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The Essential Role of Organizational Law

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The Essential Role of Organizational Law

Abstract

The Role and Structure of Organizational Law In every society, the law establishes a set of standard legal entities. In the United States, these entities include 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. In important respects, the number and nature of these entities is often strikingly similar from one jurisdiction to another, but at the same time, there are conspicuous variations, even among jurisdictions with similar economies. In this essay, we focus on two questions: What are the common features shared by legal entities, and to what extent do these features require specialized legal rules? Our thesis is that the essential feature of organizational law is asset partitioning – that is, the provision of a mechanism by which creditors of the firm obtain a priority claim in the firm’s assets over individual creditors of the firm’s managers or HBIs. 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 focuses on devices for asset partitioning other than organizational law (for example, security interests). Our contribution here is to demonstrate the close relationship between asset partitioning and organizational law.

THE ESSENTIAL ROLE OF ORGANIZATIONAL LAW

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I. INTRODUCTION

In every society, the law establishes a set of standard legal entities. In the United States, these entities include 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.

In important respects, the number and nature of these entities is often strikingly similar from one jurisdiction to another. At the same time, there are conspicuous variations, even among jurisdictions with similar economies. For example, the nations of Western Europe, in contrast to the United States, generally lack the private trust and the general-purpose nonprofit corporation, while at the same time they have a highly-developed and widely-used special statutory form for closely-held business corporations that is generally lacking in the U.S.

There has also been substantial variation across time. Many of the basic U.S. legal entities took their present shape in the nineteenth and early twentieth centuries. The limited liability company, however, is a more recent creation. Unknown twenty-five years ago, it is now provided for in the law of nearly all states and is widely used.

This array of legal entities confronts us with four basic questions: (1) What are the essential characteristics of legal entities? What features do all entities have in common, and along what important dimensions do they differ? (2) What is the role of law in establishing these characteristics? To what extent could they be left simply to private contracting? (3) What is the functional logic to the variety of legal entities that we actually see in use? Why does a given society have the particular set of entities we observe, instead of more entities, fewer entities, or different entities? (4) What is the optimal set of entities for any given economy? Is the optimal set the same for all contemporary market economies?

These questions are of practical as well as theoretical interest. This is most conspicuous in the formerly communist nations, which have suddenly been forced to decide, more or less from scratch, what legal entities to adopt. Even in the developed economies of the West, however, a better understanding of the nature and role of organizational law can also inform policy debates. Should the civil law countries of Europe adopt the private trust? Should the EU countries harmonize their organizational law in general, and if so what set of entities should they adopt as the common set? Is the U.S. limited liability company an important organizational innovation, or an artifact of tax law? Will, or should, the current tendency toward making the U.S. entities more flexible culminate in the contractualization of most of organizational law, with the legal system itself providing perhaps just a small set of basic elements with which a wide range of forms can be assembled?

While we do not seek to answer all of these questions here, we do seek to develop a general analytic framework in which they can be addressed more clearly. In particular, we focus on the first two of the four basic questions raised above: What are the common features shared by legal entities, and to what extent do these features require specialized legal rules? In a companion piece, we intend to explore the third and fourth basic questions, which involve positive and normative reasons for variety in the array of legal entities.

In Section II, we define the central legal features shared by all legal entities, and articulate the central thesis of this essay, which we describe as an “asset partitioning” theory of organizational law. In Section III, we discuss the economies achieved by having the tools for asset partitioning supplied by law. In Section IV, we address other ways in which organizational law structures contracting between a firm and its creditors. In Section V, we discuss the use of organizational law to adjust the relationship among an organization’s beneficial owners and between those owners and the firm. Section VI concludes.

II. WHAT IS AN ORGANIZATIONAL FORM?

There are, broadly speaking, two ways to coordinate the economic activity of two or more individuals. The first is by having those individuals contract directly with each other on their own account. The second is by having each of those individuals enter into a contract with a third party who undertakes the 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 commonly called a *firm*. The firm, then, serves as the requisite “nexus of contracts” for the persons whose activity is to be coordinated -- that is, as the common party to individual contracts with those persons.¹ Organizational law facilitates this form of coordination by providing for the formation of firms as juridical persons that can contract in their own name.

Economic theory does not offer a completely satisfactory explanation for the fact that productive activity is commonly organized in the form of large loci of contracts, in which a central actor contracts simultaneously with employees, suppliers, and customers who may number in the thousands or even millions. Although we shall say a few words about this problem below, in general we shall not delve into it here. Rather, we will simply take for granted that it is essential, in modern market economies, that

1. See Alchian and Demsetz; Jensen and Meckling.

such large loci of contracts can be constructed.²

A. The Nature of a Legal Entity

To serve its function as a locus of contracts, a firm must have three attributes. First, there must be well-defined decision-making authority. More particularly, there must be one or more persons in whom resides the ultimate authority to commit the firm to contracts. We shall term those persons the *managers* of the firm. In a U.S. business 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.³

Second, the firm's managers must have an interest in coordinating the contracts in a fashion that produces net benefits. This implies that there must be a class of persons for whose benefit they are acting. We shall term those persons the *holders of the beneficial interest (HBIs)*. The managers of the firm may or may not be distinct from its HBIs. In a business corporation, the firm's principal HBIs, its common shareholders, are commonly distinct from its managers. In contrast, in a general partnership, the firm's partners are simultaneously its HBIs and its managers.

Third, the firm must have the ability to bond its contracts credibly. That is, the firm must have the ability to provide assurance to the firm's creditors that those who control the firm will not behave opportunistically, diverting to themselves some or all of the expected value promised to the creditors.⁴ Absent such bonding, potential creditors, anticipating opportunistic behavior, may refuse to contract with the firm in the first place.

2. The literature that focuses on asset specificity to explain vertical integration is of course important here. See, e.g., Klein, Crawford, and Alchian (1978) and Williamson (1986), and the "property rights" approach to the theory of the firm that has evolved out of that work, most conspicuously in the work of Hart & Moore (e.g., Hart's book (1994[?])).

A related but somewhat different reason for large centralized loci (as opposed, e.g., to more decentralized structures) may be the need to avoid opportunistic threats to disassemble a set of transactional relationships that has been costly to assemble, or to expropriate an entrepreneur's or organization's accumulated experience with working procedures and forms of organization. See, e.g., Rajan & Zingales (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).

3. 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.

4. [Describe the three principal sources of the agency costs of debt, as per RK.]

This implies that there must be a pool of assets that the firm's managers can pledge as security for the performance of its contracts.⁵ We shall term this pool of assets the *bonding assets*.

