

Article

The Essential Role of Organizational Law

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I. INTRODUCTION

In every developed market economy, the law provides for a set of standard-form legal entities. In the United States, these entities include, among others, 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. To an important degree, these legal entities are simply standard-form contracts among the parties who participate in an enterprise—including, in particular, the organization's owners, managers, and creditors. It is therefore natural to ask what more, if anything, these entities offer. Do they—as the current literature increasingly implies—play essentially the same role performed by privately supplied standard-form contracts, just providing off-the-rack terms that simplify negotiation and drafting of routine agreements?¹ Or do the various legal entities provided by organizational law permit the creation of relationships that could not practicably be formed by contract alone? In short, what, if any, essential role does organizational law play in modern society?

We offer an answer to that question here. In essence, we argue that the essential role of all forms of organizational law is to provide for the creation of a pattern of creditors' rights—a form of “asset partitioning”—that could not practicably be established otherwise.² One aspect of this asset partitioning is the delimitation of the extent to which creditors of an entity can have recourse against the personal assets of the owners or other beneficiaries of the entity. But this function of organizational law—which includes the limited liability that is a familiar characteristic of most corporate entities—is, we argue, of distinctly secondary importance. The truly essential aspect of asset partitioning is, in effect, the reverse of limited liability—namely, the shielding of the assets of the entity from claims of the creditors of the entity's owners or managers. This means that organizational law is much more important as property law than as contract law. Surprisingly, this crucial function of organizational law has rarely been the explicit focus of commentary or analysis.³

1. *E.g.*, FRANK EASTERBROOK & DANIEL FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 24-25 (1991); RICHARD POSNER, *ECONOMIC ANALYSIS OF LAW* 396 (4th ed. 1992); *see infra* notes 70-71 and accompanying text.

2. A preliminary version of the economic argument developed here was presented at the European Economic Association meeting in Santiago, Spain, in September 1999, and published as Henry Hansmann & Reinier Kraakman, *Organizational Law as Asset Partitioning*, 44 *EUR. ECON. REV.* 807 (2000).

3. Since we offered our initial paper on this issue, *id.*, Paul Mahoney, building on that analysis, has written a short but informative essay exploring the historical roots of asset partitioning in organizational law. Paul Mahoney, *Contract of Concession? An Essay on the*

II. FIRMS AND LEGAL ENTITIES

There are a variety of ways to coordinate the economic activity of two or more persons. One common approach is to have each of those persons enter into a contract with a third party who undertakes the 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 we commonly call a “firm.” The firm therefore serves—not just metaphorically, but quite literally—as the requisite “nexus of contracts” for the persons whose activity is to be coordinated: It is the common party with whom each of those persons has an individual contract.⁴

Economic theory does not offer a completely satisfactory explanation for the fact that productive activity is commonly organized in the form of large nexuses of contracts, in which a single central actor contracts simultaneously with employees, suppliers, and customers who may number in the thousands or even millions. Why, for example, are organizational employment relationships not constructed in the form of contractual cascades, in which each employee contracts, not directly with the firm, but rather with his or her immediate superior, so that the pattern of contracts corresponds to the authority relationships we see in a standard pyramidal organization chart? Although this subject is interesting, we will not delve into it here. Rather, we will simply take it for granted that it is essential, in modern market economies, that such large nexuses of contracts can be constructed.⁵

History of Corporate Law, 34 GA. L. REV. 873 (2000). We say a few more words on these historical issues in Part IX *infra*.

4. The now-familiar economic concept of the firm as a “nexus of contracts” derives from Armen Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777 (1972); and Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

5. The literature that focuses on asset specificity to explain vertical integration is of course important here, for example, OLIVER E. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM* (1985); and Benjamin Klein et al., *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J.L. & ECON. 297 (1978), as is the “property rights” approach to the theory of the firm that has evolved out of that work, most conspicuously in the work of Hart and Moore, for example, OLIVER HART, *FIRMS, CONTRACTS, AND FINANCIAL STRUCTURE* (1995); and Oliver Hart & John Moore, *Property Rights and the Nature of the Firm*, 98 J. POL. ECON. 1119 (1990).

A related but somewhat different reason for large centralized nexuses (as opposed, for example, 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. *E.g.*, RAGHURAM RAJAN & LUIGI ZINGALES, *THE FIRM AS A DEDICATED HIERARCHY: A THEORY OF THE ORIGIN AND GROWTH OF FIRMS* (Nat’l Bureau of Econ. Research, Working Paper No. 7546, 1998). All of this literature, however, seems to leave important things unexplained. *E.g.*, HENRY HANSMANN, *THE OWNERSHIP OF ENTERPRISE* 15 n.8 (1996).

To serve effectively as a nexus of contracts, a firm must generally have two attributes. The first is well-defined decisionmaking authority. More particularly, there must be one or more persons who have ultimate authority to commit the firm to contracts. We term those persons the “managers” of the firm. In a corporation, the managers (as we use the term here) are the members of the firm’s board of directors; in a partnership, they are the firm’s general partners.⁶ The firm’s managers may or may not be distinct from the persons for whose benefit the managers are charged to act—namely, the firm’s owners or, in the case of nonproprietary organizations, the firm’s beneficial owners or beneficiaries. (For simplicity, we generally use the simple term “owners,” rather loosely, to refer to all of these persons: the partners in a general partnership, the shareholders of a business corporation, and the members of a cooperative, as well as the limited partners in a limited partnership, the beneficial owners of a private trust, the beneficiaries of a nonprofit corporation, and the residents of a municipal corporation.)

The second attribute a firm must have, if it is to serve effectively as a locus of contracts, is the ability to bond its contracts credibly—that is, to provide assurance that the firm will perform its contractual obligations. Bonding generally requires that there exist a pool of assets that the firm’s managers can offer as satisfaction for the firm’s obligations.⁷ We term this pool of assets the firm’s “bonding assets.”

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, the single individual 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 authority to enter into contracts that will bind him in most future states, and the law also provides that, if the individual defaults on a contract, the other party will have (unless waived) the right to levy on all assets owned by that individual (which is to say that the law provides that all assets owned by an individual serve as bonding assets).

Legal entities, like individuals, are legal (or “juridical”) persons in the sense that they also have the two attributes described above: (1) a well-defined ability to contract through designated managers, and (2) a

6. In large partnerships, authority is sometimes delegated to designated managing partners. In those cases, only the latter partners would constitute managers in our sense of the term.

7. There are alternative means of bonding performance. The most obvious is to expose the firm’s managers or owners to personal sanctions such as (publicly enforced) criminal penalties or (privately enforced) reputational penalties, including personal shaming and refusals to deal with them in the future. These are poor substitutes for bonding assets, however, particularly when—as with the shareholders in publicly held business corporations—the firm’s owners are numerous and constantly changing.

designated pool of assets that are available to satisfy claims by the firm's creditors. Legal entities are distinct from natural persons, however, in that their bonding assets are, at least in part, distinct from assets owned by the firm's owners or managers, in the sense that the firm's creditors have a claim on those assets that is prior to that of the personal creditors of the firm's owners or managers.

In our view, this latter feature—the separation between the firm's bonding assets and the personal assets of the firm's owners and managers—is the core defining characteristic of a legal entity, and establishing this separation is the principal role that organizational law plays in the organization of enterprise. More particularly, our argument has four elements: (1) that a characteristic of all legal entities, and hence of organizational law in general, is the partitioning off of a separate set of assets in which creditors of the firm itself have a prior security interest; (2) that this partitioning offers important efficiency advantages in the creation of large firms; (3) that it would generally be infeasible to establish this form of asset partitioning without organizational law; and (4) that this attribute—essentially a property attribute—is the *only* essential contribution that organizational law makes to commercial activity, in the sense that it is the only basic attribute of a firm that could not feasibly be established by contractual means alone.

III. FORMS OF ASSET PARTITIONING

Asset partitioning has two components. The first is the designation of a separate pool of assets that are associated with the firm, and that are distinct from the personal assets of the firm's owners and managers. In essence, this is done by recognizing juridical persons (or, as we will usually say here, “legal entities”) that are distinct from individual human beings and that can own assets in their own name. When a firm is organized as such an entity, the assets owned by that entity in its own name become the designated separate pool of firm assets.

The second component of asset partitioning is the assignment to creditors of priorities in the distinct pools of assets that result from the formation of a legal entity. This assignment of priorities takes two forms. The first assigns to the firm's creditors a claim on the assets associated with the firm's operations that is prior to the claims of the personal creditors of the firm's owners. We term this “affirmative” asset partitioning, to reflect the notion that it sets forth a distinct pool of firm assets as bonding assets for all the firm's contracts. The second form of asset partitioning is just the opposite, granting to the owners' personal creditors a claim on the owners' separate personal assets that is prior to the claims of the firm's creditors. We term this “defensive” asset partitioning, to reflect the common

perception that it serves to shield the owners' assets from the creditors of the firm.

Both forms are clearly illustrated by the typical business corporation. Under the default rules established by corporate law, a corporation's creditors have first claim on the corporation's assets—which is to say, their claims must be satisfied before the corporation's assets become available to satisfy any claims made against the corporation's shareholders by the shareholders' personal creditors. This is affirmative asset partitioning. Defensive asset partitioning, in turn, is found in the rule of limited liability that bars the corporation's creditors from levying on the shareholders' personal assets.

We should emphasize that, throughout our discussions of asset partitioning, we use the term "creditors" quite broadly to include all persons to whom there is owed a contractual obligation that has not yet been fulfilled.

A. *Affirmative Asset Partitioning*

The type of affirmative asset partitioning that we see in the business corporation can be termed "priority with liquidation protection." It not only assigns to the corporation's creditors a prior claim on corporate assets, but also provides that, if a shareholder becomes insolvent, the shareholder's personal creditors cannot force liquidation of corporate assets to satisfy their claims upon exhausting the shareholder's personal assets. Rather, a shareholder's creditors at most can step into the shareholder's role as an owner of shares—a role that generally offers the power to seek liquidation only when at least a majority of the firm's shareholders agree. This type of affirmative asset partitioning is found not only in business corporations but also, for example, in cooperative corporations and limited liability companies, and for the limited partners in a limited partnership.⁸

A weaker type of asset partitioning, priority *without* liquidation protection, is afforded by the partnership at will, in which creditors of a bankrupt partner generally have the power to force liquidation of the partnership by foreclosing on the partner's interest in the partnership⁹—though if the partnership assets are insufficient to satisfy both individual

8. A limited partner's personal creditors generally cannot force dissolution of the partnership or otherwise levy directly on partnership property, but can only accede to the bankrupt partner's rights in distributions made by the partnership. *Baybank v. Catamount Constr.*, 693 A.2d 1163 (N.H. 1997); ALAN R. BROMBERG & LARRY E. RIBSTEIN, *BROMBERG AND RIBSTEIN ON PARTNERSHIP* § 13.07(b)(2) (1999).

9. REVISED UNIF. P'SHIP ACT (R.U.P.A.) § 801(6) (amended 1997), 6 U.L.A. 103 (Supp. 2000); UNIF. P'SHIP ACT (U.P.A.) § 32(2), 6 U.L.A. 804 (1995); BROMBERG & RIBSTEIN, *supra* note 8, §§ 3.05(d)(3)(v), 7.06(f).

and partnership creditors, then the creditors of the partnership itself have priority over the partner's creditors in the assets of the partnership.¹⁰

A stronger type of affirmative asset partitioning is found among firms that are managed on behalf of beneficiaries who lack the complete earning and control rights of full owners, including nonprofit corporations, municipal corporations, charitable trusts, and spendthrift trusts. This form gives to a firm's creditors not just a prior but (among creditors) an *exclusive* claim on the entity's assets, in the sense that the creditors of a beneficiary have no claim even to the beneficiary's interest in the firm. The beneficiaries can continue to be beneficiaries even after they have gone through personal bankruptcy, without passing to their creditors any portion of their expected benefits from the firm.

Legal entities in which affirmative asset partitioning takes the form of priority for business creditors without liquidation protection we will term, for convenience, "weak-form legal entities." Entities exhibiting both priority and liquidation protection we will term "strong-form legal entities." Strong-form legal entities in which entity creditors get an exclusive claim to the entities' assets we will term "super-strong-form legal entities."

B. *Defensive Asset Partitioning*

There are various degrees of defensive asset partitioning, just as there are degrees of affirmative asset partitioning. Indeed, the range and variety we observe among forms of defensive asset partitioning is far greater than what we observe in affirmative asset partitioning.

The strongest type of defensive asset partitioning is that found in the standard business corporation, in which creditors of the firm have no claim at all upon the personal assets of the firm's shareholders, which are pledged exclusively as security to the personal creditors of the individual shareholders. This exclusive type of defensive asset partitioning, generally referred to simply as "limited liability," also characterizes other standard types of corporations—nonprofit, cooperative, and municipal—as well as limited liability companies.

At the other extreme lies the contemporary U.S. general partnership,¹¹ in which there is no defensive asset partitioning at all; partnership creditors share equally with the creditors of individual partners in distributing the separate assets of partners when both the partnership and its partners are

10. R.U.P.A. § 807(a).

11. That is, the modern general partnership under the Bankruptcy Act of 1978, 11 U.S.C. § 101 (1994), and the R.U.P.A.

insolvent. Indeed, as the latter example indicates, defensive partitioning is not required for the formation of a legal entity.

Between these two extremes lie a variety of intermediate degrees of defensive asset partitioning that are, or once were, in common use. One of these is illustrated by the traditional approach to partnerships prior to the 1978 Bankruptcy Act. Under that approach, partnership creditors could levy on the assets of individual partners, but their claims were subordinated to the claims of the partners' personal creditors.¹² A second is a rule of pro rata personal liability, under which owners are liable without limit for the debts of the firm, but bear this liability in proportion to their claims on the firm's distributions. This rule—which was in fact applied to all corporations in California from 1849 until 1931¹³—implies, for example, that a five-percent shareholder is personally liable, without limit, for five percent of any corporate debts that cannot be satisfied out of the corporation's own assets. A third intermediate form is a rule of multiple liability, exemplified by the rules of double and triple liability that were applied to many U.S. banks in the late nineteenth and early twentieth centuries, under which the personal assets of a shareholder are exposed to liability for the firm's unpaid obligations up to a limit equal to the par value (or, in the case of triple liability, twice the par value) of the shareholder's stock in the firm.¹⁴ A fourth alternative, illustrated by the "companies limited by guarantee" provided for in the law of the United Kingdom and some other Commonwealth countries, permits individual owners to make specific pledges of the amount for which they will be personally liable for a firm's unpaid debts.¹⁵

C. *Patterns of Partitioning*

The standard-form legal entities that we observe today involve different combinations of affirmative and defensive asset partitioning. Table 1 categorizes a few of the most common types of legal entities in these terms, and also includes, for comparison, the sole proprietorship, in which the firm is not a separate legal entity.

