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Henry Hansmann

Reinier Kraakman

Harvard Law School

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THE ESSENTIAL ROLE OF ORGANIZATIONAL LAW

Henry Hansmann
Reinier Kraakman

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Harvard Law School
Cambridge, MA 02138

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THE ESSENTIAL ROLE OF ORGANIZATIONAL LAW

Henry Hansmann*
&
Reinier Kraakman**

Abstract

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 that provide convenient default terms for contractual relationships among the owners, managers, and creditors who participate in an enterprise. In this essay we ask whether organizational law serves, in addition, some more essential role, permitting the creation of relationships that could not practicably be formed just by contract.

The answer we offer is that organizational law goes beyond contract law in one critical respect, permitting the creation of patterns of creditors’ rights that otherwise could not practicably be established. In part, these patterns involve limits on the extent to which creditors of an organization can have recourse to the personal assets of the organization’s owners or other beneficiaries – a function we term “defensive asset partitioning.” But this aspect of organizational law, which includes the limited liability that is a familiar characteristic of most corporate entities, is of distinctly secondary importance. The truly essential function of organizational law is, rather, “affirmative asset partitioning.” In effect, this is the reverse of limited liability: it involves shielding the assets of the entity from the creditors of the entity’s owners or managers. Affirmative asset partitioning offers efficiencies in bonding and monitoring that are of singular importance in constructing the large-scale organizations that characterize modern economies. Surprisingly, this crucial function of organizational law – which is essentially a property-law-type function – has largely escaped notice, much less analysis, in both the legal and the economics literature.

JEL Classifications: D23, K22, L22

*Professor of Law, Yale Law School; NYU School of Law (Visiting).
**Professor of Law, Harvard Law School.
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Henry Hansmann
Yale Law School
NYU School of Law (Visiting)

Reinier Kraakman
Harvard Law School

Send correspondence to:

Henry Hansmann
NYU School of Law, Room 335
40 Washington Square South
New York, NY 10012
212-998-6132
212-995-4763 fax
henry.hansmann@yale.edu

Reinier Kraakman
Harvard Law School
Cambridge, MA 02138
617-495-3586
617-495-1110 fax
kraakman@law.harvard.edu

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THE ESSENTIAL ROLE OF ORGANIZATIONAL LAW

Henry Hansmann & Reinier Kraakman

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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 owners, managers, and creditors of the enterprise. It is therefore natural to ask what, if anything, these entities offer that could not be accomplished with just the basic law of contracts. Do they just serve the same function performed by typical privately-supplied standard form contracts, providing off-the-rack terms that simplify negotiation and drafting of routine agreements? Or do they offer something beyond that, permitting the creation of relationships that could not practicably be formed just by contract? 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.¹ 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.²

¹. A brief preliminary sketch of the economic argument developed here was presented at the European Economic Association meeting in Santiago, Spain, September 1999, under the title “Organizational Law as Asset Partitioning,” and will be published with the proceedings of that meeting in the European Economic Review.

². It has been prominently said that the law of business corporations may be “trivial” in that it does no more than provide contractual default rules that can easily be waived or evaded. Bernard Black, Is Corporate Law Trivial? A Political and Economic Analysis, 84 NW. L. REV. 542
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.3

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.4


4. The literature that focuses on asset specificity to explain vertical integration is of course important here (e.g., Klein, Crawford, & Armen Alchian (1978), Williamson (1986)), 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 (e.g., Hart (1995)).

A related but somewhat different reason for large centralized nexuses (as opposed, e.g., to more decentralized structures) may be the need to avoid opportunistic threats to disassemble a set of transactional relationships that has been costly to assemble, or to expropriate an entrepreneur’s or organization’s accumulated experience with working procedures and forms of organization. See., e.g., Raghuram Rajan & Luigi Zingales, The Firm as a Dedicated Hierarchy: A Theory of the Origin and Growth of Firms (1998).

All of this literature, however, seems to leave important things unexplained. See, e.g., Henry Hansmann, THE OWNERSHIP OF ENTERPRISE 15, 15n.8 (1996).
To serve effectively as a nexus of contracts, a firm must generally have two attributes. The first is well-defined decision-making authority. More particularly, there must be one or more persons who have ultimate authority to commit the firm to contracts. We will 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, the managers are the firm’s general partners. The firm’s managers may or may not be distinct from the persons for whose benefit the managers are acting. We will refer to the latter persons as the firm’s beneficiaries. As used here, then, the term “beneficiaries” comprises the shareholders in a business corporation, the partners in a partnership, and the members of a cooperative, as well as the beneficiaries (as the term is conventionally used) of a private trust or a nonprofit 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 commonly requires that there exist a pool of assets that the firm’s managers can offer as satisfaction for the firm’s obligations. 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 beneficiary, 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) well-defined ability to contract through designated managers, and (2) a 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 beneficiaries or managers, in the sense

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5. 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.

6. There are alternative means of bonding performance. The most obvious is to expose the firm’s managers or beneficiaries to personal sanctions such as (publicly enforced) criminal penalties or (privately enforced) reputational penalties, including personal shaming and refusals to deal 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 beneficiaries are numerous and constantly changing.
that the firm’s creditors have a claim on those assets that is prior to that of the personal creditors of the firm’s beneficiaries or managers.

In our view, this latter feature -- the separation between the firm’s bonding assets and the personal assets of the firm’s beneficiaries 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 property attribute is the only essential contribution that organizational law makes to commercial activity.

III. FORMS OF ASSET PARTITIONING

There are two components to asset partitioning. 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 beneficiaries 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 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 formation of a legal entity. This assignment of priorities takes two distinct 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 beneficiaries. We term this affirmative asset partitioning, to reflect the notion that it sets forth the 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 beneficiaries’ personal creditors a claim on the beneficiaries’ 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 beneficiaries’ 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.

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, upon exhausting the shareholders’ personal assets, force liquidation of corporate assets to satisfy their claims. Rather, a shareholders’ creditors can at most 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 is by far the most common type of affirmative asset partitioning. It is found, for example, in corporations of all types (including nonprofit corporations, cooperative corporations, and municipal corporations), in partnerships, and in limited liability companies.

A stronger type of affirmative asset partitioning 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. This type is moderately familiar. It is found, for example, in nonprofit corporations, municipal corporations, charitable trusts, and spendthrift trusts. The beneficiaries of these organizations can continue to be beneficiaries even after their bankruptcy, without passing to their creditors any portion of their expected benefits from the firm.

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 we observe in affirmative asset partitioning.