A natural person has these three attributes, and hence can -- and very frequently does -- serve as a firm, in the form of a sole proprietorship. In this case, there is a single individual who serves as both manager and HBI, 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 right to enter into contracts that will bind him in most future states, and provides that creditors of an individual have, as a default rule, the right to levy on all assets owned⁶ by that individual.

Legal entities, like natural persons, are legal (or "juridical") persons in the sense that they have the three attributes described above: (1) well-defined ability to contract through designated managers; (2) designated HBIs; (3) a designated pool of assets -- the bonding 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 distinct from assets owned by the firm's HBIs or by the firm's manager(s), in the sense that the firm's creditors have a claim on the bonding assets that is prior to that of the personal creditors of the HBIs or the managers.⁷

Because, for us, this latter feature is the essence of a legal entity, and its establishment the prime contribution of organizational law, our view might be appropriately labeled "The Asset Partitioning Theory of Organizational Law," where by "asset partitioning" we mean the assignment of priority claims in different pools of assets to different groups of creditors. In essence, this approach places creditors' rights at the

5. [There are other means of bonding performance, particularly through exposing managers or HBIs to personal sanctions. These are not particularly relevant today, however, where commercial contracting is involved.]

6. [Discuss what "owned" means here -- that it's a legal construct?]

7. [Possible FN: What about personal remedies? Specific performance is another way of getting legal enforcement of contracts. We don't in fact use jail or other direct personal remedies much anymore, so we perhaps don't have to worry about this. Money damages are effectively the only remedy we have for debt. But we can ask, e.g., what it would look like if the law permitted the agent to be thrown in jail if the enterprise didn't perform on its contracts. (If the HBIs can be thrown in jail, it looks like it's just a common venture among them.) The problem is that, if the HBIs can encumber the enterprise but the agent suffers, then there's a problem in how the HBIs will bond themselves to the agent not to behave opportunistically.]

center of organizational law.

B. Asset Partitioning

The term “asset partitioning,” as we use it here, refers to the division of a pool of assets into subpools, each of which is separately pledged as security to a different group of creditors. The principal rational for this partitioning is to reduce the overall cost of credit when dealing with a heterogeneous group of creditors. Partitioning assets reduces costs principally because some creditors are in a better position than others to monitor the value of particular assets, or to realize the value of those assets in case of default by the debtor.

A simple example can help to illustrate this idea. 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 oil refineries. Now 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 three separate corporations: a parent holding company, a hotel subsidiary wholly-owned by the parent, and an oil subsidiary wholly-owned by the parent. Does the choice between these structures affect the costs of the enterprise? The answer is clearly yes. In particular, the structure with only a single corporation is likely to involve a substantially higher cost of credit.

The reason is that the two lines of business are likely to depend, at least in part, on two distinct classes of creditors. 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. For one thing, the supplier may well deal with other hotel chains as well, 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 learn a great deal about how financially sound that chain is. Such a supplier to the hotel industry is not likely, however, to know much about the oil industry, either in general or as administered by the company that owns 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, this will have 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 monitoring the fortunes of the hotel operation. 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 to 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.⁸

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. 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.⁹ Another 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 in contemplation of insolvency, and hence effectively expropriate the creditors of that business. Although, as we shall discuss further below, much of organizational and non-organizational law is devoted to reducing the potential for this sort of debtor opportunism, the protection offered is far from perfect.

Asset partitioning will only succeed in reducing the overall costs of credit when the benefits we have described here exceed the costs. There is every reason to believe, however, that this is often the case in complex enterprise.

The oil and hotel example discussed above involves partitioning business assets under the overall control of a single firm. Of equal or greater importance, however, is the role played by organizational law in partitioning business assets from personal assets. As an example, let us return to our hypothetical oil and hotel holding company, and assume that the holding company is collectively owned by a large number of investors. By incorporating the holding company, business planners can insure that creditors of the company have a priority claim on the company's assets in preference to the claims of the personal creditors of the company's investors (or managers), while simultaneously assuring that the personal creditors of the investors have a priority claim over the business creditors in the personal assets of the investors. Once again, this partitioning is likely to reduce the overall cost of credit to the business and its investors combined. Personal creditors of an individual investor may well be in a relatively good position to assess the creditworthiness of that individual, but in a poor position to assess the overall risks of the oil and hotel business, and of every other business that the individual has invested in. Similarly, creditors of the oil and hotel businesses may be well placed to assess the prospects of those businesses, but poorly placed to monitor the financial affairs of each of the businesses' individual investors.

8. 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.

9. This rationale for the conglomerate form is well known from the finance literature. See [_____].

The idea that partitioning a fixed pool of assets can reduce overall costs of credit by reducing monitoring costs is already familiar.¹⁰ In large part, however, the existing literature on this subject focuses on devices for asset partitioning other than organizational law (for example, security interests¹¹). Our contribution here is to demonstrate the close relationship between asset partitioning and organizational law.

III. Constructing Entities Without Organizational Law

We asserted above that the essential feature of organizational law is asset partitioning -- that is, the provision of a mechanism by which creditors of the firm obtain a priority claim in the firm's assets over individual creditors of the firm's managers or HBIs. Absent organizational law, large transaction costs would be involved in establishing, with only the tools supplied by the general law of property and contracts, a viable nexus for a large group of actors -- a group that, in a large business corporation, may well include hundreds of thousands of investors, workers, suppliers, and customers.

To understand these transaction costs, we will explore here the methods that would have to be employed to create a firm in the absence of organizational law. That is, we will ask how difficult it would be to create a firm using only the standard tools of property law, contract law, agency law,¹² and basic elements of the law of creditor protection. By this means, we can see more clearly what organizational law adds to contract and property law.

A. Sole Proprietorship

As we noted above, an individual person has the attributes of a legal entity, and thus can in principle serve as the nexus of contracts for a firm. Indeed, an individual *is* a firm as we define it: his life is his enterprise.

10. [Cite Posner, Levmore, Jackson, Kronman, Baird, etc.]

11. [Cites]

12. 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 shall not explore that question here, however, but rather shall take it for granted that agency doctrine is in place.

It is often possible to establish and operate a substantial productive enterprise using only a natural person as the requisite nexus of contracts. This is the sole proprietorship. In the sole proprietorship, there is no distinction between personal assets and business assets; both are available to satisfy the claims of both personal and business creditors of the proprietor.

