save businesspeople and their lawyers the bother of drafting up their own terms? Or does the law play some more essential role in the formation of organizations? Despite the enormous volume of scholarship on the law and economics of organizations – and particularly business corporations – in recent years, the existing literature still offers no clear answer to this basic question. We describe an answer here.¹

For convenience, we use the term ‘legal entities’ to refer to organizational forms – such as the business corporation, the general partnership, and the trust – that are established by law, and we refer to the law that creates and regulates legal entities as ‘organizational law’.

2. Legal entities as loci for contracting

There are, broadly speaking, two ways to coordinate the economic activity of two or more individuals. The first is by having those individuals contract directly with each other on their own account. The second is by having each of those individuals enter into a contract with a third party who undertakes the

¹ For more extensive exposition and analysis, see Hansmann and Kraakman (1999).

coordination through design of the separate contracts and – most importantly – through exercise of the discretion given the third party by those contracts. A third party that serves this coordination function is what is commonly called a *firm*. Or, to use the now-conventional terminology, a firm serves as the requisite ‘nexus of contracts’ for the persons whose activity is to be coordinated – that is, as the common party to individual contracts with those persons.

Economic theory does not offer a completely satisfactory explanation for the fact that a substantial portion of productive activity is today organized in the form of very large nexuses of contracts, in which a central actor contracts simultaneously with employees, suppliers, and customers who may number in the thousands or even millions. Why, for example, are organizations not constructed in the form of contractual cascades, in which each party contracts not with the firm but with his or her immediate superior, so that the pattern of contracts corresponds to the authority relationships we see in a standard pyramidal organizational chart? We do not deal with this question here, however, but simply take it for granted that, to create a modern market economy, it is essential that large nexuses of contracts can be constructed.²

2.1. *The nature of a legal entity: Managers, owners, and bonding assets*

To serve effectively as a locus of contracts, a firm must have at least two attributes. The first is well-defined decision-making authority. More particularly, there must be one or more persons – whom we will refer to as the firm’s *managers* – who possess ultimate authority to commit the firm to contracts. The managers may or may not be distinct from the persons for whose benefit the managers are acting, whom we will rather loosely refer to as the firm’s *owners*. (More particularly, the term *owners* as we use it comprises not only the shareholders in a business corporation and the partners in a partnership, but also persons who hold only beneficial interests in the firm, such as the beneficiaries of nonprofit organizations and trusts.)

The second attribute is a reasonably well-defined pool of assets – which we term the firm’s *bonding assets* – that the managers of the firm can pledge as security for performance of the firm’s contracts. Bonding assets serve the obvious function of permitting the firm to assure its creditors that the firm will

² The literature that focuses on asset specificity to explain vertical integration is of course important here (e.g., Klein et al., 1978; Williamson, 1985), as is the ‘property rights’ approach to the theory of the firm that has evolved out of that literature, most conspicuously in the work of Hart and Moore (e.g., Hart, 1995). A related but somewhat different reason for large centralized loci (as opposed, e.g., to more decentralized structures) may be the need to avoid opportunistic threats to disassemble a set of transactional relationships that has been costly to assemble, or to expropriate an entrepreneur’s or organization’s accumulated experience with working procedures and forms of organization (Rajan and Zingales, 1998). All of this literature, however, seems to leave important things unexplained (Hansmann, 1996 at 15 & 15 n. 8).

not exploit them by opportunistically defaulting on its obligations. Also, quite apart from problems of opportunism, bonding assets permit the shifting of risk from the firm's creditors to its owners, which may offer superior risk-bearing.

A natural person has the two attributes just described and hence can – and very frequently does – serve as a firm, in the form of a sole proprietorship. In this case, there is a single individual who is both manager and owner, and the bonding assets consist of all of the assets owned by that individual. Note, however, that individuals have these attributes because the law provides them. In particular, the law gives an individual the ability to enter into contracts that will bind him in most future states, and provides that creditors of an individual have the right (absent contractual waiver) to levy on all assets owned by that individual if he defaults on his obligations to them.

Legal entities – often referred to, appropriately, as 'juridical persons' – also have the two attributes described here. Legal entities are distinct from natural persons, however, in that their bonding assets are distinct from other personal and business assets owned by the firm's owners or managers, in the sense that the firm's creditors have a claim on the firm's bonding assets that is prior to claims of the personal creditors of the firm's owners or managers. More particularly, organizational law (1) permits the formation of a firm that can have ownership of assets of its own, and (2) establishes a pattern of creditors' rights under which the business creditors who contract with the firm have, as a default rule, the right to satisfy their claims out of assets owned by the firm, while the personal creditors of the firm's owners and managers have, at most, a subordinate claim on the firm's assets, in the sense that they can levy on the firm's assets, if at all, only after the claims of the business creditors have first been satisfied.