12. This approach applies even today for the liquidation outside of bankruptcy of partnerships still governed by the old U.P.A.

13. PHILLIP I. BLUMBERG, *THE LAW OF CORPORATE GROUPS: TORT, CONTRACT, AND OTHER LAW PROBLEMS IN THE SUBSTANTIVE LAW OF PARENT AND SUBSIDIARY CORPORATIONS* § 2.01.1, at 42-46 (1987); Mark I. Weinstein, *Limited Liability in California: 1928-1931* (unpublished manuscript, on file with *The Yale Law Journal*), available at <http://marshallinside.usc.edu/mweinstein/research.html> (version of Sept. 15, 2000).

14. For extensive discussion, see Jonathan R. Macey & Geoffrey P. Miller, *Double Liability of Bank Shareholders: History and Implications*, 27 WAKE FOREST L. REV. 31 (1992).

15. PAUL L. DAVIES, *GOWER'S PRINCIPLES OF MODERN COMPANY LAW* 10-11 (6th ed. 1997).

TABLE 1. ORGANIZATIONAL FORMS AND CREDITORS' PRIORITIES

Type of Legal Identity	<i>Affirmative Partitioning:</i> Firm Creditors' Claim on Firm's Assets	<i>Defensive Partitioning:</i> Owner's Creditors' Claim on Owner's Assets
Nonprofit Corporation Municipal Corporation Spendthrift Trust	Exclusive	Exclusive
Business Corporation Cooperative Corporation Limited Liability Company Limited Partnership	Prior with Liquidation Protection	Exclusive
Partnership for a Term	Prior with Liquidation Protection	Prior (pre-1978) Shared (post-1978)
Partnership at Will	Prior Without Liquidation Protection	Prior (pre-1978) Shared (post-1978)
Sole Proprietorship	Shared Without Liquidation Protection	Shared

Various other patterns of affirmative and defensive asset partitioning, beyond those included in Table 1, can also be found. Interesting examples are provided, for example, by the law of marriage, where the pattern of partitioning differs substantially from state to state.¹⁶

16. Among states that have adopted the community property approach to marital property law, there are a variety of different patterns of partitioning between the property of the marriage and the separate property of the individual spouses. 4 THOMPSON ON REAL PROPERTY § 37.13(b)(4)-(5) (David A. Thomas ed., 1994). The following table offers illustrations, based largely on Thompson's. Among the states in the table, Wisconsin and Arizona clearly establish marriage as a legal entity, in the sense that they give marriage creditors priority in (indeed, an exclusive claim on) marital assets. California, conversely, actually gives marital property *less* protection from the separate creditors of the individual spouses than would be available to property owned jointly by the spouses if they were not married, since it grants a separate creditor of an individual spouse the right to proceed against *all* of the marital property, and not just the individual spouse's share. Thus, in California, marriage might be considered an "anti-entity."

D. *Partitioning with Respect to a Firm's Managers*

The preceding discussion has focused on partitioning between the assets of a firm and the assets of the firm's owners. Partitioning between the assets of the firm and the assets of the firm's *managers* is also important, however. Here the pattern established by organizational law is quite uniform. In nearly all standard-form legal entities, both affirmative and defensive asset partitioning with respect to managers follow a rule of exclusivity: The firm's assets are not available to satisfy the manager's personal obligations, and the manager's personal assets are not available to satisfy the firm's obligations. While we generally take this rule for granted, the importance that organizational law plays in establishing this pattern will become evident when we discuss the law of trusts below.

IV. BENEFITS OF AFFIRMATIVE ASSET PARTITIONING

Asset partitioning plays several distinct roles in the functioning of legal entities that are critical to the interests of both the creditors and the owners of these entities. We examine those roles here, with special focus on the functional contributions made by affirmative asset partitioning. In particular, we consider how affirmative asset partitioning reduces the cost of credit for legal entities by reducing monitoring costs, protecting against premature liquidation of assets, and permitting efficient allocation of risk.

In important respects, defensive asset partitioning is just the mirror image of affirmative asset partitioning: Defensive partitioning with respect to claims by the firm's creditors is effectively affirmative partitioning with respect to claims by the owners' creditors. Consequently, the efficiency advantages of affirmative asset partitioning described here also apply in large part to defensive asset partitioning. But the symmetry is not perfect.

MARITAL ASSET PARTITIONING IN SELECTED COMMUNITY PROPERTY STATES

State of Marriage	<i>Affirmative Partitioning:</i> Claim of Marriage Creditors on Marital Assets	<i>Defensive Partitioning:</i> Claim of Spouse's Separate Creditors on Spouse's Separate Assets
Wisconsin	Exclusive	Exclusive
Arizona	Exclusive	Shared
New Mexico	Shared Without Liquidation Protection	Shared
California	Shared (with Respect to <i>Entirety</i> of Marital Property) Without Liquidation Protection	Exclusive?

Another common organizational form whose status as a legal entity has varied over time and from state to state is the unincorporated association, discussed *infra* note 36.

Defensive asset partitioning serves some special purposes of its own, which we examine separately in Part VI.

A. *Reducing Monitoring Costs*

The potential economies offered by asset partitioning are most clearly seen by considering subpartitioning of assets within a single firm. Consequently, we begin with that case. We then turn to the more important and familiar use of affirmative asset partitioning, namely, to partition the business assets of a firm from the personal assets of the firm's multiple owners.

1. *Subpartitioning Assets Within a Single Firm: Corporate Subsidiaries*

Imagine a company that is engaged in two distinct lines of business: ownership and management of a chain of hotels, and ownership and management of oil fields and refineries. Then consider two distinct ways in which these entities could be structured: (1) as a single corporation with two operating divisions, one for the hotel business and one for the oil business; (2) as two distinct corporations, one for the hotel business and one for the oil business, both of which are wholly owned by a single parent holding company that has no separate assets of its own, but simply holds all of the stock of the two subsidiary corporations. In terms of decisionmaking authority, the two structures are essentially identical: In each, the board of directors of the parent firm has complete control over both the oil business and the hotel business. Likewise, the company's aggregate assets are the same in both cases. Yet the choice between these two structures may have a large effect on overall costs. In particular, the structure in which the two operating divisions are separately incorporated may face a substantially lower cost of credit.

The reason is that the two lines of business are likely to depend, to a significant degree, on two distinct classes of creditors. (Again, we use the term "creditor" here and throughout to refer not just to persons to whom the firm is indebted in monetary terms, but to any person to whom the firm has an outstanding contractual obligation.) This is most obvious with respect to trade creditors. A lessor of real estate or a supplier of linens to the hotel business, for example, is likely to be in a relatively good position to judge the financial viability of the hotel operation. To begin with, the supplier may also deal with other hotel chains, and thus be continually well-informed about the overall prospects of the hotel industry. In addition, through its repeated dealings with the particular hotel chain in question, the supplier is likely to know a great deal about how sound that chain is

financially and how well it is managed. Such a supplier to the hotel business is *not* likely, however, to know much about the oil industry, either in general or as administered by the particular company that also owns and operates the hotel chain.

If the hotel business is operated as a separately incorporated subsidiary, then the hotel supplier need not be much concerned about the prospects of the oil business. Even if the company's oil operation becomes insolvent, there will be little effect on the ability of the hotel subsidiary to pay its debts. The same, conversely, is true for suppliers to the oil operation: They need not concern themselves with screening and monitoring the fortunes of the hotel operation. Indeed, this is also true for *customers* of the oil business who hold long-term supply contracts and consequently have a strong interest in the business's continued solvency.

If the hotel and oil operations are conducted as part of a single corporate entity, however, then suppliers to the hotel business will always run the risk that unexpected developments in the oil business will impair the security of their credit, and vice versa for suppliers (and some customers) of the oil operation. It follows that both sets of suppliers are likely to extend credit on more favorable terms if the hotel and oil operations are separately incorporated, so that the suppliers are spared the costs of monitoring business activities with which they are unfamiliar.¹⁷

There are, of course, costs to partitioning the assets of a single firm by subincorporation. One is that formal bankruptcy proceedings, and the transaction costs associated with them, are more likely to arise as asset pools become smaller and more homogeneous. Both the hotel operation and the oil operation in our example are more likely to become the subject of bankruptcy proceedings if they are separately incorporated than if they are organized simply as divisions within a single conglomerate corporate shell. The latter form of organization offers the advantage of diversification as a bankruptcy-prevention device.¹⁸

Another potential cost of asset partitioning is the increased risk of opportunism by the debtor. For example, if insolvency should threaten the hotel subsidiary in our example, the holding company might be tempted to drain assets from that subsidiary to the parent corporation or to the oil subsidiary, hence effectively expropriating the creditors of the hotel

17. The same logic applies if the hotel and oil businesses are simply spun off as separate companies with different sets of stockholders rather than held by a single parent company.

18. This rationale for the conglomerate form is well-known from the finance literature. James M. Gahlon & Roger D. Stover, *Diversification, Financial Leverage and Conglomerate Systematic Risk*, 14 J. FIN. & QUANTITATIVE ANALYSIS 999 (1979); Haim Levy & Marshall Sarnat, *Diversification, Portfolio Analysis and the Uneasy Case for Conglomerate Mergers*, 25 J. FIN. 795 (1970); Wilbur G. Lewellen, *A Pure Financial Rationale for the Conglomerate Merger*, 26 J. FIN. 521 (1971); Ronald W. Melicher & David F. Rush, *Evidence on the Acquisition-Related Performance of Conglomerate Firms*, 29 J. FIN. 141 (1974).

business. Various legal doctrines—including fraudulent conveyance, veil-piercing, minimum legal capital, and equitable subordination—are designed to reduce the potential for this kind of opportunism. Nevertheless, these protections are by no means perfectly effective, and they bring administrative and incentive costs of their own.

Asset partitioning will reduce the overall costs of credit only when its benefits outweigh such disadvantages. In general, it appears that the more distinct the business operations involved, the more likely it is that partitioning will be efficient.

The idea that partitioning a fixed pool of assets can reduce overall costs of credit by reducing monitoring costs is already familiar.¹⁹ In large part, however, the existing literature on this subject focuses on devices for asset partitioning other than organizational law (for example, security interests²⁰) or, when it does look at organizational law, focuses just on the law's role in establishing *defensive* asset partitioning—that is, limited liability for a firm's owners vis-à-vis a firm's business creditors.²¹ Our principal objective here is to demonstrate the critical role played by organizational law in establishing *affirmative* asset partitioning as a means of reducing the costs of business contracting. The importance of that role becomes even more clear when we examine firms with multiple owners.

2. *Partitioning Between a Firm and Its Individual Owners*

The hotel and oil example is useful because it illustrates in reasonably clear isolation the potential monitoring-cost advantages of asset partitioning. Since the assets in the example are under the same common management and ownership with or without partitioning, other incentive issues are largely unaffected. This simple common ownership structure, however, also makes the potential efficiency advantages of partitioning relatively modest; such partitioning by subincorporation will be cost-effective only in particular circumstances.²²

19. Thomas H. Jackson & Anthony T. Kronman, *Secured Financing and Priorities Among Creditors*, 88 YALE L.J. 1143 (1979); Saul Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 YALE L.J. 49 (1982); Richard Posner, *The Rights of Creditors of Affiliated Corporations*, 43 U. CHI. L. REV. 499 (1976).

20. E.g., Jackson & Kronman, *supra* note 19.

21. See, for example, Posner, *supra* note 19, who offers an example very much like our oil and hotel business but employs it only to illustrate the utility of respecting limited liability among affiliated corporations.

22. One such circumstance involves large-scale capital development projects of the type that have commonly been organized under the increasingly popular "project finance" approach. The projects involved are, for example, capital infrastructure projects in developing countries that involve construction and operation of facilities such as telecommunications networks; railroads, or toll roads. Equity financing and management of the project is provided by a sponsoring corporation with relevant expertise that also operates other projects or businesses and may have its principal operations outside the country where the project is located. Most financing for the

The advantages of asset partitioning, and particularly of affirmative asset partitioning, are far more obvious in the case of a business firm that has numerous individuals as owners. In the absence of affirmative asset partitioning, creditors of any single owner would have the right to proceed against that owner's share of the firm's assets in case of the individual's insolvency. As a consequence, potential creditors of the firm itself would have difficulty determining the appropriate terms on which to extend credit. Intimate familiarity with the firm's own assets and business affairs would not suffice to determine the firm's creditworthiness; knowledge of the personal creditworthiness of each of the firm's owners would be necessary as well. Moreover, if a creditor's relationship with the firm were to extend over any considerable period of time, the creditor would need to *keep* monitoring the creditworthiness, not only of the firm itself, but also of all of its individual owners. And, if the nature and number of the firm's owners were to change over time—as they commonly do with business corporations—the creditor would need to keep assessing the creditworthiness of the new owners.

Clearly, the costs of such monitoring would often be enormously high—so high, presumably, that creditors frequently would be unwilling to incur them. Rather, potential creditors of the firm would simply increase the cost of credit to compensate for the high uncertainty they must face, or just deny credit entirely.

This becomes all the more obvious when one considers that it is not just the personal financial affairs of the individual owners that would be relevant to a potential firm creditor, but also the affairs of any other businesses in which the owners had an equity investment. Thus, suppose that—in a firm without asset partitioning—firm *A* were to have among its owners individual *X*, who also had an ownership stake in firms *B*, *C*, and *D*. Someone considering doing business with firm *A* would need to consider not only the probability that *A* would mismanage his personal finances in a fashion that would render him insolvent, but also that any of firms *B*, *C*, or *D* might for any reason fail, with the result that the creditors of the failed firm would seek to foreclose, via their claims against *X*, on *X*'s share in *A*.