The strongest type of defensive asset partitioning is that which we see 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,\(^7\) in which there is no defensive asset partitioning at all: partnership creditors share

\(^7\) That is, the modern general partnership under the 1978 Bankruptcy Act and RUPA.
equally with the creditors of individual partners in distributing the separate assets of partners when both the partnership and its partners are insolvent. Indeed, as the latter example indicates, defensive partitioning is not requisite 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 which partnership creditors could levy on the assets of individual partners, but were subordinated to the claims of the partners’ personal creditors. A second is a rule of pro rata personal liability, under which beneficiaries are liable without limit for the debts of the firm, but bear this liability proportional to their claims on the firm’s distributions. This rule – which in fact applied to all California corporations from statehood (1849) until 1931 – implies, for example, that a 5% shareholder is personally liable, without limit, for 5% 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. A fourth alternative, illustrated by the “companies limited by guarantee” provided for in the law of the UK and some other commonwealth countries, permits individual beneficiaries to make specific pledges of the amount to which they will be personally liable for a firm’s unpaid debts.

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, where the firm is not a separate legal entity.

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8. This approach applies even today for the liquidation outside of bankruptcy of partnerships still governed by the old UPA.


<table>
<thead>
<tr>
<th>TYPE OF LEGAL ENTITY</th>
<th>AFFIRMATIVE PARTITIONING: FIRM CREDITORS’ CLAIM ON FIRM’S ASSETS</th>
<th>DEFENSIVE PARTITIONING: BENEFICIARY’S CREDITORS’ CLAIM ON BENEFICIARY’S ASSETS</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Nonprofit Corporation • Municipal Corporation • Spendthrift Trust</td>
<td>Exclusive</td>
<td>Exclusive</td>
</tr>
<tr>
<td>• Business Corporation • Cooperative Corporation • Limited Liability Company</td>
<td>Prior with Liquidation Protection</td>
<td>Exclusive</td>
</tr>
<tr>
<td>• Partnership prior to 1978</td>
<td>Prior with Liquidation Protection</td>
<td>Prior</td>
</tr>
<tr>
<td>• Partnership today</td>
<td>Prior with Liquidation Protection</td>
<td>Shared</td>
</tr>
<tr>
<td>• Sole Proprietorship</td>
<td>Shared without Liquidation Protection</td>
<td>Shared</td>
</tr>
</tbody>
</table>

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.¹²

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¹² 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. See 4 THOMPSON ON REAL PROPERTY, THOMAS EDITION §§37.13(b)(4), 37.13(b)(5) (David A. Thomas, ed., 1994). The following table offers illustrations, based largely on Thompson. 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 permits 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 beneficiaries. 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 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 beneficiaries of these entities. We focus specifically in this Part on the functional contributions made by affirmative asset partitioning: that is, asset partitioning that establishes a pool of bonding assets for the firm’s contracts. In particular, we consider how affirmative asset partitioning reduces the cost of credit for legal entities and enhances the value of these entities by protecting against premature liquidation of their assets.

In important respects, defensive asset partitioning is just the mirror image of affirmative asset partitioning: what is defensive asset partitioning with respect to claims by the firm’s creditors is effectively affirmative asset partitioning with

<table>
<thead>
<tr>
<th>MARITAL ASSET PARTITIONING IN SELECTED COMMUNITY PROPERTY STATES</th>
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<tbody>
<tr>
<td>STATE OF MARRIAGE</td>
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<tr>
<td>• Wisconsin</td>
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<tr>
<td>• Arizona</td>
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<td>• New Mexico</td>
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<td>• California</td>
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</tbody>
</table>

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 25.
respect to claims by the beneficiaries’ 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. Defensive asset partitioning serves some special purposes of its own, which we will examine separately in Part VI.

A. Reducing the Costs of Credit

A simple example illustrates how affirmative asset partitioning can reduce the cost of credit. 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 decision-making authority, the two structures are essentially identical: in each, the single 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 operative 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 be at 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 they are spared the costs of monitoring business activities with which they are unfamiliar.13

To be sure, there are countervailing considerations. 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. Thus, the hotel operation in our example is more likely to become the subject of bankruptcy proceedings if it is separately incorporated than if it is managed as a division of a larger conglomerate firm.14 Creditors of the oil and hotel subsidiary lose the benefits of diversification as a bankruptcy-prevention device.

Another potential cost of asset partitioning is the increased risk of opportunism by the debtor. The holding company in our example might be tempted to drain assets from the hotel subsidiary (and perhaps put them in the oil subsidiary) in contemplation of insolvency, and hence effectively expropriate the creditors of the hotel business. Although, as we discuss below, much of organizational and non-organizational law is devoted to reducing the potential for this kind of opportunism, the protective devices employed are far from perfect and involve administrative and incentive costs of their own.

Asset partitioning will reduce the overall costs of credit only when its benefits exceed these costs. There is every reason to believe, however, that this is often the case in complex enterprise.

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

The form of asset partitioning involved in the oil and hotel example just discussed, in which the two corporations are both wholly-owned by a third corporation, is perfectly symmetric: the creditors of each of the two businesses have exclusive claim to the assets of the business they contract with, and no claim to the parent corporation’s other assets, which are the assets of the other business. Other combinations of legal entities could, however, produce other patterns of asset partitioning. For example, the hotel and oil businesses could be separately incorporated, but with the hotel corporation wholly-owned by the oil corporation. The asymmetry between affirmative and defensive asset partitioning that characterizes the corporate form would then create asymmetry in the rights of the creditors of the respective businesses: hotel creditors would have a prior claim on the assets of the hotel business and no claim on the assets of the oil business, while oil creditors would have exclusive claim on the assets employed in the oil business and -- via the oil corporation’s shares in the hotel corporation -- a subordinated claim on the assets employed in the hotel business.

As the oil and hotel example illustrates, efficient asset partitioning may often involve formation of a corporation with a sole shareholder – a “corporation sole.” Use of the corporation sole for efficient asset partitioning need not, moreover, be limited to corporations that are subsidiaries of other corporations; similar efficiencies can be obtained by separately incorporating a business that is owned by a single individual. Opposition to the “corporation sole” as an acceptable legal form – an opposition that has largely died out in the U.S. but continues in some civil law jurisdictions – stems from a failure to appreciate this fact. Although the term “corporation” suggests 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.

The idea that partitioning a fixed pool of assets can reduce overall costs of credit by reducing monitoring costs is already familiar. In large part, however, the existing literature on this subject focuses on devices for asset partitioning other than organizational law (for example, security interests) or, when it does look at organizational law, focuses just on the law’s role in establishing defensive asset partitioning – i.e., limited liability for a firm’s beneficiaries vis-a-vis a firm’s beneficiaries...

15. This opposition continues with respect to the “LLC Sole,” as reflected in the recent Massachusetts legislative debate on the subject.


17. E.g., Jackson & Kronman, supra.
business creditors. Our principal objective here is to demonstrate the central role of organizational law in establishing affirmative asset partitioning as a means of reducing the costs of business contracting.

