LEGAL ENTITIES, ASSET PARTITIONING, AND THE EVOLUTION OF ORGANIZATIONS

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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. Our object here is to portray the evolution of that legal framework from Roman times to the present, and to explore the relationship of that framework to the evolution of both commercial and noncommercial organizations.

Previous work in economic and legal history has focused heavily on limited shareholder liability – the rule that shields the assets of a firm's owners from creditors of the firm -- as the legal innovation most critical for the development of large 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] (AAP), is logically prior to limited liability, in that limited liability would be largely unworkable without it. Moreover, while both logic and experience show that large firms are viable in the absence of limited liability, we do not see firms of significant scale that lack AAP. Finally, while limited liability can be, and often has been, established simply by contract without benefit of special legal doctrine, AAP requires enabling law to be workable.

The necessary legal doctrine to support AAP evolved in steps over the past two millennia, and the most important steps came surprisingly late. Moreover, while legal doctrine was necessary for the creation of modern business firms, it was not sufficient. For AAP to be effective, a firm's creditors and owners must have the practical ability to police the boundary between the assets of a firm and the assets of the firm's owners. That practical ability also evolved slowly. Indeed, the law and the practice developed in tandem, as they had to, since it is useless, and even counter-productive, to have the ability to establish legal distinctions between claimants to assets when those distinctions cannot be policed. Moreover, this historical codevelopment is not at an end, but rather continues actively, as both law and practice permit ever greater flexibility in AAP, and hence in the organization of enterprise.

The slow development of the legal and institutional framework required for AAP may help to explain why large-scale commercial enterprise is in general a

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

phenomenon only of recent centuries. Yet it is of course also quite plausible that causation has run principally in the reverse direction: As the returns to large-scale enterprise grew, owing to technological progress over recent centuries, the demand for effective forms of AAP likewise grew, and provided the stimulus for the requisite legal and institutional innovations. While we cannot sort out these questions of causation here with confidence, we offer evidence that provides perspective on the issue.

One place where we believe that we can point with some confidence to a strong role for supply-side causation involves the development of noncommercial versus commercial organizations. It is a striking fact of Western (and Eastern) history that, many centuries before the advent of legal entities of a commercial character, including not just joint stock corporations but even modern partnerships, large *noncommercial* organizations formed as private (nongovernmental) corporations were commonplace. It seems likely that this pattern is explainable, in important part, by the much greater ease of establishing AAP in nonprofit firms than in proprietary firms.

We begin, in the section immediately following, with a general discussion of asset partitioning, its relationship to the structure of legal entities, and its economic role in the organization of enterprise. The remainder of the essay then proceeds historically, portraying the general legal and economic evolution of organizational forms over the past two and a half millennia, and seeking to understand the factors responsible for the pattern of development we observe. We confine our focus principally to the path that leads from ancient Rome 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

Asset partitioning is the division of commonly-owned assets into pools that can be separately pledged to different groups of creditors. We are concerned here with partitioning between a person's personal assets and their business assets. This partitioning takes two basic forms: defensive asset partitioning and affirmative asset partitioning.

A. Defensive Asset Partitioning

Defensive asset partitioning (DAP) limits or eliminates the claims of business creditors on the personal assets of the owners of the business, thus giving personal creditors a prior or exclusive claim on those assets. The most familiar example of DAP is the rule of limited liability that completely shields a corporate shareholders' personal assets from the claims of the corporation's creditors, leaving those creditors with only he assets of the business as security. We will sometimes refer to this form of DAP as *strong form* DAP (or *full* limited liability), to distinguish it from *weak form* DAP (or *partial* limited liability), which only partially shields the personal assets of a business's owner from creditors of the business. A prominent example of weak form DAP is the traditional rule of partnership law, applied in the U.S. prior to 1978, that, while permitting creditors of a partnership to proceed against the partners' personal assets, subordinates the partnership creditors' claims on those assets to the claims of the partners' personal creditors.