Nor is it just potential creditors of the firm that would have an interest in the status of each owner's personal and other business affairs. All owners

project is provided by loans from one or more public or private lending institutions. The project is organized through the formation of a separate corporation—a subsidiary of the sponsoring corporation—that owns the project assets and receives the project revenues. The loans that finance the project are obligations of the latter corporation, and not of the parent sponsoring corporation. This arrangement is chosen self-consciously to permit the project lenders to confine their evaluation and monitoring to the project in question, free of credit risks from the sponsor's other obligations, and conversely to keep the project from directly affecting the creditworthiness of the sponsor. See ESTEBAN BULJEVICH & YOON PARK, PROJECT FINANCING AND THE INTERNATIONAL FINANCIAL MARKETS 87-95, 121-29 (1999).

of the firm would have a similar interest, since they would bear the consequences in terms of the firm's cost of credit. Mutual monitoring among the individual owners of a firm may make sense in a small partnership with stable membership, but it is obviously less efficient in firms that, as with much medium and large-scale enterprise today, have a numerous and constantly changing class of owners.²³

Affirmative asset partitioning eliminates much of the risk that a firm's finances will be affected by unrelated changes in the personal and business affairs of its owners. It assures that the creditors of a firm will have first right to the assets of that firm against any personal creditors, or other business creditors, of the firm's owners. *Defensive* asset partitioning, such as the limited liability of the type we see in the modern business corporation, is neither necessary nor sufficient for this form of partitioning. Even if organizational law offered only the contemporary partnership, which offers affirmative asset partitioning but no defensive asset partitioning, first priority claim on any firm's assets could easily be pledged to that firm's creditors alone.

3. *Protecting the Firm's Going Concern Value*

As the last statement suggests, many of the monitoring-cost advantages of affirmative asset partitioning can be obtained simply with the weak form of affirmative asset partitioning found in partnerships, which grants to creditors of the firm priority of claims but no liquidation protection vis-à-vis the owners' personal creditors. So long as a firm's own creditors have a prior claim on firm assets, there is a substantial limit to the threat that can be presented to them by any effort of the owners' personal creditors to liquidate firm assets. Nevertheless, absent liquidation protection, *some* threat still remains.

That threat lies principally in the possibility that partial or complete liquidation of the firm's assets could destroy some or all of the firm's going concern value, with the result that, even if the firm were to remain solvent after a partial liquidation, the net value left to the firm's owners, and available as security for the firm's creditors, might well be reduced. If this loss of firm value exceeded the value of the foreclosing personal creditor's claim, then it of course would be open to the firm to buy out that claim. But this would require that the firm be sufficiently liquid. Moreover, a personal creditor with a right to foreclose on firm assets might well threaten to

23. Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89 (1985), emphasized some time ago that limited liability—a form of defensive asset partitioning—has the benefit of reducing the need for a corporation's shareholders to monitor the finances of their fellow shareholders. What we wish to point out here is that similar monitoring economies result from *affirmative* asset partitioning as well.

exercise that right and destroy substantial going concern value—even if he could realize little or nothing thereby because the firm lacks sufficient net worth—simply to hold up the firm (or its owners or creditors) for a sum larger than his claim on the firm would receive if he actually foreclosed.²⁴

For these reasons, even with the weak form of asset partitioning that offers priority of claims but no liquidation protection, both the firm's creditors and its owners would be at the mercy of, and have an incentive to seek to monitor, the personal and other business affairs of all of the firm's owners—a burden that would often be inefficient for them to bear. It is understandable, then, that the dominant form of affirmative asset partitioning among legal entities today is the strong form, in which firm creditors are given not just priority in firm assets but also liquidation protection.²⁵

4. *Risk Sharing*

The foregoing discussion has focused largely on monitoring—that is, efficient incentives for gathering and using information. But asset partitioning can also be used to apportion risk among owners and creditors in various patterns according to their relative costs of bearing that risk—costs that will be affected by factors such as liquidity and diversification. This is a familiar benefit of limited liability and other forms of defensive asset partitioning. It is also an important benefit, however, of affirmative asset partitioning, which substantially isolates a firm's creditors from risks not associated with the fortunes of the firm.

5. *The Corporation Sole*

As the oil and hotel example illustrates, efficient asset partitioning may often involve formation of a corporation with a sole shareholder—a “corporation sole.” That single shareholder may be another corporation, as in the example. But use of the corporation sole for asset partitioning may also be efficient where the shareholder is an individual, and the individual (and her personal creditors) find it most convenient to segregate her personal assets from her business assets for purposes of pledging those assets as credit. Opposition to the “corporation sole” as an acceptable legal

24. This point is well-understood in partnership law, where liquidation by creditors is possible. *See* BROMBERG & RIBSTEIN, *supra* note 8, § 6.02(c).

25. Even in general partnerships at will, which as a general rule lack liquidation protection, the courts are sensitive to the desirability of preserving going concern value, and for this reason will generally decree foreclosure on an interest in a partnership only as a last resort. *See* 91st St. Joint Venture v. Goldstein, 691 A.2d 272 (Md. 1997); BROMBERG & RIBSTEIN, *supra* note 8, § 3.05(d)(3)(v).

form—an opposition that has largely died out in the United States²⁶ but continues in some civil-law jurisdictions—stems from a failure to appreciate this important asset partitioning function of the corporate form. Although the term “corporation” may suggest a collective entity, the rationale for the form of asset partitioning established by the business corporation does not depend on collective ownership of the firm, and there is no reason to insist on collective ownership when employing that form.

B. *Preserving the Assets of Beneficiaries*

As we noted in Part III, a few legal entities deploy a form of affirmative asset partitioning even stronger than priority with liquidation protection—namely, exclusive partitioning that denies the separate creditors of a firm’s owners (or, more accurately for the firms involved, the firm’s beneficiaries) *any* claim on the assets of the firm. Principal examples of these legal entities are nonprofit corporations, municipal corporations, charitable trusts, and spendthrift trusts.

One rationale for exclusivity is paternalism, as the example of the spendthrift trust suggests. The settlor of the trust, while giving up all claims on the trust assets for himself and his own creditors, wishes to protect the trust’s assets from the possibly reckless spending habits of the beneficiary, and thus provides that trust assets are unavailable to the beneficiary’s creditors. A similar paternalistic rationale may be present in charitable trusts and, to the extent they are redistributive, municipal corporations. A second rationale for denying personal creditors any claim on the assets of these entities is that in many cases the beneficiaries’ expected benefits from the firm would be extremely difficult to value and virtually impossible to levy on as a practical matter. What is the value of municipal services to a given resident, for example, and how might that value be monetized to repay a debt?

Exclusivity is a far more common rule in defensive asset partitioning than it is in affirmative asset partitioning, as Table 1 illustrates. We explore the reasons for this in Part VI, in which we discuss defensive asset partitioning more thoroughly.

26. This opposition continues with respect to the “LLC Sole,” as reflected in the recent Massachusetts statute. *Compare* MASS. GEN. LAWS ANN. ch. 156C, § 2(5) (West 2000) (requiring LLCs to have two or more members), *with* UNIF. LTD. LIAB. CO. ACT § 202(a), 6A U.L.A. 443 (1995) (expressly permitting single-member LLCs).

V. CONSTRUCTING ENTITIES WITHOUT ORGANIZATIONAL LAW

In the absence of organizational law, it would be effectively impossible to create the affirmative asset partitioning that is the core characteristic of a legal entity. While in theory the pattern of rights that constitute affirmative asset partitioning might still be established through contracting, the transaction costs necessary to accomplish this would be prohibitive.

To understand these transaction costs, we explore here the methods that might be employed to create the functional equivalent of a legal entity using only the basic tools of property law, contract law, and agency law.²⁷ That is, we ask how difficult it would be to establish affirmative asset partitioning if society lacked those special bodies of statutory and decisional law that constitute the separate law of partnerships, business corporations, private trusts, and so forth. By this means, we can see more clearly what makes organizational law distinctive and important.

A. *Single-Owner Enterprise*

It is easiest and most instructive to begin with the simplest possible case, in which a single individual owns and operates a business as a sole proprietor. Suppose that this entrepreneur wishes to partition off the assets associated with the business into a separate pool in which his business creditors will be given a prior claim over his personal creditors—that is, he wishes to undertake affirmative asset partitioning. If the law of business corporations were available, this could of course be accomplished easily: The entrepreneur would simply incorporate his business, transferring to the corporation his title to the business assets in exchange for the corporation's stock. This would result in the desired asset partitioning without interfering with the entrepreneur's control over the business, which, as sole shareholder in the corporation, he would continue to exercise as before.

It would not be practicable, however, to accomplish the same result without incorporating the business or otherwise relying upon organizational law. We can see this by considering how our hypothetical entrepreneur might try to establish affirmative asset partitioning simply by contract. (Since our focus for the moment is on affirmative, rather than defensive, asset partitioning, we assume that the entrepreneur is not concerned about

27. The concept of agency, in which a principal can authorize an agent to bind the principal to contracts with third parties, is crucial to the construction of a nexus of contracts with any appreciable scope, whether the juridical person that is the central node of that nexus is an individual human being, a group of individuals, or an organization. It is interesting to ask whether the legal doctrine of agency is primitive, or whether it would be feasible to construct the functional equivalent of agency using other, more basic elements of contract doctrine. We do not explore that question here, however, but rather take for granted that agency doctrine is in place.

shielding his personal assets from his business creditors. We explore contractual approaches to defensive asset partitioning in Part VII.)

1. *Establishing Priority by Contract*

The default rules of property and contract law in effect provide that, absent contractual agreement to the contrary, each of the entrepreneur's creditors has an equal-priority floating lien upon the entrepreneur's entire pool of assets as a guarantee of performance. That is, the creditors each have a shared property right of sorts in the entrepreneur's assets—a contingent claim on the assets that can be exercised in case of the entrepreneur's nonperformance.²⁸ If we ignore the possibility of using security interests—a topic to which we return below—the entrepreneur cannot alter these rights simply by putting a term in his contracts with his business creditors that promises them a prior claim, over his other creditors, on the subset of the entrepreneur's assets that he uses in his business. The entrepreneur's existing personal creditors already have a claim on those assets that cannot be subordinated without those creditors' consent. Moreover, so far as the entrepreneur's *future* nonbusiness creditors are concerned, the law, absent explicit agreement to the contrary, will also impose a default term in their contracts with the entrepreneur that gives them, likewise, an equal-priority claim on the entrepreneur's assets in case of default—a contractual commitment inconsistent with any prior claim that the entrepreneur previously gave to his business creditors.

Consequently, to assure his business creditors a prior claim on his business assets, the entrepreneur would need to promise them credibly that he would obtain from all of his *personal* creditors, *both past and future*, agreements subordinating their claims on the entrepreneur's business assets to those of the entrepreneur's business creditors. Absent organizational law, an entrepreneur would generally be both unwilling and unable to make a credible promise of this sort. He would be unwilling because the costs of obtaining the necessary subordination agreements would be prohibitive in virtually any practical situation. He would be unable because his compliance could not be monitored or bonded.

Consider first the simple transaction costs that the contracting in question would involve. These would include the expense of drafting and inserting appropriate provisions in all contracts between the entrepreneur and his personal creditors on one side, and in all contracts between the entrepreneur and his business creditors on the other. Those provisions

28. To be more precise, the creditors have a right to levy on the assets so long as they remain in the pool of assets belonging to the entrepreneur: The claim floats in the sense that assets are subjected to the claim when they become property of the entrepreneur and are released from the claim when they are no longer his property.

would not be simple. They would need to be crafted with sufficient detail and precision to distinguish clearly the entrepreneur's business assets from his personal assets, and to distinguish his business creditors—those entitled to a prior claim on the business assets—from his personal creditors. In this connection, we must remember that the business assets are likely to be a large and shifting pool of tangible and intangible items, including equipment, supplies, inventory, accounts receivable, supply contracts, credit agreements, and trademarks. Moreover, beyond these drafting costs, there would be the costs of bargaining with all of the entrepreneur's personal creditors to secure their agreement and to determine, among other things, the consideration necessary to offset those creditors' loss of security.

Even if the costs of obtaining the requisite subordination agreements were worth incurring, however, the entrepreneur would find it virtually impossible to assure his business creditors that he would in fact obtain them. Although each of the entrepreneur's business creditors would have a contractual right to insist that the entrepreneur obtain those agreements, that right would generally be enforceable only against the entrepreneur—and not against his personal creditors—in the event that the entrepreneur failed to negotiate the requisite subordination term.

Thus, the entrepreneur and his business creditors would face an enormous problem of moral hazard. The entrepreneur would have a strong incentive not to obtain the necessary subordination agreements, particularly in the circumstances in which they would be most important to the business creditors—namely, when the entrepreneur is facing a substantial risk of insolvency and hence is both (a) in strong need of further credit, and (b) in a poor position to obtain credit that is subordinated. By failing to obtain a subordination agreement with a personal creditor, the entrepreneur and the personal creditor can externalize to the entrepreneur's business creditors a larger portion of the potential costs of the entrepreneur's insolvency than the business creditors had bargained for. For these reasons, in order for the entrepreneur's business creditors to have faith in the entrepreneur's compliance with his promise to give them priority in his business assets, they would have to engage in continuous monitoring of the entrepreneur's contracts with all of his individual creditors—a task that generally would be infeasible.

Organizational law eliminates the need for such elaborate contracting and thereby avoids the transaction costs and moral hazard it involves. First, by permitting the firm itself to be an owner of assets, organizational law provides a simple means for identifying which assets are to be considered personal assets as opposed to business assets: The latter are simply the

assets to which an appropriately organized firm holds title.²⁹ Second, organizational law provides a simple means for distinguishing the individual's personal creditors from his business creditors: The latter are simply those whose contracts are with an appropriately organized firm rather than with the individual directly. Third, and most importantly, organizational law alters the default rules of contract law by imposing a special term in every contract that a person enters into with a personal creditor. That term provides, in effect, that if (a) that person transfers assets to an appropriately organized firm owned by that person, or (b) that person purchases assets in the name of an appropriately organized firm that he owns rather than in his own name, then his personal creditor's claim on those assets will be subordinated to the claims of the business creditors with whom he has contracted in the name of the firm.

This special contractual term that organizational law imposes is, moreover, a *mandatory* term. If it were just a default term, waivable by the parties, then the problems of moral hazard discussed above would return. A business creditor would have difficulty assuring that his claim was in fact prior to those of all of the personal creditors of the firm's owner, since the owner might have waived the term in question for the benefit of some or all of that owner's personal creditors.

2. *Efficiency Concerns*

This altered pattern of contractual rights that organizational law establishes would not be useful, of course, if it were not efficient—that is, if it did not lead to an increase in the aggregate value of the contractual rights held by all parties concerned. In general, one can expect not only that it will be efficient, but also that the individual transactions that it facilitates will be to the advantage of all the contracting parties involved.