B. Protecting the Firm’s Going Concern Value.

In theory, only the weakest form of affirmative asset partitioning – a rule giving firm creditors priority in firm assets – is necessary to reduce monitoring costs in the manner described above. After all, so long as assets are available to pay off the debts owed to firm creditors, these creditors should have little interest in what happens to the remainder of the firm’s value. The question thus arises, why is the dominant form of affirmative asset partitioning among legal entities the strong form in which firm creditors are given not just priority in firm assets but also liquidation protection? Clearly asset partitioning must do something more than reduce the monitoring costs of creditors and long-term customers. That additional function is to protect the going concern value of the firm, which works in the interest of both the creditors and the beneficiaries of the firm.

To see this, suppose that business corporations were governed instead by a weaker rule of affirmative asset partitioning in which firm creditors received a priority claim on firm assets but no liquidation protection. The liquidation rights of solvent shareholders, we will assume, remain governed by the usual rule requiring at least a majority vote of shareholders to compel liquidation of the firm or its assets. Then, even though a minority shareholder holding, say, 5% of the firm’s shares would not be able to force liquidation, if that shareholder were to become insolvent his creditors would have the power to force partial or complete liquidation of the corporation by proceeding directly against its assets.

Of course, it might be that the insolvent shareholder’s creditors or bankruptcy trustee would choose to realize the value of the shares he held in the corporation simply by selling the shares without disrupting the firm’s operations. But if the shares have no established market value -- as could well be the case with a closely held firm -- this approach might be unattractive to the creditors, as might the alternative of simply holding the minority shares. Thus, in the absence of liquidation protection for the firm, the insolvent shareholder’s creditors or bankruptcy trustee might proceed directly against the assets of the corporation, forcing liquidation of some or all of those assets and, in the process, destroying their going concern value. Moreover, the fact that the shareholder’s creditor has only a subordinated claim on the firm’s assets might actually increase the potential scope of such a potentially inefficient liquidation, increasing the chances that the firm would have to be liquidated in its entirety to guarantee fair treatment.

18. E.g., Posner, supra note 16, 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.
of both the creditors of the firm, who have a right of absolute priority, and the creditors of the bankrupt shareholder.

To be sure, if the going concern value of the firm were substantially greater than its liquidation value, the parties involved would have an incentive to find a way to avoid dissipating that value through liquidation. Most obviously, the firm or its other shareholders could offer to buy out the property right in its assets belonging to its bankrupt shareholder. But problems of valuation might make the negotiations difficult, and problems of liquidity might prevent the firm or its shareholders from being able to make the necessary payment. Worse, the creditors of the insolvent shareholder might threaten to force liquidation of the firm just to hold up the other shareholders for a lucrative settlement. Liquidation protection eliminates the threat of inefficient liquidation of firm assets, whether that threat is deployed opportunistically or not.

Another reason for liquidation protection is to reduce monitoring costs for the firm’s beneficiaries. Insofar as the creditors of beneficiaries have a contingent claim on the assets of the firm, firm value at any point will potentially depend on the vicissitudes of the personal finances of all the firm’s beneficiaries. Thus, to value the firm, a beneficiary must monitor not only the prospects of the business but also the finances of his fellow beneficiaries.19 These particular monitoring economies, we note, extend only to the firm’s beneficiaries and not to its creditors. Firm creditors receive adequate protection from the insolvency of the firm’s beneficiaries just by having a prior claim on the firm’s assets, even absent liquidation protection. This is because personal creditors gain nothing from liquidating a firm unless its liquidation value exceeds the outstanding claims of firm creditors. Or at least this is the case if we neglect the threat, discussed in the preceding paragraph, that creditors of the firm’s beneficiaries will opportunistically hold up firm creditors by threatening to destroy going concern value through inefficient liquidation.

For the preceding reasons, nearly all legal entities are characterized by liquidation protection that permits the creditors of a bankrupt beneficiary to claim from the entity no more than the personal rights to distributions and (in some cases) control that the beneficiary enjoyed.20

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19. Frank Easterbrook and Daniel Fischel, Limited Liability and the Corporation, 52 Univ. Chi. L. Rev. 89 (1985), point out 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 (a point we note in our discussion of defensive asset partitioning below). What we emphasize here is that similar monitoring economies result from affirmative asset partitioning as well.

20. Personal creditors can receive only distribution rights from the partner of a general partnership (in the form of a “charging order”), but they can receive distribution and control rights from the shareholder of a corporation (in the form of shares). In the case of a corporation, then, a creditor who receives sufficient shares can liquidate the firm by exercising her new rights as controlling shareholder.
C. 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 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 spending habits of the beneficiary. A similar paternalistic rationale may be present in charitable trusts and, to the extent they are redistributive, municipal corporations. A second rationale for refusing 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 I illustrates. We explore the reasons for this in Part VI, when we discuss defensive asset partitioning more thoroughly.

V. CONSTRUCTING ENTITIES WITHOUT ORGANIZATIONAL LAW

In the absence of organizational law, it would effectively be 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 will 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. That is, we

21. 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 a primitive, or whether it would be feasible to construct the functional equivalent of agency using other, more basic elements of contract doctrine. We will not explore that question here, however, but rather will take it for granted that agency doctrine is in place.
will 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 -- a small construction firm, say -- 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. Using the law of business corporations, 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 will assume that the entrepreneur is not concerned about shielding his personal assets from his business creditors. We explore defensive asset partitioning by contract in Part VII.)

The default rules of property and contract law provide that, absent contractual agreement to the contrary, each of the entrepreneur's creditors has an equal-priority claim upon all of his assets, including the assets used in his business, in case of his nonperformance. If we ignore the possibility of using contractual security interests -- a topic we return to below -- the entrepreneur cannot alter this pattern simply by putting a term in his contracts with his business creditors that promises them a prior claim on the assets used in the business. That would essentially involve taking a property right from his personal creditors and giving it to his business creditors without the personal creditors' consent. Rather, to assure his business creditors a prior claim on the business assets, the entrepreneur would be obliged, in each contract between himself and a creditor of the business, to insert a clause describing the pool of bonding assets and promising credibly that he will obtain from each of his personal creditors, both past and future, agreement to insert a term in his contract with that personal creditor under which the personal creditor agrees to subordinate his right to satisfy contractual claims against the entrepreneur out of the designated pool of business assets.
This kind of contracting would be prohibitively costly in any practical situation. Consider the principal kinds of transaction costs that it would impose.

First, there would be the costs of drafting and inserting standard 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. These standard provisions 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 priority in the bonding 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.