There are, as well, other frequently-employed types of weak form DAP (or partial limited liability). One is a rule of unrestricted pro rata liability for firm debts. This regime, which has been employed in a variety of settings from ancient Roman partnerships to pre-1931 California business corporations, makes each owner of the firm personally liable for firm debts, yet provides that this liability is not joint and several, as in the traditional partnership rule, but rather is limited, for each individual owner, to just a fraction of the firm's unpaid debt, with the fraction determined by the owner's share in firm profits. Another common type of weak form DAP provides that owners of a firm are personally responsible for unpaid firm debts up to some multiple of their initial investments, as when the shareholders of federally-chartered banks in the U.S. once bore double liability for bank failures.[2]

B. Affirmative Asset Partitioning

Affirmative asset partitioning, which is our principal focus in this essay, is in effect the reverse of defensive asset partitioning. AAP limits or eliminates the claims of a business owner's personal creditors on assets dedicated to the business. There are three relatively distinct forms of AAP, which we will label *weak form, strong form*, and *super-strong form.*

Weak form AAP simply involves priority among creditors. It provides that the creditors of the firm have a claim on the firm's assets that is prior to that of personal creditors of the firm's co-owners. This has long been the rule of partnership law, which permits the personal creditors of a bankrupt partner to dissolve the partnership and liquidate its assets, but subordinates their claims on those assets to the claims of the partnership's own creditors.

In strong form AAP, the personal creditors of the firm's owners are not only subordinated to the firm's own creditors, but also lack the right to force liquidation of the firm and levy on its assets. The contemporary business corporation is the most familiar example: The law reserves to corporate creditors the right to levy directly on corporate assets, and limits the shareholders'

[2] [References]

personal creditors to seizing the shareholders' shares, which gives the personal creditors the power to force liquidation of the firm only if the number of shares involved is sufficient to force liquidation of the corporation under the terms of its charter. We will sometimes refer to this defining characteristic of strong form AAP as *liquidation protection* for the assets of the firm.[3]

Super-strong form AAP goes beyond strong form AAP by providing for a *nondistribution constraint* that bars persons who exercise control over the firm (officers, directors, or those who select the directors) from distributing to themselves any of the firm's net earnings or assets.[4] (As we will use the term, the nondistribution constraint always extends to current distributions, and may or may not extend as well to distributions upon dissolution.) Nonprofit corporations and charitable trusts are contemporary examples of firms with super-strong form AAP. In such firms, only the firm's creditors can lay claim to the firm's assets.

C. The Economics of Asset Partitioning

Both affirmative and defensive asset partitioning offer several types of efficiencies, as well as some potential costs. We consider first the efficiencies.

1. Reducing Creditors' Monitoring Costs

One important advantage of both affirmative and defensive asset partitioning 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 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.

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[3] As a matter of strict logic, the form of liquidation protection that is the defining characteristic of strong form AAP need not imply the type of priority that is the defining characteristic of weak form AAP. That is, the law could provide for a type of firm in which the owners' personal creditors cannot force liquidation of the firm, yet those creditors share equally with firm creditors in the firm's assets if the firm is liquidated (a procedure that would then have to be initiated either by the firm's owners or creditors). 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] The term "nondistribution constraint" derives from Henry Hansmann, The Role of Nonprofit Enterprise, 89 YALE LAW JOURNAL 835 (1980).

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 various different partnerships, each of which does business of a different type or in a different location and has different partners. Absent 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 each of the firm's partners. With strong form AAP, in contrast, the creditor of a firm can largely ignore the other business affairs of the firm's owners, and focus attention only on the business of the particular firm to which he is extending credit. [5] Weak form AAP will also serve this purpose, though in more modest degree. So, too, will DAP: by investing in a firm characterized by full or partial limited liability, an individual shields, in whole or in part, both his personal assets and his other business investments from the firm's creditors, and hence reduces the need for his other business creditors and his personal creditors to monitor the firm's affairs.

2. Protecting Firm-Specific Investments

Another important function of asset partitioning – and, in particular, of strong form AAP -- is to protect the going concern values of operating businesses. This protection will commonly be important both to a firm's creditors and to its co-owners.

