LEGAL ENTITIES,
ASSET PARTITIONING,
AND THE
EVOLUTION OF ORGANIZATIONS

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November 2002

NEWLY REVISED DRAFT FOR NBER CONFERENCE, DISTRIBUTED NOVEMBER 19, 2002

Preliminary Draft: Not for general distribution.

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THIS IS VERY MUCH A PRELIMINARY DRAFT. THE HISTORICAL PORTIONS THAT BEGIN WITH SECTION IV, IN PARTICULAR, ARE SOMETIMES EXCESSIVELY DISCURSIVE, AND AT OTHER POINTS INCOMPLETE. WE HOPE THAT, FOR THOSE WHO HAVE THE PATIENCE TO COPE WITH IT, THE ESSENTIAL POINTS NEVERTHELESS COME THROUGH.

I. INTRODUCTION

Economic activity in modern market economies is dominated, not by individuals, but by organizations. Most prominent among those organizations are private business firms that own assets, contract, and incur liabilities as legal entities that are distinct from the firms' owners. Firms of this character are, in historical terms, a relatively recent phenomenon. They are largely a product of the last three centuries, and particularly of the past two. If we look back much further than that, we find not just that such firms were absent, but that the basic legal framework required to form them was lacking as well. In this essay, we analyze, in economic terms, the evolution of that legal framework from Roman times to the present, and explore its relationship to the development of both commercial and noncommercial organizations. Our object is not simply to understand the past, but also to shed light on the modern state of organizational structure and organizational law, and on their likely future development.

Previous work in economic and legal history has focused heavily on limited liability – the rule that shields the assets of a firm's owners from creditors of the firm -- as the legal innovation that has been most important in the development of commercial firms. We believe that this emphasis is misplaced. Of much greater importance is the reverse rule, which shields the assets of the firm from creditors of the firm's owners. This rule, which we have elsewhere termed "affirmative asset partitioning,"[1] is logically prior to limited liability, in that limited liability would have little value without it. Moreover, while experience shows that large firms can survive without limited liability, large firms without affirmative asset partitioning are simply unknown. Finally, while limited liability can be, and often has been, established simply by contract without benefit of special rules of law, affirmative asset partitioning must be specifically recognized in legal doctrine to be workable. The development of affirmative asset partitioning ("AAP") is therefore the central focus of our attention.

From an historical point of view, a critical question is why commercial firms that are organized as distinct legal entities arose so late. The existing literature focuses on the demand side: The industrial revolution brought productive technology requiring large amounts of capital that had to be assembled from multiple investors; legal forms suited to raising that capital were therefore devised. Clearly this is part of the explanation. But there must be more. Today, even very small businesses are routinely formed as distinct legal entities. Why was that not also true in earlier times?

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[1] Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE LAW JOURNAL 387-440 (2000).

To understand the answer, we argue here, one must look to the supply side as well as the demand side. The affirmative asset partitioning that is the critical feature of a distinct commercial entity is costly to establish in workable form. Beyond requiring enactment and enforcement of the relevant legal doctrine, it requires that a firm's creditors and owners have the practical ability to demarcate and police the boundary between the assets of a firm and the assets of the firm's owners. The costs of maintaining that boundary are worth incurring only where there are concomitant benefits. Not surprisingly, therefore, we find that the first commercial firms that were formed as distinct entities were generally such that the character of their assets or the nature of their business made it relatively inexpensive to maintain the boundary between, on the one hand, the assets and creditors of the firm and, on the other hand, the personal assets and creditors of the firm's owners.

While our principal focus is on commercial enterprise, our analysis also sheds light on the development of noncommercial organizations. It is a striking fact of Western (and Eastern) history that, many centuries before the advent of significant legal entities of a commercial character, large *noncommercial* corporations were commonplace and played a substantial role in the economy. This pattern, we argue, is explainable in significant part by supply-side factors affecting the development of affirmative asset partitioning: It is much easier to police asset boundaries in nonprofit organizations than in proprietary ones.

Another conspicuous development of recent centuries is the shift from the family to the individual as the most basic "legal entity" in society. This change, we argue, was linked to the simultaneous development of commercial firms as legal entities. When, with the development of commercial legal entities, it became unnecessary to use families as business units, it was no longer advantageous to impose on the extended family a legal regime that effectively made it a business partnership.

Our focus here is principally on the past. But we seek to illuminate the present and the future as well. The temporal coevolution of law and organizations that we describe here is still very much underway. Indeed, the current moment is particularly rich in the development of new legal entities and of organizations that employ the increasing flexibility and complexity that those forms permit. Our analysis, we believe, offers a clearer understanding of this continuing process, and of the directions it is likely to take in the future.

We begin, in Section II, with a general discussion of asset partitioning and its relationship to the structure of legal entities. In Section III, we survey the benefits and costs of affirmative asset partitioning, and identify economic factors favorable to the development of legal entities embodying that attribute. Subsequent sections proceed historically, portraying the general legal and economic evolution of organizational forms over the past two millennia, and seeking to determine the extent to which that evolution reflects the economic factors described in Section III. We confine our focus principally to the path that leads from ancient Rome through medieval Italy to pre-modern England and ultimately to the contemporary United States. We believe, however, that the considerations most important in explaining the pattern of development in the West have been similarly important in governing the evolution of organizations and organizational law in other societies.

II. LEGAL ENTITIES AND ASSET PARTITIONING

Law reinforces the credibility of contractual commitments by establishing publicly-enforced sanctions for failure to keep those commitments. A variety of sanctions have been used for this purpose at various times and places, including prison and enslavement. The principal sanction employed in contemporary legal systems, however, is to permit the unpaid creditor to seize, from the defaulting promisor, assets of sufficient value to provide compensation for the creditor's claim.

This sanction requires demarcation of the assets subject to seizure. For an individual, the common rule today is that all assets owned by the individual are subject to seizure by his unpaid creditors. Thus, when an individual enters into a contract, by operation of law he implicitly pledges all of his assets as security for his performance of that contract. A similar rule of law applies to business corporations: All assets owned by the corporation are implicitly pledged as security for the corporation's contractual commitments.

These rules of law make both individuals and corporations instances of what we will term "contracting entities." In our terms, a contracting entity consists of (1) an agent or agents with authority to enter into contracts and (2) a designated pool of assets that bond those contracts, in the sense that they can be seized by unsatisfied promisees. A contracting entity differs from a security interest, such as that created by a mortgage or even by the more complex forms of commercial liens that can be created under the modern law of secured transactions, in that the agent has continuing authority to enter into new contracts that will be bonded by the pool of assets. Consequently, the group of creditors that have claims on a contracting entity's pool of bonding assets "floats," expanding as new contracts are entered into and shrinking as the entity's existing contractual commitments are satisfied.[2]

There must be a rule to determine how the entity's bonding assets will be shared among its creditors if those assets prove insufficient to cover all claims.

[2] Even security interests created under Article 9 of the American Uniform Commercial Code, which offers the most flexible form of secured contracting outside of entity law, cannot float with respect to creditors, and thus cannot be used as a substitute for the contracting entities provided for by the law of legal entities. See Hansmann & Kraakman, supra note 1, at [ ].

The usual rule today is that, absent special pledges of security, all creditors will share pro rata in the entity's assets (rather than, say, giving priority to claims that arise earlier in time). One effect of this rule is that the value of any given creditor's claim on the pool is subject to constant change as the set of other creditors with whom the claim on the pool must be shared expands and contracts.

Typical contracting entities, such as individuals and corporations, have a constantly changing pool of assets. New assets enter the pool as they are purchased by an individual or corporation; likewise, old assets leave the pool as they are sold. Thus a contracting entity, in effect, bonds its contracts with a lien that floats over a constantly changing pool of assets. Taken as a whole, then, a contracting entity creates what we might term a "double floating lien" – a lien that applies to a floating pool of assets, and that provides security to a floating pool of creditors.

Security interests created under the modern law of commercial contracting – such as Article 9 of the U.S. Uniform Commercial Code -- can be used to create a lien that covers a floating pool of assets. As we have already noted, however, such security interests cannot be made to apply to a floating pool of creditors, and thus cannot be used to create a contracting entity. Rather, creation of contracting entities requires distinct rules of organizational law.

A. Asset Partitioning in Organizations

All contemporary standard legal forms for enterprise organization – including business corporations, partnerships, limited liability companies, nonprofit corporations, and trusts -- are contracting entities. The central concern of this essay is with the construction of these various types of entities. This requires, in turn, that we examine closely the ways in which the pools of bonding assets associated with different contracting entities are separated – or "partitioned" – from each other. More particularly, we are concerned with the ways in which claims against one entity's assets can spill over onto the assets associated with another entity.

Often, the partitioning is complete; there is no spillover. This is generally the case with individuals today: One individual's assets are not subject to the claims of another's creditors. Partitioning is also complete between separate firms that have no cross-ownership. But the partitioning between the assets of different contracting entities can also be partial, in the sense that creditors with a claim on one entity's assets may also have a claim of some form on the pool of assets associated with a different entity. In particular, there is generally only incomplete partitioning between the assets of a business firm and the personal assets of the firm's owners. To explore this partitioning, it helps to distinguish between *affirmative* asset partitioning and *defensive* asset partitioning.

1. Affirmative Asset Partitioning

Affirmative asset partitioning involves the shielding of the firm's assets from the claims of the personal creditors of the firm's owners. The adjective "affirmative" serves to emphasize that the effect of this shielding is to pledge the firm's assets as security for commitments made in the name of the firm. Contemporary organizations exhibit three distinct forms of affirmative asset partitioning (henceforth "AAP"), which we will label *weak form, semi-strong form*, and *strong form.*

- ***Weak form AAP*** provides simply that firm creditors have a prior claim on firm assets over the personal creditors of the firm's owners. This is the rule that has long characterized general partnerships. If a partner goes bankrupt, his personal creditors can proceed against the partner's share of the partnership assets, but his claim on those assets will be subordinated to the claims of the partnership's own creditors.

- ***Semi-strong form AAP*** adds to weak form AAP a rule of *liquidation protection.*[3] It not only subordinates the claims of the owners' personal creditors to the firm's assets, but also prevents the personal creditors from forcing liquidation of the firm's assets to satisfy their claims. The contemporary business corporation is the most familiar example. The law reserves to corporate creditors the right to levy directly on corporate assets. A shareholder's personal creditors have only the power to seize the shareholder's shares. They have no more power than any other shareholder to force liquidation of the firm in whole or in part – which means that, if they acquire less than a majority of the firm's shares, they are powerless to force liquidation on their own.

- ***Strong form AAP*** provides that the personal creditors of a firm's owners have no claim at all on firm assets. This form of AAP is not found in business firms, but rather is typical of nonprofit corporations and charitable trusts. In the latter organizations, the two basic elements of ownership – the right to control the firm and the right to the firm's residual earnings -- are separated, with control in the hands of managers who have no right to earnings, but who are instead charged to manage the firm for the benefit of a separate class of beneficiaries.[4] The personal creditors of neither the

[3] Hansmann & Kraakman at 403-04. As a matter of strict logic, these forms of AAP could exist separately, i.e., an entity could have liquidation protection without a rule of priority for entity creditors. Under such a regime, which the owners' personal creditors would not be able to force a liquidation of the entity, but they would share equally in the entity assets with the entity creditors if liquidation were ordered by the entity creditors or owners. As a practical matter, however, there would be no obvious advantage in creating firms of this type, and we do not observe them. Consequently, we can limit our attention to a strong form of AAP that always implies weak-form AAP as well.

[4] See Henry Hansmann, The Role of Nonprofit Enterprise, 89 YALE LAW JOURNAL 835 (1980).

managers nor the beneficiaries of the firm have any claim on the organization's assets, which only bond contractual commitments made in the name of the organization itself.

All contemporary standard legal forms for enterprise organization – including the various types of partnerships, of corporations, and of trusts – provide for one or the other of these forms of AAP as the default rule. As a result, an organization created under any of these forms is a separate contracting entity, distinct from its owners, with its own separate pool of bonding assets.

2. Defensive Asset Partitioning

Defensive asset partitioning involves the shielding of the personal assets of a firm's owners from the creditors of the firm. Like affirmative asset partitioning, defensive asset partitioning ("DAP") comes in different forms.

- ***Weak form DAP*** provides that firm creditors can levy on the personal assets of the firm's owners if they cannot be satisfied out of the assets of the business, but their claims on the owners' personal assets will subordinated to the claims of the owners' personal creditors, who must be paid off first if there are insufficient assets to satisfy both business and personal creditors. Weak form DAP is the rule that characterized partnerships in both the U.S. and England for several centuries prior to 1978, and that continues to characterize English partnerships today

- ***Strong form DAP*** provides that firm creditors have no claim at all on the personal assets of the firm's owners. A familiar example of strong form DAP is the rule of limited shareholder liability that characterizes contemporary business corporations.

While, in the U.S., all of the standard legal forms for enterprise organization provide for some degree of AAP, the same is not true of DAP. For example, since 1978, general partnerships in the U.S. have no DAP: partnership creditors who cannot be satisfied out of partnership assets can proceed against the personal assets of the firm's partners, and their claims are given a priority equal to the claims of the partners' personal creditors.

There are partial forms of DAP other than the weak form we have described here. One is the rule that unpaid business creditors can levy against the personal assets of the firm's owners, but only up to a specific limit, such as a multiple of the amount that the owner in question originally invested in the firm. Conspicuous historical examples are the rules of double or triple shareholder liability that were applied to many federally-chartered and state-chartered banks in the U.S. in the late nineteenth and early twentieth centuries.[5] While this rule

[5] [Macey & Miller; etc.]

might be thought of as lying somewhere between weak form and strong form DAP, it is not symmetrical to semi-strong form AAP, and we will therefore not give it that (or any other) label.

When a firm lacks DAP, there must be some rule for the apportioning of the firm's debts among the owners of the firm. One common rule, typically applicable to general partnerships, is *joint and several* liability. Under that rule, each owner is potentially liable for the all of the firm's debts if his fellow owners are unable to pay their share. The other common rule is *pro rata* liability, under which each owner is liable only for his pro rata share of a firm's unpaid debts, the ratio being generally determined by the owner's share in firm profits. Pro rata unlimited liability is the form that was commonly applied to the shareholders of joint stock companies in England in the U.S. in the 18th and early 19th centuries.[6]

3. Symmetry Between DAP and AAP

As our terminology suggests, there is close symmetry between both the strong and weak forms of AAP and DAP. As between any two contracting entities A and B, to say that A has strong form AAP with respect to B is to say that A has strong form DAP with respect to B. Thus, we could describe the relationship between the assets of two unrelated individuals (or business corporations) by saying either that they each have strong form AAP with respect to the other, or by saying that they each have strong form DAP with respect to each other. Likewise, to say that A has weak form AAP with respect to B is to say that A has weak form DAP with respect to B. We could therefore describe the pre-1978 U.S. partnership by saying that the partnership had weak form AAP with respect to the partners, and the partners had weak form AAP with respect to the firm. We could describe the post-1978 partnership by saying that the partnership has weak form AAP with respect to the partners and the partners have no AAP with respect to the firm. And we could describe the business corporation by saying that the firm has semi-strong form AAP with respect to its

[6] In Hansmann & Kraakman, supra note 1 at [ ], pro rata liability is classified as a weak form of defensive asset partitioning. We now believe that is misleading. While an owner's potential exposure under pro rata liability is generally less than under joint and several liability, imposition of pro rata rather than joint and several liability on a firm does not in itself constitute defensive asset partitioning. To see this, imagine a partnership that (as was historically common) has neither AAP nor DAP, and where the personal liability of owners for partnership debts is joint and several. The absence of asset partitioning means that the exposure of a partner's assets to either firm creditors or personal creditors does not depend on whether the firm's assets are held in the name of the firm or are held in the names of the individual partners – e.g., jointly owned as tenancy in common. That is, distributing firm assets pro rata to the partners would not affect the rights of either partnership creditors or the personal creditors of the individual partners. Now suppose that the rules were changed to make the partners' personal liability for partnership debts pro rata rather than joint and several. The claims of personal and firm creditors still would not be affected by whether assets were held in the name of the firm or simply held in joint ownership by the firm's partners.

shareholders, while its shareholders have strong form AAP with respect to the firm.

4. Firms Without Asset Partitioning

At least in the case of business firms, however, it is convenient to have separate terms for the shielding of a firm's assets from its owners' creditors (AAP) and the shielding of the owners' assets from the firm's creditors (DAP). This is particularly true here, where we are primarily concerned with the former.

To appreciate the role of asset partitioning in economic organization, it is helpful to have clearly in mind what a firm would look like in the absence of either AAP or DAP. This is easy, because throughout most of history partnerships lacked both of these attributes. Assets used in the business could be jointly wned by the partners, but nothing more than co-ownership was involved. If a partner were to default on a contract he had entered into personally, his share of the jointly owned business assets would be available to his creditors just as would his solely-owned personal assets.

The converse would also be true of creditors of the business. The partners or their agents might have authority to enter into contracts that would be binding on all the partners. But the effect would simply be that those contracts would bind all f the partners personally, on the same terms as any contract they might enter into as individuals. If there were default on such a contract, the creditor would have a claim on each partner's share of the jointly held assets used in the business, and also on the partners' individual assets, on the same terms as would any of the partners' personal creditors.

In short, there would be no distinction between firm creditors and personal creditors, or between firm assets and personal assets.

B. Why We Focus on AAP

Although we examine here the historical role and evolution of both DAP and AAP, our primary focus is AAP. This is partly because AAP has received far less attention in the existing literature.[7] Our emphasis on AAP, though, goes beyond simple gap-filling. We believe that AAP is a more important legal innovation than DAP, and thus deserves central place in studying the history of organizations and the historical role of law in creating organizations. There are several reasons for this.

1. The Economic Benefits of AAP Exceed Those of DAP

DAP, and particularly limited liability, offer important economic benefits in organizing commercial firms – benefits that have been relatively well rehearsed

[7] [Repeat citations from Chapter 1 regarding DAP; include also Mahoney as an exception.]

in the literature.[8] The much less familiar benefits of AAP, however, appear of greater importance. Those benefits take two principal forms: reducing creditor monitoring costs, and protecting going-concern value.[9]

a. Reducing Creditor Information Costs

An important advantage of asset partitioning -- both affirmative and defensive -- is that it can economize on creditors' information costs. As between the commercial creditors of a business firm and the personal creditors of the firm's owners, the business creditors are likely to be in the best position to monitor the assets of the business, while the personal creditors are likely to be in the best position to monitor the owners' personal assets. Thus, by drawing a distinction between business assets and personal assets, and giving a first priority claim in those separate pools to, respectively, business and personal creditors, it is possible to reduce creditors' monitoring costs overall, and thereby lower the joint cost of capital to the firm and its owners.

The economies that can potentially be realized in this way are most conspicuous when the owners of a firm are simultaneously owners of other firms. Thus, consider the situation – reasonably common from the 15th through the 18th centuries – in which a merchant is simultaneously a partner in several different partnerships, each of which does business of a different type or in a different location and has different partners. Absent asset partitioning – and, prior to the late 17th century, partnership law did not offer asset partitioning -- the failure of any one of the partnerships would threaten the security available to the creditors of all the others, since the creditors of the failed partnership would become personal creditors of the partner, and thus could levy on his share of the assets of any other firm in which he was a partner, and have equal priority in those assets with the latter firm's own creditors. Consequently, to assess the value of the security offered by any given firm, a creditor would need to be well informed about all the other business affairs of every partner in the firm. And this task would be all the more complex if the identity and number of those partners were subject to constant change, as it would be if shares in the firm were tradable.