Second, a contractual effort to set aside this pool of business assets would incur the costs of explaining the meaning and scope of such a pool to the personal creditors who would be disadvantaged by it, and of bargaining over the consideration necessary to offset their loss of security. The entrepreneur would have to negotiate with all personal creditors to assure the integrity of his bonding assets since, in the absence of an agreement to be subordinated, any personal creditor would be entitled to participate in business assets on equal terms with business creditors. Moreover, subordination agreements would have to be extracted not only from the entrepreneur’s new personal creditors, but also from all of his existing personal creditors.

Third, a contractual attempt to demarcate a pool of bonding assets would impose enormous policing costs. Although business creditors would have a contractual right to insist that the entrepreneur negotiate to subordinate the claims of personal creditors against business assets, this right would have force only against the entrepreneur – and not against his personal creditors -- in the event that the entrepreneur failed to negotiate the requisite subordination term. Thus, business creditors would face a large moral hazard problem. They could effectively enforce an agreement by the entrepreneur to preserve a pool of bonding assets for their security only by continuously monitoring the entrepreneur’s transactions with individual creditors.

Organizational law eliminates the need for such elaborate contracting, and thereby avoids the transaction costs and moral hazard they involves. First, by permitting the firm itself to be an owner of assets, the 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 the firm holds title. Second, the 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 the legal entity rather than with the individual
directly. Third, the law provides that when a person -- including the firm’s owner-- conveys assets to the firm, a claim in those assets is given to the business creditors that is prior to the claims of the owner’s personal creditors.

In this latter respect, it is critical to note, organizational law provides for changes in rights that affect third parties. When a firm is organized as a legal entity, and an owner of that firm – even the sole owner – transfers assets to the firm, the creditors of the firm are automatically given a contingent claim on those assets (exercisable in case of contractual default), while the contingent claim on those assets previously held by the owner’s personal creditors is subordinated to the claims of the firm’s creditors, all without recontracting with the owner’s personal creditors or otherwise obtaining their consent. This ability to rearrange the rights of numerous third parties without renegotiation, in essence a property right, is a crucial contribution of organizational law.

This contribution would not be useful, of course, if the rearrangement of contractual rights involved 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 involved. In general, however, 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 each actor 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). His personal creditors will, as a consequence of this transaction, lose the right to levy directly on the equipment and 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 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 that the entrepreneur generally has an incentive to use only when its benefits exceed its costs, both from an individual and a social point of view.

B. Multiple-Owner Enterprise

When a business has multiple beneficiaries, 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 numerous group of individuals might seek to create a jointly-owned business in the absence of organizational law -- the type of business that would usually be formed today as a partnership in which the individuals are partners, or as a corporation in which they are shareholders.

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 to their chosen methods for apportioning among themselves the earnings of the enterprise and 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 practically do is to establish either of the two basic elements of affirmative asset partitioning: priority of claims or liquidation protection.

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 would (in case of the individual’s nonperformance) 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 single-owner enterprise, though exponentially greater in magnitude.

A grant of priority in the business assets to business creditors 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 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 could be expected to 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 entrepreneur to neglect 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. Moreover, as the number of co-owners increases, it becomes more difficult for co-owners themselves to control this problem by monitoring each other’s private debts.

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 cotenant 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.22 Creditors of a bankrupt tenant in common step into the bankrupt’s shoes as tenant in common, and therefore presumably have the same right to force partition.23 Although tenants in common can enter into a contractual agreement among themselves not to partition the property. Such an agreement must, however, be limited in duration.24 Moreover, whatever its duration, an agreement not to partition evidently would not bind the cotenants’ creditors. The effect of a cotenant’s bankruptcy would effectively be to throw into breach all of his contractual commitments, including his commitment not to partition, and reduce those commitments to mere obligations to pay money damages.25 The other co-owners might have a damage claim against the bankrupt individual for breaking up the business, but that would be a mere money claim that would share pro rata in the bankrupt’s assets – including his share of the business assets – with the claims of the bankrupt’s personal creditors.

The essential contribution of partnership law is to offer a solution to these problems, and thereby permit affirmative asset partitioning. The law of


24. An agreement not to partition is unenforceable as an invalid restraint on alienation unless it is for a reasonable time only. See RESTATEMENT (SECOND) OF PROPERTY § 4.5, reporters note 2c (1983); Raisch v. Schuster, 47 Ohio App. 2d 98, 352 N.E. 2d 657 (1975). See also Cribbet, supra note 22, at 106 (citing Michalski v. Michalski, 142 A.2d 645 (N.J. 1958)).

partnership establishes a special form of concurrent tenancy for all assets held in partnership name. 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. Liquidation protection, in turn, is provided by the rule that a partner’s personal creditors 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.26

From the functional view of legal entities we take here, it is these property-law-type features of partnership law that make the partnership a legal entity rather than a mere common agency, and thus make 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 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, however, they are only that; in general, they can be avoided by contractual means. The priority and liquidation protection that partnership law establishes for the firm’s creditors are of a different character, since they could not, as a practical matter, be established by contract.27

26. This type of affirmative asset partitioning applies even to a traditional partnership at will organized under the old Uniform Partnership Act of 1914 (UPA), where the bankruptcy of a partner is a technical event of dissolution for the partnership, but only a partner (including the bankrupt partner) can elect to liquidate the partnership in order to make its underlying assets available for distribution. In a modern partnership at will organized under the Revised Uniform Partnership Act of 1994 (RUPA), the bankruptcy of a partner is no longer even a technical event of dissolution, and only a majority vote of the partners can force a liquidation of partnership assets. See Larry E. Ribstein, UNINCORPORATED BUSINESS ENTITIES 198 (1996).

27. 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 were consequently 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 20th 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
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. See Karl Rove & Company v. Thornburgh, 39 F.3d 1273, 1285-86 (5th Cir. 1994); Kimberly A. Davison, Cox v. Thee Evergreen Church: Liability Issues of the Unincorporated Association, Is it Time for the Legislature to Step In?, NOTE, 46 BAYLOR L. REV. 231 (1994). It was largely this issue that prompted the promulgation, in 1992, of the Uniform Unincorporated Nonprofit Association Act, 6A U.L.A. 509, 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. See Davison, supra.

Once this 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 that has a single shareholder.28 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 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 does not provide for it is perhaps explainable in part by conceptual confusion (as with early resistance to the corporation sole) and in part by the fact that, at least today, roughly the same result can be obtained by incorporating the business and having its sole shareholder cosign contracts between the corporation and its most important creditors.

C. Agency with Title

In the immediately preceding discussion, we assumed that the individuals investing in the business -- whom we will revert to calling the “beneficiaries” of the business -- would remain co-owners of the specific assets used in the business. An alternative approach would be to transfer title in those assets to one (or more) of the managers of the business, subject to a contractual commitment by the manager, acting as agent for the beneficiaries, to manage the

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.