This pattern of creditors' rights is a common characteristic of all legal entities, from partnerships and business corporations to nonprofit organizations and trusts. Moreover, the establishment of this pattern of rights is, we argue, the single essential contribution of organizational law to the furtherance of economic activity.

2.2. *Asset partitioning*

This view can be labeled an 'asset partitioning' theory of organizational law, where by 'asset partitioning' we mean the division of a fixed pool of assets into subpools, each of which is separately pledged as security to a different creditor or group of creditors. The principal rationale for asset partitioning is to reduce the overall cost of credit when dealing with a heterogeneous group of creditors. The reason that asset partitioning can reduce costs is that some creditors are better able than others to assess and monitor the value of particular assets, or to extract value from those assets if, upon default by the debtor, the creditor takes possession of them.

As an illustration, imagine an airline company that decides to go into the car rental business, hoping that there will be synergies between the two activities. Should the two businesses be operated as part of the same corporation, with the car rental operation organized simply as a separate division? Or should the car rental operation be separately incorporated, with all of its stock held by the airline company (or by a holding company that also owns all the stock of the airline company)?

The two businesses are likely to be managed in much the same way under either of these corporate structures, and the aggregate assets of the two businesses will also be the same under either structure. Nevertheless, the separate incorporation approach may significantly reduce the aggregate cost of credit. The reason is that the firms that extend credit to the car rental business – such as the auto manufacturers from whom the business purchases or leases its cars – will often be in a good position to assess both the financial condition of the car rental industry in general and the effectiveness with which this particular car rental firm is managed, and at the same time be largely ignorant of the prospects of the airline business, both in general and as managed by this particular firm. The reverse, in turn, is likely to be true of the creditors of the airline company (such as the airplane manufacturers that supply their planes), who will know the airline business well but not the car rental business.

If the two operations are combined in the same corporation, then creditors of either of the two businesses are always exposed to the risk that the other business will fail. Separate incorporation, in contrast, gives the creditors of the car rental business first priority claim on the car rental assets, which by virtue of corporation law are considered to be the separate property of the car rental corporation. Creditors of the airline operation, in turn, obtain first claim on the assets of the airline. The consequence is that creditors of one business are shielded from the vicissitudes of the other. Their perceived level of risk in extending credit therefore goes down, and the price they will demand for credit goes down too.

In this example, the airline company (or the holding company) is the (only) owner of the car rental business. But much the same logic applies when the owners of the firm are individuals, such as the shareholders in a business corporation or the partners in a partnership. In the latter cases, the asset partitioning that organizational law imposes is between the personal assets of the individual owners and the assets of the business. When a firm is organized as a legal entity, the creditors of the firm have first priority claims against the assets to which the firm holds title, which must be satisfied before claims of the owners' personal creditors can be satisfied out of those assets. As a consequence, creditors of the firm can determine appropriate terms for credit in large part simply by monitoring the assets and prospects of the firm itself – which is to say, the net value of the assemblage of contracts and property rights that the firm possesses – since the personal creditors of the firm's owners, and the creditors of

other businesses in which those owners have invested, will have no claim on the firm's assets until the firm's own creditors have been satisfied.

There are, of course, countervailing costs. In particular, asset partitioning reduces diversification and hence increases the probability that one of the entities involved will face bankruptcy and its associated transaction costs. Asset partitioning is efficient only when its benefits exceed the costs.

3. Why is law necessary?

If all statutory and decisional (i.e., judge-made) law specifically related to legal entities were repealed – that is, if we were to eliminate the special bodies of law applicable to business corporations, partnerships, cooperatives, and so forth – how difficult would it be to form firms using just the remaining general tools of property law, contract law, and agency law?

It would not, in fact, be difficult to establish the basic nexus of contracts structure, either under the civil law systems of continental Europe or under the Anglo-American common law systems. The firm's prospective owners could simply appoint one or more persons to act as the owners' common agent in managing the firm's affairs, with full authority to contract on the owners' behalf with respect to matters involving the firm's business.

The answer is different, however, with respect to asset partitioning. Without organizational law the firm could not be established as a juridical person that could hold title to assets in its own right. This does not mean that there would necessarily be no bonding assets with which to secure the firm's contracts. On the contrary, the owners could authorize their agent to commit the owners' personal assets as security for the firm's contracts. Indeed, standard agency law would *presume* that all of the owners' personal assets served this role. This approach has the serious problem, however, that the personal creditors of the owners would also have a claim on that same pool of assets that would be equal to that of the business creditors of the firm. This would be a problem not only because it would increase the cost of risk assessment facing the business creditors, or because it might establish an inefficient pattern of risk sharing among the owners and their personal and business creditors, but also because it would create the potential for moral hazard on the part of the owners, who would have both the ability and the incentive to explicitly or implicitly pledge the firm's assets to support their individual activities (including their other business investments).