The sole proprietorship has distinct limitations as a form for organizing business firms, however. First, there may be no natural person capable of serving as an entrepreneur who also possesses sufficient personal assets to serve as a guarantee for the firm's creditors. Second, even if a sufficiently wealthy entrepreneur exists, that entrepreneur may wish to shelter a substantial portion of his assets from the hazards of the business venture, leaving too few assets to support the enterprise.¹³ Borrowing the requisite capital from other persons does not solve either problem, but merely displaces it from one set of creditors to another.¹⁴

Third, even if a sufficiently wealthy entrepreneur exists, and is willing to expose sufficient personal assets to bond the contracts of the business, there may be substantial economies available to him from separating his personal from his business assets in order to reduce the monitoring efforts of his creditors. For instance, if a rich entrepreneur were to own 100% of the oil and hotel business in our preceding example, he might be able to reduce his overall cost of credit significantly by separately incorporating both businesses, thus partitioning his business assets from his personal assets, and simultaneously subpartitioning his business assets into two separate pools.

For this reason, we see that it may make sense for an individual to incorporate

13. [This may be because of risk aversion, or because of the advantages of partitioning assets among different creditors for monitoring purposes (see the discussion below).]

14. [A variant on borrowing is to attempt to deploy the net value of the firm's assembled nexus of contracts as security for each of those individual contracts. It is possible that, in many cases, this net value will be sufficiently large to serve that function. To make this approach work, the entrepreneur must presumably assemble the contracts in question initially on a contingent basis, with each individual contract conditional upon the entrepreneur's success in entering into all the others. But this approach, too, will be unworkable unless the entrepreneur can effectively assign to the firm's creditors a priority claim to the net value of the nexus of contracts. Absent priority, the entrepreneur has both the ability and the incentive to behave opportunistically, pledging that value for his personal consumption or business ventures and thus compromising the security of the parties who contract with the firm. Consequently, a critical element in creating a firm is some mechanism for giving the firm's creditors priority over the personal creditors of the firm's manager.]

one or more of his business activities even if he is to be the sole shareholder in each of the resulting corporations. Opposition to the “corporation sole” as an acceptable legal form – an opposition that has largely died out in the U.S.¹⁵ but continues in some civil law jurisdictions¹⁶ – stems from a failure to appreciate this fact. Although the term “corporation” suggests a collective entity, in fact 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.

Would it be possible for an individual entrepreneur to establish the pattern of asset partitioning created by a corporation sole without the benefit of organizational law (including, in particular, the law of corporations)? In general the answer is no, as a practical matter. The principal problem is not, however, in establishing the limited personal liability that is associated with the corporate form. Rather, the obstacle lies in establishing a pool of bonding assets for the firm’s creditors.

We can see this by considering what a sole proprietor would have to do to establish such an asset pool by contract. (We ignore, for the moment, the possibility of using security interests – a topic we return to below.) 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 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 bonding assets.

This kind of contracting is so costly that, as a practical matter, it would never be undertaken. Consider the principal kinds of transaction costs that it would impose.

First, it would impose 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 sharply distinguish the entrepreneur’s bonding assets from his personal assets, and to distinguish his business creditors -- those entitled to priority in the bonding assets -- from his personal creditors.

Second, a contractual effort to set aside a pool of bonding assets would incur the

15. [Cite to older literature. Note that this opposition continues with respect to the “LLC Sole”; see the recent Massachusetts legislative debate on the subject.]

16. [Cites]

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 huge 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 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. Such monitoring would be prohibitively costly.

The inventory of transaction costs considered thus far would be associated with resolving by contract only one side of the asset partitioning problem: securing a pool of bonding assets for business creditors. The corporate form provided by organizational law not only automatically provides for such a pool of business assets but also limits shareholder liability to creditors of the business, and thus secures a pool of bonding assets for the entrepreneur's personal creditors.

We postpone until Section IV an analysis of the costs of contracting for limited liability for HBIs in the absence of organizational law. Here it suffices to note that the “full” asset partitioning offered by the corporate form -- the restriction of business creditors to business assets and personal creditors to personal assets -- is not essential to support a nexus of contracts and may not always be necessary for efficient contracting. Indeed, sometimes it may be more efficient to give creditors of the business first claim on the assets of the business, while also allowing them to proceed against the personal assets of the individual if the business assets do not suffice to satisfy their claims. This is, of course, the pattern of claims established by partnership law.

A corollary of this observation is the seemingly odd claim that the partnership form ought to be open to sole proprietors. The law of partnership, by its terms, traditionally applies only when a business has two or more owners.¹⁷ But there is no logical reason why this should be so, just as there is no reason not to recognize the corporation sole. A “partnership sole” makes perfect sense. While it is common to think

17. [Cite]

of a sole proprietorship as, in effect, a one-person partnership, once we appreciate the importance of asset partitioning we see that it is not. A sole proprietorship, unlike a partnership, does not partition off from the entrepreneur's total assets a separate pool of bonding assets -- assets that are owned by the business, rather than being owned directly by the owner of the business -- that are automatically pledged as security to creditors of the entrepreneur's business, leaving his personal creditors with only a subordinated claim on those assets. Yet it is perfectly reasonable for a single entrepreneur/owner to wish to achieve the latter result -- to demarcate a pool of business assets that will serve principally to bond his obligations to his business creditors, while at the same time offering (as the partnership form does for multiple owners) his personal assets as added security for his business creditors.¹⁸

B. Partnership

Another approach to capitalizing -- or, more accurately, bonding -- a nexus of contracts is to have a group of individuals serve jointly as the nexus, all becoming signatories to the organization's contracts. Let us term these individuals "partners," though without seeking to attribute legal significance to that label (since we are imagining a world in which partnership law as such does not exist). Since the partners are all signatories to the contracts, all of their individual assets are pledged as security for those contracts. So long as those assets are, collectively, of sufficient value, they then provide the requisite bond for the contracts. Title to assets actually used in the business can either be held by individual partners (who devote the assets to the business through contract with the other partners) or -- assuming forms of joint ownership are available, such as joint tenancy or tenancy in common -- by the partners collectively.

This partnership approach is consistent with providing for well-defined contracting authority through designated managers. Using established principles of agency law, even in the absence of the law of partnership, all partners of the firm, or some designated subset of the partners, can be vested with authority to contract on behalf of the firm.

There remains, however, the same problem of the overlapping claims of personal creditors that we examined in the case of the sole proprietorship. An individual partner's

18. The continuing absence of the "partnership sole" from the law is presumably due to the existence of relatively inexpensive substitutes -- in particular, the corporation sole. The rough functional equivalent of a partnership sole can effectively be created by forming a closely held corporation with the entrepreneur as sole shareholder, then having the corporation borrow from a bank with the entrepreneur's personal assets pledged as security for the loan, and using the proceeds of the loan to bond the firm in its dealing with other, smaller creditors.

personal creditors can have access to the individual partner's assets, including the personal assets dedicated to the business, and to that extent threaten the assets that bond the organization's contracts.