Consider first the situation of a firm's creditors when one (or more) of its co-owners becomes bankrupt. If the firm lacks strong form AAP, then the personal (or other business) creditors of the bankrupt owner could levy on the owner's pro rata share of firm assets. This might not matter if the firm were perfectly liquid. But most firms hold significant intangible and indivisible assets that cannot survive piecemeal distribution or liquidation without significant loss of value. Moreover, in many cases the firm and its other owners will lack the

[5] 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, perhaps by incorporating 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.

liquidity to buy off readily the bankrupt owner's creditors in order to conserve the firm's going concern value. Of course, so long as the firm has weak form AAP, the firm's own creditors will have a claim on the firm's assets that is prior to that of the bankrupt owner's creditors. But that priority will be insufficient to protect the creditors if there is a possibility that the liquidation value of the firm's assets might be less than the total amount the firm owes. In the latter case, the owner's personal creditors have the ability to hold up the firm, and perhaps its creditors, by threatening to force liquidation of the firm if they are not paid off. Strong form AAP shields the firm's creditors from this kind of threat.

Similar considerations apply to the interests of a firm's co-owners. To protect a firm's going concern value, its co-owners will often have an incentive to agree among themselves not to withdraw their individual investments in the firm before the owners as a group have agreed liquidate the firm. But this promise will be of only limited value if it does not bind the owners' personal (or other business) creditors as well. For, in the latter case, each owner can individually threaten the firm's going concern value by incurring personal obligations that he might not be able to repay. By forming a firm that is characterized by strong form AAP, the individual owners of the firm all effectively bond themselves not to create such a threat. [6]

Strong form DAP – full limited liability -- has a similar effect in the other direction, protecting the going concern value of an individual's household (or other business affairs) from claims by firm creditors.

3. Other Benefits

Beyond the functions just described, both affirmative and defensive partitioning serve other purposes that are already familiar from the literature on limited liability. For example, they permit flexibility in apportioning risk between owners and creditors of firms. They also facilitate various of the features we have come to associate with the modern corporation, such as active and liquid markets in shares and active markets in corporate control. It is important to recognize, however, that to serve these functions well it is necessary to have affirmative as well as defensive partitioning. For example, if a joint stock company were to lack strong form AAP, then, even if it benefited from full limited liability, the price of its shares would still depend on the personal finances of its individual shareholders.

4. Some Costs of Asset Partitioning

[6] As the modern law of general partnerships and close corporations makes clear, however, strong affirmative asset partitioning also imposed important costs by locking in assets and depriving vulnerable minority investors of their exit opportunities.

In addition to the benefits just described, asset partitioning can also bring costs.

First, both DAP and AAP require 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, assets frequently move – via the act of investing – from being property of the owners to being property of the firm, and conversely – via distributions of profits – from being property of the firm to being personal property of its owners. Consequently, to be effective, asset partitioning requires the capacity for clear accounting as to which assets are firm assets and which are the owners' personal assets, and likewise the capacity for 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 a far greater problem in earlier eras – a point that will be a leitmotif of the historical discussion that follows in subsection sections.

Second, 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 will increase them. This is a familiar problem with limited liability for corporate shareholders. It applies 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.

Third, even if asset partitioning can be costlessly established, it is likely to reduce diversification and hence, ceteris paribus, increase the chances that one or another of the partitioned pools of assets will become insolvent and incur the transaction costs of bankruptcy. Where this effect of partitioning is strong enough to outweigh the monitoring efficiencies it offers, partitioning will increase rather than decrease the overall cost of credit to a firm and its owners.

Yet a fourth cost, presented particularly by strong form AAP, involves governance of the firm. Granting to each of a firm's owners the right to withdraw from membership in the firm, and in the process demand that his share of the firm's assets be distributed to him, provides powerful protection against exploitation by the firm's managers or controlling owners. It is presumably for this reason that such a withdrawal right is the default rule in general partnerships.

Yet strong form AAP requires abandonment of this right, and hence of the protection it offers.[7]

D. Why Affirmative Asset Partitioning is Key

Modern legal entities are diverse and, as the preceding discussion suggests, offer many degrees of both defensive and affirmative asset partitioning. Curiously, however, legal scholarship has focused almost exclusively on defensive asset partitioning. There is a large literature exploring the history and economic significance of limited liability,[8] but little recognition of the development of affirmative asset partitioning. This neglect of affirmative asset partitioning gives a distorted view of the development of organizational law and history of organizational forms. From a functional standpoint, the development of affirmative asset partitioning is at least as important a story to tell, if not a more important story, than the development of limited liability, for several reasons.