These problems might be avoided by having the owners transfer, to the agent or agents who manage the firm, title to a pool of assets sufficient to serve as the bonding assets for the business, subject to the agent's contractual promise to employ those assets only in the designated business, and only for the benefit of the owners. The bonding assets would then be shielded from the claims of the

owners' personal creditors, since they would no longer be owned by the owners. But this approach would make the bonding assets subject to claims of the *agent's* personal creditors, thus putting the business's creditors at the risk of the insolvency of the managing agent.

Whether title to the business's bonding assets is held by the business's owners or by its manager, it would be possible in theory to use contractual means to partition off the bonding assets from the claims of other creditors. In the case in which title to the business assets is held by the owners, each individual owner could insert, into each personal contract he enters into, a provision whereby the other party to the contract waives any recourse, in case of nonperformance, against that portion of the individual owner's assets that are used in the business. The transaction costs of this form of contracting would be immense, however. Such clauses would need to be inserted in every personal and business contract to which any of the firm's owners was a party. Beyond the negotiating and drafting costs involved, there would remain the essentially insurmountable problem of moral hazard: each individual owner would have an incentive to omit the relevant provision in some of his contracts (especially those involving other business investments), and such behavior would be extremely difficult for the other owners, or the creditors of the business, to police.

In the case in which the owners transfer title in the business assets to the firm's manager, there would be similar difficulties. The manager would have to place an appropriate waiver in all contracts with his other personal and business creditors, and the owners and creditors of the firm would face the severe problem of assuring themselves that he did this.

Organizational law eliminates the need for such contracting, and the transaction costs and moral hazard associated with it. By permitting the firm itself to be an 'owner' of assets, the law permits business assets to be insulated easily from claims of the individual creditors of the firm's owners or managers. In this respect – and this is the crucial point – organizational law operates as a form of property law, permitting changes in rights that bind third parties. When a firm is organized as a legal entity, and an owner of that firm – even the sole owner – transfers assets to the firm, the creditors of the firm are automatically given a contingent claim on those assets (exercisable in case of contractual default), while the contingent claim on those assets previously held by the owner's personal creditors is subordinated to the claims of the firm's creditors, all without any form of recontracting or assent on the part of the owner's personal creditors or the creditors of the business.

Organizational law would not be necessary for this purpose if the law in general were more flexible in permitting the creation and assignment of security interests in particular items of property. But the law of every country puts strong limits on the ways in which property rights can be subdivided, including the formation of contingent rights such as security interests. The principal reason for these limits is evidently to prevent the fractioning of property rights in ways

that – because of high transaction costs – cannot be undone through private contracting if and when the fractioning becomes inefficient. In the course of the twentieth century, the law of developed countries – and particularly U.S. law – has relaxed these limits somewhat by becoming increasingly flexible in permitting the free formation of complex security interests. If that liberalization continues, it may some day reach the point where a separate body of organizational law is unnecessary to accomplish the type of asset partitioning created by the formation of a legal entity. Until then, however, the formation of a large nexus of contracts will generally be infeasible without organizational law.

The basic efficiency advantage of asset partitioning – the fact that the aggregate cost of credit can be reduced by appropriately dividing up a fixed pool of assets for purposes of pledging those assets as security to diverse creditors – has long been familiar in the law and economics literature (Posner, 1976; Jackson and Kronman, 1979; Levmore, 1982). Yet, surprisingly, the particular form of asset partitioning that is at the heart of organizational law – insulation of a firm's assets from the individual creditors of the firm's owners or managers – has gone largely unremarked.

4. Limited liability

In contrast, the existing literature in law and economics *does* focus extensively on the reverse form of asset partitioning: insulation of the personal assets of the firm's owners and managers from the creditors of the firm through the doctrine of limited liability (e.g., Woodward, 1985). This form of asset partitioning, however, is both less important in efficiency terms, and much less difficult to achieve through individual contracting without benefit of organizational law, than is the type of partitioning on which we have focused here.

To begin with, limited liability is not a characteristic of all legal entities. Partnerships, for example, lack this attribute. This is because there are situations in which the aggregate cost of credit is reduced by letting business creditors share with personal creditors a security interest in the owners' personal assets. At the same time, there are many firms, and especially large firms with multiple owners, for which this is not the case. Consequently, it is useful to make limited liability an option by providing for legal entities that do and do not have that attribute.