28. At present, formation of a partnership requires “an association of two or more persons.” Uniform Partnership Act §6; Revised Uniform Partnership Act §202(a).
assets for the exclusive benefit of the beneficiaries and to reconvey the assets to the beneficiaries under appropriate circumstances.

This approach would provide a relatively workable means of granting business creditors a claim in the business assets that is prior to the claims of the beneficiaries’ personal creditors. Since title to the business assets would not be in the hands of the beneficiaries, the beneficiaries’ personal creditors would have no right to levy on those assets. At most the beneficiaries’ creditors could succeed to the beneficiaries’ contractual claims against the agent. But those claims, being contractual, would be limited to the terms of the contracts between. And the contracts between the beneficiaries and the manager serving as their agent could provide that claims of the beneficiaries 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 beneficiaries 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 those creditors, it would be sufficient to show to them the waivers in the agency contracts between the beneficiaries and the manager.

Liquidation protection from the beneficiaries’ personal creditors might also be established through this approach. In case of a beneficiary’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 revocable\(^\text{29}\) -- 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.\(^\text{30}\) The reason it succeeds is that the beneficiaries are, in fact, employing a separate legal person to serve as the firm. That person, however, is a real individual -- the agent/manager -- rather than an

\(^{29}\) The general rule is that an agency cannot be made non-revocable. 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 does, in fact, have a substantial equitable interest in the assets.

\(^{30}\) As a bonus, this approach may also provide limited liability for the beneficiaries, 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 beneficiaries 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.
artificial legal person. And therein lies the problem with this approach. By borrowing the legal personality of the manager to form the firm, the manager’s property of the firm becomes indistinct from the manager’s personal property. The result is that the business assets held by the manager, while insulated from the creditors of the beneficiaries, are not insulated from the creditors of the manager. Absent organizational law, the business assets would, as a default rule, be available to the manager’s personal creditors unless the manager secured explicit agreement from those creditors that the assets are not available to them.

The agency contract between the beneficiaries and the manager could, to be sure, 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 beneficiaries 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 beneficiaries (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 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. And it 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-a-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 to effectively 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. 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 beneficiaries. 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 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 beneficiaries.

D. Security Interests

Since we have identified, as the principal contribution of organizational law, the assignment to business creditors of a priority claim to the firm’s bonding assets, it is natural to ask whether it would be possible to give a firm’s creditors this priority simply by assigning security interests to those creditors, without relying on organizational law for that purpose. The answer is that, while the modern law of security interests has gone far to facilitate the granting of priority interests to business creditors, it does not provide an adequate substitute for organizational law in this respect, and it does nothing at all to provide liquidation protection.

1. Priority

To see the possibilities for using security interests to establish priority of claims, let us return to the simple case of a single entrepreneur who wishes to create a business whose creditors will have a prior claim, over the entrepreneur’s personal creditors, to assets associated with the business. Under contemporary U.S. commercial law, the entrepreneur could 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 approach to affirmative asset partitioning would require a reduction to writing of (1) a description of all of the assets to be pledged and (2) all of the present and future creditors to which these assets can be pledged. Further, a statement pledging these assets as security would have 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 simple costs of taking these steps might be so burdensome as to be prohibitive. But even if they were not, there are other important obstacles to this approach.

First, although current law permits the pledge of both present and future assets by type, it is unclear whether a “supergeneric” pledge of all assets of any description could be included among the assets pledged in a security agreement, and thus whether all assets associated with a business could be effectively partitioned by such an agreement. To the extent that such a pledge is disallowed, business creditors could not be given priority over the entrepreneur’s personal creditors in assets of a type not described. It is possible, however, that this problem is not itself an important obstacle to substantially effective asset partitioning; most business assets of consequence could probably be described and pledged effectively under current law.

Second, and far more serious, under current law a financing agreement must list the name and address of each creditor who is secured by the agreement. 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—which would be an infeasible burden in a business of any complexity. 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). However, the UCC does not . . . contemplate ‘floating secured parties’ . . . .” Consequently, this approach is unworkable as a means of affirmative asset partitioning.

2. Liquidation Protection

32. Under current Article 9, which covers the pledge of personal property and fixtures, for example, courts are split over whether to enforce supergeneric descriptions such as “all the debtor’s assets” or “all the debtor’s personal property.” In a new version of Article 9, recently drafted by NCUSL, §9-108 explicitly disallows such pledges in security agreements (though new §9-504 specifically allows such a description in a financing statement).

33. UCC Section 9-402. Although new §9-502 dispenses with the requirement that a financing statement include the creditor’s address, “the name of the secured party” is still required.

Beyond these problems of establishing priority of claims for the business creditors, there is the problem of protecting the firm from the threat of premature liquidation. Security interests do not provide liquidation protection; they simply provide priority of claims.

This point is illustrated by the asset securitization transactions that have become commonplace in recent years. In a typical transaction of this character, a corporation will transfer some of its assets -- say, its accounts receivable -- to a private trust, which will in turn issue bonds backed by those assets. The trust serves simply as an intermediary in the transaction; in economic effect, the corporation is just borrowing against its accounts receivable. The same transaction might be undertaken without use of the trust by having the corporation itself issue the bonds and back them with a security interest in the corporation’s accounts receivable. The principal reason for use of the trust is that it serves as a “bankruptcy remote vehicle”: if the corporation should ever fall into bankruptcy, the trust assets will remain insulated from that procedure, and thus provide more secure backing for the bondholders.35 In short, the trust provides a degree of affirmative asset partitioning unavailable simply through security interests – even though the assets involved in these transactions are usually well within the categories of assets in which security interests can easily be created.36 The importance of this partitioning is evident in the fact that asset securitization trusts are now the issuers of a large fraction of all outstanding American debt securities, worth several trillion dollars in aggregate value.37

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 shifting creditors, then -- though it still could not provide liquidation protection -- that body of law might provide a workable substitute for organizational law at least so far as establishing priority of claims is involved.38 The reason for this is that both


37. See Ingo Walter & Roy Smith, GLOBAL BANKING 201, Figure 7-6 (1997); Marshall Tracht, supra note 35; John Langbein, The Secret Life of the Trust: The Trust as an Instrument of Commerce, 107 YALE L. J. 835 (1980).

38. As an historical matter, it should be kept in mind that the law of secured interests is relatively recent and localized law. In the U.S., 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 Uniform Commercial Code. Most contemporary forms of organizational law are
organizational law and the law of security interests are at bottom forms of property law: they define the types of property interests that can be created and conveyed to others, and the types of property interests a person is presumed to convey to others under given circumstances.