If, however, the partnership in question were endowed with weak form AAP, a potential creditor of that firm could, simply by examining the firm's balance sheet, discover the value of a distinct pool of assets that he could look to for security (namely, the assets of the firm), and the size of the other claims with which he must share that security. Moreover, since those assets are the assets

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[8] See. e.g., Halpern, Trebilcock & Turnbull, *An Economic Analysis of Limited Liability in Corporation Law*, 30 U. TORONTO L.J. 117, 148-49 (1980); Easterbrook & Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89 (1985); Easterbrook & Fischel, The Economic Structure of Corporate Law, ch. 2 (1991); Woodward, *Limited Liability in the Theory of the Firm*, 141 J. INSTITUTIONAL & THEORETICAL ECON. 601 (1985); Ribstein, *Limited Liability and Theories of the Corporation*, 50 Md. L. Rev. 80 (1991); Hansmann & Kraakman, *supra* note 1, at [ ].
[9] See, for an earlier treatment, Hansmann & Kraakman, *supra* note 1, at [ ].

used in the business with which the creditor is dealing, he would presumably be in a particularly good position to make an independent judgment of the value of those assets, and of the other claims on them (since those claims would likewise be confined to the creditors of that particular business).

In short, AAP promotes specialization, permitting creditors to limit the risks they face to those originating in businesses in which they have special knowledge, while avoiding risks they neither understand nor can easily identify, including in particular risks associated with all of the other industries in which the firm's owners hold equity stakes, and risks arising from each owner's management of his personal affairs.[10]

While this specialization can be useful in closely-held firms, it is critical in firms with publicly tradable ownership shares. With only weak form AAP or no AAP, the creditworthiness of the firm would be dependent on the creditworthiness of its individual owners, and hence would be constantly changing – in degrees largely unobservable to the firm's creditors and co-owners -- as shares were traded. This is an important reason, presumably, why firms with tradable shares are nearly always organized with semi-strong form AAP.

In contrast, DAP – including, in particular, strong form DAP, or limited liability – is much less important for tradability of shares. It has, to be sure, been prominently argued that limited liability is important for publicly traded business corporations as a means of making the value of the firm's shares independent of the personal finances of its shareholders, and thus permitting them to trade at a single price.[11] The focus of this argument has been on the value of the shares to the shareholder herself, the logic being that, with unlimited joint and several liability, a firm's shares would be much less valuable to a rich shareholder than to a shareholder of modest wealth. A similar argument might focus on the firm's creditors: With unlimited liability, the security available to firm creditors would depend on the personal wealth of its shareholders; consequently, the cost of capital to the firm, and thus the value of the firm's shares, would fluctuate as its shares were traded.

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[10] On the same principle, a firm and its owners can often reduce the monitoring costs of creditors still more if the firm's assets (already protected from personal creditors) can be subpartitioned again, and pledged to subsets of business creditors with specialized lending expertise in particular lines of business. Suppose, for example, that a firm owns both oil wells and hotels, although hotel suppliers know little about oil, and oil lenders know nothing about hotels. In this case, there are two separate networks of creditors, each of which is likely to offer favorable terms only to the business that it knows. It follows that the firm can reduce its overall cost of capital by partitioning its business assets into separate oil and hotel asset pools, for example by forming separate hotel and oil subsidiaries to hold its two pools of specialized assets. This is arguably the most important reason for a business corporation to create wholly-owned subsidiary corporations. See Hansmann & Kraakman, supra note 1, at 399-401.
[11] [Easterbrook & Fischel.]

As has been argued elsewhere, however, the force of these arguments largely disappears when shareholder liability for the firm's debts is not joint and several, but pro rata.[12] When personal shareholder liability is pro rata, the burden of that liability to an individual shareholder does not depend strongly on the shareholder's wealth. Likewise, with pro rata liability, the added security that unlimited liability gives to firm creditors depends only modestly on the distribution of shareholdings. Moreover, so long as the firm has semi-strong form AAP, the firm's creditors are more likely to look to the firm's own assets for security than to the less easily assessed (and accessed) assets of the firm's shareholders. It is therefore not surprising that unlimited pro rata shareholder liability for the debts of companies with tradable – and publicly traded – shares has, in the past, been relatively common.[13]

b. Protecting Going-Concern Value

If an individual co-owner of a firm were free to withdraw his share of the firm's net assets from the firm at will, thus forcing a partial liquidation of the firm, the firm could be inefficiently constrained to keep its liquidity high and its investment in firm-specific assets correspondingly low. For this reason, it is common for the individual co-owners to commit themselves not to withdraw their investments from the firm until the owners as a group decide to liquidate. This is the nature of the investment contracts in a standard business corporation, for example.

If this commitment were simply contractual, however, it would not bind the personal (and other business) creditors of the firm's owners, who would remain free to seek liquidation of the owner's share of the firm's assets to pay off their claim. This is essentially the case with the contemporary general partnership, for example. To avoid this problem, the law today permits the formation of organizations, such as business corporations, with semi-strong form AAP – which is to say, with liquidation protection against the owners' creditors.

2. AAP Is Universal; DAP Is Not

Strong form DAP – full limited liability -- has a similar effect in the other direction, protecting the going concern value of an individual's household from claims by creditors of the firm. Much of this going concern value, however, principally benefits the holders of the "equity" interest in the household (i.e., the family members), and is either protected in part from creditors by exclusions such as homestead exemptions, or is nonpecuniary and takes forms (such as personal relationships among the family members) that are not subject to liquidation in

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[12] Hansmann and Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L. J. 1879-1934 (1991); David Leebron, *Limited Liability, Tort Victims, and Creditors*, 91 COLUM. L. REV. 1565 (1991).

[13] In our earlier work, we described unlimited *pro rata* shareholder liability (in contrast to unlimited joint and several liability) as a weak form of DAP. We now believe that this is a misleading description.

bankruptcy.

As we have noted, all of the standard legal forms used by modern organizations provide AAP, while the same is not true of DAP. For example, DAP was self-consciously stripped from the U.S. partnership form, at least in the all-important context of bankruptcy, in 1978.

Indeed, DAP – including, in particular, limited liability (strong form DAP) -- has been less important historically than is often suggested by the attention given it. England did not provide limited liability for business corporations in its first general corporation statute, enacted in 1844, but added that feature only in 1855.[14] Meanwhile, large numbers of joint-stock companies flourished in England during the eighteenth and early nineteenth centuries under partnership rules, and subsequently corporation rules, that imposed unlimited liability on shareholders for company debts.[15] Limited liability for corporate shareholders was also spotty in the U.S. during the first half of the nineteenth century,[16] and California retained a rule of unlimited shareholder liability until 1931.[17]

3. AAP Requires Law; DAP Does Not

A third reason for making AAP our central focus is that DAP can be achieved by contract, while AAP requires special rules of law. If a firm – such as a contemporary general partnership in the U.S. – lacks DAP, it can gain that attribute simply by inserting, in all of its contracts, a term by which the other party waives any claim on the personal assets of the firm's individual partners.[18] That was, in fact, the approach used by many English joint stock companies before English law made limited liability the rule for such firms.[19] Indeed, the feasibility of creating limited liability by contract has led some commentators to conjecture that affirmative legal enactments are not necessary for creating business entities. On this view, contractual substitutes for the corporation and other legal entities

[14] Id., at 9-23.
[15] Id.
[16] See P. Blumberg, THE LAW OF CORPORATE GROUPS: SUBSTANTIVE LAW 23-38 (1987).
[17] See Mark I. Weinstein, *California's Move to Limited Liability: 1928 – 1931*, Marshall School of Business and University of Southern California Law School (2001).

Another example is the American Express Company, a large financial services firm, which operated as a publicly-traded New York joint stock company without limited liability protection for its shareholders until 1961, when it finally chose to reincorporate as a conventional business corporation. See Peter Z. Grossman, *The Market for Shares of Companies with Unlimited Liability: The Case of American Express*, 24 J. LEGAL STUD. 63 (1995).
[18] We are speaking here of contractual liability only. Limited liability toward involuntary creditors such as tort claimants, in tort, which is today a universal attribute of business corporations, could not be achieved by contract, and must be established by law. But limited liability toward involuntary creditors has been relatively unimportant to the economics of organizations except very recently in the U.S. Moreover, there is reason to doubt the efficiency of limited liability of this type. See Henry Hansmann & Reinier Kraakman, Toward Unlimited Shareholder Liability for Corporate Torts, 100 Yale LAW JOURNAL 1879 (1991).
[19] P. Blumberg, supra note __, at 15-16.

could have developed, and as an historical matter might have developed even sooner, in the absence of legal intervention by the state.[20]

But this view overlooks the crucial fact that, unlike DAP, AAP *cannot* feasibly be achieved by contract.[21] To establish weak form AAP by contract would require that all owners of the firm obtain from each of their non-firm creditors -- past, present, and future – an agreement subordinating the creditor's claim on the owner's share of business assets to the claims of the creditors of the business. To establish semi-strong form AAP by contract would require that the owners' non-firm creditors waive, in addition, the right to seek liquidation of the assets of the firm. Because of the large number of non-firm creditors that this could involve – which would include not just persons who had extended credit for the owners' private consumption, but the owners' other business creditors as well – the transaction costs of this approach would likely be prohibitive for firms with more than several owners, and perhaps even for those.[22]

In addition, an effort to establish AAP simply by contract would encounter seemingly insuperable problems of moral hazard. The benefit of the waivers that each owner would need to obtain from his non-firm creditors would go primarily to the firm's creditors and other owners. Yet the cost of the waivers would be borne by the individual owner who extracted them, through diminished access to credit. As a consequence, the firm's owners would face a strong temptation to omit the waivers in some or all of their personal dealings. And the other owners of the firm, not to mention its creditors, would seemingly face insuperable difficulties in assuring that no individual owner ever succumb to this temptation.[23]

The law largely eliminates the transaction costs of adopting AAP by imposing that attribute on all firms that adopt one or another of the standard legal forms for enterprise organization. The result is that, when a firm adopts one of

[20] Gary M. Anderson & Robert D. Tollison, *The Myth of the Corporation as a Creation of the State,* 3 INT. REV. OF L. & ECON. 107 (1983). See also Paul Mahoney, *Contact or Concession? An Essay on the History of Corporate Law*, 34 GA. L. REV. 873 (2000);
[21] This point is explored at greater length in Hansmann & Kraakman at [ ].
[22] The transaction costs of establishing DAP by contract, in contrast, can be kept within reasonable bounds by such expedients as putting the requisite waiver provision on the firm's letterhead and in its standard form contracts.
[23] The moral hazard problem is far less serious when establishing DAP by contract. The centralization of management in most large firms makes it relatively easy to monitor firm managers to assure that they extract the necessary waivers from the firm's creditors. But the moral hazard in contracting for DAP is relatively modest even in a firm, such as a general partnership, in which all of the firm's owners are managers with full authority to commit the firm to contracts. While the cost of omitting the subordination or waiver clause in a contract with a firm creditor is potentially borne by all owners, because the non-firm assets of all owners thereby become pledged to secure the debt, at the same time the benefit of omitting the waiver is also shared by all owners in the form of lower borrowing costs for the firm. As a consequence, the disparity between personal benefit and personal cost is less than when contracting for AAP, and so is the incentive to cheat on an agreement to extract the requisite waivers.

these forms, the law, in effect, automatically inserts the necessary subordination and waiver clauses into all contracts between the owners of the firm and their non-firm creditors. The law also largely removes the moral hazard problem by making AAP *mandatory*, in the sense that individual owners of the firm are not free to waive the rule with respect to their non-firm creditors and thereby give those creditors a stronger claim, vis-à-vis firm creditors, on the owner's share of the firm's assets.[24]

Because of the symmetry between AAP and DAP, many of the benefits of AAP could in theory be obtained just by use of DAP. For example, suppose that the law were to confer weak form DAP on partnerships, but did not provide partnerships with AAP. Then, if an individual were to invest in several partnerships, the creditors of each of those partnerships would have de facto weak form AAP with respect to the creditors of each of the partner's other partnerships.

4. DAP Cannot Substitute for AAP

But this does not mean that it is sufficient for the law to provide just for DAP and not AAP. For one thing, a partnership's creditors still would not have AAP with respect to creditors that a partner deals with in his own name, rather than through a partnership. For another, there would still remain the problem of moral hazard: creditors of any given partnership would run the risk that a partner would incur substantial liabilities through investments in firms that did not have (or had waived) DAP, hence eliminating the partnership's effective AAP.

5. DAP Requires AAP

When, in contrast, a firm itself has AAP, the firm's creditors need know only that fact; they need not concern themselves with the organization of the other businesses in which the firm's owners invest.

Finally, while AAP without DAP is not only logically sensible but can be observed in important classes of organizations (such as the contemporary U.S. partnership), the reverse is not the case. Limited liability and other forms of DAP make little economic sense in the absence of AAP, and in fact – as we will explore in detail below – limited liability has generally developed only among forms of organization for which effective affirmative partitioning has already been established.

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[24] To be sure, it may be within a firm's power to guarantee the personal debts of an individual owner. But this requires action by the firm, which generally means acquiescence by a majority of the firm's owners. The guarantee must also conform to rules intended to protect the assets available to firm creditors, such as fraudulent conveyance rules and rules against impairing the firm's net capital. And it commonly requires a degree of notice to the firm's other creditors, in the sense that the debt must be entered on the firm's books.

To see the logic behind this, imagine a legal form of business organization with limited liability but no affirmative partitioning. Such a form would grant personal creditors an exclusive claim to the personal assets of bankrupt owners and a claim on the owners' business assets of equal priority to the claims of the business creditors. Business creditors, in contrast, would have no claim on personal assets and only a shared claim on business assets. As a result, business creditors would be highly vulnerable to personal borrowing by the firm's owners: By borrowing heavily on personal account, co-owners of a firm could encumber the assets available to satisfy business creditors, and thereby reduce firm creditors' security to arbitrarily low levels.[25]

To be sure, even with AAP, a creditor of the firm is exposed to the possibility that the firm itself will engage in further borrowing and hence further encumber the assets that bond the creditor's claim. But borrowing by the firm in the presence of AAP is less threatening to firm creditors than is personal borrowing by the firm's owners in the absence of AAP. For one thing, borrowing by the firm is likely to be easier for a creditor of the firm to monitor. For another, when the firm incurs debt, the firm is obligated to obtain value in return for that debt – an obligation that the law imposes in such forms as fraudulent conveyance doctrine and capital maintenance rules. And the value so obtained will add to the security available to the firm's pre-existing creditors, in at least partial compensation for the decrease in security resulting from the firm's greater indebtedness.

C. Legal Entities and Legal Persons

We have spoken so far of "contracting entities" – a neologism of our own – rather than using the more conventional terminology of "legal persons" and "legal entities." One reason for this is that we have wanted to be able to speak separately of the economic attributes of organizations and of the role of law in establishing those attributes. As it is, however, all of the standard forms for enterprise organization that we will be concerned with here have been endowed with some degree of asset partitioning by operation of law. Consequently, we will use the term "legal entity" to encompass all contracting entities that have some form of asset partitioning conferred on them by operation of law. That partitioning nearly always includes AAP, and may or may not include DAP as well. Under this definition, natural persons are legal entities today, as are organizations that take any of the standard legal forms, such as corporations, partnerships, and trusts. We caution that this is not a conventional definition, however, and that the term "legal entity" is commonly used to encompass a

[25] This is not to say that it is never efficient to use a limited liability entity, such as a business corporation, as a convenient means of borrowing on a non-recourse basis. But borrowing with no assets pledged whatsoever to any of a firm's creditors is likely to be an uncommon need, and where it arises it can as well be met in other ways, such as by using a legal entity that has AAP but that holds no assets in the firm's name.

different – generally narrower and often more vaguely defined –set of organizations.

Because AAP is our central focus, and because AAP comes in different degrees, we further define three categories of legal entities:

- ***weak form entities,*** which provide weak-form AAP (e.g., the contemporary general partnership);

- ***semi-strong form entities***, which provide semi-strong form AAP (e.g., contemporary business corporations, cooperative corporations, business trusts, and partnerships for a term);

- ***strong form entities***, which provide strong form AAP (e.g., nonprofit corporations and charitable trusts, and also -- today -- natural persons).

Because the term “legal entity,” as we define it, comprises natural persons as well as organizations, we will us the term “organizational entity” to refer to legal entities that have the character of firms or organizations – such as partnerships, business corporations, and nonprofit corporations – in contrast to natural persons.

It is common to refer to organizational entities – or at least some types of them -- as “legal persons.” This metaphoric terminology has an obvious stimulus. As we indicated above, the law commonly treats all of the assets owned by a (natural) person as a pool of bonding assets available to that person’s creditors when the person defaults on a contract. A corporation is thus like a person in the sense that the assets held in the name of the corporation likewise bond the contracts made in the name of the corporation. It thus easy to think of the corporation as analogously “owning” its own assets, and contracting “in its own name,” the latter fiction also serving the purpose of obviating the cost of naming each of the corporation’s owners in its contracts or in suits by creditors to enforce those contracts. The convention of ownership, in short, partitions the assets pledged to one person’s creditors from those pledged to the creditors of another person, and the convention works whether the “persons” are natural or legal.

The legal person metaphor works best when the organization is, for example, a nonprofit corporation that exhibits by the type of strong form asset partitioning that characterizes a natural person’s assets. The metaphor is least apt, in contrast, for organizations like the (modern) general partnership that have weaker forms of asset partitioning. This may be one reason why there has been much debate as to whether particular types of organizations are or are not legal persons, and why in particular it is sometimes said that partnerships are not legal persons.[26]

An additional problem with the "legal person" metaphor is that it implies a unity between the assets that an organization controls and those that bond its debts. This unity occurs with natural persons, because the assets that bond a person's debts are, by a default rule of property, the assets that a person owns and thus controls. The available deviations from this scheme, without resorting to entity law, generally take the form of pledges of specified assets to specified creditors, as in the case of a mortgage on real estate. But the unity between controlled and bonding assets need not hold in the case of organizations. For example, the medieval law merchant, as we will see, sometimes partitioned merchants' assets into pools much larger than individual firms. Contemporary organizational law, in contrast, facilitates elaborate partitioning into pools smaller than individual firms. Where these more complex patterns of partitioning develop, the metaphor of the "legal person" is less useful, and can be misleading, as a characterization of the law of legal entities.

For this reason, among others, we will not make further reference to "legal persons," much less enter into the confusing and confused debate as to what they might be and what use the expression might have. Rather, we will simply refer to "legal entities," and will use that term with the simple meaning we have given to it here.

III. ECONOMIC FACTORS GOVERNING THE PROVISION OF ORGANIZATIONAL ENTITIES

Our object here is to both describe and – to the extent possible -- explain, from an economic point of view, the historical development of legal entities and of the organizations built on those legal forms. We have already surveyed the economic benefits of AAP to commercial actors. But if AAP brought only benefits, we would not expect it to be, as it is, only a relatively recent phenomenon in the organization of commercial enterprise. Consequently, we turn now to an examination of the costs of AAP. With these costs in mind, we proceed to identify practical and legal conditions, divided into "demand factors" and "supply factors," that we expect to influence the development of AAP, and whose influence will be traced in the historical survey that occupies the rest of the essay.

[26] This raises the question whether, on net, the "legal personality" metaphor has facilitated or retarded the development of organizational law. The metaphor (or "fiction") has probably facilitated the law's recognition of certain legal entities by making salient the tactic of endowing certain kinds of organization with the same contracting powers, and supporting asset partitioning, that the law gives to natural persons. But the metaphor perhaps retarded the development of organizations such as partnerships, for which the appropriate forms of affirmative asset partitioning differ from those that are given to natural persons.