At first glance it might seem that, if the partners are sufficiently numerous, the danger that personal creditors will seize business assets of a partnership is a more modest threat than that posed by the personal creditors of a single entrepreneur. There is, however, a countervailing free rider problem: each partner has a stronger incentive than would a single entrepreneur to pledge his share of partnership assets to his personal creditors, since – holding the actions of his fellow partners constant – he bears only part of the costs that such action imposes on the firm's creditworthiness. Moreover, as the number of the firm's partners increases, it becomes more difficult for creditors of the firm to monitor the partners' private debts. On balance, then, it is clear that adding additional partners to a sole proprietor will not solve the firm's bonding problem in the absence of organizational law.

The essential contribution of partnership law is to offer a solution to this bonding problem. The common law of partnership created a new form of concurrent tenancy, "tenancy in partnership," which effectively made it possible to create a tenancy in common, otherwise available only for specifically designated items of real or personal property, to all the assets of a business.¹⁹ Moreover, the law of partnership permits the creation of security interests in property held in this form. And finally, the law of partnership imputes this form of ownership to all assets held in partnership name, and as a default rule grants to the creditors of the partnership a security interest in those assets. In short, the law of partnership makes it simple to designate a separate class of business assets and to pledge those assets as a bond to creditors of the business.

From the functional view of legal entities we take here, this feature of partnership law is what makes it part of organizational law, and is what makes the partnership a legal entity. 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 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 impediments to the creation of a functioning nexus of contracts, however, they are

19. [Note also that the evolution of the law of real property fits this analysis. Tenancy in common provides that leases and debts backed by mortgages against the property shall have priority over the individual creditors of the tenants in common. It doesn't, however, seem to provide for any limitation of the liability of the tenants in common vis-a-vis the creditors of the property. (# check this)]

by no means fatal obstacles. The implicit priority that partnership law establishes for the firm's creditors is a far more important foundation for forming the requisite nexus, precisely because -- as in the case of sole proprietorships considered above -- this priority could as a practical matter be created using only the law of contract.

C. Trusteeship

In the partnership approach (prior to partnership law), as in the case of the sole proprietorship, the HBIs are also the managers of the firm. Another approach to construction of a firm that provides for a separate pool of bonding assets without the benefit of organizational law involves the use of a manager who is separate from the firm's HBIs.

In particular, the HBIs might seek to use the legal personality of an agent to serve as the requisite nexus of contracts by transferring to the agent the formal title to assets sufficient in value to bond the firm's contracts with third parties. This agent, whom we might refer to as a "contractual trustee," would then be constrained, by means of the contract establishing his agency, to administer these assets for the benefit of the HBIs.

This approach has the benefit of insulating the pool of pledged assets from the claims of the personal creditors of the individual HBIs, since each HBI has only a contractual right against the agent, not a property right in the assets managed by the agent. While the creditors of an HBI may be able -- in case of the HBI's insolvency -- to step into the contractual rights of the HBIs vis-a-vis the agent, so long as the agency is irrevocable²⁰ they cannot force dissolution of the agent's activities or sale of the pledged assets.

This approach may therefore succeed in insulating the pledged assets from the creditors of the HBIs.²¹ It will not, however, insulate the pledged assets from the

20. 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." [# cite] 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.

21. As a bonus, this approach may also provide limited liability for the HBIs, 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

creditors of the *manager*. Absent organizational law, if the manager has title to assets, those assets are automatically pledged as security to the manager's personal creditors unless the manager secures explicit agreement from those creditors that the pledged assets are not available to them. The agency contract between the HBIs and the manager could require that the manager obtain such an agreement from each of his personal creditors. The resulting transaction costs, which would resemble those of contracting for a pool of bonding assets in a sole proprietorship, would make such agreements impracticable, however. Moreover, not only the creditors of the business but also the HBIs would run the substantial risk that the manager would fail to obtain such an agreement from one or more of his creditors, either from inattention or – worse and perhaps more likely – from opportunism. The HBIs (and perhaps the business creditors) would retain a contractual claim against the manager in such a case, but that claim 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 is no more workable than the other two we have examined.

The common law of trusts solves this problem of insulating the pledged 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. Thus, the law of trusts makes the trustee, vis-a-vis creditors with whom he contracts, two distinct persons: a natural person contracting on behalf of himself and a nexus of contracts acting on behalf of others (the HBIs).

This insulation of assets held in trust from the personal creditors of the trustee is the essential contribution of trust law, and is what makes trust law a form of organizational 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.²² While it is sometimes said that the common law trust lacks legal personality, for our purposes it is clearly a legal entity.

D. Security Interests

HBIs 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.

22. See Hansmann & Mattei.

Since we have identified, as the principal contribution of organizational law, the assignment to business creditors of a priority claim to the 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 employing organizational law for the purpose.

With the modern law of secured interests, it might in fact be possible to establish priority for a firm's creditors roughly approximating that which is available through organizational law. This is most readily seen in the case of a single entrepreneur who wishes to establish an enterprise whose creditors will have priority, over the entrepreneur's personal creditors, to assets associated with the enterprise. The most straightforward approach would be for the entrepreneur to draft and register a financing agreement assigning to all of the firm's creditors an undivided security interest in all of the firm's present and future assets, with the creditors' claims to be satisfied out of the security pro rata according to the amount of the firm's outstanding debt to the various creditors.

There are some ambiguities, however, as to how comprehensive such a security agreement could be. First, it is unclear whether, under existing law, some important but inchoate firm assets such as goodwill could be included among the assets pledged in such an agreement.²³ To the extent that they could not, firm creditors could not be given priority in those assets over the entrepreneur's personal creditors.

Second, it is unclear whether such a financing agreement can be extended to include all unnamed future firm creditors without requiring a new filing each time the firm deals with a new creditor.²⁴ If such refilings are necessary, then the transaction costs of this approach become large.

Moreover, even if these ambiguities were to be resolved in favor of permitting comprehensive and flexible pledges of security, this approach would still involve substantial contracting costs. First, there would have to be 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. Second, 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

23. [# Citations and explanation.]

24. UCC Section 9-402, which requires that a financing statement contain the name and address of the secured party "from which information concerning the security interest may be obtained," seems to rule out the prospect of creating a security interest in favor of unnamed future creditors.

include all of the firm's suppliers, employees, and customers.