The underlying law of property rights in all contemporary economies places strong limitations on the ways in which property rights in any given asset can be divided up among two or more persons. Both the law of security interests and organizational law create exceptions to these limitations, permitting the grant of contingent ownership rights in specific categories of assets under well-defined conditions. One of the most important of those conditions is that adequate notice be given to third parties who might be affected. The law of security interests requires notice through means such as filing. Organizational law provides for notice by providing for assignment of prior claims only in assets held by a legal entity.

VI. BENEFITS OF DEFENSIVE ASSET PARTITIONING

Defensive asset partitioning limits the exposure of the personal assets of a firm’s beneficiaries to the claims of business creditors. Unlike affirmative asset partitioning, it is not essential for the existence of the firm as a free-standing contracting entity. The general partnership, for example, is a legal entity in our usage, even though its beneficiaries -- the general partners -- do not enjoy any legal protection from the default regime of joint and several liability. Nevertheless, even if defensive asset partitioning is not essential for the creation of a legal entity, it performs a variety of important functions for many forms of legal entities and their beneficiaries.

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 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.

The costs of defensive asset partitioning derive principally from the possibilities it creates for the firm’s beneficiaries 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 substantially older, having arisen when even 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.

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 his 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; others have not. We briefly survey here the most important of these benefits.

A. Monitoring Economies.

To begin, 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 beneficiaries to focus principally on the personal assets of beneficiaries. 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 firms’ beneficiaries that are analogous to those generated by affirmative asset partitioning. Affirmative partitioning protects beneficiaries from reductions in firm value that might otherwise result from the bankruptcy of a fellow beneficiary. Defensive partitioning goes further. It protects beneficiaries from personal liability for firm bankruptcy that is induced by the bankruptcy of their fellow beneficiaries. It also insulates beneficiaries from fluctuations in firm value that would otherwise result from fluctuations in the personal finances of their fellow beneficiaries. Without these protections beneficiaries would, as Easterbrook and Fischel remind us, have an interest in continually monitoring not only the assets and liabilities of their corporation, but also the assets and liabilities of their fellow shareholders.

It is not only conventional limited liability that generates the monitoring economies just referred to. Weaker forms of defensive asset partitioning -- such

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41. See Easterbrook and Fischel, supra.
as multiple shareholder liability, or pro rata shareholder liability\textsuperscript{42} -- also yield those economies, though in lesser degree.

\textbf{B. Decision-making Economies}

Beyond economizing on monitoring costs, 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 decision-making costs of a firm -- such as a corporation - in which multiple beneficiaries share in the legal right to control the firm's policies and/or select its managers. Limited liability ensures that all beneficiaries 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 beneficiaries a homogeneous economic interest in the firm's decisions, which greatly facilitates collective decision-making.\textsuperscript{43} Weaker forms of defensive asset partitioning can be expected to reduce governance costs in much the same 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 liability costs. In the complete absence of defensive asset partitioning, on the other hand, beneficiaries -- such as partners in a general partnership -- must select fellow beneficiaries with similar assets and risk preference or face significant negotiating costs.

\textbf{C. Reducing Agency Costs}

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 beneficiaries 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 otherwise 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 beneficiaries, even when these beneficiaries themselves can monitor with fair competence. Creditors may have access to different types of information than do beneficiaries, and they may also have different means for influencing managers. But creditor monitoring of managers is particularly likely to have strong efficiencies when the beneficiaries are poorly situated to monitor the organization’s managers, as are the passive shareholders of most large corporations. In the latter firms, important creditors may be much better monitors of management overall, and limited liability gives them the incentive to make use of that ability – for which, of course, they will extract a price from the firm’s beneficiaries 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 beneficiaries are solvent. The same is true of the next benefit we examine.

D. Collection Economies.

A third benefit, 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 has perhaps 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 were, at least in some contexts, developed to the point where the transaction costs of collecting were evidently quite manageable.44

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 beneficiaries. Limited liability obviously permits such a separation. Weaker forms of defensive asset partitioning can, however, effect the same separation in

44. Macey & Miller, supra note 10.
varying degrees, as evidenced by historical examples of business corporations whose shares have traded freely under regimes of multiple or pro rata shareholder liability.45

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 beneficiaries. 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 risk borne by beneficiaries 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 beneficiaries.

The second form of risk sharing is among the beneficiaries themselves. A background rule of joint and several liability (i.e., no defensive asset partitioning) gives the beneficiaries little control over their relative exposure to risk. The degree of control available then increases progressively as defensive partitioning of increasingly stronger forms is 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 beneficiaries, 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,46 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


46. 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 U.S. under a nonprofit corporation statute, which is lacking in UK law.
two extreme forms has widened, as the result of recent changes in U.S. bankruptcy and partnership law. Those changes increase the priority of partnership vis-a-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 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 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 those firm owners who wish to pledge their personal assets to firm creditors the greatest possible freedom to do so.

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 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 beneficiaries of roughly the type found in the contemporary (post-1978) general partnership. This is because, so long as the beneficiaries retain some minimal degree of control over the firm’s managers (or are the managers themselves), the managers would be considered agents of the beneficiaries and the law of agency would therefore make each beneficiary 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 waives 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 to incorporate the waivers in their contracts with the firm — and particularly small trade creditors who utilize standard form contracts or invoices of their own that do not include such a waiver.

On the other hand, even at their worst these transaction costs would be an order of magnitude 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 beneficiaries and all of their individual creditors, and no need to confront the moral hazard associated with that contracting.

Moreover, the transaction costs of establishing limited liability by contract might be quite modest if creditors and the courts were willing to recognize a convention whereby it is understood that beneficiaries bear no personal liability whenever their firm uses the term “limited” following its name in a contract that it enters into. In that case, the transaction costs of adopting limited liability would be nearly as low as they are under a corporation statute. This was, in fact, the approach taken in England before Parliament adopted legislation establishing
limited personal liability for shareholders in English joint stock companies in the middle of the nineteenth century.47

So long as we consider “organizational law” to include the willingness of the courts to accept conventions such as that under which the term “limited” in an organization’s name suffices to put creditors on notice that the organization’s owners have limited liability, then organizational law is still important to forming legal entities with limited liability at any reasonable level of transaction costs. The conventions by which limited liability of beneficiaries is signaled to creditors may or may not be established by (statutory) law; what is critical is that these conventions be recognized by the courts.

In sum, while organizational law plays a role in reducing the transaction costs of establishing defensive asset partitioning, that role is far 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.48Id. at 506 (emphasis supplied). 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.)

47. See, e.g., Michael Smart, On Limited Liability and the Development of the Capital Markets: An Historical Analysis, UNIVERSITY OF TORONTO LAW AND ECONOMICS WORKING PAPER WPS-70 (1996) at 5 & n. 5. Prior to enactment of the English Limited Liability Act 1855 establishing limited liability for English corporations, it was held that a standard ‘limited liability’ clause inserted into all of a joint stock company’s contracts with creditors was effective, Hallett v Dowdall, 21 LJQB 98 (1852), 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, Re Sea, Fire & Life Insurance Co, 3 De G M & G 459 (1854).