Consider, again, our hypothetical entrepreneur. Suppose that he has already incorporated his business and now wishes to transfer to the business a piece of equipment that was previously his personal property. In exchange, he will receive additional shares in the corporation (or perhaps, if he is the sole shareholder, simply an increase in the value of his existing shares). As a consequence of this transaction, his personal creditors will lose the right to levy directly on the equipment and will receive, in place of that right, an increase in the value of the entrepreneur's shares that they can levy on. The creditor-monitoring economies and other advantages of affirmative asset partitioning, however, should render that increase in share

29. Of course, in the case of small, informal entities such as general partnerships, there may still be ambiguity on the margin as to which property belongs to the firm and which belongs to individual partners. See BROMBERG & RIBSTEIN, *supra* note 8, §§ 3.02-.03.

value greater than the value that the equipment had when it was owned personally by the entrepreneur. If it were otherwise, the entrepreneur would have had little incentive to transfer the equipment to the corporation.

Thus, the transaction should redound to the benefit of all involved—the entrepreneur's personal creditors, the entrepreneur himself, and the entrepreneur's business creditors. The same logic applies, moreover, when an entrepreneur originally incorporates a business that was previously operated as a sole proprietorship. In sum, affirmative asset partitioning is a bonding mechanism—a means of pledging assets to business creditors—that the entrepreneur generally has an incentive to use only when its benefits exceed its costs, from both an individual and a social point of view.

B. *Multiple-Owner Enterprises*

When a business has multiple owners, the costs of establishing affirmative asset partitioning by simple contracting—already prohibitive in the case of a single owner—grow exponentially, while at the same time the benefits of affirmative asset partitioning also increase dramatically. This becomes clear when we imagine how a group of numerous individuals might try to create a jointly owned business with affirmative asset partitioning—the sort of firm that could be formed using partnership law or corporate law—if partnership law, corporate law, and other forms of organizational law did not exist.

Basic property law would permit these individuals to purchase and own the property used in the business jointly, as tenants in common. Basic agency law would permit the co-owners to delegate to managers well-defined authority to act on behalf of the owners and to commit, as security for performance of the business's contracts, both the jointly owned assets used in the business and the individual owners' personal assets. And basic contract law would permit the co-owners to commit themselves both to their chosen methods for apportioning among themselves the earnings of the enterprise, and to the voting rules or other mechanisms they will use to make those decisions that are not delegated to the managers. Consequently, using just these basic legal tools, the individuals could create a nexus of contracts with many of the attributes of a partnership. What these individuals could *not* practicably do is establish either of the two basic elements of affirmative asset partitioning: priority of claims or liquidation protection.

1. *Establishing Priority*

Consider first the problem of giving creditors of the business a prior claim on the jointly owned assets used in the business. Under the

background rules of contract and property law, the personal creditors of an individual co-owner, in the case of the individual's nonperformance, would be able to levy on all of the individual's assets, including his share in the co-owned business property. And their claim on the latter property would be equal in priority with that of the business creditors. Any effort to change this pattern of creditors' rights would run into problems of the same kinds explored above in the case of a single-owner enterprise, though exponentially greater in magnitude.

In particular, to give the business creditors a prior claim to the assets used in the business would require that each of the co-owners pledge, in each contract with a business creditor, that they will extract from each of their personal creditors—both those already existing as well as all future personal creditors—a waiver of claims against the co-owners' share of the business assets. These pledges might be made easily enough by the managers, acting as their agent, via standard-form contracting. But the transaction costs to the co-owners of complying with these pledges would be immense—roughly the same as for the single owner we discussed previously, but multiplied by the number of co-owners involved. Moreover, the problems of moral hazard and monitoring involved in enforcing these pledges would increase much more than proportionately to the number of co-owners. The reason is that, with multiple co-owners, there arises a free-rider problem. Each co-owner has a stronger incentive than would a single owner-entrepreneur not to extract the promised waiver from one or more of his personal creditors and thus effectively pledge to them his share of the commonly-owned assets, since—holding the actions of the other co-owners constant—he bears only part of the costs that such action imposes on the creditworthiness of the business. Further, as the number of co-owners increases, it becomes more difficult for the co-owners themselves to control this problem by monitoring each other's private debts.

2. *Liquidation Protection*

In addition to the problem of establishing priority in business assets for business creditors, there is the problem of liquidation protection. With only basic property law to work with, liquidation protection would be difficult to obtain. Each co-tenant of property held as tenancy in common has a right to force partition of the property, either through physical partition (nominally the law's preferred method) or through sale of the property and division of the proceeds.³⁰ Creditors of a bankrupt tenant in common step into the

30. *E.g.*, *Delfino v. Vealencis*, 436 A.2d 27 (Conn. 1980); *Johnson v. Hendrickson*, 24 N.W.2d 914 (S.D. 1946). Statutory law in most states includes provisions allowing this forced partition. RESTATEMENT (SECOND) OF PROPERTY § 4.5 cmt. a (1983); JOHN E. CRIBBET, *PRINCIPLES OF THE LAW OF PROPERTY* 106 (1975). *See generally* Note, *Partitions in Kind: A*

bankrupt person's shoes as tenant in common,³¹ and therefore presumably have the same right to force partition. Although tenants in common can enter into a contractual agreement among themselves not to partition the property, such an agreement must be limited in duration.³² Moreover, it is doubtful whether an agreement not to partition, whatever its duration, would bind the cotenants' creditors.³³

3. *Partnership as Partitioning*

The law of partnership solves the problem of granting creditors a prior claim on the assets of the firm, and hence permits the weak form of affirmative asset partitioning, by creating a special form of concurrent tenancy for all assets held in partnership name. (A partner is said to hold partnership assets as a "tenant in partnership" under the old Uniform Partnership Act.³⁴) The rules of creditors' rights and bankruptcy applied to partnership provide that creditors of the partnership have a claim on these partnership assets, in case of the partnership's insolvency, that is prior to the claims of the partners' personal creditors.³⁵

From the functional view of legal entities that we take here, it is this feature of partnership law that makes the partnership a legal entity rather than a mere common agency, and thus makes partnership law part of organizational law. There has long been debate in the legal literature as to whether the partnership, at one or another point in its historical evolution, should properly be considered to have attained legal personality. Those who have argued to the contrary have pointed, for example, to the fact that until relatively recently, it was necessary to name all of a firm's individual partners in a lawsuit to enforce a claim against the partnership, or to the

Preference Without Favor, 7 CARDOZO L. REV. 855 (1986) (surveying and criticizing the law's preference for partition in kind).

31. 20 AM. JUR. 2D *Cotenancy and Joint Ownership* § 38 (1995) (citing *New Haven Trolley & Bus Employees Credit Union v. Hill*, 142 A.2d 730 (Conn. 1958); *First Fed. Sav. & Loan Ass'n v. Lewis*, 218 N.Y.S.2d 857 (App. Div. 1961); and *Sipes v. Sanders*, 66 S.W.2d 261 (Tenn. Ct. App. 1933)); see also 86 C.J.S. *Tenancy in Common* § 13 (1997) (discussing the sale or conveyance of common property to a third person).

32. An agreement not to partition is unenforceable as an invalid restraint on alienation unless it is for a reasonable time only. *Raisch v. Schuster*, 352 N.E.2d 657, 659-60 (Ohio Ct. App. 1975); RESTATEMENT (SECOND) OF PROPERTY: DONATIVE TRANSFERS § 4.5, reporter's note 2(c) (1983); see also CRIBBET, *supra* note 30, at 106 (citing *Michalski v. Michalski*, 142 A.2d 645 (N.J. Super. Ct. App. Div. 1958)).

33. The Bankruptcy Code permits a trustee in bankruptcy to sell both the interest of a bankrupt debtor and the interest of a co-owner in property that the parties held as tenants in common. 11 U.S.C. § 363(h) (1994). This provision of the Code makes no reference to agreements not to partition, and it seems implausible that they would be considered relevant. The same Code provision, for example, applies to property held as tenancy by the entirety, in which by law, and not just as a contractual option, an individual co-owner lacks the right to compel partition.

34. U.P.A. § 25, 6 U.L.A. 699 (1995).

35. The rule is stated quite explicitly, for example, in *id.*

traditional rule that a change in the membership of the partnership leads to a dissolution of the partnership. While such elements of the traditional law of partnership are inconveniences for a smoothly functioning firm, they are only that; in general, they can be avoided by contractual means. The priority of claims that partnership law establishes for the firm's creditors is of a different character, since it could not, as a practical matter, be established by contract.³⁶

If the owners of a firm want liquidation protection, the general partnership at will, of course, will not suffice. Rather, the owners will need to use a strong-form legal entity, such as the business corporation.

C. *An Aside on the "Partnership Sole"*

Once this last point is recognized, we see that it would make sense for partnership law to recognize the "partnership sole"—that is, a partnership with only a single partner—just as corporation law has come to recognize the corporation sole. With the ability to establish a business as a partnership sole, an individual entrepreneur could give all of her business creditors a prior claim on her business assets while also offering them a claim against

36. Like the partnership, the unincorporated association has long been the subject of debate as to its status as a legal entity. In the case of the unincorporated association, however, there has been more reason for debate.

The traditional common-law rule was that an unincorporated association could not hold assets in its own name. As a result, there existed no separate pool of association assets against which creditors of the association could proceed. Creditors of the association who sought satisfaction of their claims consequently were permitted to bring suit against members and other persons acting on behalf of the association. An unincorporated association was therefore not a legal entity as we use that term here.

Beginning in the early twentieth century, many states adopted "sue and be sued" statutes recognizing the capacity of an unincorporated association to hold assets and incur debts in its own name, with the result that creditors of the association could reach the assets of the association to satisfy unpaid debts. Those statutes consequently established affirmative asset partitioning, and thus made unincorporated associations legal entities in the sense used here. To be sure, affirmative asset partitioning requires not only demarcation of the firm's assets, but also creation of a priority claim on those assets for firm creditors. The statutes in question do not expressly address the latter question of priority. Nevertheless, priority for association creditors is the logical consequence of the statutes: Assets held by the association are presumably not also to be considered personal property of the members, and thus cannot be levied upon directly by creditors of the individual members.

The sue-and-be-sued statutes did not, however, establish *defensive* asset partitioning. Members, as well as others acting on behalf of the association, remained personally liable, jointly and severally, for the association's debts. *Karl Rove & Co. v. Thornburgh*, 39 F.3d 1273, 1285-86 (5th Cir. 1994); see Kimberly A. Davison, Note, *Cox v. Thee Evergreen Church: Liability Issues of the Unincorporated Association, Is It Time for the Legislature To Step In?*, 46 BAYLOR L. REV. 231, 235-36 (1994). It was largely this issue that prompted the promulgation, in 1992, of the Uniform Unincorporated Nonprofit Association Act, 6A U.L.A. 509 (1995), which has now been adopted in a number of states. That Act roughly replicates the affirmative asset partitioning provisions of the sue-and-be-sued statutes, but goes further by establishing a substantial, though ambiguous, degree of defensive asset partitioning, stating that a person is not personally liable for an unincorporated association's debts "merely" because that person is a member of the association or participates in its management. Davison, *supra*, at 254-56.

her personal assets for any business debts that could not be satisfied out of business assets. This form of affirmative asset partitioning without defensive asset partitioning would have the same advantages for a small business with a single owner as it does for one with two or more owners. The fact that partnership law requires, instead, at least two partners³⁷ is perhaps explainable in part, like early resistance to the corporation sole, by conceptual confusion: "Partnership," even more than "corporation," seems to connote multiple owners. Another explanation may be that, at least today, roughly the same result can be obtained by incorporating the business and having its sole shareholder assume personal liability by cosigning contracts between the corporation and its most important creditors.

D. *Agency with Title*

In the preceding discussion, we assumed that the individuals investing in the business would remain co-owners of the specific assets used in the business. An alternative approach to establishing affirmative asset partitioning without organizational law might be to transfer ownership of those assets to the manager(s) of the business, subject to a contractual commitment by the manager, acting as agent for the owners, to manage the assets for the exclusive benefit of the owners and to reconvey the assets to the owners under appropriate circumstances.

This approach would provide a relatively workable means of granting business creditors a claim to the business assets that is prior to the claims of the owners' personal creditors. Since title to the business assets would not be in the hands of the owners, the owners' personal creditors would have no right to levy on those assets. At most the owners' creditors could succeed to the owners' contractual claims against the agent. But those claims, being contractual, would be limited to the terms of the contracts. And the contracts between the owners and the manager serving as their agent could provide that claims of the owners against the assets held by the manager would be subordinate to the claims of the business creditors with whom the manager contracts.

Consequently, separate waivers from all the personal creditors of the owners would not be necessary, thus avoiding the prohibitive transaction costs and moral hazard that such waivers would involve. To make the business creditors' priority credible to them, it would be sufficient to show them the waivers in the agency contracts between the owners and the manager.

37. At present, formation of a partnership requires "an association of two or more persons." R.U.P.A. § 202(a), 6 U.L.A. 53 (Supp. 2000); U.P.A. § 6.

Liquidation protection from the owners' personal creditors might also be established through this approach. In case of an owner's personal bankruptcy, his creditors could seek to realize the value of his contractual commitments from the manager of the business, but presumably—at least so long as the agency is not revocable³⁸—could pursue only a monetary claim against the manager, and could not seek to levy directly on the business assets whose title is held by the manager.

This approach may therefore succeed in insulating the pledged assets from the creditors of the co-owners.³⁹ The reason it succeeds is that the owners in fact are employing a separate legal person to serve as the firm. That person, however, is a real individual—the agent/manager—rather than an artificial legal person. And therein lies the problem with this approach. By borrowing the legal personality of the manager to form the firm, the business assets held by the manager become indistinct from the manager's personal property. The result is that the business assets, while insulated from the creditors of the owners, are not insulated from the creditors of the *manager*. Absent organizational law, the business assets would be, as a default rule, available to the manager's personal creditors, unless the manager secured explicit agreement from those creditors that the assets would not be available to them.

The agency contract between the owners and the manager, to be sure, could require that the manager obtain such an agreement from each of his personal creditors. But the resulting transaction costs—which would resemble those we surveyed when considering the possibility that a single owner of a business could affirmatively partition off the assets of that business—would commonly make such agreements impracticable. Moreover, not only the creditors of the business, but also the owners, would run the substantial risk that the manager would fail to obtain such an agreement from one or more of his creditors, whether from opportunism or mere inattention. In that case, while the owners (and perhaps the business creditors) would retain contractual claims against the manager, those claims would be parallel with, rather than superior to, the claims of the manager's

38. The general rule is that an agency cannot be made nonrevocable. There is an exception, however, if the agency "is coupled with an interest." Presumably the transfer of title in the pledged assets to the agent gives the agent the requisite interest (from the law's point of view). To be sure, the agency contract employed here seeks to deprive the manager of any equitable interest in the assets, leaving him only with formal legal title. On the other hand, as the following discussion shows, there may be no way to prevent those assets from serving as security for the manager's personal creditors, and thus the manager in fact does have a substantial equitable interest in the assets.