Nevertheless, subject to these ambiguities and transaction costs, it would be possible to construct a legal entity, as we define it, using just the law of property and contract, so long as the modern law of security interests is included within our definition of contract law. Two points should be kept in mind, however. First, using security interests for this purpose imposes significant contracting costs. Second, and more important, it is only through the action of the modern law of security interests that the entrepreneur can create a legal entity. Absent that law, it would effectively be impossible to pledge assets as security to the firm's creditors. For, absent the law of security interests, a creditor could obtain a claim, prior to the claims of the entrepreneur's personal creditors, over some of an entrepreneur's assets only if all of the entrepreneur's personal creditors were to give their consent to this priority. A creditor could, to be sure, demand from the entrepreneur a commitment to extract such a promise from each of the entrepreneur's past and future personal creditors. There would, however, be no way for the entrepreneur to commit himself credibly to do this. The law of security interests has the advantage that it effectively imposes the relevant subordination term in each of the entrepreneur's past and future contracts with other creditors, without requiring any further action on the part of the entrepreneur or his personal creditors.

From these observations, it follows that the law of security interests is, in effect, a form of organizational law as defined here. Moreover, it is relatively recent and localized law. In the U.S., the law of security interests was insufficiently well-developed prior to the advent of the Uniform Commercial Code to permit pledging of assets with sufficient generality and flexibility to approximate the results that can be achieved through organizational law,²⁵ and there remain many important jurisdictions today where this is still the case.²⁶

E. The Origins and Elements of Elementary Organizational Law

In sum, while there are several potential approaches to constructing, with just the ordinary tools of property and contract law, a nexus of contracts that can serve as a firm, each of these approaches ultimately runs into an obstacle. For three of the approaches we have surveyed here -- partnership, trusteeship, and security interests -- special bodies of law have been developed to surmount these obstacles. These bodies of law

25. [# Is this quite true? Citations.

The law of security interests has made this progressively easier, by continually expanding the range of things in which you can give a security interest. It starts with the law of real mortgages, when most firms were merely agricultural.]

26. [# Citations and explanation]

all have, as their central focus, the same element: some means by which assets can effectively be pledged to the creditors of the firm, in the sense that those creditors will have a prior claim to those assets over the creditors of the firm's managers and HBIs. For this reason, each of these bodies of law – the law of security interests, the law of partnership, and the law of trusts – can appropriately be considered organizational law. Of course, other laws establishing legal entities -- such as the laws governing business corporations, limited liability companies, and nonprofit corporations – are also forms of organizational law, precisely because they set aside a pool of bonding assets for the creditors of the enterprise.

In short, establishing a pool of bonding assets is an essential contribution of organization law. It is one reason why a separate law of organizations is necessary. It remains to be asked, however, whether this is the *only* essential role for organizational law, or whether organizational law makes other contributions that also could not be replicated by contract without incurring prohibitive transaction costs. Put differently, we ask whether partitioning off a pool of bonding assets is not just necessary for a body of organizational law, but also sufficient. We examine this issue in two steps. First, we explore the other potential contributions of organizational law to contracting between the firm's HBIs and its creditors. Second, we examine the potential contributions of organizational law to contracting among a single firm's HBIs.

IV. CONTRACTING WITH CREDITORS

We have argued that the essential element of a legal entity is a pool of bonding assets to which the entity's creditors have priority of claim over the personal creditors of the entity's HBIs. It remains to determine the extent to which creditors of the entity also have a claim on the personal assets of the HBIs. We confine ourselves initially to contractual debts; tort liability is a separate matter that we shall discuss afterward.

A. Reasons for Limited Liability

1. High Creditor Monitoring Costs

The fundamental rationale for limiting the personal liability of the HBIs is to partition assets in a manner that economizes on creditors' costs of monitoring. With full limited liability, creditors of the firm need only monitor the assets actually held by the firm, and have little reason to concern themselves with keeping track of the assets of the individual HBIs, while the reverse is true for the creditors of the individual HBIs. In large firms, this partitioning of assets among creditors is likely to reduce the total costs of monitoring, and hence reduce as well the total cost of credit to the firm and its HBIs. This partitioning can serve the same purpose in small organizations, or in large firms with a single HBI, where the HBIs wish to pledge only specific assets as security for the

debts of the firm.²⁷ Hence we see limited liability even in organizations whose beneficial claims are not tradeable, such as cooperatives, mutuals, and (typical) private trusts, and also among organizations that are typically closely held, such as LLCs and GmbHs.

On the other hand, there are situations in which the HBIs may well find it advantageous to be able to pledge their personal credit for all the debts of the organization – as where the organization has need to possess few assets itself (which might serve as security) and where it has no reputation on which its creditors can rely. The general partnership serves this role. By adopting that form, the HBIs automatically pledge their personal assets as security to all creditors of the firm.

It is understandable, therefore, that legal entities are importantly differentiated according to whether the personal assets of their HBIs are pledged as security to creditors. Through the option of choosing only one legal entity as opposed to another – e.g., the general partnership as opposed to the business corporation – an investor has a convenient device both for determining the extent of her personal liability for the organization's debts and for signaling the extent of that liability both to her personal creditors and to the creditors of the organization.

2. Creditor Monitoring of Managers

Delegated management provides a rationale for limited HBI liability that is closely related to the argument just offered concerning the comparative costs (as between the owners' creditors and the firm's creditors) of monitoring the firm and its assets.

In Table 1 below, we have arrayed some of the most familiar standard legal entities on a simple two by two chart according to whether they have (1) limited or unlimited personal liability for the owners of the organization, and (2) whether they have delegated management or, conversely, are managed directly by their HBIs.

As Table 1 shows, there is an extremely strong correlation between delegated management and limited HBI liability. An obvious explanation for such a correlation is that, when one assumes unlimited liability for the actions of managers over whom one has little control, and from whose authority one cannot easily escape, one creates the potential for large losses owing to managerial error or opportunism, while it is not clear that one also creates a potential for large offsetting benefits.²⁸

27. Posner; H & K; Int Fac.

28. The common law ban on irrevocable agency arguably reflects the same cost-benefit analysis.

TABLE 1
Limited Liability and Delegated Management

MANAGEMENT LIABILITY	UNDELEGATED	DELEGATED
UNLIMITED	General Partnership	Some Large Partnerships; Some Private Trusts
LIMITED	Member-Managed LLC; Close Corporations	Publicly Traded Business Corporations; GmbHs; Manager-Managed LLCs; Limited Partnerships; Nonprofit Corporations; Cooperative Corporations; Municipal Corporations; Charitable Trusts; Most Private Trusts

If the result of limited HBI liability were just to push the costs of managerial opportunism or error onto the firm's creditors, however, this might not be a persuasive explanation for linking limited liability to delegated management, since creditors may often not be better risk-bearers than are HBIs. But limited liability also 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 HBI monitoring even when the HBIs themselves can monitor with fair competence. But creditor monitoring of managers is particularly likely to have strong efficiencies when the HBIs are poorly situated to monitor the organization's managers, as with most of the entities in the lower right hand cell of Table 1.