48. For example, Posner, supra note 16, states that

“[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 beneficiaries 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 essential 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 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 induce severe inefficiencies in the pricing of tradeable 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 adequately protect the marketability of corporate shares without permitting shareholders to externalize the costs of corporate torts.49

In fact, corporate limited liability in tort appears to be an historical accident, perhaps encouraged in important part by the rarity, during the formative period of corporate law in the nineteenth and early twentieth century, of tort liability sufficient to bankrupt a corporation. The 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.50

49. 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 42, at 1901-2.

50. See Hansmann and Kraakman, supra note 42.
VII. DOES ORGANIZATIONAL LAW SERVE OTHER ESSENTIAL FUNCTIONS?

Thus far we have seen that affirmative asset partitioning is an essential function of organizational law, in the sense that firms could not practicably be given this important attribute in the absence of organizational law. Defensive asset partitioning is also a useful function of organizational law, though whether it is essential is a matter of interpretation. It remains to ask whether organizational law serves other essential functions as well.

The question is posed squarely by the recent evolution of the statutory business trust, as exemplified by the Delaware Business Trust Act. That statute provides for both affirmative asset partitioning and defensive asset partitioning -- the latter being in the form of full limited liability of the type found in business corporations. It leaves virtually all other aspects of organizational structure open, however. Thus, it permits the formation of limited liability legal entities with virtually any desired designation of beneficiaries, and with virtually any conceivable assignment of control and distribution rights to the beneficiaries. It even appears possible to form a nonprofit corporation under the statute.51 Given this highly protean form, why does Delaware need any other forms? Are its other statutory forms for legal entities -- including business corporations, limited liability companies, nonprofit corporations, cooperative corporations, general partnerships, and limited partnerships -- 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 practicably be created by contract in their absence?

In answering this question, there are two sets of functions performed by organizational law that need to be considered. The first involves aspects of organizational law, other than asset partitioning, that facilitate contracting between the firm and its creditors. The second involves aspects of organizational law that govern relationships among the firm’s beneficiaries and between the firm’s beneficiaries and managers. We deal with these two sets of functions here in turn.

A. Facilitating Contracting with Creditors

In principle, one reason to have multiple forms of legal entities is that creditors might care about other aspects of legal entities besides asset

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51. To create a nonprofit entity, the firm’s managers, and any beneficiaries who exercise control rights, must be able to commit themselves irrevocably not to distribute to themselves the firm’s net earnings, either currently or on dissolution. This not only appears possible under the statute, but is specifically contemplated by it. DELAWARE BUSINESS TRUST ACT, DEL. CODE ANN. tit. 12, § 3801(a) (1996).
partitioning. In particular, the extent to which beneficiaries can exercise control over the enterprise, and the ease with which beneficiaries can withdraw their assets from the enterprise, could well affect the creditworthiness of the firm. Thus, one might think that the choice of legal entities could be used as a means of credibly signaling to a firm’s creditors the powers of a firm’s beneficiaries in these regards. That is, the legal entity might serve in effect as a means by which the firm’s beneficiaries bond themselves to the firm’s creditors not to engage in types of opportunistic conduct that might otherwise be open to them.

It is not apparent, however, that bonding to creditors with respect to other aspects of organizational structure is an important function served by legal entities. Unlike the access to bonding assets involved in asset partitioning, the internal control and earnings rights of a firm’s beneficiaries and managers are rarely chosen with an eye to creditor protection. Thus, for example, beneficiaries do not choose between a business corporation and a limited liability company, or between a nonprofit corporation and a cooperative, for the purpose of obtaining better access to credit. While these forms differ from each other in important respects concerning the control and withdrawal rights of beneficiaries and managers, there is little evidence that one form offers substantially easier access to credit than does another.

In sum, though we do not explore the issue in depth here, the basic asset partitioning function of organizational law is not only a vital role, but seemingly the only vital role, that organizational law plays in contracting with a firm’s creditors.

B. Rights and Obligations of a Firm’s Beneficiaries

A firm’s beneficiaries have a strong interest in many aspects of their relationship with the firm and with each other. Apart from the elements of organizational form that establish asset partitioning, at least seven major characteristics of legal entities are commonly provided by organizational law and are sometimes said to be fundamental for their functioning. We survey each of these in turn.

1. The Control Structure

One fundamental characteristic is the legal control structure of the firm. For example, is the management function delegated, as in the corporation, or retained by the beneficiaries, as in the partnership? If management is delegated, is it selected by the beneficiaries in periodic elections, or appointed once and for all as in some business trusts and most limited partnerships?

However central these features may be to a firm, they can easily be dealt with by contracting among the firm’s beneficiaries and between the beneficiaries
and the managers – for example, through the firm’s articles or other founding
document.

2. Withdrawal Rights

A second basic characteristic concerns the withdrawal rights of
beneficiaries: can beneficiaries withdraw their pro rata economic interest, and if
so, when can they exercise their withdrawal rights? This set of questions
involves aspects of the firm such as dividend rights, dissolution rights, appraisal
rights, and redemption rights.

As with control rights, this is an issue that can easily be dealt with simply
by contracting among the firm’s beneficiaries -- as we see, for example, when
firms specify in their charters special dividend rights and liquidation priorities for
different classes of shareholders.

3. Transferability

A third characteristic is transferability of the interests of the firm’s
beneficiaries. This, too, seems unproblematic as a matter of contract.
Contractual interests can in general be made assignable under the law of
contracts. And the founding document – i.e., the contract among the
beneficiaries – that establishes a firm can provide that the interests of the
beneficiaries will be assignable, with the assignees stepping into all the rights
and responsibilities of their predecessors.

4. Duration

A fourth characteristic is the duration of the entity – is it perpetual or is it
for a finite term, after which it will be dissolved? It might at first seem that
provision for the infinite lifespan that characterizes most modern legal entities
requires special legal authority. But in fact it does not. An ongoing association of
purely contractual character could easily be constructed, simply by permitting
substitution of the beneficiaries of the association through transferability of
interests or otherwise, thus permitting the class of beneficiaries to be constantly
renewed over generations while their contractual relationship with each other --
including, e.g., control and withdrawl rights -- remains relatively constant.

5. Fiduciary Duties

A fifth basic characteristic is the legal accountability of the firm’s
managers. To many, the fiduciary duties established by organizational law are
core characteristics of legal entities, and their creation and enforcement are key
features of organizational law.
Yet, like the other organizational features surveyed here, fiduciary duties are essentially contractual in character and could easily be articulated in provisions of the firm’s founding document. 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 transactions will be considered self-interested – 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. And 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.