39. As a bonus, this approach may also provide limited liability for the owners, in the sense that their exposure to the creditors of the firm may be limited to the assets whose title they have transferred to the manager. This will not be the case, however, if the owners retain sufficient control over the manager that the law of agency makes them personally responsible for contracts entered into by the agent on their behalf.

personal creditors: "As a result, in the absence of organizational law, this approach fails to establish affirmative asset partitioning, just as do the other two approaches we have examined.

The common-law trust solves this problem of insulating the business assets from the personal creditors of the manager by permitting the manager to be designated a "trustee" whose assets—that is, assets to which he holds legal title—are effectively partitioned into two sets: his personal assets, and the assets he holds in trust for designated beneficiaries. Further, trust law provides that, as a general rule, the latter assets are not available to satisfy the claims of the trustee's personal creditors. Thus, the law of trusts makes the trustee, vis-à-vis creditors with whom he contracts, two distinct legal persons: a natural person contracting on behalf of himself, and an artificial person acting on behalf of the beneficiaries.

This insulation of assets held in trust from the personal creditors of the trustee is the essential contribution of trust law. Its importance can be seen by examining the use of trust-like relationships in civil-law countries where the law of trusts is lacking. While it is not uncommon in those jurisdictions for individuals to proceed in the manner described above, transferring to an agent the title to assets that the agent is to manage on the individuals' behalf, the persons chosen as agents are almost invariably banks or other institutions with sufficient safe assets effectively to eliminate the risk of the agent's insolvency. This is in contrast to common-law jurisdictions where, as a consequence of the law of trusts, individuals have long been commonly used as trustees.⁴⁰ While it is sometimes said that the common-law trust lacks legal personality, in our view it is, on the contrary, quite clearly a legal entity, and trust law is consequently a form of organizational law.

Indeed, one might go further. We have taken it for granted that, even in the absence of trust law, the agency-with-title arrangement described here would at least succeed in partitioning off the business assets held by the manager from the personal assets of the owners. But that assumption is based on legal rules that might themselves be considered to have the character of organizational law. After all, the law might quite reasonably say, instead, that an effort to transfer formal title in an asset from a principal to an agent, when that agent remains subject to the control of the principal and to a promise ultimately to reconvey the asset and the title to the principal, does not succeed in changing the legal character of that asset as property of the principal rather than of the agent, at least for purposes of creditors' rights. Thus, the asset would remain available to the principal's personal creditors just like other assets owned directly by the principal. Viewed this way, the law of trusts is important not only for permitting

40. See Henry Hansmann & Ugo Mattei, *The Functions of Trust Law: A Comparative Legal and Economic Analysis*, 73 N.Y.U. L. REV. 434 (1998).

affirmative partitioning of trust assets with respect to the personal assets of the trustee, but also—like corporation law and partnership law—for permitting affirmative partitioning with respect to the personal assets of the owners.

E. *Security Interests*

It remains to ask whether affirmative asset partitioning might be accomplished through contracting, without resort to organizational law, if we supplement contract law rules with the modern law of secured transactions, such as that found in Article 9 of the Uniform Commercial Code (U.C.C.).

Of the two principal components of affirmative asset partitioning—priority of claims and liquidation protection—security interests offer a potential substitute only for the first. They provide a mechanism for assigning different priorities to the claims that different creditors hold on a given set of assets, but they do not, in their contemporary form, offer a means of preventing one or another class of creditors from forcing liquidation of the assets in satisfaction of their claim. Consequently, security interests can serve at most as an alternative to organizational law in forming weak-form legal entities such as partnerships; they cannot suffice for the construction of strong-form entities such as corporations. Moreover, even with respect to priority of claims, security interests do not today offer an effective substitute for organizational law.

1. *Establishing Priority*

To see the possibilities for using security interests to establish a priority of claims, let us return to the case of a group of individuals who wish to create a business that they will own jointly, and whose creditors will have a prior claim, over those individuals' personal creditors, on assets associated with the business. And let us suppose that the owners have at their disposal the contemporary U.S. commercial law of security interests, but no organizational law such as the law of partnership or the law of business corporations (thus forcing the owners to employ a nonentity form of joint ownership, such as tenancy in common).

To achieve their purposes using only the law of secured transactions, our hypothetical owners might seek to draft and register a financing agreement assigning to all business creditors an undivided security interest in all present and future business assets, with the creditors' claims to be satisfied out of the security pro rata according to the amount owed them. This would require a reduction to writing of (1) a description of all of the assets to be pledged, and (2) a listing of all of the present and future

creditors to which these assets can be pledged. A statement pledging these assets as security would then need to be included in the individual contracts between the firm and each of its creditors. To be comprehensive, this class of creditors would have to include all of the firm's suppliers, employees, and customers. The essential question is whether the transaction costs of accomplishing this would be prohibitive.

The current law of secured transactions permits the pledge of both present and future ("after-acquired") assets by type. Consequently, it offers a relatively simple method of establishing a broad floating lien over assets held by a given debtor. To be sure, the most recent revisions to the U.C.C. specifically forbid debtors from offering, in a security agreement, a blanket pledge of all assets of any description, requiring instead more specific description of the particular assets that are covered by the agreement.⁴¹ Consequently, using just the law of secured transactions, business creditors could not be given priority over the business owners' personal creditors in assets of a type not specifically described. This clearly makes a security agreement a relatively awkward means for affirmative asset partitioning. Since, however, most business assets of consequence can be described and pledged effectively under current law, this problem is not a fundamental obstacle to substantially effective asset partitioning via secured transactions.

In contrast to the flexibility it offers in describing pledged assets, however, current commercial law creates severe difficulties in describing the creditors to whom those assets are to be pledged. A financing agreement must list the name and address of each creditor who is secured by the agreement.⁴² This means that a secured financing agreement cannot be extended to include unnamed future business creditors without requiring a new filing each time the firm deals with a new creditor. As one court has put it, "the UCC clearly contemplates and sanctions floating collateral (after-acquired property of the debtor) and floating debt (future advances [from already existing creditors]). However, the UCC does not . . . contemplate floating secured parties . . ."⁴³ Undertaking a new filing with each new creditor—which means, to match the consequences of organizational law, filing virtually every time that the firm contracts with someone new—would obviously be an infeasible burden in a business of any complexity. Consequently, security interests fall far short of offering a

41. In a new version of U.C.C. Article 9, recently drafted by the National Conference of Commissioners on Uniform State Laws, section 9-108 explicitly disallows such pledges in security agreements (though the new section 9-504 specifically allows such a description in a financing statement). U.C.C. §§ 9-108, 9-504 (2000).

42. U.C.C. § 9-402 (1992). Although the new section 9-502 dispenses with the requirement that a financing statement include the creditor's address, "the name of the secured party" is still required. U.C.C. § 9-502 (2000).

43. *In re E.A. Fretz Co.*, 565 F.2d 366, 369 (5th Cir. 1978) (footnote omitted).

workable substitute for establishing the pattern of priorities that is involved in the affirmative asset partitioning offered by organizational law.

It might be argued that, while security interests cannot suffice to provide priority of claims for *all* of the creditors of a business, this is not really necessary to create a viable firm. Rather, it is sufficient if the business simply obtains all of its credit from one big creditor rather than from many small ones. In fact, small businesses commonly follow this path today, obtaining most or all of their financing from a single creditor such as a bank that takes a security interest in all of the business's assets.⁴⁴ If the business goes bankrupt, the single secured creditor commonly gets paid nearly in full, while the other, smaller creditors get little or nothing.⁴⁵ Realizing this, the unsecured creditors can adjust their terms of credit accordingly.

But this one-big-secured-creditor approach to creating a viable firm suffers from two serious problems. First, it is not the case that, if a business relies upon a single secured creditor for its principal financing, it is irrelevant to other parties who contract with the firm whether the firm is formed as a legal entity—that is, whether the business as a whole exhibits affirmative asset partitioning. Other persons who contract with the business (customers, suppliers, workers, etc.) will still need to assess the likelihood that the firm will keep its contractual promises to them, so that they can determine the terms on which they are willing to deal with the business. This requires, in particular, an ability to predict the likelihood with which the business will go bankrupt. For, even if (or especially if) it is clear to the firm's customers and suppliers that they will get nothing from the firm in the case of its bankruptcy, owing to the presence of the one, big secured creditor, the *probability* of nonperformance (and nonpayment of damages) remains important when deciding whether and on what terms to contract with the business. And in the absence of affirmative asset partitioning, it will be very much harder than it otherwise would be for the firm's customers and suppliers to predict the likelihood of the business's bankruptcy, since that will depend on the probability that each of the business's owners will become insolvent, and not just on the probability that the business itself will become unprofitable. In short, the monitoring-cost advantages of affirmative asset partitioning do not disappear when a firm depends principally on one large secured creditor for financial credit.

Second, there is the problem of how the business's one large creditor will obtain its *own* financing in the absence of organizational law. Suppose, for example, that—as is common for small businesses today—the one large

44. See Robert E. Scott, *A Relational Theory of Secured Financing*, 86 COLUM. L. REV. 901, 948-50 (1986) (discussing single creditor "relational" lending to small firms).

45. Lucian Ayre Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857, 862 (1996).

creditor is a bank that obtains the funds it lends by taking deposits from numerous small depositors. In the absence of organizational law, and of the affirmative asset partitioning it affords, the bank's depositors run the risk that the bank will be thrown into bankruptcy by creditors of the bank's owners even if the bank's own operations are highly profitable. Thus, to an important degree, the one-big-secured-creditor approach just shifts the problem of creditors' monitoring costs from the creditors of the business itself to the creditors of the business's single secured creditor.

2. *Respecting Priority*

Beyond the problem of determining the pattern of priorities among a business's creditors and the creditors of the business's owners, there is the problem of determining how closely those priorities, once established, will be respected. Here, too, there is a difference between what can be accomplished with organizational law and what can be accomplished with the law of secured interests. Organizational law offers stronger respect for these priorities.

Bankruptcy law in the United States sometimes fails, in practice, to give full respect to the relative priorities among the creditors of a business, advantaging junior creditors and equityholders at the expense of senior creditors.⁴⁶ To avoid this problem, some companies obtain debt financing through the use of a separate entity. This approach is typified by the asset securitization transactions that have become commonplace in recent years.⁴⁷

In a typical asset securitization transaction, a corporation transfers some of its assets (say, its accounts receivable) to a wholly owned subsidiary corporation created just for purposes of the transaction. The subsidiary in turn issues bonds backed by the accounts receivable, paying the receipts from the bond issue to the parent corporation as compensation for those

46. Undercompensation of secured creditors relative to general creditors and equity is, for example, a direct consequence of the doctrine established in the Supreme Court's ruling in *United Savings Ass'n v. Timbers of Inwood Forest Associates*, 484 U.S. 365 (1988), which disallows interest on secured creditors' unpaid claims during bankruptcy proceedings. For a discussion, see DOUGLAS G. BAIRD ET AL., *BANKRUPTCY* 381-83 (3d ed. 2000).

For a general analysis of absolute-priority valuations, as well as the direct costs of bankruptcy reorganization, see Lawrence A. Weiss, *Bankruptcy Resolution: Direct Costs and Violation of Priority of Claims*, 27 J. FIN. ECON. 285 (1990); see also Lynn M. LoPucki & William C. Whitford, *Bargaining over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 139 U. PA. L. REV. 125 (1990) (offering an empirical estimate of deviations from absolute priority). See generally Barry E. Adler, *A Theory of Corporate Insolvency*, 72 N.Y.U. L. REV. 343 (1997) (collecting sources on the theory and empirical evidence of absolute-priority violations and the costs of reorganization).

47. On the popularity of these transactions, see INGO WALTER & ROY SMITH, *GLOBAL BANKING* 201 fig.7-6 (1997); and John Langbein, *The Secret Life of the Trust: The Trust as an Instrument of Commerce*, 107 YALE L.J. 165 (1997).

assets.⁴⁸ In economic effect, the parent corporation is just borrowing against its accounts receivable. Those assets are usually well within the categories of assets in which security interests can easily be created. Consequently, the same basic secured borrowing transaction might be undertaken without use of the subsidiary by having the corporation itself issue the bonds and back them with a security interest in the corporation's accounts receivable. The advantage of using the subsidiary—which, though nominally a distinct legal entity, typically performs no significant operational functions—is that it serves as a “bankruptcy remote vehicle”: If the parent corporation should ever fall into bankruptcy, the trust assets will remain completely insulated from the bankruptcy proceedings, reducing the risk that the priority of the bondholders' claim on the pledged assets will be compromised.⁴⁹ Even greater bankruptcy remoteness can be obtained through a common variant on such transactions in which the pledged assets are transferred, not to a wholly owned subsidiary, but to a legal entity such as a trust that is, at least nominally, completely separate from the corporation for whose benefit the transaction is undertaken.⁵⁰

The great popularity of these types of “structured finance” transactions reflects the widespread belief that legal entities provide greater protection than do security interests against the tendency of bankruptcy law to compromise priorities among creditors and hence frustrate efficient asset partitioning. To be sure, this advantage of legal entities over security interests is arguably a relatively modest one. Moreover, it is in part just an artifact of the weakness of U.S. bankruptcy law in respecting priorities—a weakness not generally shared by other legal systems. The critical advantage of legal entities over security interests today does not lie in the degree of protection that they offer for established priorities, but rather, as described in the preceding Subsection, in the greater facility that entities offer to establish priorities in the first place.

48. See STEVEN L. SCHWARCZ, *STRUCTURED FINANCE: A GUIDE TO THE PRINCIPLES OF ASSET SECURITIZATION*, 16-36 (2d ed. 1994) (describing the structure and motivation of typical securitization transactions); Comm. on Bankr. and Corporate Reorganization of the Ass'n of the Bar of the City of N.Y., *Structured Financing Techniques*, 50 BUS. LAW. 527, 538, 569 (1995) [hereinafter *Structured Financing Techniques*] (describing vendor and lessor financing through separate entities such as General Motors Acceptance Corporation).