A. The Costs of AAP

While previous work has demonstrated the benefits of AAP, much of our focus here will be on its costs. Both are important in understanding the development of entities with AAP over time.

1. Boundary Patrol

To be effective, AAP requires that public and private costs be incurred to demarcate and police the boundary between those assets that belong to the firm and those that belong to the firm's owners in their personal capacity. This is not a trivial task because, in a typical commercial firm, there are frequent movements of assets across that boundary that are legitimate: Via the act of investing, assets move from being property of the owners to being property of the firm; conversely, via distributions such as dividends, salaries, and other purchases of inputs, assets move from being property of the firm to being personal property of its owners. Consequently, AAP requires not just clear accounting as to which assets are firm assets and which are the owners' personal assets, but also enforceable rules as to when a movement of assets into or out of the firm is legitimate and when, on the contrary, it is in derogation of the rights of creditors. This remains an awkward problem for contemporary organizational law, which employs variety of devices – including doctrine on minimum legal capital, fraudulent conveyance, equitable subordination, and veil-piercing – to deal with it. It was evidently an even more awkward problem in the past, as we will see.[27]

2. Debtor Opportunism

To the extent that the firm/owner boundary is poorly maintained, the firm, its owners, and their creditors face the costs of potential debtor opportunism. If the distinction between assets belonging to the firm and assets belonging to the firm's owners is difficult to police – or if the discretion of the firm's owners to move assets back and force across that boundary is too difficult to constrain – then, rather than reducing the costs of monitoring for creditors, asset partitioning may increase them. This is a familiar problem with limited liability – strong form DAP -- for corporate shareholders. It can apply as well to AAP: giving firm creditors first claim on firm assets is at best meaningless, and at worst misleading, if owners are unconstrained in taking assets out of corporate solution. And AAP can be used opportunistically to abuse firm owners' personal and other business creditors, by shifting assets from personal to firm ownership,

[27] The problem is not unique to entity-based asset partitioning, but rather arises with all contracting entities, including individuals. Thus, an individual debtor on the brink of bankruptcy might improperly transfer assets to friends or family to keep them out of the hands of creditors. But most people are disinclined to destroy or give away their wealth, and thus the incentives of creditors and debtors are largely aligned where individuals are concerned, at least until default is imminent. Legal entities, on the other hand, have no intrinsic motivation to preserve the value of their assets, and the owners may face strong incentives to move assets from the entity to their personal accounts in a way that thwarts the expectations of creditors.

just as DAP can be used to abuse firm creditors by shifting assets out of the firm.

3. Minority Exploitation

The contemporary general partnership provides, as a default rule, that each partner has the right to withdraw at will from membership in the firm, and in the process demand that his share of the firm's assets be distributed to him. An important function of this withdrawal right is to protect minority partners against exploitation by owners who hold a controlling stake in the firm. The presence of this withdrawal right therefore serves as an important governance device; the threat of its use, and the potential destruction of going-concern value that it might bring, gives minority partners bargaining power in the ongoing management of the firm that they would otherwise lack. Semi-strong form AAP requires abandonment of this right, and hence of the minority protection it offers.[28] It follows, in turn, that firms with strong-form AAP are likely to face greater difficulty in inducing investors to take minority stakes in the firm than will firms with only weak-form AAP, or no AAP at all.

4. Illiquidity

The loss of withdrawal rights that accompanies semi-strong form AAP also imposes a degree of illiquidity on the owners' investments in the firm. This illiquidity can be mitigated by making ownership shares transferable; it is not surprising, therefore, that ownership shares are commonly transferable in legal entities with semi-strong form AAP.

B. Supply and Demand Factors for AAP

The fact that AAP entails costs as well as benefits suggests that we are unlikely to find rules of AAP in every historical context. Instead, we would expect AAP to arise only under conditions where AAP's benefits clearly exceed its costs. We identify some of those conditions here. We divide them into "demand factors," which tend to increase the need for rules that reduce creditor information costs and protect firm going-concern value, and "supply factors," which reduce the costs of establishing and enforcing AAP.

1. Demand Factors

The information costs and moral hazard that are mitigated by AAP increase rapidly as the number of owners in a firm increases. Consequently, the economic benefits of AAP are strongest in multi-owner firms. The need for multi-owner firms, in turn, is likely to depend importantly on the following factors:

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[28] In theory, it would be possible to have strong form AAP that simply prevented creditors of the firm's owners from levying on firm assets, while leaving the firm's owners themselves with the right to withdraw their share of firm assets at will. As a practical matter, however, such an arrangement seems likely to have little advantage over weak form AAP.

- *Capital-intensive production techniques.* The greater the amount of firm-specific capital that is required for efficient production, the greater the likelihood that the required capital must be raised from multiple individuals.

- *Risky production. A*s the riskiness of enterprise increases so does the need to substitute equity for debt, and thus owners for creditors, as sources of firm financing.

- *Socially deconcentrated wealth.* The less wealth is concentrated in the hands of single individuals, the greater the number of individuals who must be drawn upon to finance a single firm.

These demand-side factors, and particularly the first, are already familiar explanations for the rise of the business corporation following the industrial revolution. In contrast, the supply side, to which we now turn, has been much neglected.

2. Supply Factors

A variety of factors are likely to favor the availability of AAP as a practical option for commercial actors. We begin with some relatively obvious legal factors. We then turn to some less obvious, but perhaps ultimately more important, practical factors.

a. Ease of Legal Innovation

AAP, as we have argued, requires affirmative legal doctrine. More particularly, AAP seems most likely to appear where we find the following:

- *Presence of the Idea in Analogous Forms.* The likelihood that a society will adopt rules of AAP naturally increases if the society is in contact with others that have already adopted AAP. Similarly, the likelihood of adopting AAP for any given form of enterprise is likely to be increased by the presence of analogous institutions – such as elaborate forms of secured debt -- within the same society.

- *Receptive Legal Authorities:* A legal innovation requires not just the idea but also the desire to implement it. AAP seems more likely to develop, therefore, in a society whose law is particularly responsive to commercial interests.

These factors are, of course, difficult to quantify. What is of particular interest to us, however, is the absence of AAP even in societies where, by any reasonable measure, both factors seem present -- thus underlining the importance of other considerations.

b. Complementary Legal Rules

Once rules of AAP are available to commercial actors, other legal rules and innovations make AAP more practicable by reducing its associated costs. These include:

- *Multi-Creditor Bankruptcy Proceedings.* AAP requires, to be effective, that the legal system be capable of administering multi-creditor bankruptcy proceedings in which the aggregate value of all assets held by a firm can be assessed separately from the assets belonging to the firm's owners, as can the value of all creditors' claims against those assets, and jurisdiction can be obtained over all those assets and claims for as long as is required to apportion the assets among the claimants.

- *General Creditor Protection Rules.* Certain rules associated with bankruptcy law, although applicable to any debtor, are particularly useful in enforcing the asset boundary of an entity. These include the modern laws of fraudulent conveyances and voidable preferences.

- *Entity-Specific Creditor Protection Rules*. The effectiveness of AAP is increased by supplementing it with rules that specifically protect entity creditors, such as equitable subordination doctrine, veil piercing rules, and minimum capital requirements.

c. Easily Segregated Assets

AAP is not a helpful doctrine if it is not possible for the relevant actors – owners, creditors, and courts – to distinguish between assets belonging to the firm and the personal assets of the firm's owners. Several factors help make this line easier to determine.

- *Accounting*. The better the available rules of accounting, the easier it is for owners and creditors to agree on, and to monitor, the assets that properly belong to the firm, and hence back the firm's credit.

- *Physically Fixed Assets.* Even today, systems of accounting are far from perfect, and they were much less adequate in the past. Consequently, other means of distinguishing a firm's assets are also needed. The physical nature of the assets themselves can be important here. Certain types of assets are, by their nature, easier to identify and evaluate, and more difficult to distribute surreptitiously to the owners' personal ownership, than are others. If most of a firm's assets consist of a large mill, for example, there is likely to be little room for mistake or deceit in these regards. The assets of a bank or an insurance company, on the other hand, may be much more difficult to monitor. All other things equal, we might therefore expect that AAP would work more effectively with a mill than with a bank or an insurance company.

- *Physically Isolated Assets.* For similar reasons, firms whose assets are well separated physically from their owners' physical assets – as when the firm's assets are on a ship at sea – are likely to have an advantage in offering credible AAP.

- *Multiple Owners*. We have already invoked multiple owners as a demand side factor. But it can be a supply side factor too. In a firm with many owners, each individual owner has a strong interest in assuring that his fellow owners do not make improper distributions to themselves of firm assets. Consequently, distributions to owners in such firms are likely to be carefully formalized, routinized, publicized, and policed. The result is to make it easier for creditors of the firm, too, to be assured that improper withdrawals of firm assets so not take place.

d. Low Owner/Creditor Pressure on Firm Assets

The credibility of AAP to firm creditors is likely to be highest where there is least temptation for the firm's owners or personal creditors to try to withdraw those assets from the firm. We might therefore expect, particularly in weak legal and institutional environments, that AAP would be particularly likely to be employed in such situations. Factors that help give firms this character include the following:

- *Illiquid Firm Assets*. Some firms possess assets that, while of great value in the hands of the firm, would have little or no value in the hands of the firm's individual owners or their creditors. An obvious example – and one that we will see repeatedly in our historical survey – is a monopoly franchise granted to the firm by the state, and subject by its terms to exploitation only by the firm.[29] Owners of such a firm, and their personal creditors, have no incentive to seek liquidation of the firm, for they would thereby kill the goose that lays the golden eggs.

- *Physically Isolated Assets.* Where a firm's assets are physically separated from its owners and their creditors – again, as on a ship at sea – those assets will be especially free from their claims.

- *Separation Between Control Rights and Rights to Assets and*

[29] One might think of the restrictions on ownership of the franchise as themselves a form of legally-imposed liquidation protection.

> *Earnings.* Where the persons who control a firm do not benefit personally from distributions of the firm's earnings and assets, they may have little incentive to make such distributions, preferring instead to accumulate assets within the firm. The result will be to reinforce the credibility of AAP to the firm's creditors. This may be one reason why publicly traded joint stock companies were among the first commercial firms in which AAP was effectively established. It may also help explain why entities of a nonprofit character were well developed long before the advent of proprietary entities.

C. What Can History Tell Us?

Legal entities with AAP should arise, as we have said, only up to the point where demand intersects supply – that is, only where their benefits exceed their costs. As demand for these entities increases, one expects them to be more common. But, whether demand is strong or weak, one expects entities with AAP to be found where supply factors are most favorable. The historical survey that follows can be taken as a casual empirical test of this proposition. More particularly, we intend our survey to be a first effort at teasing out which supply factors are most important in determining the viability of legal entities. More generally, our survey is an effort to discover how easily the historical facts can be understood in terms of the demand and supply factors outlined here.

IV. ANCIENT ROME

The organizational law of ancient Rome presents a puzzle. From early times, Roman law provided several organizational forms with rules of AAP. All but one of these forms, however, were noncommercial, and the commercial form was restricted to a narrow industry. The puzzle, then, is why Rome, despite its evident ingenuity in developing organizational entities with AAP, never produced such an entity for general use in commerce.

A. Roman Commercial Organizations

The vast majority of Roman commercial transactions occurred among firms that lacked organizational entity status, and were thus legally indistinct from the families and individuals that owned them.

1. The *Societas*

Most scholars consider a quasi-partnership form -- the "*societas"* -- to have been Rome's only general-purpose form of business enterprise.[30] While the *societas* facilitated the joint conduct of business, it was a weaker form than

30 [Cite.]

the modern partnership in several respects. For one thing, it lacked mutual agency: Partners could not bind one another contractually; rather, each partner had to assent individually to a contract to be bound by it.[31] In addition, the liability of partners for the debts of a *societas* was pro rata rather than joint and several.[32]

Finally, and most important for our purposes, the *societas* lacked both affirmative and defensive asset partitioning. Roman law made no distinction between the obligations and assets of the *societas* and those of its partners.[33] While a *societas* might employ assets that were the mutual property of the firm's partners, those assets were simply treated like any other asset that was jointly owned with another person. The personal creditors of a bankrupt partner could liquidate these assets and levy on the partner's share of their value in satisfaction of their claims, just as they could levy on any of his other assets. Creditors of the firm did not have a prior claim on assets used by the firm, whether those assets were jointly owned or not.[34] Even if the partners in a *societas* agreed among themselves not to withdraw assets from the firm, their individual creditors would not be bound by that agreement,[35] and thus remained able to force the firm's dissolution (or to demand payment for not doing so.)[36]

2. The Family

While the Roman *societas* did not have the attributes of a an organizational entity, the Roman family *did* have those attributes. Unlike modern law, which treats individuals as a separate legal entities, Roman law considered the *family* to be the principal unit of property ownership. The family, for these purposes, was defined as a father and all of his male descendants. All of the family's property was considered the property of the oldest living male – the *pater familias* – whatever the age of his sons or grandsons. Subject to the rules of the *peculium*, discussed below, the entire family's assets bonded the contracts of each individual family member.[37] In consequence, there was effectively a regime of mutual agency with joint and several liability among relatives, giving the family a character much like that of a modern partnership.

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31 Buckland at 507, 510; Crook at 233.
32 Buckland at 507.
33 Buckland at 507.
34
35 Schulz at 550.
36 Of course, if a partner, by failing to pay his debts, were to cause a breach of the partnership agreement, his co-partners also could seek judgment against him. But Roman law appears to have not enforced such contracts through specific performance – which implies that she, like pre-existing partners, would have received only a fraction of the money damages do to them.
37 [Cite.]

In fact, most private Roman businesses were owned by single families, not *societates* composed of unrelated co-venturers.[38] The family, it seems, was Rome's real partnership form.

3. The Tax Farming Partnership

An exception to the preceding observation was the specialized Roman tax farming partnership, or *societas publicanorum.* For much of Roman history, partnerships formed by wealthy investors known as *publicani* bid for the right to collect taxes on behalf of the state. A region's future tax revenues were worth large sums, which may explain why the *societates publicanorum* were the only private Roman enterprises known to have had large numbers of investors, and the only enterprises subject to an industry-specific organizational law.[39] Under this law, tax partnerships followed a majority decision-making rule instead of the rule of unanimity that bound the *societas*.[40] In addition, the *societas publicanorum,* unlike the *societas*, did not automatically dissolve upon a partner's death or renunciation,[41] but instead continued to operate under its initial agreement, which remained enforceable against all partners.[42] Thus, the firm could not be dissolved before the end of its term, which was typically for five years – the standard duration of a tax farming franchise.[43]

The inability of the partners of a *societas publicanorum* to force liquidation suggests that these firms enjoyed true affirmative asset partitioning. Since no bankruptcy record for a s*ocietas publicanorum* appears to survive, there is no evidence directly on point. It is logically possible that the creditors of individual partners might have been able to do what partners could not, i.e., force the liquidation of the firm. But according the creditors of bankrupt partners the power to force the dissolution of these large firms would have been perverse if, as we surmise, the reason that the partners themselves were denied this power was to prevent premature dissolution and withdrawal of capital. Thus, we think it likely that tax farming partnerships enjoyed, like the modern corporation, semi-strong form AAP.[44]

4. Businesses Run by Slaves and Sons: The *Peculium*

38 [Cite. Crook at 229?]
39 Crook at 234.
40 Duff at 161.
41 Unless the death was of the particular partner who held the contract with the State. Duff at 160.
42 Cf. Crook at 234 and Buckland at 510.
43 Crook at 234, Buckland at 234.
44 A likely implication of liquidation protection for the *societates publicanorum* is that creditors of these firms enjoyed priority of claim to its assets. As will be discussed later, the rule of priority of claim for creditors of the modern corporation arose in this manner. Although rules of priority follow naturally upon liquidation protection, the result is not inevitable, and one could imagine a regime wherein non-entity creditors are unable to force liquidation, but may levy claims equal in priority to the claims of entity creditors when those creditors or the owners force the firm to dissolve.

Under Roman law, slaves, like sons of a living *pater familias*, could not own property in their own right. A *pater familias* could, however, entrust to his slave (or son) assets that the latter could use to start an independent business with its own set of creditors. The master continued to own the assets, which were termed the *peculium,* since a slave could neither own property nor, for that matter, be named a party to a lawsuit.[45] If a slave defaulted on business debts arising from his use of the *peculium,* Roman law allowed his creditors to bring suit against the master,[46] but limited the master's aggregate liability to the business's creditors to the value of the *peculium.* [47]

A business financed with a *peculium* constituted an organizational entity in our terms, since it involved a distinct pool of assets as well as a manager authorized to pledge these assets to a particular set of creditors. The assets were partitioned from the master's other assets by (strong form) DAP: The rule limiting creditor claims to the amount of the *peculium* established limited liability for the master. A business financed with a *peculium* evidently did not, however, exhibit AAP. If a *pater familias* defaulted on his debts, his personal creditors could force him into bankruptcy. In the bankruptcy proceeding, all of his assets would be auctioned off, and the proceeds distributed pro rata among his creditors. In this process, there was evidently no distinction made for assets entrusted to slaves and sons in the form of *peculia*. *Peculium* creditors would have no prior claim on the returns from liquidating the *peculium* assets. Rather, those assets would be treated as part of the common pool. The only distinction between *peculium* creditors and the bankrupt's other creditors was that the former were limited, in their claim against the aggregate assets of the bankrupt, to the amount of the *peculium.*[48]

Some commentators have argued that the device of the *peculium* could have been used by wealthy Romans to establish multiple firms with limited liability, much in the same way that the corporate form is used today.[49] In our view, this comparison is overstated because a *pater familias* could not retain the protection of limited liability if he managed a business financed with a *peculium* in

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45 John Crook, LAW AND LIFE OF ROME 110, 187-89 (1967). A paterfamilias also could give a peculium to a son or daughter, although this was far less frequent, and the rules were the same in any case. Id.
46 Crook at 187-89.
47 Crook at 188-89.
48 The secondary literature on Roman law, while making much of the limited liability created by the device of the *peculium,* does not address the question of AAP in activities financed with a *peculium*. We infer the absence of AAP, in part, from the treatment accorded businesses financed with a special form of the *peculium*, the *peculium castrense*, which was a *peculium* given to a son who had achieved distinction in the Roman army. Creditors of businesses financed with a *peculium castrense* were explicitly granted priority of claim in the *peculium* over the other creditors of the *pater familias* – that is, the *peculium castrense* created AAP. This explicit recognition of priority in the *peculium castrense* suggests strongly that the background rule for *peculium* creditors in general was that they had no such priority. See Solazzi at []. We are indebted to Bruce Frier for extensive help in researching this issue.
49 See, e.g., Robert W. Hillman, Limited Liability in Historical Perspective, 54 WASH. & LEE L. REV. 615, 617-18 (1997); Alan Watson, ROMAN SLAVE LAW 107-08 (1987).

the way that a controlling shareholder might participate in the management of a corporation. The slave's master was liable in full, rather than to the amount of the *peculium*, if he ordered a transaction involving the slave, or even if he selected the particular business in which the slave engaged.[50] Thus, a better comparison is between the *peculium* and the classic limited partnership form that prevailed throughout the U.S. as recently as twenty-five years ago, in which limited partners became lost their limited liability if they participated in control of the firm. In this comparison, oddly, the slave is the "general partner" and the master is the limited partner.