3. Collection Costs

It is often suggested that an important reason for limited owner liability, at least in firms such as publicly-held business corporations that have tradeable shares and large numbers of owners, is that the costs of securing and collecting personal judgments against the personal assets of the firm's owners would be excessive, hence rendering personal liability relatively valueless. There is undoubtedly some truth to this, but it has

perhaps been exaggerated. Firms whose shares are tradeable, but whose owners bear 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 developed to the point where the transaction costs of collecting were evidently quite manageable. Overall, the costs of monitoring the assets of multiple owners have probably been more important than the costs of collecting from them as a reason for limiting the personal liability of a firm's owners.

4. Transferability of HBI Interests

Limited liability is commonly rationalized on the grounds that it is necessary to make ownership shares in an organization, such as a business corporation, freely transferable. In fact, however, full limited liability is neither necessary nor sufficient for free transferability of ownership interests. Both logic and historical experience suggest that freely transferable interests are consistent with either unlimited or multiple liability for HBI's, so long as that liability is pro rata rather than joint and several.²⁹

5. Risk Sharing

Risk sharing is also commonly offered as a rationale for the form of asset partitioning involved in limited liability. Like collection costs and transferability, however, risk sharing seems distinctly secondary to monitoring costs as an explanation for observed patterns of limited liability. In the publicly traded business corporation, for example, so long as shareholders' personal liability is pro rata rather than joint and several, portfolio diversification remains extremely effective at eliminating unsystematic risk, and arguably makes a firm's shareholders, in general, much better risk-bearers than the firm's creditors.

B. Is Law Necessary for Limited Liability?

Given that the form of asset partitioning involved in limited owner liability is evidently efficient for some -- though not all -- firms, it remains to ask whether organizational law is necessary to establish this form of partitioning.

In the absence of organizational law, so long as the HBIs retain some minimal degree of control over the entity's managers (or are the managers themselves), the managers would be considered agents of the HBIs and the law of agency would therefore impute joint, or joint and several, liability to the HBIs on contracts entered into by the managers for their benefit. Thus, no separate body of organizational law is needed for an entity to adopt unlimited (joint and several) HBI liability; it is effectively the default rule.

29. See H & K; American Express; Macey & Miller.

Is organizational law necessary to reverse this default, and permit the establishment of limited HBI liability? To put the question more precisely, suppose that there were a body of organizational law that permitted the formation of legal entities with a pool of bonding assets, but did not provide for limited HBI liability. This is not hard to imagine, of course, since the body of law would essentially be that which today governs the general partnership. So we need simply ask: how difficult would it be to establish limited liability 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 could involve very 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 the transaction costs of establishing limited liability by contract would be several orders of magnitude smaller than the transaction costs, described in Section III.A., that would be necessary to create a separate pool of bonding assets using only the tools of contract law. Establishing limited HBI liability, unlike partitioning off the bonding assets, would not require the costs of altering the contracts between the individual HBIs and all of their individual creditors, nor would it create the great potential for moral hazard presented up by the necessity for contracts of the latter type.

Moreover, the transaction costs of establishing limited HBI liability by contract might be quite modest if creditors and the courts were willing to recognize a convention whereby it is understood that HBIs 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.³⁰

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

30. #

limited liability at any reasonable level of transaction costs. The conventions by which limited liability of HBIs is signalled 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, we can say that organizational law plays an important role in reducing the transaction costs of establishing the form of asset partitioning involved in limited HBI liability. That role is less important, however, than the role that organizational law plays in partitioning off a firm's bonding assets. The latter partitioning, unlike the former, would generally be quite impossible to establish without organizational law.

C. Organizational Law Versus Tort Law

Although it is to some extent a question of interpretation whether organizational law is essential for the creation of entities whose owners have limited liability for toward 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 immunity.

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. For 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 corporate securities, or if collection of excess liability judgments from corporate shareholders would necessarily be a very costly process, then limited liability in tort might be justified as a regrettable necessity. But this does not appear to be the case. So long as the rule of shareholder liability is a pro rata rule as described above, assessment of shareholders for their share of tort judgments that cannot be paid out of the corporation's assets does not seem to threaten important inefficiencies. Rather, 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.³¹

D. What Is the Minimum Number of Legal Entities?

The minimum number of legal entities for which the law must provide is at least one. The law must establish some relatively simple mechanism for creating an artificial person with the three attributes described in Section II: managers, HBIs, and a pool of bonding assets. Absent organizational law, as we have argued in Section II, the transaction costs of creating an adequate substitute for a legal entity – and particularly of endowing it with bonding assets – would be prohibitive.

From the immediately preceding discussion we see that a weaker claim can be made that an efficient corpus of law must provide for at least two distinct legal entities – one with unlimited HBI liability and one with limited liability. Experience suggests that there are many circumstances in which a firm's HBIs find it to their advantage to be able to pledge their personal assets as security for the firm's debts, and that there are also many circumstances in which limited liability is more efficient. Consequently, it is important to be able to create both limited liability and unlimited liability entities with relative ease.³² This is easily done if the law provides for two distinct forms, one (such as the general partnership) with unlimited liability as the default rule and one (such as the business corporation) with limited liability as the default rule.

However, even if there are substantial efficiencies in having two distinct legal entities, one with and one without limited liability, it is not clear that two distinct *statutory* forms are required. Only one is required if the courts are prepared to recognize, without specific statutory authority, signaling conventions such as that by which inclusion of the word "limited" in a firm's name indicates that the organization's HBIs and managers have limited liability for the firm's debts. But this is, as suggested above, largely a definitional

31. See Hansmann and Kraakman, *supra* note 9.

32. This should not be overstated, however. It is possible that, given an unlimited liability form, the advantages of also having a limited liability form – whether that form is created by law or by contract – are relatively modest. This is suggested by the substantial development of unlimited liability firms in the early nineteenth century, in both the U.S. and England, prior to the advent of the general corporation laws that embodied limited liability as a default term. Indeed, as already noted, California business corporations – some of which were publicly traded – flourished with unlimited shareholder liability until 1931. Once an organization's HBIs become sufficiently numerous, and thus hard to monitor (and perhaps hard to collect from), creditors probably place little reliance on the personal assets of the HBIs when extending credit to a firm, and instead place their principal reliance upon the bonding assets owned by the firm itself.

question of what legal doctrines we include within the concept of “organizational law.”