49. SCHWARCZ, *supra* note 48, at 16-36; *Structured Financing Techniques*, *supra* note 48, at 553-67; Claire A. Hill, *Securitization: A Low-Cost Sweetener for Lemons*, 74 WASH. U. L.Q. 1061, 1090-93 (1996); Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J.L. BUS. & FIN. 133, 135 (1994); Marshall E. Tracht, *Contractual Bankruptcy Waivers: Reconciling Theory, Practice, and Law*, 82 CORNELL L. REV. 301, 310-11 (1997).

50. See SCHWARCZ, *supra* note 48, at 21-36.

3. *Adding Flexibility to Property Law*

If the law of security interests were substantially more flexible, and permitted the creation of floating liens with the appropriate scope and force, and with substantial flexibility in accommodating shifting creditors, then that body of law might provide a workable substitute for organizational law, at least so far as establishing priority of claims is involved (though it still would not provide liquidation protection).⁵¹ The reason for this is that both organizational law and the law of security interests are at bottom, in important part, forms of property law: They define the types of property interests that can be created and made binding against third parties.

The underlying law of property rights in all economies places strong limitations on the ways in which transferable property rights in any given asset can be divided up among two or more persons.⁵² Both the law of security interests and organizational law create exceptions to these limitations. They permit the grant of a contingent ownership right—a right to take possession of the asset in case of contractual default—and make that right enforceable against third parties, including, in particular, other creditors who also have a contingent claim on the assets in question. An important consideration in permitting creation of these rights is that third parties who might be affected by the rights—such as other creditors whose interests might be subordinated by them—have some form of notice. The law of security interests provides for notice through means such as filing. Organizational law provides for notice by permitting assignment of rights only to assets held by a legal entity. When assets are held in the name of a legal entity, the owners of that entity effectively give notice to personal creditors that a prior contingent claim on those assets may well be held by other persons—namely, creditors who have contracted with the entity itself.

4. *Historical Evolution*

The law of security interests, in its modern general form, is a relatively recent innovation. Until well into the twentieth century, that body of law was much less suited than it is now to creating broad floating liens of a type that offer a partial substitute for organizational law.

51. As a historical matter, it should be kept in mind that the law of secured interests is relatively recent and localized law. In the United States, where that body of law appears most advanced, it expanded to something approximating its current scope only with the advent, in the mid-twentieth century, of the U.C.C. Most contemporary forms of organizational law are substantially older, having arisen when the law of security interests was much less well-developed, and hence even less useful than it is now as an alternative approach to asset partitioning.

52. See Henry Hansmann & Reinier Kraakman, *Unity of Property Rights* (June 2000) (unpublished manuscript, on file with *The Yale Law Journal*).

It is possible that the law of security interests will continue to evolve, so that it provides not only for floating assets and floating debt, but also for floating secured parties. Perhaps, too, it will at some point come to offer a form of liquidation protection. If so, the line between organizational law and the law of secured interests may become quite indistinct—particularly given the tendency of organizational law to develop forms like the business trust, discussed below, that can be effectively employed as pure asset partitioning devices.

VI. BENEFITS OF DEFENSIVE ASSET PARTITIONING

Defensive asset partitioning limits the exposure of the personal assets of a firm's owners to the claims of business creditors. In contrast to affirmative asset partitioning, which by and large takes a single form, we observe many degrees of defensive asset partitioning. These range, as we noted in Part III, from none whatsoever in the contemporary general partnership to complete claim exclusion (conventional "limited liability") in most corporate forms, with various intermediate forms between these extremes (and even more in the past). As this variety suggests, defensive asset partitioning has costs as well as benefits, and those costs and benefits are sometimes in close balance. In this respect, defensive asset partitioning contrasts with affirmative asset partitioning, the net benefits of which are so decisive that it is today an element of all of the law's standard forms for enterprise organization.

The costs of defensive asset partitioning, which are conspicuous, derive principally from the possibilities it creates for the firm's owners to act opportunistically toward business creditors. If the credit required for the business substantially exceeds the value of the assets held by the firm, then limited liability creates an inducement for the owners of the firm to divert value from the firm's creditors by any of a variety of means, such as shirking with respect to their own promised effort, investing in excessively risky projects, or simply withdrawing assets from the firm in anticipation of insolvency.

The benefits of defensive asset partitioning, on the other hand, are various. Some of those benefits have been well-explored in the existing literature,⁵³ while others have not. We briefly survey here the most important of these benefits.

53. See, e.g., Easterbrook & Fischel, *supra* note 23, at 93-101; Paul Halpern et al., *An Economic Analysis of Limited Liability in Corporation Law*, 30 U. TORONTO L.J. 117, 147-49 (1980); Larry E. Ribstein, *Limited Liability and Theories of the Corporation*, 50 MD. L. REV. 80, 99-107 (1991); Susan E. Woodward, *Limited Liability in the Theory of the Firm*, 141 J. INSTITUTIONAL & THEORETICAL ECON. 601, 601-02 (1985).

A. *Monitoring Economies*

To begin with, limits on liability create monitoring economies much like those generated by affirmative asset partitioning. Just as affirmative asset partitioning permits firm creditors to focus their attention principally on the firm's assets, defensive asset partitioning permits the personal creditors of the firm's owners to focus principally on the personal assets of owners. From the perspective of the two sets of creditors, defensive and affirmative asset partitioning are largely symmetric: Affirmative asset partitioning is "defensive" with respect to the claims of personal creditors, and defensive asset partitioning is "affirmative" with respect to the claims of personal creditors.

Defensive asset partitioning also generates potential monitoring economies for the firm's owners. As others have observed, in the absence of limited liability, each of a firm's owners would have an interest in continually monitoring not only the assets and liabilities of their jointly owned business, but also the personal assets and liabilities of their fellow owners.⁵⁴ It is not only conventional limited liability that generates these monitoring economies. They are also offered by weaker forms of defensive asset partitioning—such as multiple personal liability or pro rata personal liability⁵⁵—though in lesser degree.

B. *Decisionmaking Economies*

Defensive asset partitioning also performs functions that have no parallel in the context of affirmative asset partitioning. Chief among these is reducing the costs of firm governance. One way in which defensive asset partitioning can reduce governance costs is by lowering the decisionmaking costs of a firm—such as a corporation—in which multiple owners share in the legal right to control the firm's policies or select its managers. Limited liability ensures that all owners in such a firm experience the same proportional gains and losses from the firm's policies, regardless of their identities or assets. Consequently, limited liability gives these owners a homogeneous economic interest in the firm's decisions, which greatly facilitates collective decisionmaking.⁵⁶ Weaker forms of defensive asset partitioning can be expected to reduce governance costs in much the same

54. See Easterbrook & Fischel, *supra* note 23.

55. See generally Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879 (1991) (exploring a rule of pro rata liability).

56. For a related argument concerning the virtues of having a corporate income tax that is strongly separated from the personal tax liability of the corporation's shareholders, see Hideki Kanda & Saul Levmore, *Taxes, Agency Costs, and the Price of Incorporation*, 77 VA. L. REV. 211, 229-34 (1991). On the importance of homogeneity of interest among those who share ownership in firms generally, see HANSMANN, *supra* note 5.

way. For example, pro rata shareholder liability homogenizes the preferences of shareholders as effectively as full limited liability so long as all shareholders are able to cover their share of the firm's liabilities. In the complete absence of defensive asset partitioning, on the other hand, owners—such as partners in a general partnership—must select fellow owners with similar assets and risk preferences or face significant negotiating costs.

C. *Enhanced Creditor Monitoring*

A second way in which defensive asset partitioning can reduce governance costs is by shifting some of the burden of monitoring the firm's managers from the firm's owners to its creditors. This is a particularly conspicuous advantage of full limited liability in firms that, like most public corporations, are managed by professional managers.

In effect, limited liability permits the firm to enlist creditors as monitors. If creditors know that they have recourse only to assets held by the firm, they are more likely than they otherwise would be to scrutinize closely—both before and after extending credit—the likely fortunes of the firm and the behavior of the firm's managers. The resulting creditor monitoring may often be a useful complement to monitoring by the firm's owners, even when these owners themselves can monitor with fair competence. Creditors may have access to different types of information than do owners, and they may also have different means for influencing managers. But creditor monitoring of managers may have particularly strong efficiencies when a firm's owners are poorly situated to monitor the organization's managers for themselves, as with corporations that have numerous dispersed shareholders. In firms of the latter type, important creditors may sometimes be even better overall monitors of management than are the firm's owners. Limited liability gives creditors the incentive to make use of their monitoring abilities—for which, of course, they will extract a price from the firm's owners in the cost they charge for credit.

In contrast to other benefits from defensive asset partitioning, the strength of partitioning matters a great deal here. Full limited liability is a credible incentive for creditors; weaker forms, such as double liability and pro rata liability, give creditors a much weaker monitoring incentive as long as a firm's owners are solvent. The same is true of the next benefit we examine.

D. *Collection Economies*

A third benefit of defensive asset partitioning, often given as a justification for limited liability in publicly held business corporations, is

that the costs of securing and collecting personal judgments against the personal assets of the firm's owners would consume a large fraction of the amount collected—so large as to render personal liability inefficient, in the sense that shareholders would be better off *ex ante* paying more for credit in return for a pledge from creditors not to collect from them personally.

There is undoubtedly some truth to this, though it perhaps has been exaggerated. Corporations with numerous shareholders that bore personal liability for the firm's unpaid debts were relatively common in the nineteenth and early twentieth centuries, and procedures for collecting personal judgments against their owners, at least in some contexts, were developed to the point where the transaction costs of collecting were evidently quite manageable.⁵⁷

E. *Economies of Transfer*

Limited liability is also commonly said to facilitate the transferability of ownership shares in an organization such as a business corporation. This point, which is undoubtedly correct, is closely related to the monitoring and governance economies considered above. As a practical matter, markets for ownership interests are unlikely to form unless traders can separate the value of these shares from their own personal assets and the personal assets of other owners. Limited liability obviously permits such a separation. Weaker forms of defensive asset partitioning can, however, effect the same separation in varying degrees, as evidenced by historical examples of business corporations whose shares have traded freely under regimes of multiple or pro rata shareholder liability.⁵⁸

F. *Risk-Bearing Economies*

Finally, risk sharing provides a potential rationale for defensive asset partitioning. It is important here to distinguish between two forms of risk sharing. The first is risk sharing between a firm's creditors and its owners. Limited liability, the most extreme form of defensive asset partitioning, has the important advantage here that, by putting a greater or lesser amount of equity in the firm, the balance between the risk borne by owners and that borne by the firm's creditors can be modulated over a wide range. Weaker forms of defensive partitioning, in turn, provide for even greater risk bearing by owners.

57. Macey & Miller, *supra* note 14, at 55-57.

58. See Peter Grossman, *The Market for Shares of Companies with Unlimited Liability: The Case of American Express*, 24 J. LEGAL STUD. 63, 72-75 (1995); Hansmann & Kraakman, *supra* note 55, at 1923-25; Macey & Miller, *supra* note 14, at 35-39; Weinstein, *supra* note 13, at 7-9.

The second form of risk sharing is among the owners themselves. A background rule of joint and several liability (that is, no defensive asset partitioning) gives the owners little control over their relative exposure to risk. The degree of control available then increases progressively as increasingly stronger forms of defensive partitioning are employed.

G. *The Evolution of Defensive Asset Partitioning*

As the previous discussion indicates, defensive asset partitioning can offer various efficiencies, only one of which—the reduction of monitoring costs—directly parallels an efficiency of affirmative asset partitioning. Many of these efficiencies can be realized with weaker limitations on the liability of owners, such as multiple liability and pro rata liability. This may explain the complex pattern of evolution that defensive asset partitioning has followed over the past two centuries.

In the late nineteenth century, a variety of intermediate forms of defensive asset partitioning were in common use, including all of the forms described in Part III—pro rata liability, multiple liability, and liability limited by guarantee. Today these intermediate forms have largely fallen into disuse,⁵⁹ leaving only the two extreme rules—full limited liability on the one hand, and unlimited joint and several personal liability on the other hand. Moreover, the gap between these two extreme forms has widened, as a result of recent changes in U.S. bankruptcy and partnership law. Those changes increase the priority of partnership creditors vis-à-vis personal creditors in the partners' personal assets, and also increase the effective size of the claim that partnership creditors can assert against the personal assets of individual partners.

One likely reason for this evolution lies in improved mechanisms for controlling opportunism toward creditors on the part of corporate shareholders, hence making the full limited liability that characterizes the corporate form workable for a broader range of firms. These mechanisms include, for example, improved accounting standards, more extensive disclosure, more sophisticated credit rating services, and other institutional monitors. They also include more specialized forms of regulation, such as the mandatory deposit insurance and accompanying federal financial supervision now imposed on most U.S. banking institutions.

A second reason lies in the increasing availability of the corporate form, and other limited liability forms, to small-scale enterprise. Until well into the twentieth century, the corporate form was designed almost

59. The company limited by guarantee is still in common use in some Commonwealth jurisdictions, but is now used almost exclusively to form nonprofit entities of the sort formed in the United States under a nonprofit corporation statute, which is lacking in U.K. law. DAVIES, *supra* note 15, at 10-11.

exclusively for large-scale enterprise, and did not accommodate the types of specialized arrangements (such as shareholder voting agreements and restrictions on share transferability) needed for small firms. Small-scale enterprise was therefore effectively restricted to the partnership form even for those firms that would otherwise have chosen limited liability. It therefore made sense to apply to partnerships an intermediate form of defensive asset partitioning (with priority in personal assets for personal creditors) as a compromise: It allowed owners of a firm to pledge their personal assets to firm creditors when, as was often the case, that was the efficient thing to do, but still provided at least some ability to insulate an individual's personal financial affairs from the vicissitudes of the firms he invested in.