Moreover, businesses financed with a peculium differed from both today's corporations and today's limited partnerships in lacking AAP. We observed in Section II that generally one would not expect to find an organizational form that provides DAP but not AAP. And, in fact, the Roman device of the peculium offers one of the rare examples of such a form. What did it lack AAP? We comment on the general lack of AAP in Roman commercial forms below. But two additional factors were perhaps important in the particular case of the peculium. First, the value of AAP to a peculium creditor may have been relatively modest, because the likelihood that the family of the pater familias would become insolvent was presumably much smaller than the likelihood of insolvency for the particular peculium business with which the creditor dealt. Indeed, a *peculium* creditor could probably often find security for repayment, not just in the master's initial investment of the peculium, but also in the support of a large, rich, diversified, and politically connected family with a reputational interest in the survival of the businesses if its sons and slaves. Second, there may have been concern that granting AAP to peculium creditors would have created excessive opportunities for a pater familias to shield assets from his creditors, if insolvency were to become a risk for him, by granting peculia to his sons and slaves.

B. Why did Roman Commerce Lack General-Purpose Commercial Entities with AAP?

In general, Rome seems to support the theory that AAP plays an important role in addressing the problems of widely-held firms. Rome lacked a general-purpose commercial entity with AAP and, as theory would predict, it also had relatively few commercial firms with numerous investors. Instead, Roman firms seem to have been organized largely as family enterprises, as *societates* with just a few members, or as slave-managed firms financed with a *peculium*.[51]

This observation in itself does not clarify, however, the extent to which the general absence of AAP was due to supply factors as opposed to demand factors. We assemble here some evidence on this score.

1. The Supply Side.

50 Henry John Roby, ROMAN PRIVATE LAW IN THE TIMES OF CICERO AND OF THE ANTONINES 54-56, 238-48 (1902).
51 Crook at 229, Toutain at 301, Frank at 222.

[On the supply side, an initial issue is whether Rome had the legal ingenuity or doctrinal sophistication to take the innovative leap of developing organizational entities with AAP. Arguably some jurisdictions might find that organizational entities equipped with AAP break too sharply with prior legal traditions that viewed asset boundaries only in terms of human owners, individually or as families. Such an explanation for Rome appears foreclosed, however, by its law of noncommercial organizations, which produced several entity forms with AAP.]

a. Noncommercial Organizational Entities: Townships and Nonprofit Associations

Beginning in the fourth century BC, the Roman *municipium* (township) enjoyed "the practical power to own property—land, houses, slaves, and other things of all kinds."[52] The senates that governed the townships appointed agents to represent town interests in commercial transactions and legal disputes.[53] Neither townsfolk nor their creditors could levy claims against municipal assets, and thus neither group could force liquidation.[54] The only parties who could lay claim to township assets, evidently, were creditors who transacted directly with township agents. Thus, a township enjoyed strong form AAP. It also exhibited strong form DAP, since municipal assets were the sole source of satisfaction for a municipality's creditors.

After its initial emergence in this "municipal corporation" form, AAP found its next application in the *collegium* form, which included a wide variety of fraternal associations -- perhaps the most common of which were groups of tradesmen who assembled for some combination of social, religious, and professional purposes.[55] Some *collegia* solicited contributions from their members and wealthy benefactors, and used their endowments for the construction of public goods such as shrines and cemeteries, or to conduct services such as banquets, religious rituals, and burials.[56] Important for our purposes is the fact that a donor to a *collegium* could not unilaterally reclaim his gift.[57] The *collegia* thus became *de facto* owners of separate organizational assets, much like the townships had become earlier. They were also like the townships in that they enjoyed full liquidation protection against both their

52 Duff at 70. See also Berger at 590.
53 Duff at 70, 76.
54 Duff at 64 [check cite]. See also Schulz at 92.
55 Duff at 102.
56 Duff at 102.
57 Duff at 130-34. It was true that upon dissolution a college's assets were distributed to its members, some of whom could have been donors. Duff at 127. But there is no evidence that what one put in corresponded to what one got out: Dissolution was simply an act of splitting up the college property when the members lost interest in holding more meetings. Schulz at 100.

members and their members' creditors, and thus strong form AAP.[58] In short, they resembled the modern nonprofit corporation.

Indeed, by the third century AD Roman jurists had extrapolated from the laws of the *municipia* and *collegia* to the general concept of the "legal person."[59] This concept is, as we have remarked, a useful foundation for AAP in both commercial and noncommercial entities because the convention that an abstract entity "owns" property makes salient the distinction between organizational and personal assets upon which AAP relies. Moreover, as we have seen, Rome may in fact have developed AAP in a commercial setting to serve the special needs of the *societas publicanorum.* This suggests that a general-purpose commercial entity with AAP would have involved a relatively modest conceptual step for the Romans.

b. The Broader Legal Environment

The development of noncommercial organizational entities might not have spilled over to the development of commercial entities if the Roman state were hostile to private commerce. And, beginning in the third century A.D., that seems to have been the case.[60] But before the end of the second century, Rome's consuls and emperors intervened little in the economy.[61] On the contrary, during that period Rome created a sophisticated system of creditor rights that would have provided support to commercial entities. It had a law of fraudulent conveyances,[62] which could be used to protect the prior or exclusive claims of entity creditors by reversing illegitimate transfers of assets across the entity

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58 The last form of organization to acquire rules of AAP in Roman times was the charitable foundation. The advantages of strong form asset partitioning were long clear to Roman benefactors who, starting in the first century AD, could make charitable gifts, encumbered with rules regarding their disposition, to the municipia. Duff at 168-69. When the formerly underground Christian colleges gained state recognition in the fourth century AD, the Church became the most popular custodian of charitable gifts. Id. at 171-73. As the Church grew over the next two centuries, it spawned a variety of organizations that it directly or indirectly controlled, such as monasteries and charitable "houses." Id. at 173-76. Finally, in the Eastern Empire in the sixth century AD, a new form of charitable foundation arose that, so long as the custodian obeyed the will of the benefactor, operated as a distinct entity free from Church interference. Id. at 184. The form was frequently used to establish almshouses, hospitals, and orphanages. Id. at 188. These foundations were similar to modern charitable trusts, and their "trustees" exercised wide powers, including contracting, litigating, and alienating property. Id. at 192. The record suggests that the rules of asset partitioning for the charitable foundations were the same as for the collegia, their predecessors on the roster of Roman legal entities – that is, they had strong form AAP as well as strong form DAP.

59 Duff at 71.

60 The fate of the collegia is instructive. In the third century AD, the Roman state effectively nationalized the professional colleges as a way to control labor and guarantee the flow of goods to the emperor and his armies. Louis at 259-61. To enforce production quotas, the state made continued participation in the same industry mandatory upon each college member, as well as his sons. Louis at 263. In this way, the professional colleges became the instrument of a system of serfdom that contributed to Rome's decline.

61 Rostovtzeff at 145.

62 [Cite.]

boundary. And, by the second century B.C., Rome had developed, for individuals (which is to say families), multi-creditor bankruptcy proceedings in which a bankrupt's assets would be auctioned and the aggregate proceeds distributed *pro rata* to all creditors who presented a valid claim.[63]

c. Boundary Patrol

That Rome had a reasonably sophisticated law of creditors' rights does not, however, necessarily imply that it could easily have policed the boundary between the assets of a commercial firm and the assets of the firm's owners with the effectiveness necessarily to make AAP workable for such firms. In the particular types of organizations for which Rome developed AAP – the family, the municipality, the nonprofit association, and the tax farming partnership – that problem of boundary patrol would probably have been much easier than it would have been in commercial firms.

As we argue in Section III, the asset boundaries of organizational entities tend to be more porous than those that surround a family, as those who own a commercial entity can easily alienate its assets but keep ultimate control of those assets by, for example, distributing the assets to themselves. Thus, all other things equal, creditors of a family need generally be less concerned that the family will alienate its bonding assets than do creditors of a commercial firm.

Likewise, the existence of noncommercial entities such as municipalities and nonprofit organizations does not prove that AAP would work in commerce, as most distributions of assets or earnings by noncommercial organizations to controlling persons are *per se* illegitimate, and so the asset boundaries of such entities experience less pressure than do those of organizational entities that are dedicated to profit and thus may legitimately issue assets to controlling persons in the form of dividends.

Finally, the boundary patrol problems with tax farming partnerships would have been much simpler than those in other forms of commercial enterprise. The tax farms each owned a single, large, wasting pecuniary asset: the right to collect a given set of taxes. Their operations consisted of liquidating this asset and distributing the proceeds, after which they themselves were liquidated. Presumably these partnerships had few suppliers and little need for credit. Thus, it is unlikely that AAP would have served an important role in demarcating a set of bonding assets for firm creditors. If AAP was important, it was probably to prevent the personal creditors of the firm's partners from seeking liquidation of the firm, and hence destroying going concern value for the other partners. But the firm's most important asset – its monopoly franchise from the state – was evidently a personal grant to the firm, and could not be exploited by anyone else. (In fact, the franchise was apparently a personal grant to the firm's lead partner.64) Hence, it would probably have made little sense for the personal

63 Louis Edward Levinthal, The Early History of Bankruptcy Law, U. PA. L. REV. 235-37 (1917-18). See also Brunstad at 513-14.
64 [Cite]

creditors of a partner to seek to foreclose on the firm. Their better option, presumably, would have been simply to appropriate the partner's share in the stream of revenue coming from the partnership. Thus, the partners' personal creditors would have placed little pressure on the firm's asset boundaries.

That Roman law extended AAP to these various types of organizations but not beyond them suggests, then, that the practical difficulties of boundary patrol were a significant factor in the development of commercial entities. This conclusion gains further plausibility from the fact that the Roman pattern continues for the next 1500 years: Prior to the 18^{th} century, one finds in general few types of entities endowed with AAP other than families, nonprofit organizations, and commercial firms holding monopoly franchises from the state.

d. Summing Up

While it appears that supply side factors – especially boundary patrol – were important in determining where Rome developed AAP, it also seems clear that Rome could have supported a rule of AAP for organizational entities in commerce if the payoff for doing so had been large enough. The idea was present in analogous forms in noncommercial entities, legal authorities would have been amenable to it at least until the late second century AD, and bankruptcy law could enforce the type of asset boundary upon which commercial AAP relies. The general lack of organizational entities of a commercial character, therefore, evidently also reflects relatively weak demand.AAP in Roman commerce thus does not appear to lie on the supply side entirely, or even primarily.

2. The Demand Side

Several factors suggest that demand for commercial organizational entities would have been weak in Rome. To begin, Roman law made the family an organizational entity suitable for commercial activities. The family was a relatively large organization that spanned multiple generations and had potentially unlimited life, and that had an ongoing stake in its reputation; consequently it was well adapted to undertake businesses that required continuity of commitment. The family was given added flexibility in commercial affairs, moreover, through the ability to partition its assets into subentities through the device of the *peculium*. It follows that for commercial activity that could conveniently be conducted by a single family, there may have been little pressure to acquire a general-purpose commercial entity with AAP.

One reason why a single family might not have been able to carry on an activity is that this activity was too capital intensive. But for most branches of Roman commercial life, capital constraints do not seem to have been an important drag on economic activity. Most Roman enterprise was small in scale. The bulk of industrial production -- such as ceramic lamps, ironware, lead pipes, jewelry, furniture, and clothing – occurred in small workshops or in the homes of craftsmen.[65] In addition, although some industries were capital intensive, there were also fabulously wealthy Roman families engaged in these enterprises. This allowed even the capital-intensive metalworking and brick-making industries to organize as a series of sole proprietorships and close partnerships, with workshops located on the estates of landowners who had made fortunes in agriculture and then diversified.[66]

And as for the large-scale, capital-intensive public works, the state (or the emperor) provided the capital: state slaves to build the aquaducts and temples, legions to build the roads, and land to yield the state-owned mines.[67] In this regard, note that the state itself had the attributes of a strong form organizational entity,[68] and as such was an effective device for pooling capital from many individuals and directing it toward an asset-intensive commercial project.

The exception that proves the rule – and also makes our point – is the *societas publicanorum*, which required funds too large to be comfortably supplied by any one family, and which could not be state financed since their whole reason for existence was to raise immediate capital funds *for* the state. It is no surprise, then, that this appears to be the only Roman organizational entity of a commercial character.[69] Even here, the intensity of demand may not have been

65 Frank, generally at 219-274. While some firms, especially in the glassblowing and ceramic tableware industries, operated in relatively large urban factories, they seem to have derived their scale economies from labor specialization rather than asset aggregation. Frank at 222, 226. Moreover, Rome's law of secured transactions with floating liens would have displaced demand for weak-form AAP in some small firms. Although such a secured loan is an imperfect substitute for entity-based AAP, as its lien "floats" only with respect to assets, it may have been adequate for small firms who needed only one large creditor for seed capital, and whose other transactions occurred mainly with local players and thus could be secured through reputation effects.

66 Toutain at 301, Crook at 229, Frank at 222.

67 Louis at 78, 202, 274.

68 The entity-like nature of the state has not eluded Roman legal scholars, who have noted that the populus, a term referring to the collective people of Rome, was like other Roman "legal persons" in the sense that from early times it could enter contracts and hold property[0].

69 We acknowledge that the presence of the state in this pattern is somewhat question-begging, as one potential explanation for state involvement in other large-scale public works actitivities is that a lack of certain supply-side factors precluded formation of the large, multi-owner firms that would have been required to handle privately such capital-intensive projects as temples and roads. Particularly interesting in this regard is evidence that in early Roman times the societates publicanorum served as general state contractors entrusted with tasks that included the construction of certain public works and the collection of revenues from state mines. Love at 174-78. That the state controlled these activities for at least the majority of Roman history, with the societates publicanorum restricted to tax farming, Crook at 234, might suggest that this partnership form proved too weak to support most asset-intensive public projects. Although such an explanation for the Roman pattern is possible, we find it unlikely. First, the record indicates that, far from being weak, the *societates publicanorum* proved to be so effective as organizations that they threatened the hegemony of the Empire, which responded by pushing them almost entirely out of the Roman tax collection system by the second century AD. Id. Second, state involvement in activities such as road construction persists to this day[0] for the independent reason that roads are a public good and thus may suffer under-investment if left entirely to the private sector. Thus, other political and economic factors, rather than an inability of Roman law

great, however. There was an alternative to the formation of these private firms – namely, for the state to collect the taxes itself, as most modern states do. This would have required only that the state create the necessary bureaucracy, and that it be patient about receiving its revenues. This suggests, in turn, that the supply side factors discussed above, which were seemingly favorable to granting AAP to the *societatus publicanorum*, played an important role.

One might also argue that the Roman nonprofit associations –the *collegia* – accord with a demand-side explanation for the rise of AAP, as well as with the supply-side explanation we examined above. The members of these large organizations, presumably drawn from many different families, would presumably have found personal liability to be an extremely awkward means of bonding the organizations' credit, and a means attended as well with high managerial agency costs. Thus, the strong form AAP that characterized these organizations would have been extremely attractive.

3. The Balance

It is awkward to judge the relative importance of supply and demand factors in explaining the pattern of organizational entities exhibited by ancient Rome.[70] We can only say that this pattern suggests strongly that both types of factors were important – an inference that is supported by the experience of later ages.

V. THE MIDDLE AGES

After five centuries of stagnation, the European economy grew modestly but more or less continuously between the 10th and the 16th centuries.[71] This growth, in turn, generated cumulative innovation in the legal forms of enterprise during the Middle Ages. In most respects, the forms of commercial organization available during the Middle Ages resembled those that had been available in Ancient Rome. As in Rome, productive capital belonged to families, and the family "partnership" was the conventional unit of production throughout the economy. Moreover, as in Rome, there was no general purpose commercial entity equipped with AAP. Except in limited circumstances, the law failed to make a systematic distinction between personal and business creditors. As in the preceding Section, then, our two controlling questions in this Section are: why was there no general purpose business entity equipped with AAP, and how do

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to support commercial AAP, seem the likely explanation for the state's participation in the Roman economy.

[70] The problem is all the more awkward because we cannot say whether the Roman solicitude for well established, wealthy families of a character suitable for engaging in commerce on their own account was cause or consequence of the lack of workable entities for jointly owned commercial activities.

71 Lopez (1976) at 27-34, 59.

we explain the emergence of special-purpose commercial entities and non-profits that did possess AAP in certain sectors of the economy and the broader society?

A. Forms of Enterprise During the Middle Ages

As in the case of Roman organizational law, legal forms of enterprise during the Middle Ages into fall into three categories: (1) general partnerships, (2) limited liability vehicles that – like the Roman *peculium* – bear a passing resemblance to the modern limited partnership, and (3) "non-profit" enterprises such as monasteries and the state enterprises.

1. European Partnership Law: 1000-1500 A.D.

The general partnership – usually a small firm, co-owned by relatives and with a fixed term of from one to five years[72] -- was the standard form for jointly-owned commercial firms throughout the medieval period, just as it had been in ancient Rome. The common term for these partnerships was "*compagnia,"* or "companies".[73] At the outset of the medieval period, there appears to have been only one important legal difference between the *compagnia* and the Roman *societas*. Where the s*ocietas* imposed pro rata liability on partners for business debts, medieval law applied the Germanic rule of holding partners jointly and severally liable for business debts (just as family members had long been jointly and severally liable for family debts, in Rome as in medieval Europe).[74]

As southern Europe prospered, c*ompagnia* began to recruit unrelated partners to increase capital and establish branches in foreign cities. By the last half of the 13th century, large *compagnia* had as many as twenty (mostly unrelated[75]) partners, and several hundred employees.[76] Typically the largest of these *compangnia* originated as traders of grain or textiles in central Italy,[77] and grew principally by establishing new branches in foreign cities.[78] Once these partnerships established a network of international branches, moreover, they

72 Favier at 157.
73 Lopez and Raymond at 185. The term derived from a Venetian legal institution called the *fraterna compagnia* that governed relations among heirs to an undivided estate. This suggests that the ties to Roman partnership law had been completely severed during the Dark Ages, with the new partnership rules evolving out of local estate law, just as the original *societas* had descended from the Roman law of consortium. In some European jurisdictions partnerships were still terms sociatates, as they had been in ancient Rome, even though they did not follow Roman law. Mitchell at 129.
74 Lopez (1976) at 74.
75 For example, in 1312 only 9 of the 17 partners of the large Peruzzi compagnia were blood members of the Peruzzi family. De Roover (2: 1963) at 77.
76 De Roover (1: 1963) at 75; Hunt and Murray at 62, 105-9.
77 Hunt and Murray at 102-4.
78 De Roover (1: 1963) at 70-89; Hunt and Murray at 102-5.

were well placed to trade in international currencies as well,[79] and so they soon became Europe's dominant international bankers as well.[80]

Large *compagnie* were also vulnerable to legal risk, however. Because they traded over long distances, they successfully sought authority for individual partners to bind their firms without obtaining the consent of their co-partners, at first by contract (through so-called "procuration" agreements), and later by encouraging courts to interpolate a default rule of mutual agency into the partnership law.[81] But mutual agency, in turn, allowed single partners to squander the assets of their firms *and* all of their co-partners on imprudent ventures.[82] In addition, larger *compagnie* also faced large risks that personal creditors might seek to claim the ownership stakes of insolvent partners by forcing the liquidation of entire partnerships.[83] This problem was so serious, in fact, that many *compagnie* barred their partners contractually from joining other partnerships.[84] How much protection such prohibitions could confer is questionable, however, since they did not reach either the personal creditors of insolvent partners or the third-party creditors of other firms in which partners invested in violation of their contractual undertaking not to.[85]

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79 Previously, merchants who were paid overseas in foreign currency had only two options: one, they could transport the coin home themselves, and thereby bear the opportunity cost of idle capital plus the risks of shipwreck, piracy, and exchange rate fluctuation; or two, they could use the foreign currency to buy goods for import, and thereby face market risk back home. To such merchants the great compagnia offered a third option: the cambium maritimum, or exchange contract. De Roover (1:1963)at 55. A merchant could purchase this instrument with foreign currency at the compagnia's overseas branch, and later redeem it for domestic currency at the compagnia office back at his homeport. Because of the slow speed of transport during the Middle Ages (three months between Venice and London), De Roover (2:1963) at 112, the exchange contract was also a short-term loan, complete with an interest payment hidden in the exchange rate to evade Church usury laws. Lopez (1976) at 104.