Moreover, there is good reason to believe that, even if limited liability were unavailable as a standard legal option, the formation of modern business firms would not be radically affected. It seems likely that, even with unlimited owner liability, creditors of a firm that has thousands of owners would often take little account of the personal assets of the individual owners in establishing the firm's cost of credit, because the personal assets of the individual owners are simply too difficult to assess, monitor, and levy on. Consequently, for firms with dispersed

ownership, limited liability probably has little effect on the firm's cost of credit. At the same time, unlimited liability would probably have relatively modest consequences for the prices investors would pay for shares in large firms of the type that are today commonly incorporated (at least if the owners' personal liability were pro rata – i.e., proportional to the amount of their investment in the firm). The risk borne by a firm's owners and other personal creditors could be diversified, and could be further reduced to any arbitrarily small level by supplying the firm with sufficient bonding assets.

Finally, organizational law is not essential to establish limited liability. If the law failed to provide standard form legal entities with limited liability, the transaction costs of creating limited liability by contract would be relatively modest – in contrast to the seemingly unsurmountable costs of using ordinary contractual means to partition off a firm's bonding assets by shielding them from the personal creditors of the firm's owners and managers. To establish limited liability by contract, it would be sufficient for the firm itself simply to insert, into each contract with its own creditors, a disclaimer by the creditors of claims against the firm owners' personal assets – something that might be achieved just by putting a brief statement to this effect in the firm's letterhead. Moreover, the problem of moral hazard is largely absent here, since there is little incentive for a firm's managers *not* to deploy such disclaimers.

Indeed, limited liability for business firms is a relatively recent invention, and the historical evolution of that invention provides evidence that limited liability was not essential for the development of modern firms. English law did not grant limited liability to manufacturing companies until 1855, yet well before then joint stock companies were common, including some with thousands of shareholders (Blumberg, 1987). Similarly, from 1849 to 1931, shareholders in business corporations in California bore unlimited pro rata liability for corporate debts, yet publicly traded firms prospered, and the state's switch to limited liability in 1931 aroused little attention among the California business community. And, as a more recent example, the American Express Company had, by virtue of its charter, unlimited shareholder liability from the firm's formation in 1850 until 1965. Yet shares in American Express traded freely during that period, and it is not apparent that unlimited liability had an appreciable effect upon either the firm's stock price or its cost of credit (Grossman, 1995).

The foregoing reasoning, to be sure, applies principally to limited liability for *contractual* obligations. Today, in all jurisdictions, legal entities that limit liability in contract also limit the liability of the firm's owners for torts – i.e., accidental or intentional injuries – committed by the firm. To achieve this, law is essential: because the firm often has no prior contractual relationship with its tort victims, limited liability in tort could not be established by contractual means. Nevertheless, limited liability in tort is arguably not an essential feature of organizational law. Indeed, as we have argued at length elsewhere, limited liability in tort (as opposed to contract) appears to be an inefficient doctrine that

developed largely by historical accident and has been perpetuated by inefficiencies in the political and competitive processes that generate organizational law (Hansmann and Kraakman, 1991).

5. Some less important functions of organizational law

Limited liability aside, the economics literature on organizational law has focused principally on the two basic agency problems facing a large firm: (1) assuring that the firm's managers act in the best interests of the firm's owners, and (2) assuring that majority or controlling owners do not exploit minority or noncontrolling owners (e.g., La Porta et al., 1998). While these issues are important, however, and while law is clearly helpful in addressing them, organizational law does not appear to play the same critical role here that it does in permitting asset partitioning. At bottom, these agency problems involve contractual relations, and can be addressed through the mechanisms of private contracting, including privately provided standard contractual forms and private reputational intermediaries such as stock exchanges and investment banks.

It follows that the minimal number of legal entities necessary for a modern economy is much smaller than the number provided by typical jurisdictions. In principle, only a single form is needed, or perhaps two: one with limited liability as the default rule, the other without. These forms would provide only for basic asset partitioning – permitting the entity to possess its own bonding assets, and perhaps governing the personal liability of owners for the firm's debts – and leave all other matters of a firm's organization to contract.

It also follows that an important subject of inquiry for economic history is to determine the point at which law developed to permit owners of a firm to form a profit-seeking business as a legal entity with clearly partitioned bonding assets of its own. We conjecture that this may have happened only relatively recently – perhaps at about the point, two centuries ago, when large-scale business firms with numerous owners first became common.

6. Conclusion

Law plays two critical roles in facilitating contractual relationships. The first is enforcement of agreements. The second is definition of the property rights that can be exchanged. The principal contribution of organizational law lies in the second category. That body of law permits the formation of a floating lien on a pool of assets associated with a given business activity. This type of security interest, which could not otherwise practicably be created, plays a critical role in permitting the formation of the large nexuses of contracts that are employed to organize most modern business activity.

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