6. The Nature of the Beneficiaries

A sixth characteristic that is conspicuous in some legal entities is specification of the nature of the firm’s beneficiaries. For example, business corporation statutes commonly provide, at least nominally, that ownership of the firm is to be restricted to persons who contribute capital to the firm (by purchasing shares). More particularly, votes in the firm, as well as the rights to residual earnings, are to be allocated pro rata according to the amount of capital invested in the firm; allocation of votes and earnings on the basis of other types of transactions with the firm – such as the amount of labor or supplies provided to the firm, or the amount of its products purchased – is (again, at least nominally) not permitted. Cooperative corporation statutes, in contrast, commonly provide for just the reverse: ownership -- which is to say, voting rights and earnings rights -- may be apportioned proportionately to any type of transaction with the firm, whether supplying inputs (including labor) or purchasing products, with the exception that votes may not be allocated according the amount of capital contributed. In other words, as one of us has put it elsewhere, the business corporation statutes provide for capital (lenders’) cooperatives, while the cooperative corporation statutes provide for all other types of cooperatives.52 Various other legal entities are also specific about the types of persons who can serve as beneficiaries. These include specialized agricultural cooperative statutes providing for firms whose owners are agricultural producers, mutual life insurance company statutes for forming mutual companies whose beneficiaries are life insurance policyholders, or condominium statutes providing for collective ownership of buildings by their occupants. The reasons for this specialization according to classes of beneficiaries presumably include (1) the convenience of having standard form features tailored for their needs, (2) the utility of providing notice to beneficiaries -- and to other parties who contract with the firm -- as to whose interests the firm serves, and (3) avoidance of the severe problems of governance that can arise when a firm’s beneficiaries have heterogeneous stakes in the firm.

Once again, however, this is not a task that is beyond the capacity of contracting via a firm’s charter, which can include terms specifying the class of persons who can be admitted as parties to the charter.

7. Nondistribution Constraints

A final characteristic of some legal entities, and the one that might seem most difficult to provide by contract, is a formal separation of control rights from distribution rights whereby those who control the firm are barred from appropriating the firm’s net earnings. That separation is a defining feature of the nonprofit corporation and the charitable trust, and characterizes many private trusts as well.

One might think that, in a nonprofit corporation or a charitable trust, the nondistribution constraint is commonly intended to protect the interests of a large and inchoate class of potential beneficiaries whose relationship with the firm will be primarily that of donees (rather than, for example, paying customers), and that the conventional tools of contract would be inadequate to establish enforceable obligations to such a class that are of similar character. There are, however, two responses to this concern.

First, it is far more appropriate to see the nondistribution constraint as a device for protecting donors to the nonprofit rather than donees; the latter derive benefits from the firm simply because the former want them to. From this perspective, it is sufficient protection of the nondistribution constraint simply to require consent of the organization’s donors before it can be altered. (For this purpose, we should probably include paying customers of a nonprofit -- such as a nursing home or a hospital -- among its donors, since they are simultaneously both, in a sense, donors and donees.)

Second, whether one thinks the nondistribution constraint serves to protect donees or just donors, contractual means should suffice to impose that constraint in a form that protects against its opportunistic alteration. To this end, terms establishing the nondistribution constraint can be included in a firm’s charter and protected by a rule requiring unanimous agreement of the signatories to the charter to amend it. To be sure, it might be impossible, under ordinary contract law, to go further and make the nondistribution constraint unamendable even by unanimous agreement. Nevertheless, a unanimity requirement would make the nondistribution provisions effectively non-amendable whenever signatories to the charter were numerous. And, to gain even further protection, an agreement to maintain and adhere to the nondistribution provisions in the charter could be included in contracts between the firm and each of its donors or customers.

To be sure, while these methods might suffice to create a close functional equivalent to a nonprofit corporation without exceeding the bounds of basic property, contract, and agency law, they might not suffice to create the complete equivalent of the nonprofit corporation. For, in most states of the U.S., it is possible and indeed common to create nonprofit corporations in which both donors and beneficiaries lack voting rights and 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 permit imposition of perpetual obligations on self-appointing managers who cannot – because of the absence of control over them – be considered agents of any party in interest. In this respect, then, the law of charitable trusts and nonprofit corporations 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.

Three points, however, are worth noting. First, this feature of organizational law is confined to several types of legal entities that are employed today for only a small subset of all organizations. Second, for many purposes the functional equivalent of those organizations could be created without the special “essential” features of organizational law of concern here. Third, the features of the law of nonprofit organizations that are in question here have a distinctly property-law-like character – a characteristic they share with asset partitioning.

C. Essential Terms Versus Useful Terms

The preceding discussion seeks 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 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 beneficiaries. 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 beneficiaries 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 their 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 they reduce significantly 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 quite 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 exist without these features of organizational law, while it could not exist without legal provision for affirmative asset partitioning. It is only the latter 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.

IX. HISTORICAL DEVELOPMENT

Given the critical role of law in permitting affirmative asset partitioning, it is natural to ask when and where, as an 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), 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.

Prior to the advent of the joint stock company, 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. 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. See, e.g., Henry Hansmann, The Role of Nonprofit Enterprise, 89 YALE L. J. 835, 843 n. 32 (1980); J. DAVIS, CORPORATIONS (1961 [1905]). Whether or not it was self-consciously thought of as such, affirmative asset partitioning was presumably always a well-developed aspect of the latter corporations. Because the diffuse beneficiaries of those corporations were not considered owners of the corporations, however, it was presumably just taken for granted that an individual beneficiary's creditors would have no recourse against a corporation's assets.
possible to have a form of 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 developed much later – perhaps, in Europe, only in the late eighteenth or the nineteenth century, simultaneously with the evolution and rapid spread of the large-scale business firms with numerous joint owners that characterize contemporary economies. Prior to that time, some evidence suggests, the partnership form served principally as just a liability-expanding device that permitted more than one individual or family to act as surety (by becoming a partner) for the debts incurred in connection with a given business enterprise. Indeed, the absence of affirmative asset partitioning may have had advantages, effectively permitting each partner to pledge all of the assets of all of his business activities as security for each individual activity. The need for affirmative asset partitioning may have become apparent only when businesses grew to the point where they required a substantial number of partners, rendering it difficult for creditors of the business to assess the creditworthiness of the businesses’ various partners.

We leave it to subsequent work to explore these historical issues more thoroughly.

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 core, organizational law is property law, not contract law. 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 the assets from creditors of the firm’s managers and beneficiaries. 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. In contrast, defensive asset partitioning – including the rule of limited liability that is so often celebrated as a foundational achievement of organizational law – seems of distinctly secondary importance.