80 Lopez (1976) at 103-4. Through the fifteenth century currency exchange comprised most of the business of banking, so that the Italian expressions "to run a bank" and "to deal in exchange" were synonymous. De Roover (2: 1963) at 108. However, certain compagnia also accepted regular demand deposits that paid fixed rates of interest. See De Roover (1: 1963) at 66.

81 Mitchell at 132-133; De Roover (1948) at 32.

82 Some jurisdictions tried unsuccessfully to solve this problem by legislative fiat. After the large Bonsignore *compagnia* went bankrupt in 1298, Siena switching to a rule of *pro rata* partner liability for partnership debts. But this new regime merely shifted the risk of partner insolvency to the partnership creditors, and the resulting rise in borrowing costs caused many *compagnie* to relocate. Sienna shortly restored the old rule, which stopped the exodus of partnerships but left the problems created by joint and several liability unsolved**.** Lopez and Raymond at 291.

83 Although the partners in large *compagnie* typically waived their right to withdraw their assets, it is doubtful that their waivers would have been binding on their personal creditors – absent an agreement to this effect. Lopez and Raymond at 204.

84 Favier at 164.

85 In particular, if a partner were to break a promise to his co-partners by joining a second *compagnia*, those partners would have been able to obtain a damages award against the dishonest partner, but would have no ability to directly block the partner's creditors whose claims arose from the partner's activities in the second *compagnia*, especially if those creditors had been ignorant at the time of lending of the partner's promise not to assume dual membership.

Ultimately, the large single-firm *compagnie* of the Middle Ages collapsed under the weight of its own legal risk. Partnership failure rates increased steadily during the first half of the 14th century, and culminated mid-century, when the three largest existent partnerships – the Accioiuoli, the Bardi, and the Peruzzi – all failed within thirty months of each other between 1343 and 1346.[86] The next year saw the beginning of the Black Plague, which decimated Europe's population and economy,[87] and eliminated the few large *compagnia* that remained.

Approximately fifty years later, new *compagnia* remerged, but without the relatively simply structure of the single large partnership. Instead, these new enterprises bundled networks of small partnerships in order to minimize legal risk. The best-known example is the Medici Bank, which operated between 1397 and 1497. Like its forebears, this "bank" was a diversified concern that dealt not only in currency exchange, but also in manufacturing and commodities trading.[88] But instead of organizing as a single partnership, the Medici Bank structured itself as a series of interconnected *compagnie* extending outward from the Medici family like the spokes of a wheel. Each banking branch or textile workshop was a separate partnership, in which the Florentine Medici took a majority stake and the local managers signed on as junior partners.[89] This structure protected junior partners the liabilities of the Medici's other branches, and also insulated from the partnership as a whole from the collection efforts of the personal creditors of individual partners. Even with these improvements, however, the Medici family -- as the contractual hub of the enterprise – remained liable on all of the debts of its affiliated *compagnie*. It sought to ameliorate its risks with certain limited-partnership-like investment contracts, as we discuss below. Nevertheless, its vulnerability to cross-partnership bankruptcy ultimately caused all of the various branches of the Medici Bank to fail in close succession between 1494 and 1497.[90]

As the preceding discussion indicates, then, the partners of a medieval *compagnie* enjoyed neither defensive nor affirmative asset partitioning, at least insofar as liquidation protection was concerned. Proceeding as personal creditor, a business partner of an insolvent partnership could force liquidation of a solvent partnership when the two shared a common (insolvent) partner. Through at least the fourteenth century, courts adjudicating the bankruptcies of

86 Hunt and Murray at 113, 119; Lopez (1976) at 75; De Roover (1948) at 32.
87 Hunt and Murray at 120.
88 Specifically, the Medici Bank traded heavily in staple products such as wool, spices, and citrus fruit, as well as luxury articles such as silk and jewelry. While its textile plants and export businesses were concentrated in northern Italy, its merchant banking business had branches in Geneva, Avignon, Bruges, and London. See generally De Roover (1963: 2) at 142-168.
89 De Roover (2: 1963) at 81-2.
90 De Roover (1963:2) at 260. The firm had persisted in various forms for a hundred years, and thus was a success as compared to the wobbly *compagnie* that came before. However, its collapse coincided with a significant depletion of the wealth of the Medici family, reinforcing the need in subsequent centuries for partnership rules that could support large-scale commercial firms that did not rely upon a single family's capital as their primary source of financing.

compagnia appear not have made any distinction between assets of partnerships and those of their partners.[91] Matters might have begun to change slightly in the latter half of the 15th century, when the partners of *compagnia* clearly conceived of each partnership as a separate entity.[92] But even here, the record is ambiguous as to whether most legal authorities shared this businessman's conception of the firm as an asset pool distinct from the personal assets of partners or the business assets of the other partnerships in which they were participants.[93]

2. Limited Liability Forms During the Middle Ages

As in Rome, the fact that the general partnership form was the workhorse of commerce did exclude the existence of limited liability vehicles in certain sectors of the medieval economy. But as with the Roman *peculium* (and the modern limited partnership), only passive investors could aspire to the protections of limited liability.

The earliest medieval limited liability form was the *commenda*, which arose during the 10th and 11th centuries to finance the trade of entrepreneurial sea captains. The terms of the *commenda* form closely tracked those of an even older debt instrument, the "sea loan," which coexisted with the *commenda* until it

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91 [Check source in Grembi memo 14 to see if Sienna was an exception in this regard.]
92 For example, the partnership agreement establishing the Venetian branch names three contracting parties: the branch manager, the assistant manager, and "the company of the Medici, Benci, and Salutati," which itself was a partnership of the familial inner circle that ran the Medici Bank from Florence. De Roover (1963: 2) at 82.
93 Two contrasting cases illustrate this point. In the 1455 case of *Ruffini* v. *Agnoli Tani & Co. of Bruges*, which was brought against the Medici's Bruges branch, a merchant complained that wool bales bought from the Medici's London branch had been packed defectively. The Medici family was a full member of both partnerships. Nevertheless, the Bruges court dismissed the case without prejudice to allow a suit against the Medici branch in London. De Roover (1963: 2) at 325-28. Under a regime of joint and several liability, sending the plaintiff back to London should have been unnecessary, since the plaintiff would have been able to seek satisfaction against the Medicis wherever he could find their assets. But the court's opinion seems to recognize the London and Bruges partnerships as separate legal entities, and thus not responsible for each other's debts. Id. at 84. The result is consistent with AAP, as it reserved the assets of the Bruges partnership for claims of its own creditors. By contrast, in *Carnago v. Lorenzo Tournabuoni & Co* (1495), a Neapolitan court allowed a creditor to sue the Medici Bank's Naples branch on a debt incurred by the Roman partnership, even though the Neapolitan partnership was not a party to the disputed transaction and was nearly insolvent itself. This result was inconsistent with AAP, as it denied the creditors of the Naples branch a prior claim to its assets. One potential explanation for the departure from the *Ruffini* result is that the Roman partnership owned 95% of the Neapolitan partnership, making it exceptionally difficult to accord the latter a distinct legal identity. Id. at 140, 260-261. Another potential explanation is that *Ruffini* actually was not based on a theory of asset partitioning at all, but on procedural or jurisdictional turning on matters such as the availability of evidence and witnesses, that might arguably make London the better forum for adjudicating a claim that arose there. Thus, the cases together seem to establish that, even if a rule of AAP had begun to emerge in the fifteenth century, its application was too inconsistent to form a reliable basis for structuring lending relationships.

was condemned by the church as usurious in the mid-13th century.[94] The most common form of *commenda*, like the typical sea loan contract, was a financing contract for a single mercantile expedition, between a passive investor who provided capital for trade, and a ship captain who contributed labor and initiative.[95] If the expedition turned a profit, the ship captain paid the passive investor the amount of the original investment plus three-fourths any surplus, keeping the last quarter for himself.[96] If the expedition proved unprofitable, however, the passive investor bore the full loss, and generally had no right of action against the ship captain to recover his capital.[97] (The terms of the sea loan were identical insofar as this loan was secured by the contents of the ship but, in the event of a loss, the lender had no recourse against the personal assets of the ship's captain.[98])

Previous scholars have attributed the importance of the *commenda* to the fact that the ship captain transacted in his own name during the course of the voyage, which presumably meant that debts he incurred during the expedition could not have threatened the passive investor's personal (i.e., non-voyage) assets.[99] From this, scholars have concluded that the *commenda* represented an innovation because it provided limited liability for the passive investor.[100] Protection for the passive investor's personal assets is indeed suggested by the structure of the *commenda,* although, interestingly, primary historical sources do not mention it.[101] However, even if the *commenda* did provide limited liability as a formal matter for the passive investor, it would not have been innovative in this

[94] Lopez (1976) at 76. The influence of religion – and, in particular, proscriptions against usury – on structuring finance terms should not be underestimated. The *commenda* form itself appears to have arrived in Italy along trade routes from the Islamic Middle East, where a virtually identical contract —the *mudaraba*— had been in use since the 7th century AD. Cizacka at 5. Islamic law, of course, proscribed all debt financing.

95 De Roover (1: 1963) at 49-50; Henry J. Berman, Law and Revolution 352 (1983). Although under some commenda the passive investor selected the port of destination and goods for exchange, more often these matters were left entirely to the ship captain's discretion. Lopez and Raymond at 176.

96 Lopez (1976) at 76-7; de Roover (1: 1963) at 49-50. In one common variant, the ship captain provided a third of the capital in addition to the labor, and thereby increased his claim on the profits to one-half. Some modern scholars call this a "bilateral commenda," to distinguish it from the "unilateral commenda," in which the ship captain contributed his labor only. Cizakca at 22. The medieval merchants, of course, had their own nomenclature. The Genoese called the "bilateral" arrangement a societas, a confusing name both because the contract resembled much more the traditional commenda than the Roman version of a societas, and because merchants in Pisa used the term societas maris to refer to the "unilateral" commenda. The Venetians made no distinction: to them it was a collegantia either way. Lopez and Raymond at 176-180.

97 Pryor at 7. The passive investor could sue the ship captain if losses resulted from misappropriation or fraud. Id. at 9.

98 Lopez (1976) at 76.

99 Pryor at 21; Mitchell at 127.

100 See, e.g., Lopez and Raymond at 174-75; Berman at 353; Paul G. Mahoney, Preparing the Corporate Lawyer: Contract or Concession? An Essay on the History of Corporate Law, 34 Ga. L. Rev. 873, 880 (2000).

101 John H. Pryor, The Origins of the Commenda Contract, 52 Speculum 9 (1997).

regard, as the passive investor would have enjoyed the same degree of protection under the sea loan by virtue of his status as a creditor.[102] Moreover, the nature of the arrangement suggests that the ship captain generally would not have incurred debt against which the passive investor's personal assets required protection. The business of the venture was conducted in a foreign port, where the ship captain sought to exchange goods he had brought from his homeport for valuables with which to return. He would have had little reason to acquire long-term obligations while overseas, even if, in a time of fragmented political authority, he could have found traders willing to let a visiting foreigner sail with their goods in exchange only for a promise of future payment.[103]

Two other similarities between the *commenda* and the sea loan probably were more important as a practical matter than any formal protection that these contracts might have provided the passive investor's personal assets. First, the *commenda* retained the contractual feature of the sea loan wherein the passive investor waived his right to assert a claim against the ship captain's assets if the venture lost money. Second, the *commenda* appears to have protected the capital contributed by the passive investor from the ship captain's *personal* creditors, who would have been of greater concern to the passive investor than any potential "firm" creditors. The fact that the *commenda* distributed profit and loss between its parties based on their respective capital contributions apparently led medieval merchant courts to conceive of it as a partnership arrangement rather than a loan.[104] This partnership status, in turn, gave the passive investor in the commenda a de facto claim in firm assets up to the full value of his claim, much as if he were a secured creditor or a creditor of an entity with AAP.[105] In

102 Perhaps for this reason, some historians have argued that the commenda, like the sea loan, is best characterized as creating a creditor-debtor relationship. See, e.g., Luzzatto at 119.

103 [Insert citation supporting idea that obtaining and enforcing judgments against foreigners was difficult in medieval times.]

104 Evidence supporting this conclusion are the facts that the passive investor appears to have retained title to his invested capital throughout the venture, Postan at 80-82, that creditors with whom the ship captain had dealt in matters directly relating to the voyage, such as seamen, were paid before the passive investor, Pryor at 7, and that the passive investor had the legal right to recall the ship captain at any time and demand a return of this capital, Gies an Gies at 53. The passive investor's right to liquidate at will would have been constrained practically, and probably was useful only to prevent fraudulent conversions by the ship captain before the venture sailed. Consistent with the view of commenda as partnership, scholars commonly refer to the passive investor and ship captain as the "passive partner" and "active partner," respectively. See, e.g., De Roover (1963: 1) at 49-50.

105 In a partnership, each partner holds title only to the fraction of the partnership assets assigned to him in the partnership agreement, which for the ship captain under a *commenda* would have been only one-fourth of any increase in the value of the invested capital. A default rule of property is that a creditor may seize only those assets that his debtor owns, and thus under a conception of the *commenda* as a partnership the ship captain's personal creditors would not have been able to reach beyond the ship captain's quarter share of the profits to satisfy their claims, even if they were owed more. The result would have been a *de facto* prior claim for the passive investor

these two important ways, the *commenda* preserved the sea loan's division of risk between the parties.

In addition to retaining the essential qualities of the sea loan, the partnership-like *commenda* arguably had advantages over the fixed-return sea loan as well. Its variable payoff might have better aligned the incentives of passive investor and ship captain by giving them similar risk profiles. Moreover, structuring the venture as a partnership rather than a secured loan allowed a ship captain to collect capital for a single voyage from multiple passive investors, each of whose shares would have been protected from the personal creditors of the ship captain as if the expedition were an entity with AAP.[106]

It should also be noted that while the principal application of the *commenda* was in long-distance maritime trade, it also found use in overland expeditions, most often to commercial fairs that organized regularly in Europe during the medieval period.[107] These fairs, such as those that flourished in Champagne more or less continuously during the twelfth and thirteenth centuries,[108] attracted merchants from throughout the continent, who brought their own goods and, often, the goods of other merchants lent through a *commenda*.[109] Much like a maritime expedition in an overseas port, a merchant at a fair was an attractive debtor, as the distance from his home reduced the chances that one of his personal (i.e., non-fair) creditors would seek to levy against his assets at the fair. Courts at fairs apparently reinforced this practical barrier through a legal rule that forbade non-fair creditors from levying against

106 Such interests in a fraction of a trading expedition's capital, which in many places were called *carati* after the Genoese convention of dividing an expedition into 24 parts or "carats," were transferable by succession and, after the thirteenth century, by sale. This last innovation made sea-borne trade attractive even to investors of moderate means, who could diversify their risks by holding *carati* in multiple voyages at once. Lopez and Raymond at 175; Cizakca at 27. Some evidence suggests that a holder of a carat could sell his interest only if the other investors agreed. Id. See also De Roover (1963: 1) at 71

107 Lopez and Raymond at 188-89.

108 Six of these Champagne fairs had particular commercial significance: the two fairs of Provins, the two of Troyes, one at Bar-sur-Aube, and one at Lagny-sur-Marne. Each fair was held at a different time of year. Sanborn at 157.

109 Because medieval Europe lacked a public system of courts with effective international jurisdiction, trade at the fairs was governed by the law merchant, an international body of customary law that developed during this period. Each fair had its own court, which remained in session for the fair's duration. Merchants entered contracts and incurred short-term debts while trading at the fair, and any resulting disputes were brought before the court of the fair and decided in a matter of days. The effective jurisdiction of such courts did not reach beyond a fair's boundaries, and so a court could not hear a complaint against a merchant who had left. The court did, however, have the power to bar a merchant from future fairs, and by this could enforce its judgments. Beginning in the twelfth century, courts adopted the rule that all of a merchant's assets within the fair boundaries were available to pay that merchant's creditors at the fair, generally on a *pro rata* basis.

assets within a fair's boundaries. Thus, fair creditors enjoyed priority of claim as a matter of law to a merchant's fair assets for the fair's duration.[110]

Finally, the end of the medieval period saw efforts to introduce a kind of general limited partnership form through a modified debt contract. Perhaps the best-known example is the *societá en accomandita*, first authorized by Florence in 1408—presumably at the behest of the Medici.[111] Under this contract, an investor lent a merchant a sum of money to be returned, along with a fraction of the income it generated, after a specified period.[112] Its only significant difference from the *commenda* was that its term was specified as a number of months or years rather than as a single voyage. Its primary advantage was that it capped losses for the passive investor at his investment amount,[113] and so a cross-partnership contagion in the Medici Bank could not have originated in a partnership in which the Medici took only an *accomandita* interest. Drawbacks of the arrangement, however, restricted its use. Participation by the passive investor in the management of a firm made him a partner rather than a creditor in the eyes of the law, and thus liable on a joint and several basis for firm debts.[114] Full liability also attached if the firm used the name of the *accomandita* investor in a business transaction,[115] denying partnerships under the *accomandita* the superior terms of borrowing that came with public affiliation with the Medici.[116] Perhaps for these reasons, the Medici appear to have used the *accomondita* only as a probationary arrangement for managers of new branches, and switched to a *compagnia* once a manager proved his worth.[117]

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110 Interestingly, the law merchant also adopted a rule that made merchants who came to a fair from the same geographic region jointly and severally liable for the debts that each incurred at the fair. As indicated in the discussion of the Roman rule of familial responsibility, imposing joint and several liability on a group is the same as treating that group as a single legal entity. And, in the case of a group of merchants at a medieval fair, the entity provided affirmative asset partitioning, as creditors at the fair who contracted with the group enjoyed a claim to the group's assets that was prior to claims of the member's personal creditors. Indeed, the AAP was semi-strong form during the firm's duration, as non-fair creditors were unable for that period to levy against the assets of the group. Reflecting the entity-like nature of their relationship, merchants from the same region frequently formed an association to provide group governance.

111 De Roover (1: 1963) at 75. Before 1408, Italian authorities discouraged fixed-term commenda contracts in order to protect creditors, although there is evidence of société en commandite, the French version of the fixed-term commenda, operating on an unsanctioned basis in Southern France in the fourteenth century.
112 De Roover (1963: 2) at 89.
113 De Roover (1963: 2) at 89.
114 De Roover (1963: 2) at 325.
115 De Roover (1963: 2) at 284.
116 De Roover (1963: 2) at 325.
117 For example, when the Medici opened a branch in Avignon in 1446, they took the limited liability position in an accomandita with Giovanni di Benedettto Zampini, who had started as a Geneva office salaried employee and was sent to run the new branch. De Roover (1963: 2) at 63. Although Zampini contributed only one-eighth of the capital and received only one-eighth of the profits, he was personally liable to the extent of his wealth for all partnership debts. After Zampini proved his acumen by returning to the Medici an annual average return of 24% in his first

3. Legal Forms of Medieval Non-Profit and State Enterprises.

During the medieval period, as in Roman times, a significant fraction of economic production occurred outside of private, secular organizations. We focus here on two such loci of medieval commerce: the various Christian bodies, and the state-supported firms as exemplified by the Genoese public monopolies of the fifteenth century.