In the course of the twentieth century, however, the corporate form became sufficiently flexible to accommodate the special needs of small firms. The result is that a firm of any size can choose freely between a rule of limited liability (by forming as a corporation, or, today, as a limited liability company or a statutory business trust) and a rule of unlimited liability (by forming as a partnership). The need for a compromise form of defensive asset partitioning has therefore disappeared, and it now makes sense to offer, to those firm owners who wish to pledge their personal assets to firm creditors, the greatest possible freedom to make such a pledge.⁶⁰

VII. IS LAW NECESSARY FOR DEFENSIVE ASSET PARTITIONING?

Given that strong defensive asset partitioning—limited liability—is evidently efficient for most firms, it remains to ask whether organizational

60. Larry Ribstein offers a different view. He argues, first, that the partnership form is moving closer to the corporate form because the "exhaustion principle," under which partnership assets must be exhausted before partnership creditors can pursue individual assets, has been extended from contract creditors under the U.P.A., to contract and tort creditors under the R.U.P.A. Larry E. Ribstein, *The Deregulation of Limited Liability and the Death of Partnership*, 70 WASH. U. L.Q. 417, 430 n.65 (1992); see BROMBERG & RIBSTEIN, *supra* note 8, § 5.08(g). We are unpersuaded, because tort liability is, in our view, irrelevant to the legitimate functions of organizational law. See *infra* text accompanying notes 67-68 (discussing the distinction between organizational and tort law). In addition, Ribstein argues that the shift in priorities under the Bankruptcy Act of 1978, under which the creditors of individual partners lost their priority in the assets of these partners, was an instance of inefficient federal intervention in an area of organizational law best left to the states. Larry E. Ribstein, *The Illogic and Limits of Partners' Liability in Bankruptcy*, 32 WAKE FOREST L. REV. 31, 65-67 (1997). We disagree. The corporate form, once universally available, captures all of the creditor-monitoring economies available under the old U.P.A. priority rules for partners' creditors. Section 40(i) of the old U.P.A. gave individual creditors priority in individual assets, which encouraged partnership creditors to ignore personal assets and individual creditors to monitor business interests only insofar as these were among the partners' personal assets. U.P.A. §40(i), 6 U.L.A. 902 (1995). The corporate form, of course, puts business and individual creditors in virtually the same position. Given this, the partnership form retains value only as an *unlimited* liability alternative to the corporate form, which implies that the claim of partnership creditors should be strengthened—they should have the same claim on the assets of individual partners as do individual creditors.

law is necessary to establish this form of partitioning, as it is to establish affirmative asset partitioning.

A. *Establishing Limited Liability by Contract*

In the absence of organizational law, the default rule would presumably be unlimited joint and several liability for a firm's owners of roughly the type found in the contemporary (post-1978) general partnership. This is because, so long as the owners retain some minimal degree of control over the firm's managers (or are the managers themselves), the managers would be considered agents of the owners and the law of agency would therefore make each owner personally liable for all of the firm's debts.

Is organizational law necessary to reverse this default and permit the establishment of limited liability or other forms of defensive asset partitioning? To put the question more precisely, suppose there were a body of organizational law that permitted affirmative asset partitioning but did not provide for defensive asset partitioning. That is, suppose the only available legal entity were the modern general partnership. How difficult would it be to establish limited liability—or other forms of defensive asset partitioning—for a general partnership using only the tools of contract?

To accomplish this, it would be necessary for the partnership to insert, in its contracts with all of its creditors, provisions whereby the creditor waived any right to proceed against the partners' personal assets to obtain satisfaction of the creditor's claims against the firm. This might involve high transaction costs, at least if there were an effort to extend it to all of the firm's creditors, including the smallest trade creditors. While it might not be difficult to draft up the necessary language for the waivers, it could be costly to induce all creditors—particularly small trade creditors who utilize standard-form contracts or invoices of their own that do not include such a waiver—to incorporate the waivers in their contracts with the firm.⁶¹ On the other hand, even at their worst, these transaction costs would be vastly smaller than the transaction costs, described earlier, that would be necessary to establish affirmative asset partitioning by contract. There would be no need to alter contracts between the individual owners and all of their *individual* creditors, and no need to confront the moral hazard associated with that contracting.

61. A further problem is the possible ambiguity as to precisely which assets belonged to the firm, and hence were available to satisfy its creditors. However, the analogous ambiguity in determining the extent of partnership assets has not proven to be insurmountable. In addition, this ambiguity can be reduced by acquiring assets in the name of the firm. See Ribstein, *supra* note 53, at 108.

Indeed, there is historical experience with such a regime of limited liability by contract.⁶² In England, prior to 1844, the corporate form was not generally available to manufacturing firms. Consequently, large manufacturing firms commonly formed as joint stock companies with transferable shares—a noncorporate form that had roughly the legal characteristics of a partnership, including joint and several personal liability for all of the firm’s obligations. Between 1844 and 1855, manufacturing firms were permitted to incorporate, but still were denied limited liability. Only with the enactment of the English Limited Liability Act in 1855 was incorporation with limited liability made generally available. The pre-1855 unlimited liability regime did not, however, prevent the formation of large firms with multiple owners. By 1844, there were nearly one thousand joint stock companies in England, some with thousands of shareholders. These companies commonly sought to limit their members’ liability for the firm’s debts to third parties by such means as inserting the “Limited” after the company’s name, putting an indication of limited liability in the company’s stationery, and including limited liability clauses in the company’s contracts.⁶³ The courts ultimately gave at least a partial blessing to these practices, holding that a standard “limited liability” clause inserted into all of a joint stock company’s contracts with creditors was effective,⁶⁴ although simply inserting such a clause into a joint stock company’s deed of association would not bind creditors even if they had express notice of it.⁶⁵

In sum, while organizational law plays a role in reducing the transaction costs of establishing defensive asset partitioning, that role is substantially less important than the role that organizational law plays in affirmative asset partitioning. The latter, unlike the former, would generally be quite impossible to establish without organizational law. This critical point has been missed by contemporary scholars who, recognizing that limited liability could be established by contract, have gone on to conclude that corporation law as a whole does no more than avoid unnecessary contracting costs by offering convenient default terms.⁶⁶

62. The English experience recounted here is discussed in detail in BLUMBERG, *supra* note 13, § 1.03, at 9-23.

63. *Id.* § 1.03.2, at 15-16.

64. *Hallett v. Dowdall*, 21 L.J.Q.B. 98 (1852).

65. *In re Sea, Fire & Life Ins. Co.*, 43 Eng. Rep. 180, 186-87 (1854).

66. For example, Posner, *supra* note 19, states:

[Questions of tort liability] to one side, the primary utility of corporation law lies in providing a set of standard, implied contract terms, for example, governing credit, so that business firms do not have to stipulate these terms anew every time they transact, although *they could do so if necessary*. To the extent that the terms implied by corporation law accurately reflect the normal desires of transacting parties, they reduce the costs of transactions. . . . A corporation law that is out of step with [commercial] realities, and so induces contracting parties to draft waivers of the contract terms supplied by the law, is inefficient because it imposes unnecessary transaction costs.

B. *Organizational Law Versus Tort Law*

Although it is to some extent a question of interpretation whether organizational law is important for limiting the personal liability of owners toward a firm's contractual creditors, there is no doubt that organizational law is essential to shield owners of an organization from personal liability to *tort* victims. Almost by definition, basic contractual devices are insufficient to establish such protection.

To say that organizational law is essential for the creation of limited liability in tort is not to say, however, that organizational law serves an important efficiency-enhancing purpose in doing so. Limited liability in tort is a doctrine of very dubious efficiency. Tort victims have no control over the type of legal entity that injures them. Consequently, to make the amount recovered by a tort victim depend upon the legal form of the organization responsible for the tort is to permit the externalization of accident costs, and indeed to invite the choice of legal entity to be governed in important part by the desire to seek such externalization.

Thus, while allowing the intentional use of the corporate form to limit liability *in contract* makes eminent sense, to permit the intentional use of the corporate form to limit liability in tort does not make sense. Of course, if unlimited shareholder liability for tort damages would interfere seriously with the tradability of corporate shares, or if collection of excess liability judgments from numerous corporate shareholders would necessarily be a very costly process, then limited liability in tort might be justified, at least for publicly traded business corporations, as a regrettable necessity. But this does not appear to be the case. A much weaker form of defensive asset partitioning for corporate torts—namely, a rule of unlimited pro rata shareholder liability—would apparently protect the marketability of corporate shares without permitting shareholders to externalize the costs of corporate torts.⁶⁷

In fact, corporate limited liability in tort appears to be a historical accident, perhaps encouraged in important part by the rarity, during the formative period of business corporation law in the nineteenth and early twentieth centuries, of tort liability sufficient to bankrupt a corporation. The

Id. at 506 (emphasis added). Our argument here is that, when it comes to establishing affirmative asset partitioning, the parties could *not* “do so if necessary” by contractual means absent organizational law, and that “the primary utility of corporation law” thus lies in that partitioning. (To be sure, Posner’s statement is arguably accurate if he is assuming that, absent corporation law, the parties could still resort to modern partnership law, and obtain affirmative asset partitioning by that means, building up the rest by contract.)

67. A rule of pro rata liability would need to be accompanied by subordination of tort claimants to contractual creditors in corporate bankruptcy, in order to keep the value of contractual claims independent of the personal wealth of individual shareholders. See Hansmann & Kraakman, *supra* note 55, at 1901-02.

increasing use of the corporate form for small businesses, together with the recent advent of potentially massive tort liability for environmental harms, workplace hazards, and injurious products, suggests that the issue should be revisited—as we have argued at length elsewhere.⁶⁸

VIII. DOES ORGANIZATIONAL LAW SERVE OTHER ESSENTIAL FUNCTIONS?

We have argued here that provision for affirmative asset partitioning is an essential function of organizational law, in the sense that firms could not be given this important attribute practicably in the absence of organizational law. Defensive asset partitioning, though also a useful function of organizational law, is less important for the creation of large-scale enterprise. Moreover, whatever the utility of defensive asset partitioning, provision for defensive asset partitioning is not an *essential* function of organizational law, as we use the term “essential” here, since it would be feasible to establish defensive asset partitioning by contract even if the law did not make special provision for it.

It remains to ask whether organizational law serves other essential functions as well. That is, are there other important features of modern organizations that could not feasibly be established by contract in the absence of organizational law?

The question is posed squarely by the recent evolution of the statutory business trust, as exemplified by the Delaware Business Trust Act.⁶⁹ The statute provides for both affirmative asset partitioning and defensive asset partitioning, with the latter being in the form of full limited liability of the type found in business corporations. The statute leaves virtually all other aspects of organizational structure open, however, permitting the formation of limited liability legal entities with virtually any desired designation of owners, and with virtually any conceivable assignment of control and distribution rights among the owners. Given this highly protean form, why does Delaware need any other forms? Are Delaware’s other statutory forms for legal entities—including business corporations, limited liability companies, nonprofit corporations, cooperative corporations, general partnerships, and limited partnerships—now merely conveniences, serving the same function as privately provided standard-form contracts, or do they perform a more essential role, permitting the formation of types of firms that could not be created practicably in their absence using just the business trust statute with appropriate contractual additions and adjustments?⁷⁰

68. *Id.* at 1880-81.

69. DEL. CODE ANN. tit. 12, §§ 3801-3820 (1995).

70. Larry Ribstein has argued in a similar vein for a “contractual entity” statute that would provide investors with limited liability but none of the other provisions of a detailed standard form of legal entity. Larry E. Ribstein, *Limited Liability Unlimited*, 24 DEL. J. CORP. L. 407, 435-446

In answering this question, there are three functions performed by organizational law that need to be considered, each of which involves relations among different groups of actors. The first is to govern relations between the firm—which is to say, the firm's owners and managers—and the firm's creditors. The second is to govern relationships among the firm's owners and between the firm's owners and managers. The third is to govern relations between the firm and its nonowner patrons. We deal with these three sets of functions in turn. We do not seek to explore the issues involved in detail, but simply to touch on the main issues.

A. *Facilitating Contracting with Creditors*

Organizational law often contains provisions other than asset partitioning that help a firm's owners bond themselves credibly to its creditors. These include, for example, limitations on the ability to pay dividends that would impair legal capital, and (at least in Europe) minimum capital requirements. In the absence of controlling provisions in organizational law, however, these matters could—like limited liability—evidently be governed feasibly by inserting appropriate terms in the firm's contracts with its creditors.⁷¹ Affirmative asset partitioning is unique in that it involves an assignment of property claims to creditors that could not be made effectively, on behalf of the firm's owners, by a contract just between those owners (or their collective agent, the firm's managers) and the firm's creditors. Once the law provides the means for affirmative asset partitioning, the owners of the firm can use simple contracts with the firm's creditors to make commitments as to such matters as the quantity and nature (for example, riskiness) of the assets that the firm will hold, and hence will pledge to its creditors.

B. *Facilitating Contracting Among Owners and Managers*

Much of organizational law—such as rules concerning governance of the firm and distribution of the firm's earnings—regulates relations among the owners of a firm and relations between the firm's owners and its managers. As others have observed, however, these matters could generally be handled relatively easily, in the absence of organizational law, through privately supplied standard-form contracts.⁷²

(1999). The Delaware Business Trust Act is in effect such a contractual entity statute, which provides for limited liability and—even more importantly—affirmative asset partitioning. §§ 3803(a), 3805(b).

71. See, e.g., POSNER, *supra* note 1, at 396.

72. E.g., EASTERBROOK & FISCHER, *supra* note 1, at 34-35.

This is true, in particular, of fiduciary duties of care and loyalty, which are sometimes thought to be particularly dependent on the law. Consider, for example, the managers' duty of loyalty. This consists, in essence, of a promise on the part of the manager not to engage in self-interested transactions involving the firm's property and prospects. That promise—accompanied, if needed, by a definition in any appropriate level of detail of what types of transactions will be considered self-interested, and what forms of disclosure and approval are required—can simply be inserted into the firm's founding document and incorporated by reference in the employment contract with each of the firm's managers. The same is true of the duty of care. Indeed, even absent such explicit contracting, the law of agency would impose on managers, as a default rule, fiduciary duties of loyalty and care that are the rough equivalent of those that are imposed by most forms of organizational law.⁷³

C. *Transferability of Ownership*

The law permits free transferability of ownership interests in some types of legal entities, such as the business corporation. Absent that legal doctrine, an owner might not be presumed to have the power to substitute another person for himself with respect to his rights and obligations toward his fellow owners and toward third parties to whom the firm has contractual obligations. Yet both contractual rights and contractual duties can in general be made transferable, under the law of contracts, so long as all contracting parties expressly agree.⁷⁴ Thus, to establish free transferability of ownership interests absent specific organizational law doctrine to that effect, it should be sufficient to put terms to that effect in the owners' association agreement and into the firm's contracts with each of its creditors. This might be burdensome, but it would not be infeasible. The contracting costs involved would presumably be comparable to those of establishing limited liability by contract.

D. *Withdrawal Rights*

In some contemporary legal entities—such as the partnership at will—the firm's owners are free to withdraw their share of the firm's assets at any time. Other standard-form legal entities, however, permit limits on the withdrawal rights of individual owners. The business corporation is

73. For a more extended discussion of contractual approaches to fiduciary duties, see Hansmann & Mattei, *supra* note 40, at 447-50.