The evolution of legal entities over the past hundred years suggests strongly that there are in fact substantial efficiencies in having the law provide separately for limited liability and unlimited liability entities. The tendency of modern law has been to move toward an ever sharper distinction between limited liability and unlimited liability entities, leaving us today (in the U.S., at least) with a general partnership form that brings extreme personal liability, and then a set of limited liability entities that bring no personal liability at all.³³

E. Bonding With Respect to Other Firm Attributes

In principle, one reason to have more than two standard forms for legal entities is that creditors might care about other aspects of legal entities besides the extent of the personal liability of HBIs. In particular, the extent to which HBIs can exercise control over the enterprise, and the ease with which HBIs 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 limits of the HBIs’ powers in these regards. That is, the legal entity might serve in effect as a standard form contract through which the firm’s HBIs bond themselves to the firm’s creditors with respect to the range of opportunistic conduct open to the HBIs.

There is little evidence, however, that this is in fact an important function served by legal entities. Unlike the choice of unlimited versus limited liability, other relationships

33. In this discussion we have generally treated limited HBI liability for a firm’s debts as if it were an all-or-nothing proposition: either the HBIs have unlimited liability for all the firm’s debts that cannot be satisfied out of the firm’s (bonding) assets, or they have no personal liability for those debts (beyond their contribution to the bonding assets). In fact, however, limited liability comes in a variety of gradations. For example, there is the distinction, mentioned in the text, between joint and several liability and pro rata liability, the latter being substantially more restricted than the former. Furthermore, there is the possibility of capping personal liability at some level. For example, in the late nineteenth and early twentieth century, many U.S. banks bore double or triple shareholder liability for bank debts, under which a shareholder was personally liable to unsatisfied bank creditors not only for the amount of their equity investment in the bank, but also for an additional sum equal to that amount or (in the case of triple liability) two times that amount. While, as this example suggests, intermediate forms of personal HBI liability were relatively common in the past, today they have largely disappeared, leaving us with only two extremes: unlimited joint and several HBI liability, or no personal HBI liability. See Hansmann & Kraakman, *The Structure of Organizational Law*.

among the firm's HBIs, managers, and bonding assets are rarely chosen with an eye to creditor protection. Thus, for example, HBIs do not choose a business corporation versus a LLC, or a nonprofit corporation versus 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 HBIs and managers, there is little evidence that one form offers substantially easier access to credit than does another.

In sum, as concerns contracting with a firm's creditors, the basic asset partitioning function of organizational law is vital, but that is the only vital role that organizational law plays.

V. CONTRACTING WITH HBIs

Suppose we accept, after considering contractual relationships between HBIs and creditors, that at least two types of legal entities are needed to create the full range of modern legal entities, one with limited liability and one without. Is it necessary to have more than that number, as we do now?

The question is put squarely by the relatively new Delaware Business Trust Act. That statute permits the formation of limited liability legal entities with virtually any desired designation of HBIs, and with virtually any conceivable assignment of control and withdrawal rights to the HBIs. By making the firm's charter unamendable – which appears possible under the statute³⁴ – a nonprofit organization can also be established. Why does Delaware need more than this form, plus (perhaps) the general partnership³⁵? That is, now that Delaware has adopted a sufficiently flexible business trust act, why doesn't Delaware simply eliminate its other statutory forms for legal entities, including its Business Corporation Act, its Limited Liability Company Act, its Cooperative Corporation Act, its special statutory provisions for Nonstock Corporations (i.e., nonprofit corporations), etc.?

This question is clearly rhetorical to the extent that vast and apparently well-functioning legal structures and institutions have been built around the Business

34. [Citation] (To create a nonprofit entity, the firm's managers and any HBIs 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.)

35. If the Delaware Business Trust Act also contained a simple default option whereby some or all HBIs could accept unlimited personal liability, then the statute would also suffice for forming entities with the characteristics of general and limited partnerships.

Corporation Act and other legal entity statutes over the years. Nevertheless the question can be asked hypothetically: what if Delaware were starting from scratch? Is there a reason to have more than two forms of standard legal entities apart from a legacy of path dependence and the costs of transition?

The most plausible answer is that multiple standard organizational forms, each with its own detailed set of pre-specified default rules, simplifies contracting among the HBIs and between the HBIs and the firm's managers. This answer, however, raises a second question: how essential is the assistance provided by organizational law in facilitating contracting among HBIs and company managers? Is this assistance fundamental, as is the role of organizational law in partitioning assets, or is it a convenience for which ready contractual substitutes are available?

A. Organizational Law and HBI Contracting

HBIs 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 patterns of asset partitioning, at least six major characteristics of legal entities are commonly provided by organizational law and are sometimes said to be fundamental for their functioning. The first is the rule establishing the identity of the HBIs themselves. Is the firm a for-profit firm with HBIs who retain ultimate legal control over its policies, or is it a nonprofit firm controlled by autonomous managers who have no claim on its net earnings? A second fundamental characteristic is the legal control structure of the firm. Is the management function delegated, as in the corporation, or retained by the HBIs, as in the partnership? If management is delegated, is it selected by the HBIs in periodic elections, or appointed once and for all, as in some business trusts and most limited partnerships? A third basic characteristic concerns the withdrawal rights of HBIs: can HBIs withdraw their pro rata economic interest, and if so, when can they exercise their withdrawal rights? A fourth characteristic is the duration of the entity – is it perpetual or for a finite term, after which it is contractually scheduled to be dissolved? A fifth basic characteristic is the legal accountability of the firm's managers – to what extent is their conduct governed by fiduciary duties enforced by a realistic threat of legal action? The sixth is the transferability (or assignability) of HBI interests.

It strikes us that all of these characteristics of legal entities, and perhaps others as well, are indeed basic, and there is great value in establishing characteristics -- such as the identity of the HBIs, or whether the firm will be managed by an elected board -- as an integral feature of a standard legal form. We suspect that this value can explain the existence of many of the most commonly used legal forms without any reference to patterns of asset partitioning, which are established by all organizational forms.

Probably the greatest value arising from the existence of multiple standard forms is that they can often play an important signaling and bonding role for a firm's HBIs.

Shareholders in industrial firms, for example, may well want to be assured that they will have an annual opportunity to elect some or all of the firm's directors, and that they will have a vote on all fundamental transactions such as merger or liquidation. The business corporation statutes – but not the business trust statutes – provide this.