Without question, the most significant non-profit enterprises during the middle ages were related to the Church. After the fall of Rome, Christian bodies adopted the Germanic convention by which all community members consented to contracts on a collective basis and were namable as a group in summonses for collection of debts.[118] As for property rights, twelfth century jurists would have been aware of the maxims of Justinian's Digest, written in the sixth century AD, that "what is of the corporation is not of individuals," and "if something is owed to a corporation it is not owed to individuals; nor do individuals owe what the corporation owes."[119] But the Church nonetheless rejected the Roman corporate rule by which an organization could own property in its own name. Instead, the medieval Church maintained the Germanic convention whereby a group's assets were the common property of its members.[120] In this way, the medieval property law of Christian organizations was the same as that for families, which, as in Roman times, were liable on a joint and several basis for obligations of members, and held all assets in common.[121]

The scale and scope of economic activity in medieval Christian organizations were substantial. Thousands of monasteries operated across Europe, many of which had numerous members and held substantial property, including large building complexes and extensive landholdings. The commercial activities of monasteries were as varied as those of private merchants, and included agriculture, borrowing and lending, craft production, trade in wool and wine, iron mining and smelting, and banking -- which in the period consisted primarily of currency exchange.[122] Monasteries appear to have been medieval

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two years, the Medici changed the partnership to a regular compagnia, and increased their investment. Id. at 311-2. Presumably, the Medici believed that the advantages arising from Zampini's ability to use their seal and from the greater security for Zampini outweighed the costs of joining him in unlimited liability for partnership debts.

118 Calisse at 529. In addition, the distinction rendered clear by the Justinian Code between a body and its members again blurred, so that the law often treated the property of dioceses or charitable foundations as belonging to a particular priest or monk, or even a patron saint when attribution to a living person was impractical. Brissaud at 891; Calisse at 530.

119 Berman at 216.

120 Berman at 219.

121 U. Santarelli, "Per la storia del fallimento nelle legislazioni italiane dell'età intermedia." Cedam, Padova, 1964, 169-71.

122 [Based on summary provided by Jennifer Ottman in her memo 1.]

Europe's longest-term non-state debtors. For example, many monasteries in need of cash sold long-term "corodies" that offered their purchasers a form of life annuity, with payments to be made by the monastery in kind, in the form of food and lodging. No commercial firm at the time – or, for that matter, until the late nineteenth century -- would have had sufficient credibility to attract such long-term debt.[123]

In addition to monasteries, moreover, other substantial Church-affiliated organizations arose during the middle ages as well, including cathedrals, schools, hospitals, and the great medieval universities such as those at Bologna, Paris, Oxford, and Cambridge. The apparently stable nature of medieval Christian organizations, as compared to contemporary secular organizations engaged in the same economic activity, appears to have been derived from factors that supported affirmative asset partitioning. These organizations operated under a nondistribution constraint that, as indicated above, prohibited controlling persons from distributing assets to themselves except in the form of salaries. And even this form of distribution was not allowed for the monks in the monasteries, who took vows of poverty and were prohibited under Church law from owning property individually.[124] Thus, a court would never have had to determine whether an asset had legitimately changed from the property of the organization to that of one of its members; such transfers were always illegitimate. Finally, vows of chastity by monks and nuns would have eliminated the possibility of claims against Church bodies by legitimate heirs of members, and reduced the temptation to appropriate assets on behalf of offspring.

Besides its advances in the law of private and religious organizations, the Middle Ages also saw significant developments in public finance. The city state of Genoa may be the best example. Beginning in the thirteenth century, various Italian city-states raised funds by selling negotiable bonds that could be divided into tradable shares. Genoa, however, appears to have been the only city of the period to fund state-backed enterprises by adopting the private sector's innovation of raising capital through the issuance of multiple *commenda* contracts, or *carati*. With their tradable investment claims that had qualities of both debt and equity, Genoa's *carati* monopolies were medieval Europe's precursors to the joint stock companies of the seventeenth century.

In 1346, Genoa decided to seek public funding for its planned invasion of two Aegean islands.[125] Instead of following the standard course of issuing debt, Genoa decided to issue *carati* that paid variable returns based on the revenues generated by the exploitation of the conquered lands. The venture proved a success both militarily and commercially,[126] emboldening Genoa to widen its use

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[123] Despite this, or possibly because of it, it was not uncommon for monasteries to become heavily indebted, and insolvency was not rare.
124 [Jeniffer Ottman asserts this in a memo; we need documentary support.]
125 Mitchell at 138.
126 Indeed the Genoese company profitably exploited its colonies until they were seized by the Turks in the sixteenth century. See Mitchell at 138.

of *carati* as a device for funding public firms. In each new venture, Genoa coupled permission to issue *carati* with a grant of other privileges, including monopoly. For example, in 1407 Genoa authorized the creation of a *carati* bank, and empowered it to manage the state debt and later to exploit commercially various state colonies.[127] A *carati* tax farm partnership received control of the state's lucrative salt mines, while other *carati* partnerships gained monopoly rights over alum sales and the importation of coral and mercury.[128]

Unlike the single-expedition ventures that first used *commenda*-like contracts, the Genoese *carati* monopolies operated for a specified term. That much of these firms' assets remained fixed in one place would have made it possible for holders of *carati*, as contrasted with the passive investor in a standard maritime *commenda,* to exert a degree of control over firm operations, and thus become more like modern corporate shareholders than mere creditors. Whether the typical holder of a *carat* was actually allowed any such control is not clear, however, and the available evidence is circumstantial. Potentially relevant to this question is the belief by many historians that the holder of a *carat* enjoyed limited liability against firm debts.[129] Limited liability is consistent with the fact that *carati* were tradable,[130] as under limited liability (and also under *pro rata* liability), as contrasted with joint and several liability, owners do not bear the risk of each other's insolvency, and thus are less likely to wish to restrict who may acquire an ownership share. On the other hand, limited liability might also suggest that the holders of *carati* were merely creditors with a variable return, like the passive investor in an *accomandita*, and thus unable to exercise direct control. .

The strong public component of the *carati* monopolies also would have strongly affected the degree to which they exhibited AAP. The historical record does not appear to contain an instance of a *carati* monopoly bankruptcy, suggesting that they were too important for the government to let fail. The public importance of the firms also suggests that courts would not have allowed creditors of a bankrupt private owner to levy upon the monopoly license, thereby providing liquidation protection for the firm's most important asset. More broadly, the transferability of *carati* shares made them useful as a source of satisfaction for personal creditors, reducing the need to allow direct levying against firm assets. Finally, the fact that Genoa allowed *carati* holders to invest in private partnerships[131] supports a conclusion that these monopolies enjoyed liquidation protection and thus strong-form AAP, as it suggests that personal debts incurred by *carati* holders posed no threat to the monopolies' assets.

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127 Mitchell at 139.
128 Cizakca at 29-30.
129 See, e.g., Cizakca at 29-31.
130 Cizakca at 31.
131 Cizacka at 31.

B. Why did Medieval Commerce Lack General-Purpose Commercial Entities with AAP?

The pattern of organizational law in the Middle Ages is similar to that of the Roman era in the sense that, while several organizational entity forms with rules of AAP existed -- including the Christian bodies, the multi-merchant asset pools at trading fairs, and, probably, the state-backed *carati* monopolies -- none was a general-purpose commercial entity comparable in flexibility to the modern general partnership or business corporation. We might expect, then, that the balance of supply and demand considerations bearing on the development of a general purpose commercial entity with AAP was roughly the same during the high Middle Ages as it was during the Roman Empire – reflecting a roughly similar level of economic development.

This is not to say, however, that that Medieval Europe and Rome had identical legal forms of enterprise. There were important differences too. In particular, the Middle Ages provides more numerous examples of organizations with assets collected from multiple individuals or families, which, as we have indicated, are the organizations where rules of AAP are most advantageous. Yet, while some of these organizations -- Church organizations, groups of merchants at fairs, and probably *carati* monopolies -- did enjoy legal rules of AAP, others -- the multi-investor maritime trading expeditions and the large *compagnia* -- did not. This pattern presents the question whether private, for-profit organizations in the Middle Ages, despite their multiple owners, would not have benefited from rules of AAP.

1. The Demand Side in the Middle Ages.

With regard to the medieval maritime expeditions that operated under sea loans, *commenda,* and *carati,* demand for AAP may have muted because these ventures enjoyed effective substitutes. Although the passive investor had the legal right, at least in the *commenda,* to recall the ship captain at any time, this would have had little practical use once the voyage had sailed, due to the practical barrier of the sea and the legal consequences of Europe's diffuse political structure. Similarly, the personal creditors of the ship captain would have encountered significant difficulty in levying on the venture's assets while the expedition was away from homeport. Thus, for much of its duration, a maritime expedition enjoyed *de facto* liquidation protection against creditors of all those who might be considered its "owners," i.e., the ship captain and, arguably under the *commenda*, the passive investor. This *de facto* liquidation protection also would have given foreign creditors with whom the ship captain transacted overseas an exclusive claim to the venture's assets while it remained in their port. Meanwhile, priority of claim for the main creditor of the sea loan -- the passive investor -- was assured by a legal substitute for AAP in small ventures: the security interest. Finally, to the extent that the passive investors in *commenda* (or *carati*) contracts could be considered creditors, their priority of claim was assured by the convention of treating them as partners. Thus, various practical and legal alternatives to a legal rule AAP were available in the maritime expeditions, suggesting that the apparent absence of such a rule can be explained by a lack of demand.

These various substitutes for a legal rule of AAP were not, however, available to the large *compagnie,* whose assets generally were not separated from their owners' creditors by water. Moreover, a legal rule of AAP probably would have offered a solution to several problems that beset these multi-owner firms.

For reasons stated above, liquidation protection would have been more effective than contractual participation restrictions at preventing cross-partnership bankruptcies, and also would not have foreclosed beneficial diversification by investors. In addition, the other significant component of AAP -- priority of claim for firm creditors – also would have been useful to the large *compagnie*, as it would have enabled them to more efficiently allocate the risk of the insolvency of individual partners. As indicated, the traditional rule of joint and several liability forced the partners to bear much of the risk of each other's insolvency, which became a problem when the *compagnia* grew to a size at which partners were no longer able to monitor each other's personal affairs. The failure of Sienna's attempt to adopt *pro rata* liability, and the Medici Bank's apparent inability to make more than limited use of the *accomandita*, indicate that the risk of partners' personal insolvency could not be shifted in a cost-effective manner to firm creditors, probably because they were in no better a position that the partners as a group to monitor each partner's private affairs. Giving the firm creditors a prior claim in firm assets would have offered a way out of this one-dimensional tradeoff by enabling the groups to shift some of the personal insolvency risk to personal creditors, who might have been in the best position to bear it.[132]

That AAP would have provided a way out of the dilemma facing the *compaganie* is reinforced by evidence that Sienna, which was the only medieval Italian city-state to experiment with a rule of *pro rata* liability for partners, may also have been the only state in the period to adopt a rule of priority of claim for

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[132] The shift of risk to personal creditors would have worked as follows. A move from joint and several liability to *pro rata* liability shifts costs arising from an individual partners' insolvency from his co-partners to business creditors by making the business creditors those who must fight with personal creditors for the assets (if any) in each partner's estate to satisfy that partner's fraction of the enterprise debt. Adding weak-form AAP at this point would improve the position of the business creditors, because it would give them a prior claim on one important asset in the insolvent partner's estate: his equity share in the partnership. It is true that weak-form AAP forces personal creditors to satisfy their claims primarily from the partner's personal assets, and thus these creditors might raise their lending prices. However, to the extent that the personal creditors are in a better position to monitor the personal assets, and the business creditors in a better position to monitor the partnership assets, the decrease in enterprise borrowing costs will more than offset the rise in personal borrowing costs.

partnership creditors in partnership assets.[133] Sienna's experiment is evidence of both a need for AAP and a recognition among medieval merchants of its potential usefulness. This suggests, in turn, that legal rules of AAP might have benefited large *compagnie,* and thus that the lack of AAP for these firms was not the result of demand-side factors. We now consider whether AAP's absence in such private, for-profit entities was the result of supply-side factors.

2. The Supply Side in the Middle Ages.

A supply-side explanation for the lack of a general-use corporate form in the Middle Ages, and also the lack of a partnership form with AAP, might at first seem suspect because several organizational entities with AAP existed and even thrived during the period, and they did so while engaged in commerce. In other words, the existence of these other entities might suggest that AAP was fully feasible as a legal and practical matter. Closer inspection reveals, however, that AAP in these various organizations was supported by factors that are incompatible with for-profit, private commercial enterprise, and thus that the presence of AAP in these firms is not inconsistent with a supply-side explanation for its absence from general-purpose commercial forms such as the *compagnia*.

Medieval church organizations such as monasteries exhibited strong-form AAP, because the creditors of those who provided the organizational assets, i.e., its donors, could not levy against the organizational assets after the contribution had occurred. Monitoring the asset boundary thus was relatively easy in these organizations, because they operated under a nondistribution constraint, which prohibits controlling persons from paying dividends to themselves, and thereby relieves legal authorities of the responsibility of distinguishing legitimate from illegitimate dividend distributions. Also, the vows of poverty taken by those who controlled Church organizations such as monasteries would have further simplified the boundary-monitoring task by making distributions of assets even in the form of salaries *per se* illegitimate, and also making such distributions easy to detect. However, although these factors successfully supported AAP in the Church organizations, none could have been adopted by a secular commercial organization, which would have had great trouble attracting investors to whom it denied the possibility of dividends and of whom it required chastity and poverty.

The AAP of the merchant fairs, like that of the *commenda,* largely arose as a practical matter from the long distances that separated most merchants at fairs from their non-fair creditors back home. At the same time, these long distances separated the merchants from their non-fair, or "personal," assets, making the asset boundary that surrounded the merchants at fairs largely self-enforcing. The rule forbidding non-fair creditors from levying against assets at the fair thus merely provided a legal supplement to that which already existed as

133 [Again, check source in Grembi memo 14.]

a practical matter, and for this reason would have been easy to enforce. However, most commercial ventures are not based on a forced long-distance separation of a merchant from his home, and even those that are usually would benefit from persisting during those periods when the separation does not exist. (This would become evident in the sixteenth and seventeenth centuries, as the scale of long-distance oceanic trade required commercial organizations that lasted longer that a one-shot *commenda*.) Thus, while the physical separation of personal creditors from firm assets, and of controlling persons from personal assets, were factors that supported AAP in the trading fairs, they lacked general applicability, and could not have solved the boundary enforcement problems that AAP in the large *compagnie* would have presented.

Finally, if AAP was a feature of Genoa's *carati* monopolies, as the available evidence suggests, it also was supported by factors of narrow applicability. These firms, or at least their valuable monopoly franchises, probably enjoyed liquidation protection, meaning that the personal creditors of those who provided the firms with their capital -- the holders of *carati* -- could not levy against firm assets. Such liquidation protection against personal creditors would have supported a rule forbidding *carati* holders from recovering their investments through exercise of a withdrawal right, which probably was necessary given the nature of these enterprises. However, loss of the withdrawal right creates its own problems for the *carati* holders: namely, lost liquidity for their investment positions, and a reduced ability to deter exploitative action by firm insiders through withdrawal threats.[134] The *carati* monopolies apparently addressed this first problem by making *carati* tradable, an innovation that, in turn, comes with its own difficulties. Specifically, tradability of shares is incompatible with joint and several liability, which perhaps explains why the *carati* monopolies apparently adopted a rule of limited liability. Thus, if the *carati* monopolies had been like most medieval partnerships, they would have bought their AAP by paying high rates for their capital, as the *carati* holders would have demanded higher returns to compensate for their inability to punish insiders through withdrawal, and firm creditors would have required higher interest rates to compensate for their inability to proceed against owners' personal assets. Fortunately for these Genoese firms, their status as state-backed monopolies would have largely obviated such problems. Its interest in the success of such firms effectively would have made the state the guarantor of firm debt, thereby providing a deep pool of assets that would have more than compensated firm creditors for their inability to proceed against the personal assets of the *carati* holders. And greater profits associated with monopolistic privileges would have made the firms better able to pay a rate of return to the *carati* holders high enough to compensate their loss of the withdrawal right. Again, monopolistic

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134 These problems might explain why the compagnie operated for short, fixed terms, for if they had operated on "perpetual" basis like many modern general partnerships their partners probably would have been unwilling to waive contractually their withdrawal rights.

privileges and state backing are factors that, while supportive of AAP, are not available to firms generally.

Nevertheless, some important supply-side factors available in the Middle Ages would have been applicable to, and useful in, the large *compagnie.* Specifically, rules of accounting became well-developed during the fourteenth and fifteenth centuries,[135] simplifying the task of distinguishing firm assets from personal assets. In addition, at least some medieval courts applied a rule of *pro rata* distribution of a defaulting debtor's assets among firm creditors,[136] implying an ability to conduct complex bankruptcy proceedings and process the claims of multiple creditors simultaneously. Such a capacity is useful for AAP generally, but it is essential to effectuate weak-form AAP, as a court that can process only one claim at a time inevitably will distribute assets among creditors based on the order in which claims are fielded, and thus will be unable to enforce a priority system that is based instead on a claimant's status as a personal creditor or a business creditor.

Despite these advantages, however, medieval courts appear to have lacked a power that is a critical AAP supply-side factor: the ability to enforce judgments over large areas. The political fragmentation of Europe and especially Italy during the medieval period would have bounded the effective jurisdiction of many courts. In addition, matters among merchants were handled mostly by merchant courts, whose powers of enforcement were limited, and who relied largely on voluntary compliance by parties. In such a legal environment, individuals could successfully abscond with assets by smuggling them short distances, especially if those assets were easily movable.

Consistent with this, records of the period suggest that the partners in the *compagnie* often fled town instead of confronting creditors with unpaid claims.[137] That most of the great *compagnie* dealt primarily in banking would have exacerbated creditors' problems, because, as valuable assets go, coin is relatively easy to walk off with. In such an environment, a creditor's right as a legal matter to levy upon firm assets ahead of personal creditors would have been of relatively little value, as assets could easily escape a court's jurisdiction. Far more important would have been the right to levy in full against the business and personal assets of any partner wherever found, thus explaining the degree to which creditors apparently punished *compagnie* that did not provide joint and several liability.

135 De Roover (1953) at 81.
136 U. Santarelli, "Per la storia del fallimento nelle legislazioni italiane dell'età intermedia." Cedam, Padova, 1964, page 239.
137 See E.S. Hunt, The Medieval Super-Companies. A Study of the Peruzzi Company of Florence, Cambridge University Press, MA, 1994, page 233.