74. See E. ALLAN FARNSWORTH, FARNSWORTH ON CONTRACTS § 11.11 (1990) (stating that contractual duties can be delegated, and the delegating party can be discharged from liability, if there is consent by the party to whom the duties are owed).

conspicuous among these; shareholders generally cannot withdraw their individual share of the firm's assets short of dissolution, and dissolution generally requires consent of the holders of at least fifty percent of the firm's shares.

Could such limits on withdrawal rights be established in the absence of organizational law? There is room to doubt that they could be. Suppose, for example, that the co-owners of a business were to hold their joint property as tenants in common. Then, as we noted earlier,⁷⁵ they might not be able to agree to waive their individual rights to force partition of the property for more than a finite period of time. It is not a question of transaction costs; the law simply prohibits unlimited agreements not to partition. Thus, to mimic fully the attributes of all contemporary legal entities, arguably, the law must not just make special provision for affirmative asset partitioning, but must also provide that co-owners can commit not to withdraw their share of jointly held partitioned assets unless there is agreement to that effect by the fraction of the co-owners that is stated in their contract of association.

We might think of this as a third element of asset partitioning. We have already noted two distinct elements of asset partitioning: priority of claims and liquidation protection from personal creditors of the firm's owners. The third element we are considering here is liquidation protection from the individual owners themselves. These two forms of liquidation generally go hand in hand. Strong-form legal entities, which are characterized by liquidation protection from the owners' personal creditors, also typically provide for substantial liquidation protection from the owners themselves. Or, put differently, the liquidation powers of an owner's personal creditors are generally the same as those of the owner himself. For example, since personal creditors of a bankrupt corporate shareholder step into the bankrupt's role as shareholder, those creditors can force liquidation of the corporation's assets only if the shareholder held enough shares in the corporation—generally fifty percent—to have been able to force liquidation himself.

E. *Facilitating Contracting with Other Patrons: Nondistribution Constraints*

Some legal entities embody a formal separation of control rights from distribution rights whereby those who control the firm are barred from appropriating the firm's net earnings, either currently or upon liquidation. That separation is a defining feature, in particular, of nonprofit entities, including the nonprofit corporation, the charitable trust, and the civil-law

75. See *supra* text accompanying notes 31-32.

foundation.⁷⁶ Could organizations be given this attribute without the benefit of specially designed organizational law? While something close might be achieved using only contractual devices, it would fall short of a complete substitute.⁷⁷

In this respect, then, the law of charitable trusts and nonprofit corporations arguably adds something to the law, beyond asset partitioning, that is “essential” in the sense we use here: It could not feasibly be replicated in the absence of organizational law.⁷⁸ Several qualifications are worth making, however. First, the nondistribution constraint is confined to several standard-form legal entities that are employed today for a relatively small subset of all organizations. Second, something close to the nondistribution constraint evidently could be achieved simply by contractual means. Third, the barriers to crafting a do-it-yourself nondistribution constraint arise not from transaction costs but from legal prohibitions of contestable utility. Fourth, the nondistribution constraint has a bonding character with substantial parallels to asset partitioning: It is a means by which those who control the firm pledge to its donors—who are effectively a subset of the firm’s creditors—that the firm’s assets and net earnings will not be diverted from the objects that the donors intended.

76. Henry Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835 (1980).

77. An organization’s founders could, presumably, put a nondistribution constraint in the contract of association that serves as the organization’s founding document. To be fully effective, however, that provision would need to be unamendable, even by unanimous agreement of the organization’s founders and controllers, since the purpose of the constraint is to protect third parties—donors and beneficiaries—against opportunism by controlling persons. That is, the constraint is a means by which those who control the organization bond themselves not to take a stake in the firm that will give them an incentive to exploit the firm’s other patrons. The law, however, frowns on nonrenegotiable contracts. See Christine Jolls, *Contracts as Bilateral Commitments: A New Perspective on Contract Modification*, 26 J. LEGAL STUD. 203, 208-09 (1997). Consequently, it is doubtful that founders could make the nondistribution constraint unamendable simply by entering into an agreement to that effect among themselves.

An alternative approach might be to have the firm make a contractual commitment to each donor, in return for the donor’s contribution, to maintain and adhere to the nondistribution provisions in the charter. The result, however, would still not quite create the complete equivalent of the nonprofit corporation. For, in most states of the United States, it is possible and indeed common to create nonprofit corporations in which both donors and beneficiaries lack not just voting rights but also the right to sue the organization’s managers either directly or derivatively, with the result that neither donors nor beneficiaries have any rights of control over the organization’s managers. Arguably the tools of the common law are inadequate to achieve this result, in which perpetual obligations are imposed on self-appointing managers who, because of the absence of control over them, cannot be considered agents of any party in interest.

78. The Delaware Business Trust Act, interestingly, specifically authorizes use of the business trust form for the formation of organizations of a nonprofit character. DEL. CODE ANN. tit. 12, § 3801(a) (1995). The Act does not, however, make it clear how a nondistribution constraint is to be imposed under the Act.

F. *Essential Terms Versus Useful Terms*

The preceding discussion has sought to show that, with the possible exception of some elements of the law of nonprofit organizations, aspects of organizational law other than asset partitioning are not “essential” in the sense that workable substitutes for them could not be found elsewhere in the law. This is not to say, however, that elements of organizational law other than asset partitioning are trivial and could be dispensed with costlessly.

There are a number of ways in which standard-form legal entities can reduce the costs of contracting for a firm’s owners. Among these are (1) simplifying the drafting of the firm’s charter; (2) helping to avoid mistakes in choosing the details of the organization’s form; (3) putting all parties on notice of nonstandard provisions (by effectively requiring that all nonstandard provisions, and only those provisions, must be specifically set out in the organization’s charter); (4) providing owners with a highly credible device for bonding their commitments to each other and to those with whom they and the firm deal; (5) facilitating the efficient evolution of standard-form provisions, which are in part a public good; and (6) permitting modification of existing relationships among the parties involved in a firm, without requiring the parties’ explicit consent, when existing contractual arrangements prove inefficient.

These and other efficiencies offered by the various detailed rules governing standard-form legal entities are important. There is every reason to believe that those rules significantly reduce the costs of commercial activity. This is strongly suggested, for example, by the fact that most developed market economies provide for standard-form legal entities that are similar in their basic features. Our claim, however, is not that aspects of organizational law other than asset partitioning are not important. Rather, it is that the economies involved are not of the same order as those involved in asset partitioning. Or, put more strongly, the commercial order of a contemporary market economy could still be established without these features of organizational law, while it could not exist without legal provision for affirmative asset partitioning. The latter is the only important feature of modern firms for which substitutes could not be crafted, at any price that is even remotely conceivable, using just the basic tools of contract, property, and agency law.

G. *Enabling Rules, Mandatory Rules, and Default Rules*

The general view of organizational law today is that it is primarily enabling in character. That view is especially prominent in the literature on business corporations, which is, naturally, by far the largest body of

contemporary organizational law scholarship. Within that body of scholarship, there has been an extensive debate on the extent to which corporate law is *strictly* enabling. That debate has focused largely on the extent to which corporate law imposes important rules that are mandatory in character rather than simply defaults. It generally deals with contractual terms that the parties could have adopted on their own, but which, instead of being left to the parties to choose, are either (a) prohibited or (b) required.⁷⁹

Our concern here, in contrast, is not with the limits that corporate law, or organizational law in general, imposes on parties' freedom to contract. Rather, we are concerned with the enabling aspects of the law. We are asking what organizational law permits parties to accomplish that they could not otherwise do. On this point, the existing literature is much thinner. On the rare occasions when the issue has been addressed with any directness in the contemporary literature, the answer suggested typically has been that the law plays no essential role in this respect, but rather just offers standard-form contractual provisions of the sort that might also be provided by law firms or other private actors.⁸⁰ Our answer, of course, is different.

H. *Theories of Juridical Personality*

There is a vast literature, with deep roots in nineteenth-century German scholarship, on the nature of juridical persons. The debate over competing conceptions of juridical persons that is the central preoccupation of that literature still shows some life today, in terms not much removed from those of a century ago.⁸¹ One might think that there would be substantial overlap between the issues in that debate and those that we are dealing with here. Yet, while the literature on juridical persons sometimes points to a

79. The issues and the literature in this debate, which reached its peak in the late 1980s, are well-surveyed in Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 NW. U. L. REV. 542 (1990).

80. E.g., EASTERBROOK & FISCHER, *supra* note 1 (repeating the analysis offered earlier in Frank Easterbrook & Daniel Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1444-46 (1989)); POSNER, *supra* note 1; Posner, *supra* note 19. This view also seems implicit in much of the literature debating the issue of mandatory rules, of which Easterbrook and Fischel's article forms a part. All of these analyses, we should note, are too brief and unfocused to offer a clear and well-argued position on the issue. Hence we refer here, in the text, to the views "suggested" by these authors.

81. E.g., William G. Bratton, Jr., *The New Economic Theory of the Firm: Critical Perspectives from History*, 41 STAN. L. REV. 1471 (1989); Mark Hager, *Bodies Politic: The Progressive History of Organizational "Real Entity" Theory*, 50 U. PITT. L. REV. 575 (1989); Katsumi Iwai, *Persons, Things and Corporations: The Corporate Personality Controversy and Comparative Corporate Governance*, 47 AM. J. COMP. L. 583 (1999); Michael J. Phillips, *Reappraising the Real Entity Theory of the Corporation*, 21 FLA. ST. U. L. REV. 1061 (1994); Sanford A. Schane, *The Corporation Is a Person: The Language of a Legal Fiction*, 61 TUL. L. REV. 519 (1986); Gregory A. Mark, Comment, *The Personification of the Business Corporation in American Law*, 54 U. CHI. L. REV. 1441 (1987).

separate patrimony as a key characteristic of a juridical person,⁸² that attribute is generally not the focus of analysis. Rather, the traditional literature is principally concerned with questions—such as the power of the state versus the power of private organizations, or the nature of group will—that are tangential to our concerns.

We have sought to offer here a definition of juridical persons that is simpler, clearer, and more functional than those that have characterized the traditional literature. Indeed, one reason we have used the term “legal entity” rather than “juridical person” is to avoid confusion between our analysis and the more traditional views.

IX. HISTORICAL DEVELOPMENT

Given the critical role of law in permitting affirmative asset partitioning, it is natural to ask when and where, as a historical matter, affirmative asset partitioning evolved as a feature of organizational law. The answer to that question is difficult to determine from conventional sources. While there is extensive scholarship tracing the evolution of defensive asset partitioning (in particular, limited liability),⁸³ the evolution of affirmative asset partitioning appears to have been largely ignored in the literature on legal and economic history—a reflection, presumably, of the surprisingly low level of self-consciousness about affirmative asset partitioning in the literature generally. The exception is a recent essay by Paul Mahoney, which builds on an earlier version of this Article to explore the history of corporate entities with particular emphasis on affirmative and defensive asset partitioning (for which Mahoney uses the terms “forward” and “reverse” asset partitioning, respectively).⁸⁴

Prior to the advent of the investor-owned business corporation, which is largely a creature of the past two centuries, partnership was the form commonly used for jointly owned businesses. The interesting historical question, then, is when affirmative asset partitioning became a well-established aspect of partnership law.⁸⁵ It is possible to have a form of

82. For example, among the principal competing theories that emerged from the nineteenth-century debate, this is true both of the theory associated with Savigny and of that associated with Brinz. See Arthur Machen, Jr., *Corporate Personality*, 24 HARV. L. REV. 253, 255-57 (1911); Martin Wolff, *On the Nature of Legal Persons*, 54 LAW Q. REV. 494, 496-97 (1938).

83. E.g., BLUMBERG, *supra* note 13; LIMITED LIABILITY AND THE CORPORATION (Tony Orhnia ed., 1982); Kevin F. Forbes, *Limited Liability and the Development of the Business Corporation*, 2 J.L. ECON. & ORG. 163 (1986); Shaw Livermore, *Unlimited Liability in Early American Corporations*, 43 J. POL. ECON. 674 (1935); Macey & Miller, *supra* note 14; Weinstein, *supra* note 13.

84. Mahoney, *supra* note 3.

85. While joint stock companies are a relatively recent development in Anglo-American law, corporations of a nonprofit character—including universities, monasteries, and other eleemosynary institutions—have been common for nearly a millennium. E.g., 2 JOHN P. DAVIS,

partnership that provides for collective agency without affirmative asset partitioning. We conjecture that this is the way that partnership law first developed, and that affirmative asset partitioning became a recognized feature of partnership law only much later.⁸⁶ We hope to explore these historical issues more thoroughly in subsequent work.

X. CONCLUSION

There is a strong tendency today to view organizational law as performing functions similar to those typically performed by contract law: providing a standard set of default rules that govern when contracting parties have not specifically decided otherwise, and perhaps providing as well some mandatory rules that protect the interests of parties who would otherwise be disadvantaged in the contracting process. These contractual functions of organizational law are undoubtedly useful. They do not, however, appear to be essential, in the sense that modern firms could not feasibly be constructed if organizational law did not perform them.

A far more important function of organizational law is to define the property rights over which participants in a firm can contract. At its essential core, organizational law is property law, not contract law. In particular, organizational law permits the formation of a floating lien on the pool of assets associated with a firm, and permits as well the assignment of that lien to the constantly changing group of creditors who transact with the firm, while shielding those assets from creditors of the firm's managers and owners. This type of affirmative asset partitioning, which plays a critical role in permitting the formation of the large nexuses of contracts that are employed to organize most modern business activity, could not otherwise be accomplished. By contrast, organizational law doctrine establishing defensive asset partitioning—including the rule of limited liability that is so often celebrated as a foundational achievement of organizational law—seems to be of distinctly secondary importance.

CORPORATIONS (Abram Chayes ed., Capricorn Books 1961) (1905); Hansmann, *supra* note 76, at 843 n.32. Whether or not it was self-consciously thought of as such, affirmative asset partitioning was apparently always a well-developed aspect of the latter corporations. Because the diffuse beneficiaries of those corporations were not considered owners of the corporation, however, it was presumably taken for granted that an individual beneficiary's creditors would have no recourse against a corporation's assets.

86. Mahoney, *supra* note 3, offers the view that the legal tools for both affirmative and defensive asset partitioning may have been available much earlier in the development of the partnership form. We address Mahoney's stimulating thesis in a forthcoming paper.