B. The Character of HBIs

A customer of a firm may have an interest in knowing if the firm is operated by and for the benefit of its investors of capital (e.g., a business corporation), is operated by and for its customers (e.g., a consumer cooperative), or is controlled by autonomous managers who have no claim on net earnings (e.g., a nonprofit corporation). For example, if the firm has market power, the customer might prefer the cooperative over the business corporation. And if there are severe problems of asymmetric information – so that the customer is in a poor position to police the quality of the firm's performance – the customer might prefer a nonprofit firm over a business corporation or even a cooperative.

Organizational law provides a convenient means by which a firm can signal to its customers – or to its suppliers, employees, or other HBIs – just what kind of persons the firm's HBIs are, and in particular what kind of transactional relationship the HBIs have with the firm. In part this is for reasons of creditor protection of the sort discussed in Section IV. But in part it is for the sake of signalling to the parties involved whether *they* are among the firm's HBIs. For example, a patient of a hospital is likely to be among the hospital's HBIs if the hospital is organized as a nonprofit corporation, but not if the hospital is organized as a business corporation.

C. Other Simple Economies of Standard Form Contracts

In addition, there are a number of more minor ways in which a multiplicity of standard form legal entities can reduce the costs of contracting for a firm's HBIs. 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; and (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). These latter advantages are, of course, shared with nearly all standard form contracts. While important, the economies involved are not of the same order as those involved in asset partitioning. Moreover, many of these economies are available for organizations, as for other forms of transactions, through standard forms that are privately provided rather than being publicly provided by embedding the form in a statute.

D. The Necessary Number of Forms Versus the Optimal Number of Forms

The plausible economies that a menu of multiple organizational forms can

generate in contracting among HBIs and between HBIs and managers raises two sets of questions that we highlighted at the outset of this paper and reserved for discussion in a companion paper: (1) What is the functional logic to the variety of legal entities that we actually see in use? Why does a given society have the particular set of entities we observe, instead of more entities, fewer entities, or different entities? (2) What is the optimal set of entities for any given economy? Is the optimal set the same for all contemporary market economies?

In this paper, however, our focus is not the optimal set of organizational forms but on the necessary set of forms, in the sense that constructing the kinds of firms that populate the landscape of modern industrial societies would be impractical or enormously costly without these forms. From this perspective, it must be said that the possible economies arising from the use of multiple organizational forms, each with its own detailed set of pre-specified default rules, to simplify contracting among HBIs and firm managers seem small in comparison to those that arise from the role of organizational law in facilitating asset partitioning. The principal reason is not that the relationships between HBIs, the firm, and its managers are unimportant, but only that they are far easier to structure by contract – without the assistance of a statutory form – than is asset partitioning, which regulates the relationships between the firm, business creditors, and the personal creditors of HBIs.

In most cases, if the identity, basic powers, and entitlements of a firm's HBIs and managers were not supplied as standard terms in a statutory form, they could be included in the organization's charter, which would bind all HBIs and managers. Moreover, only a single document would be necessary because, relative to the diverse set of business and personal creditors associated with a large firm and its HBIs, the HBIs themselves of most firms, large or small, are highly homogeneous.³⁶ While some basic characteristics of the legal relationships among HBIs and managers might seem difficult to capture in the organization's charter – for example, the fiduciary duties of managers to HBIs – this difficulty is finally only one of drafting, which seems far smaller than the difficulty of surmounting the negotiation costs, monitoring, and moral hazard problems that would attend an effort to create a pool of bonding assets by contract.

VI. FISCAL AND REGULATORY USES OF ORGANIZATIONAL FORMS

A. Taxation

It is common for parties to choose one legal entity over another (say, the partnership over the corporation, or vice-versa) for tax purposes. The reason is that tax

36. The reasons for this homogeneity are explored in Henry Hansmann, *The Ownership of Enterprise* (1996).

law often imposes different rules on different legal entities simply as a matter of form. Most economists would probably agree that this is regrettable, since it increases transaction costs by causing legal entities to be used for transactions for which they are inappropriate. A more efficient approach would be to make the tax system as neutral as possible among legal entities. The most obvious means to that goal is to eliminate the separate taxation of legal entities. To this end, there have long been serious proposals in the United States for abolishing the separate corporate income tax and simply taxing all corporations like partnerships, with the corporations' net income imputed to their shareholders for tax purposes.

At present, however, the influence of taxation is so strong that it not only bears heavily on the choice of legal entity but sometimes even fosters the creation of new legal entities. This appears to have been the case in the United States recently with the limited liability company, an innovation of the past two decades that has now spread through most of the fifty states even though it seems to permit nothing that cannot be done as well with a corporation or a limited partnership. (There may, however, be a signalling function here too: according to U.S. practitioners, the limited liability company looks more familiar to Europeans than does the limited partnership, and hence is preferable in creating American entities designed to appeal to European investors.)

Conversely, a government may wish to limit the available set of legal entities in order to simplify the administration of taxes. Some civil law countries, for example, have considered the prospect of tax avoidance as an important reason not to adopt legislation providing for the general formation of private trusts. If a government is unwilling to adopt forms of taxation that are neutral among organizational forms, however, there is much to be said, not for restricting the character of the legal entities that can be formed, but rather for following the practice of defining the characteristics of taxable entities in the tax law itself and not relying upon the choice of formal legal entity as an adequate signal of an entity's tax status – which is roughly the practice followed today in the U.S.

Consequently, it is difficult to argue that organizational law is a necessary adjunct to tax law.

B. Regulation

Similar issues arise with respect to other types of regulation. Particular forms of regulation are applied only to, or differentially to, organizations formed as one type of legal entity as opposed to another. One of the most conspicuous examples is tort law, which we have already discussed. The result is not just a bias in the incentives to use one legal entity as opposed to another in forming an organization, but also an incentive for the government to limit the range of legal entities available for any given activity. As with tax law, the more flexible approach, if it is administrable, is to make regulatory law transparent with respect to the particular legal entity that is employed to structure an

enterprise, and define within the regulatory law itself the functional characteristics of an organization that determine the way in which regulation will bear upon the organization. For this reason, it is not obvious that organizational law is any more necessary an adjunct to regulatory law than it is to tax law.

VII. CONCLUSION

We have presented here an “asset partitioning” theory of organizational law. In particular, we have argued that the principal function of organizational law is to provide for the creation of a pool of bonding assets in which creditors of a firm can easily be given priority over all other creditors of the firm’s beneficial owners and managers. While organizational law also serves other useful functions, those functions are much less central to organizational law. In particular, while limited liability is often celebrated as a foundational achievement of organizational law, it seems of distinctly secondary importance – and, in the case of tort liability, seemingly a mistake. The control rights and withdrawal rights of beneficial owners, and the ability of HBIs to hold each other and their managers legally accountable, seem in turn of tertiary importance – a convenience in contracting, but arguably only that.