Courts in such an environment also may have been unwilling to apply a rule that prevented a creditor from levying against any of a debtor's assets over which the court held jurisdiction, even if those assets had been contributed to a partnership in which all partners had promised not to exercise their withdrawal rights. The alternative to allowing a personal creditor to levy against firm assets when a partner defaults on personal debt is to give the creditor a share of the income that the firm generates, as today when personal creditors of corporate owners are awarded the owners' shares rather than direct access to corporate assets. However, such a remedy would have been of little value when partners could relatively easily abscond with assets, greatly reducing the present value of a share of future income that those assets might generate. So courts may have seen liquidation protection as too easy a vehicle for fraud against personal creditors, and thus denied it to the *compagnie.*

The threat of improper asset conversion by the owners of most firms also may explain why the maritime expeditions appear to have been the only private ventures during the Middle Ages that could adopt a rule of limited liability for their controlling persons –- the ship captains -- and still attract credit. Unlike those of most *compagnie*, the assets of a venture operating under a sea loan or a sea-based *commenda* were contained in the hull of a ship for most of the venture's duration, and thus physically segregated from the ship owner's home and personal assets. Thus, improper conversion of firm assets would have been practically difficult for the ship captain: Any assets he improperly "converted" from the firm will still have to come back with him on the return voyage. The physical segregation of assets in the ship's hull thus would have provided not only liquidation protection as a practical matter, but also would have greatly increased the likelihood that the passive investor could levy on firm assets at the completion of the venture, thereby increasing his willingness to waive the right to proceed against the ship owner's personal assets.

The single-expedition duration of these contracts during the medieval period was important here. If a sea loan or *commenda* had lasted for multiple voyages, the line between the assets committed to the firm and those possessed by the ship captain in a personal capacity would have been much more difficult to enforce, rendering limited liability problematic. It is thus not surprising that the passive investor to these arrangements required an accounting and liquidation upon the voyage's return to homeport, when the opportunity for improper conversion of assets by the ship captain would have greatly increased. As we shall see, when the need for oceanic trading firms that lasted multiple voyages would arise in early modern times, the ship's hull would prove inadequate as the sole source of asset partitioning.

VI. THE EARLY MODERN ERA: THE AGE OF

EXPLORATION AND THE INDUSTRIAL REVOLUTION

With the decline of the Italian city-states in the 16th century, commercial and legal innovation moved northward, and particularly to England. We therefore shift our attention, for the 16th through the early 19th centuries, principally to English developments, with occasional glances to the continent.

A. The Evolution of the Partnership

The general partnership remained the prevalent form for organizing commercial firms in England until the 19th century. English partnership law had been formed during the late Middle Ages under the influence of Italian practices,[138] as merchants adopted the rules used by the managers of the English branches of foreign partnerships.[139] In particular, English partnerships, like Italian and Roman partnerships before them, were characterized neither by AAP nor by DAP. This remained the case until the end of the 17th century.

Then a significant break with this tradition came in 1682 with the case of *Craven v. Knight* before a bankruptcy commission in a Court of Chancery, in which the court subordinated the claims of personal creditors to those of partnership creditors with respect to partnership assets.[140] This case appears to be the first on record in which a judge utilized the distinction between the joint assets and the partners' personal assets to effect a rule of priority for creditors. And the rule created was one of (weak form) AAP. The result was to turn partnerships into legal entities, creating, for the first time in English law, a

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138 One consequence of this influence was that the Italian rule of joint and several liability for partners supplanted earlier English rules of pro rata liability[0] deriving from local custom or Roman law. 1 Holdsworth at 97.
139 Rowley at 7-8.
140 2 Chancery Reports 226, 21 ER 664. In that case, a partnership between the merchants Widdows and Berman had failed, and the court in an earlier proceeding had awarded the partnership assets to certain partnership creditors. A creditor holding debt from Widdows alone then petitioned the commission to allow him to be "let in" to the distribution of assets, because otherwise "the Plaintiffs Debts will be utterly lost." The partnership creditors (as defendants) countered that letting the plaintiff in would be contradictory to the intent of the partners, as their partnership agreement made plain that partnership debts were to be paid out of "the joint Stocks," with the remainder divided between them. Besides, the partnership creditors argued, letting the plaintiff in to collect on the partnership assets would be unfair to Berman, because Widdows alone had incurred the plaintiff's debt. The court was persuaded, and ruled that the partnership assets should be applied first to the claims of the partnership creditors. If there was any excess, it would go to the partners' individual estates for payment of their personal creditors; if a deficiency, the business creditors could turn to the partners' personal estates, with each partner retaining a claim against the other if his personal estate bore more than half of the partnership's deficiency.

general-purpose organizational entity that could be employed by business firms.[141]

A second major step in the development of the English partnership came 30 years later, in 1715, with the decision in another bankruptcy case, *Ex Parte Crowder.*[142] That case held that a partner's personal creditors would have first priority, in the partner's personal assets, over creditors of the partnership, thus adding a rule of weak form DAP to *Craven's* rule of weak form AAP.[143] Together, these cases established the rules of asset partitioning that continue to govern English partnerships to this day -- and that also governed American partnerships until, as we noted early in the essay, U.S. law eliminated *Crowder* 's rule of DAP in 1978, leaving only *Craven*'s AAP in place.

The sequence of the decisions in *Craven* and *Knight* follows was, we note, precisely that which one would expect from the analysis offered in Section II, and that we will see repeated in the law of business corporations: AAP was clearly established before DAP.

As was typical in courts of equity, neither in *Craven v. Knight* nor in *Ex parte Crowder* did the court provide much explanation for the revolutionary change in the nature of the firm that its ruling effected. A demand side explanation of course immediately suggests itself: the pace of commercial activity in England was rapidly increasing. But there were supply side considerations at play as well. In particular, there were important developments in bankruptcy law and procedure that preceded these cases. We will return to those changes later. First, however, we turn to the contemporary evolution of other, more complex organizational entities.

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141 The partnership law of other Western European nations also appears to have developed rules of affirmative asset partitioning at approximately this time. For example, a rule reserving partnership property for the prior or exclusive benefit of partnership creditors appeared in pre-Revolutionary France, and may be traceable to a 1673 ordinance (which, incidentally, also codified the rules for France's version of the limited partnership—the *société en commandite*). Brissaud at 555; Goodman at 417.

142 Equity Cases Abridged 56, 21 ER 870.

143 The case, like Craven, involved a petition by personal creditors of partners to be "let in for their debts" to the division of a partnership estate. In its decision, the court extended the Craven rule, providing:

> As the Joint or Partnership Estate was in the first place to be applied to pay the Joint or Partnership Debts; so in like Manner the separate Estate should be in the first Place to pay all the separate Debts; and as separate Creditors are not to be let in upon the Joint-Estate, until all the Joint-Debts are first paid; so likewise the Creditors to the Partnership shall not come in for any Deficiency of the Joint-Estate, upon the separate Estate, until the separate Debts are first paid.

Equity Cases Abridged 56, 21 ER 870.

B. Early Chartered Joint Stock Companies

During the sixteenth and seventeenth centuries, European patterns of commerce were largely similar to those of the fifteenth, with one important exception: long-distance exploration and trade. Increased contacts with Africa and South Asia, together with the discovery of the New World, brought about an industry in which distinctions between conquest and profit, and between public interest and private gain, were neither clear nor initially important. The overseas posts and fleets of deep-ocean vessels necessary to develop this activity, combined with its inherent risks, created unprecedented challenges in the accumulation and organization of capital.[144] The joint stock company, drawing upon the model of the Genoese *carati* monopoly,[145] proved the most successful response.

Portugal and Spain led the charge overseas in the fifteenth and sixteenth centuries, and thus were the first nations to confront the capital challenges of long-distance exploration. Their response was to organize and fund their exploratory institutions directly through the state. This had the conspicuous advantage of employing a huge established strong form entity of obvious creditworthiness. Although this approach was effective in rapidly establishing overseas colonies, the economic benefits flowing from these colonies were muted by the inefficiencies of large government bureaucracies and by the attendant prohibitions on private trading.[146]

1. The Great Private Trading Companies

The countries of Northern Europe took a different approach. To compete with the Spanish and Portuguese, England in the sixteenth century granted charters with privileges, such as powers of self-government and monopoly, to certain trading guilds.[147] Although these were called "companies" -- e.g., the Africa Company, the Russia Company, and the Turkey Company -- they were not themselves commercial firms that pooled and invested capital.[148] Rather, they were essentially nonprofit associations, each member of which traded on his own account on a voyage-by-voyage basis, sometimes in arrangements similar to that of the *commenda.*[149]

The Dutch began a similar practice in 1591, with each port city forming a guild company for purposes of organizing ventures to the Indian Ocean.[150] This approach proved disadvantageous to the Dutch position vis-à-vis the Portuguese

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144 See, generally, Supple at 416-432.
145 See 8 Holdsworth at 207: "There can be little doubt that the origin of the joint stock principle, like the origin of so many principles of our modern commercial law, must be sought in medieval Italy."
146 Coornaert, 228-230.
147 Williston, 109; 8 Holdsworth 201.
148 Williston at 109.
149 Mitchell at 139-140.
150 Cizakca at 45.

and Spanish, however, as competition among the various Dutch merchants bid up the prices for commodities and political cooperation from Indian princes.[151] In response, in 1602 the Estates General consolidated the various trading companies into one, the Dutch East India Company. The charter granted the company to hold its members' capital investments free of the usual obligation to return them to individual members on demand. At first the company was permitted to retain its members' capital in this fashion for ten years, and then, by a 1623 amendment, perpetually.[152] The Estates General compensated members for their lost withdrawal rights by allowing the sale of shares on the open market.[153] The practical effect was to create a joint stock company with semi-strong form AAP – a point we will explore with more care below. The shareholders apparently also were promised limited liability[154] -- strong form DAP -- although it is unclear whether this was ever tested by a default on company debt.

The Dutch East India Company proved a great success and inspired imitation.[155] France created its own joint stock company for purposes of colonial expansion, the Compagnie des Iles d'Amerique, in 1626.[156] Of particular interest to us here, however, is Britain's own East India Company, originally chartered in 1600. At its inception, the British East India Company was organized like the earlier British chartered trading companies of the 16th century. Members of the company invested separately in discrete voyages. At the conclusion of each round-trip voyage the cargo brought back to England was divided among the investors in the voyage and auctioned off, and the venture was liquidated.[157] After witnessing the Dutch success, however, the British East India Company reorganized[158] – first in 1614 under a series of terminal contracts, each spanning several years,[159] then in 1654 by adopting of a rule of perpetual existence,[160] and finally in 1658, when it declared its capital fixed.[161]

151 Cizakca at 45.
152 Cizakca at 46.
153 Coornaert at 257.
154 Cizakca at 47.
155 Coornaert at 234.
156 Mitchell at 139.
157 8 Holdsworth at 194; Williston at 114
158 Some of the basic rules of the joint stock form were not foreign to England: In the sixteenth century, mining guilds specializing in silver, copper, and lead had received charters of incorporation and, unlike the trading guilds, taken the additional step of pooling their capital for certain limited purposes. A "dividend" was paid in the form of a share of the minerals from the mine, which members then sold individually. Thus, these were joint stock companies for purposes of production, but mere guild companies for purposes of retailing. 8 Holdsworth at 194, 206-8; Supple at 441.
159 Williston at 110.
160 Mitchell at 140.
161 This declaration at first was not backed by the full force of law, and for a time members could still, after a delay, withdraw a portion of their investment. Coornaert at 258.

Shares in the two Dutch India Companies were made transferable, and vigorous trading in their shares ensued.[162] Perhaps inspired by this example, the English joint stock companies followed suit, indicating clearly in their charters that their shares were transferable and that the privilege of "membership," entailing the right to own shares, was open to anyone who paid a nominal fee.[163]

Chartered joint stock companies were not, however, typical of the seventeenth century. Beyond the Dutch and English East India Companies, The Dutch West India Companies (1623), the Hudson's Bay Company (1670), and the Royal Africa Company (1672) were the only other examples of lasting consequence founded before 1692 in either the Netherlands or England.[164]

2. Asset Partitioning

Whether and in what forms the joint stock companies of the seventeenth century exhibited either affirmative or defensive asset partitioning as a matter of law is a question that is complicated by several factors. The number of such companies was relatively small for most of the seventeenth century, and each operated under a particularized charter deriving from a distinct legislative act.[165] In addition, the early companies enjoyed grants of monopoly, which made insolvency unlikely, and also imbued the law concerning them with a strong public component, particularly in the Netherlands. Nonetheless, a few generalizations regarding the rules of asset partitioning in these companies are possible.

a. Affirmative Asset Partitioning

While death of a partner dissolved an English partnership,[166] seventeenth-century cases clarified that a death of shareholder did not dissolve an incorporated joint stock company,[167] the shares instead devolving to heirs.[168] By the same principle, the company could set the terms by which shareholders could recover their investments, and over the course of the seventeenth century the companies moved to a rule of fixed stock and thus the elimination of shareholder withdrawal rights.[169] Whether courts consistently held that an agreement among a joint stock company's members to waive their withdrawal rights also prevented their personal creditors from levying on firm assets, and

162 Coornaert at 259
163 Williston at 110; 8 Holdsworth at 202-3.
164 While charters were granted to other joint stock companies in England during this period, those companies commonly operated for only a few years – apparently in part because, in a time when principles of free trade were gaining favor, Parliament was reluctant to allow companies to function for extended periods under charters that, as most did, granted monopoly rights. Williston at 110; 8 Holdsworth at 209.
165 See 8 Holdsworth at 215.
166 Bisset at 83.
167 8 Holdsworth at 202.
168 Williston at 163.
169 Coornaert at 258.

thereby recognized a rule of semi-strong form AAP, is not certain, though the available evidence suggests strongly that this was the case.[170]

b. Defensive Asset Partitioning

As a result of judicial recognition of a distinction between legal and natural "persons," an owner of a joint stock company could not be made directly liable for the company's debt.[171] Often, however, a company's managers had the power to make "calls" on the stock, which were enforceable demands for further contribution on a pro rata basis.[172] If the business creditors could force the managers to make a call, or persuade a court to do the same (as they did on occasion),173 company shareholders lacked DAP.

As a legal matter, however, a company's power to make calls derived from the consent of the owners, and thus could be restricted or eliminated by contract.174 Some companies used this opportunity to create full limited liability, and others provided that the owners would be liable for only certain types of debt

170 Several considerations suggest that courts would not have allowed a personal creditor of a shareholder to force a liquidation of a joint stock company. To begin with, the principle behind the rule that the death of a shareholder did not dissolve the company -- his shares instead devolving to heirs -- would seem also to apply to the bankruptcy of a shareholder, as his shares could be given to his personal creditors.

Furthermore, courts consistently referred to chartered joint stock companies as "incorporated," a term that in other contexts implied both perpetual existence and the notion that the entity, rather than its members, owned the joint property. The term "corporation" had previously referred in England to noncommercial organizations, the law of which dated to the introduction of Roman ideas of legal personality by the Normans in the eleventh century, and which developed into a coherent set of doctrines applied to Church and civic entities in the 1400s. Williston at 164; 2 Holdsworth 118; 8 Holdsworth 482. In a departure from the law of continental Europe, which regarded Church property as owned commonly by members, a statute under the reign of Edward IV (1461-1483) provided that canonical corporations could own property directly. 3 Holdsworth 488. Therefore, the notion that a joint stock company's assets were the property of the "corporation" and not its shareholders probably would have undermined a claim by a shareholder's personal creditor of a right to levy upon those assets, especially where the creditor could instead seize his debtor's shares in the company.

Liquidation protection of this sort, in turn, implies that the creditors of a joint stock company enjoyed priority of claim to company assets. The development of weak-form AAP for English partnerships by the late seventeenth century also implies strongly that no weaker rule would have applied to chartered joint stock companies.

Liquidation protection on this basis also implies that the creditors of a joint stock company enjoyed priority of claim to company assets, as this is the logical consequence of a practice of giving an owner's shares to his unpaid personal creditors rather than allowing them to levy on company assets directly. The development of weak-form AAP for English partnerships by the late seventeenth century also implies strongly that the same rule would apply to chartered joint stock companies.

171 Williston at 160.

172 Williston at 160.

173 8 Holdsworth at 204.

174 8 Holdsworth at 204.

under specified circumstances.[175] The system thus allowed companies to vary the degree of owner liability to suit their business requirements.

The chartered companies thus show again the predicted pattern, in which AAP precedes DAP and sometimes persists without it.

3. Supply and Demand Factors

While sea-based trade under the sea loan and *commenda* enjoyed *de facto* liquidation protection as a result of the natural barrier of the water, the large and increasing scale and scope of the overseas trading companies of the early seventeenth century made the division of assets after each voyage increasingly inefficient. Accordingly, there was clearly demand for a legal entity that could assemble large amounts of capital – more than could easily be supplied by small numbers of investors – and keep the joint stocks intact across multiple voyages. Thus, increasing demand is surely important in explaining the initial development of the chartered joint stock company in England, and its deployment for overseas trading.

But we see present here, also, important supply side factors that are already familiar from earlier eras. For one thing, most of the firms' assets were overseas, and hence not only clearly segregated from their owners' personal and other business assets, but also in a position where it would be awkward for the owners' personal creditors to levy on them. In addition, the principal asset of each of these firms was its monopoly trading franchise from the state, and that asset could presumably not be transferred to other persons, including the personal creditors of the firm's owners. Consequently, the firms' asset boundaries should have been relatively to establish, and there would have been little pressure on those boundaries from the owners' nonfirm creditors.

Moreover, the fact that the firms were monopolies made it extremely unlikely that the firms themselves would become insolvent. In turn, this meant that there would be little pressure from the firms' creditors to put the firms' asset boundaries – and hence its degree of either DAP or AAP -- to the test by seeking to levy on firm assets.

The fact that the firms were able to offer effective AAP was presumably essential to making their shares transferable. Transferability, in turn, solved two problems associated with semi-strong form AAP. First, it provided equity claimants with a source of liquidity to compensate for their lost withdrawal rights. Second, it provided a liquid asset, representing a shareholder's claim on future distributions from the firm, upon which a shareholder's personal creditors could levy, thereby mitigating the cost of denying those creditors a right to levy against firm property directly.

C. Chartered Joint Stock Companies in the Eighteenth and

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175 8 Holdsworth at 205.

Early Nineteenth Centuries

Although these new rules of asset partitioning arose originally in the context of the great trading companies, demand for the form began to come from other commercial actors as well. There was a surge in applications for corporate charters in England in the 1690s. Parliament responded by granting charters to firms in the banking, mining, and insurance industries.[176] In 1692, newspapers began printing share prices, and a market for futures and options appeared.[177]

The demand for corporate charters from Parliament remained strong in England throughout the eighteenth century,[178] and became particularly intense as the Industrial Revolution gained steam around 1760. Parliament was amenable to the corporate form in some industries more than others. For example, England's decision to allow private firms to build its canal system, which broke a tradition dating to Rome of government funding of large public works, resulted in the granting of 81 corporate charters to canal companies during the period between 1791 and 1794.[179] However, in manufacturing, the sector most strongly associated with the Industrial Revolution, applications for corporate charters were frequently rejected.[180] Indeed, in general, Parliament was extremely conservative in granting charters to joint stock companies through the early nineteenth century.

The types of firms to which charters were given frequently still showed attributes that made AAP particularly easy to maintain. Many had specific Parliamentary grants of monopoly. Many others, like the canals, invested in large fixed assets that could not easily be dissipated or diverted in derogation of the rights of the firms' creditors or investors.

There seem to have been several reasons for Parliament's reluctance to grant charters during this period. One was the intense opposition forthcoming from owners of small businesses when Parliament considered granting a charter to a firm in their industry. The motivation for this opposition was evidently a fear that a chartered company, with its ability to assemble large amounts of capital, would be such a strong competitor as to threaten their livelihoods.[181] Another reason was the opposition coming from already-chartered companies that feared that their own prosperity would be threatened if they were forced to compete with other chartered firms. And a third reason was a concern that investors in chartered firms might be abused, either through stock fraud or through speculative excesses.

It does not seem the case, however, that Parliament's refusal to grant more charters reflected a well-founded judgment that the firms would not be

176 Williston at 111.
177 8 Holdsworth at 214.
178 Hunt at 10.
179 Hunt at 10.
180 Williston at 112.
181 Hunt at 16.

viable – which is to say, in our terms, that the forms of asset partitioning they involved were excessively costly. The experience with unchartered joint stock companies makes this clear.

D. Unincorporated Joint Stock Companies

Faced with the difficulty of obtaining a charter from Parliament, firms without charters began selling shares in the late seventeenth century. The practice became commonplace by the 1710s,[182] and continued well into the nineteenth century.

For reasons canvassed in Section II, one would not expect to see tradable shares appear in the absence of AAP. And, as we have seen, at the time these firms began to arise, the partnership form in England had just been endowed with AAP. The AAP offered by the partnership was, however, only weak form. For this reason, presumably, English lawyers commonly arranged for the assets of an unincorporated joint stock company to be held by a private trust. The private trust would probably at that time, as now, have provided effective liquidation protection, and hence turned the firms into semi-strong form entities.

A famous effort to suppress these firms took place in 1720 with the passage of the "Bubble Act," which forbade unchartered companies from selling shares, and chartered companies from selling their charters or engaging in lines of business not explicitly authorized.[183] While the Act remained on the books until 1825, there was only a single effort to enforce it – in 1726 – during the entire 18th century. The consequence was that, though their formal legal status remained murky, the "unincorporated" joint stock companies continued to flourish, to the point where there were more than one thousand of them operating in England at the beginning of the nineteenth century,[184] some with thousands of shareholders.[185]

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182 Williston at 112.

183 Contrary to conventional lore, the Bubble Act was not adopted as a reaction to the stock market crash that followed the South Sea Bubble of 1720, and it came to be called the "Bubble Act" only many decades later. The chain of events that led to passage of the Act was set in motion by the South Sea Company which, (despite its origins as a trading company) was seeking to sell large amounts of stock on the public markets as part of its pact with the government to refinance England's public debt. The Company was concerned that the high volume of shares being sold by unchartered companies was reducing demand for the South Sea Company's own shares. Since the Company had paid large bribes to a substantial fraction of the members of Parliament to obtain its privileges, it felt that it was entitled to be free from competition in the stock market from firms that had not incurred such expenses. Parliament obliged by adopting the Act. See Ron Harris, INDUSTRIALIZING ENGLISH LAW: ENTREPRENEURSHIP AND BUSINESS ORGANIZATION, 1720-1844, AT 60-81 (2000). The result was to precipitate a collapse of prices for the shares of unchartered joint stock companies, which caused a drop in liquidity that in turn brought down share prices across the market, including, in a bit of poetic justice, the shares of the South Sea Company itself. See [ ].

184 [Cite]

185 In France and Italy, demand for firms with tradable shares that could not be satisfied with government charters was largely filled by the société en commandite and the societa' in

Some of these firms sought to achieve limited liability by contractual means, putting provisions in their partnership agreements, on their letterhead, and in their contracts that disclaimed personal liability on the part of partners, and further signaling this attribute by putting the word "limited" in their names. These devices for limiting liability were evidently effective in practice, although the courts refused to give them a formal blessing until 1840. At the same time, many of the unincorporated joint stock companies did not seek to limit partner liability, and indeed many advertised their partners' unlimited liability as an inducement to creditors. DAP, unlike AAP, was clearly not essential to tradability of shares.

E. Developments in Bankruptcy Law

Surely demand factors go far in explaining the increased legal support for organizational entities in the period 1682–1800 – including extension of AAP to the partnership form and the granting of charters to joint stock companies in companies beyond sea trade – as well as the great expansion in practice of companies that took advantage of these new legal regimes. But supply side factors seem important as well.

At least in England, the most important supply-side innovations were arguably a set of changes that greatly increased the powers of judicial authorities to police entity asset boundaries. Some such changes were procedural. Before the seventeenth century, most commercial cases in England were decided by merchant courts similar to those of medieval Italy, where judgments were summary and infrequently recorded,[186] and judicial powers of enforcement were limited. The merchant courts' emphasis on speedy justice, although not without value, was incompatible with the extensive inquiries required to control and classify ranges of assets and creditors and thereby effectuate entity-driven rules of priority. As the seventeenth century progressed, however, commercial cases increasingly came under the jurisdiction of the regular courts of law and Chancery.[187] Unlike the merchant courts, these regular courts held jurisdiction over non-merchants, and also could enforce their decisions throughout the country in which they sat. [188] The efficacy of seventeenth-century English courts was also augmented by substantive changes in bankruptcy law, including new

accomandita, respectively, which provided both limited liability and passive equity positions, and which would eventually develop rules of liquidation protection. (For example, in the modern Italian law governing limited partnerships, a personal creditor of a partner cannot, during the life of the partnership, force the liquidation of his share. Certoma at 399.) Although in the time of the Medici the accomandita seemed to have been used mostly on a temporary basis, during the seventeenth century it grew to become the preferred organizational form in Italian manufacturing industries. (Goodman at 428.) Such a solution was not available in England, however, which – because of mistrust of limited liability, it is argued – did not import a version of the limited partnership until 1907. (Formoy at 46.)

186 Rowley at 8.

187 Rowley at 8.

188 [Cite.]

powers to avoid pre-insolvency conveyances, conferred in a series of acts between 1571 and 1623.[189]

F. General Incorporation Acts

The pressure for company formation finally led Parliament to repeal the Bubble Act in 1825,[190] and soon thereafter English courts retreated from the position, sometimes maintained, that transferable shares were illegal at common law.[191] Not long after, Parliament went further, adopting England's first general business corporation statute: the Joint Stock Companies Regulation and Registration Act of 1844.[192] This Act required all partnerships with more than twenty-five members and with transferable shares to register and to follow uniform disclosure rules.[193] More importantly for our purposes, the Act explicitly

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189 8 Holdsworth at 237-9.

Two cases from the seventeenth century demonstrate the relationship between the increase in judicial powers and the new rules of asset partitioning. Both involved the unfortunate creditors of a joint stock company called the Company of Woodmongers, who had not been paid when the owners dissolved the company and divided its assets among themselves at some point in the 1660s. In the first case, *Edmunds v. Brown*, 1 Levinz 237, 83 ER 385 (1668), a court of law dismissed a suit against two principals of the company brought by bondholders. The bonds had been issued under the seal of the company, and on this basis the court refused to let the bondholders satisfy their claims from the personal estates of the two former owners. Soon thereafter, different creditors brought suit in equity (*Naylor v. Brown,* Finch 83, 23 ER 44 *(*1673)) against all of the members of the Woodmongers, and this time the court allowed recovery, on the theory that the funds taken by the members upon dissolution were "in Equity still, a Part of the Estate of the late Company." Recovery was to come not directly from the members, but rather from the company estate, which the members were to reconstitute by returning with interest the company funds and by making up any deficiency in the creditors' debt on a *pro rata* basis.

The Woodmongers cases illustrate that owner liability in the joint stock companies was at most *pro rata* rather than joint and several. They also illustrate why such a regime would have been acceptable to company creditors. The result in *Edmunds v. Brown* would have been unimaginable in the medieval period, when firm owners could easily abscond with firm assets. If firm creditors had been unable to levy against assets of owners wherever found, creditors probably would have been unwilling to lend to firms at all. The result in *Edmunds* makes sense, however, in light of the outcome of *Naylor v. Brown,* a case which suggests a court able to exercise jurisdiction over multiple owners and creditors simultaneously, and also to make distinctions between firm assets and personal assets. Knowing that they had access to courts with such powers, firm creditors would have been more willing to accept a regime of reduced access to owners' personal assets, and thus lend to firms despite the result in *Edmunds.* This reduced access could take the form of *pro rata* or limited liability in the joint stock companies, or the weak form DAP established for partherships in the early 18th century. By making the distinction between firm and personal assets more resilient, the broadened powers of the courts also would have lent practical value to the AAP bestowed on partnerships at the end of the 17th century.

190 Hunt at 42.

191 Courts began noting that transferable shares were unknown in ancient times, and thus could not have achieved authoritative common law status in one direction or the other. See Garrard v. Hardy, 5 Man & Gr. 471 (1843).

192 Hunt at 94.

193 Hunt at 94-98.

and clearly granted semi-strong form AAP to all companies formed under it.[194] In particular, the 1844 Act explicitly granted liquidation protection by providing that the bankruptcy of a shareholder would not affect the company, its liabilities, or the liabilities of other shareholders.[195] In addition, legal capital rules were imposed to keep the firm's assets from being drained to the detriment of creditors: A company's paid-in capital could not be used for redemption of shares unless new shares were issued for the same amount, and a net reduction of capital was prohibited unless all objecting creditors were first paid off.

Although the 1844 Act clearly granted semi-strong form AAP, and made this attribute available as a matter of right to any firm that chose to incorporate under the Act, it did not provide for DAP. Rather, shareholders had unlimited pro rata liability for corporate debts. Only in 1855 was the statute amended to allow joint stock companies to adopt limited liability, and even then it was an option.[196] Although general incorporation statutes granting limited liability had been enacted in several American states before 1844, the concept had remained controversial in England, delaying its adoption. The result is a strong illustration of the primacy of AAP over DAP in the evolution of modern commercial entities.

England probably retarded its economic development somewhat by its tardy provision for incorporated joint stock companies. Nevertheless, the consequences were perhaps modest. The subsequent experience with the corporate form for business enterprise indicates that it only slowly became useful in a broad range of industries, and for firms of small as well as large scale. This is most apparent if we look at the experience in the U.S. where, though the legal obstacles to incorporation were always much smaller than they were in England, the use of the corporate form nevertheless spread only gradually across American industry.

VII. THE UNITED STATES IN MODERN TIMES (1800-PRESENT)

In the late eighteenth and early nineteenth centuries, prior to the enactment of the general business corporation statutes, the American states were much freer in granting legislative charters than was the English parliament.197 The principal activities that received those charters, however, were large projects such as canals, bridges, and turnpikes, as opposed to manufacturing or financial firms. One reason for this, of course, was that these these were projects that required capital from a number of different investors. But the semi-strong form of AAP conferred by these charters had the benefit of supply side factors as well. Most conspicuously, their capital was invested in large fixed assets whose value could be easily ascertained and that could not

194 Hunt at 97.
195 Bisset at 188.
196 Bisset at 133.
197 Dodd at 11.

feasibly be siphoned out opportunistically by the firms' owners. Also, these firms, like typical chartered companies from earlier centuries, commonly possessed a grant of monopoly privilege from the state.

A. The Early Corporation Statutes

New York passed the first general business corporation statute in 1811, adopting a Manufacturing Act that allowed any manufacturing company to incorporate for a period of twenty years simply by filing a certificate.[198] Like the later English act of 1844, the New York statute did not provide for limited liability; rather, it provided for unlimited pro rata liability for shareholders. Again, AAP preceded DAP.

The fact that this statute, like some of those that followed in other states, was confined to manufacturing firms suggests that supply side factors played a role. Such firms, in contrast to financial, trading, and service firms, would commonly have had substantial fixed assets that would be difficult to drain opportunistically. To be sure, some banking and insurance companies incorporated as early as the late 18th century in the U.S. But those firms offered relatively short-term services. Early savings banks and life insurance companies – that is, financial firms with large numbers of long-term creditors – did not originally form as business corporations. Rather, they formed as mutual companies. The reason, evidently, was that the AAP offered by a limited liability business corporation was not credible: it was too easy to maintain inadequately low reserves. Not until state regulation of the reserves of banks and insurance companies – i.e., state protection of the assets that were partitioned off for the firms' creditors – did savings banks and life insurance companies adopt the form of business corporations. In short, the joint stock business corporation was initially used principally for those types of business activities in which affirmative asset partitioning was most credible because the nature of the business made it relatively difficult for shareholders to drain out assets opportunistically.

The general corporation statutes were soon liberalized to permit formation of businesses of all types, rather than just manufacturing. But the structure imposed by these statutes was relatively rigid. They were initially designed to accommodate large publicly traded firms. Among other things, they provided for only a single class of common stock[199]; they required and enforced clear statements of the purposes to be pursued by the firm; they put a strict bar on self-dealing transactions; they did not permit ownership of a corporation's shares by another corporation; and agreements among shareholders were unenforceable. This rigidity served to protect the firm's minority shareholders, who lost the protection of the withdrawal right with the adoption of semi-strong form AAP. It presumably also served to protect the firm's creditors in much the same way: by inhibiting opportunistic distributions of the firm's bonding assets to those who controlled the firm. To similar effect, and much more explicit in this

198 Id., at 64.
[199] [Confirm for full range of statutes.]

regard, were requirements for maintaining stated legal capital, which were designed and enforced to place serious constraints on corporate distributions that would disbenefit the firm's creditors.

B. Liberalization of the Corporate Form

The ensuing century and a half – from the mid nineteenth century to the present – has seen the gradual liberalization of the corporate form, permitting ever greater freedom in the structuring of rights to earnings and control, and making the form highly adaptable, in particular, to small and closely held firms. It seems unlikely that this evolution can be attributed simply to gradually increasing imaginativeness on the part of businesspeople and lawmakers. Rather, it seems reasonable to look for the explanation, in significant part, on the supply side. As a consequence of improved mechanisms for disclosure and enforcement in corporate affairs, protection of both investors and creditors can be less reliant on rigidity of form. The same developments surely explain the gradual relaxation of the legal capital requirements imposed on corporations.

Indeed, it is the growing ability of the corporate form to accommodate small closely held firms that evidently accounts for the recent elimination of DAP in U.S. partnership law, reversing the rule adopted in 1715 in *In re Crowder*. In the past, small firms had little choice but to adopt the partnership form. In those circumstances, the weak form DAP imposed on the partnership form represented a reasonable compromise. It inhibited opportunism toward firm creditors by making the partners personally liable for firm debts, but left partners with substantial ability to attract personal creditors by giving those creditors a first claim on personal assets. Once the corporate form became available to small businesses, this compromise was no longer necessary. Business owners who felt it unnecessary or undesirable to pledge personal assets to firm creditors were not forced to do so. The principal reason for a firm's owners to use the partnership form rather than the corporate form became, in fact, precisely to maximize the firm's creditworthiness by pledging their personal assets in full as backing for their firm's debts. It then made sense to make the partnership form as effective as possible in this respect.

C. The Recent Multiplication of Forms

The basic set of general-purpose organizational entities that had become well established by the second half of the nineteenth century – the business corporation, the nonprofit corporation, the cooperative corporation, the general partnership, and the limited partnership200 -- continued to dominate until the last quarter of the twentieth century, though as just described they became increasingly flexible. In the past twenty-five years, however, new forms have suddenly proliferated, including the limited liability company ("LLC"), the limited liability partnership, and the statutory business trust. These forms all offer strong

[200] [Check dates of statutes]

form DAP and semi-strong form AAP – as in a business corporation – but permit much greater freedom in allocating earnings and control.

The first of these forms to appear – the LLC, which first emerged in the mid 1970s – appeared initially to be almost entirely tax-driven. It was clearly an effort – surprising successful – to get partnership type tax treatment for a limited liability entity. From an organizational rather than a tax perspective, the early LLC statutes did not appear to provide greater flexibility than was already available under the corporation statutes in their contemporary incarnation. And this arguably remains true today, though the LLC has now been endowed with far greater flexibility in most states. The same might also be said of the LLP. But the statutory business trust – first introduced in mature form in Delaware in 1988 – goes much further. While it explicitly offers semi-strong form AAP and strong form DAP, it leaves all other matters of organizational design – control rights, allocation of earnings, and even fiduciary duties – to the free choice of those who form the entity. In effect, the statute provides for the minimum required of law in creating an organizational entity – asset partitioning, and particularly AAP – and leaves all other attributes to be designed at will.

The business trust might be seen, then, as the final step in the historical evolution of organizational entities so far as legal forms are concerned. It might also be seen as a substantial closing of the gap between organizational law and contract law. Contract law in the U.S. has provided ever greater flexibility in using security interests to bond contracts. But, as noted, those security interests have floated only with respect to assets, not with respect to creditors. The business trust now offers a double floating lien that can be deployed to back contractual commitments of any form.[201]

The contemporary development of the statutory business trust, like the development of the LLC and the limited liability partnership, seems not to have been driven by demand side factors, such as changes in productive technology that require new forms of organization or financing. The business trust has had particularly extensive use in asset securitization, and the assets that have been the subject of these arrangement – and hence the principal assets of the trusts – have commonly been relatively old-fashioned, such as mortgages or accounts receivable. Rather, the important changes that have prompted the growth of the business trust appear to have come in supply side factors – in particular, greater capacity in the financial sector to assess and market the more specialized packages of claims that are involved.

The result of these new organizational forms is to increase organizational flexibility both externally and internally. Externally, it is now possible to create

[201] Interestingly, the business trust appears to have been employed more for the force of its semi-strong form AAP than for its ability to float with respect to creditors. It is thought to be more effective than an ordinary security interest in shielding assets from the creditors of those who hold the residual claims on the assets – or, as the language of the trade would have it, the trust provides a financing vehicle that is more "bankruptcy remote." See Steven L. Schwarcz, STRUCTURED FINANCE: A GUIDE TO THE PRINCIPLES OF ASSET SECURITIZATION, 16-36 (2d ed. 1994).

organizations in which earnings and control take patterns different from those that have been traditional, such as the conventional joint stock company. There do not appear to be strong signs of this yet, and there is good reason to believe that it may not come to pass in the foreseeable future. At least in organizations in which control is shared among multiple persons, the inadequacies of collective choice processes appear to press strongly for very simple allocations of both control and earnings to keep intra-organizational conflicts of interest within reasonably narrow bounds. For this and other reasons, the standard investor-owned joint stock company is likely to dominate most types of productive enterprise for as far as we can now see.[202]

Rather, it is in the *internal* structure of organizations that the quantitatively greater degree of flexibility afforded by the new forms of organization seems most likely to be felt. In essence, traditional commercial organizations have bonded all of their contracts with a single pool of assets, and those assets were the assets used by the firm in production. The evolution of security interests has allowed increasing sub-partitioning of those assets; the refinement of the private trust adds further flexibility. It is possible that while, as just suggested, the equity structures of firms will remain simple, the structure of credit will become increasingly complex.[203] While the firm will retain its essential character as the single central coordinator ("nexus") of a large set of contracts, the pools of assets that bond those contracts will become increasingly differentiated.

VIII. CONCLUSION

The law's critical contribution to the evolution of organizations has been the creation of legal entities – firms that can serve as credible contracting actors in their own right. The core of this contribution has been affirmative asset partitioning – the rule that grants to the organization's creditors a privileged security interest in the organization's assets. To endow an organization with that pattern of creditors' rights is costly. The costs involved depend on a variety of factors, including the nature of the organization's assets, the structure of earnings and control rights in the organization, and the legal and economic environment in which the organization operates. An understanding of these costs appears to go far in explaining the evolution of organizational forms from ancient societies to the present day.

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[202] See Henry Hansmann & Reinier Kraakman, *Toward a Single Model of Corporate Law?,* in J. McCahery, P. Moerland, T. Raaijmakers, and L. Renneboog, eds., CORPORATE GOVERNANCE REGIMES: CONVERGENCE AND DIVERSITY (Oxford University Press, 2002).

[203] The experience of Enron, with its more than one thousand sub-entities, shows clearly the potential costs of such arrangements: Complex partitioning can ultimately reduce transparency to inefficient levels.