1. AAP Is Universal; DAP Is Not

To begin with, all of the contemporary standard legal forms for enterprise organization – including partnerships, trusts, and corporations of all sorts – exhibit one or another form of AAP. Indeed, as we will argue below, we believe that a “legal entity” is best *defined* as an organization characterized by AAP of at least the weak form. Not all the standard legal forms exhibit DAP, however. Since 1978, for example, the general partnership in the U.S. has lacked even weak form DAP: Partners are personally liable, jointly and severally, for the debts of the partnership, and partnership creditors have equal priority with personal creditors in claiming the personal assets of partners.

Moreover, the importance of the strong form of DAP that receives most attention – corporate-type limited liability – often seems exaggerated, and particularly so as a necessary support for public tradeability of shares. The historical evidence suggests that large firms with tradeable shares can function quite well with at most weak form DAP. Full limited liability for shareholders was spotty in the U.S. during the first half of the 19th Century,[9] and the U.K. did not provide limited liability for business corporations until 1855.[10] Meanwhile, large numbers of joint stock companies flourished in the U.K. during the 18th and early 19th Centuries under partnership rules that imposed joint and several liability on

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[7] 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.
[8] See, e.g., ???
[9] See P. Blumberg, THE LAW OF CORPORATE GROUPS: SUBSTANTIVE LAW 23-38 (1987).
[10] Id., at 9-23.

shareholders for company debts.[11] During the 20th Century, California retained a rule of pro rata unlimited shareholder liability for corporate obligations until 1931.[12] And the American Express Company, a large financial services firm, operated as a publicly-traded New York joint stock company without the protection of limited liability for its shareholders until 1961, when it finally chose to reincorporate as a conventional business corporation.[13] Thus, while the managers and owners of large modern enterprises undoubtedly prefer limited liability to personal liability for the excess debts of their firms, the historical record also indicates clearly that large and widely-owned firms can raise capital and carry on business without limited liability.

2. AAP Is Necessary for DAP

Second, while affirmative partitioning without defensive partitioning 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 defensive partitioning make little economic sense in the absence of affirmative partitioning, and in fact – as we will explore in detail below – limited liability has developed only among forms of organization for which effective affirmative partitioning has been established.

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 pro rata claim on the owners' business assets. Business creditors, in contrast, would have no claim on personal assets and only a pro rata claim on business assets. The resulting regime would leave business creditors highly vulnerable to the borrowing activity of individual co-owners. By borrowing heavily on personal account, co-owners of a firm could reduce the assets available to satisfy business creditors to arbitrarily low levels. 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.[14] 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.

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[11] Id.

[12] See Mark I. Weinstein, *California's Move to Limited Liability: 1928 – 1931*, Marshall School of Business and University of Southern California Law School (2001).

[13] See Peter Z. Grossman, *The Market for Shares of Companies with Unlimited Liability: The Case of American Express*, 24 J. LEGAL STUD. 63 (1995).

[14] [Cite Polan v. Kinney here?]

3. Affirmative partitioning could not be introduced by contract

A fourth reason why affirmative rather than defensive asset partitioning seems to be key is that defensive partitioning is more easily secured by contract, without the assistance of the law. Once affirmative partitioning is in place, limited liability does not require a rule of positive law, at least with respect to voluntary debt.[15] Owners of firms can contract with business creditors to obtain limited liability if the law fails to provide it.[16] Many 18th and 19th century joint-stock companies in the U.K. in fact did just that.[17] Indeed, the feasibility of creating limited liability by contract has led some commentators to conjecture that law isn't really needed for creating business entities at all. On this view, contractual substitutes for the corporation and other legal entities could have developed without the assistance of positive law, and might have developed even sooner without legal intervention.[18]

By contrast, affirmative asset partitioning *cannot* feasibly be created by contract; it would be prohibitively costly to contract for even weak form affirmative asset partitioning -- that is, to subordinate the claims of personal creditors on business assets. To accomplish the necessary subordination, the owners of a firm would have to promise business creditors that they would secure subordination agreements from all personal creditors, past, present, and future. These agreements would need to distinguish business from personal assets – no easy task if the pool of business assets is always in flux. More importantly, the number of contracts that the firm's owners would need to modify in this way could be immense, with correspondingly forbidding transaction costs. But the most serious problem would be moral hazard. Business creditors commonly cannot observe contracting between the firm's owners and the owners' personal creditors. Consequently, the owners would have both the opportunity and the incentive to fail to extract the promised subordination agreements from all of their personal creditors. The only way to make affirmative asset partitioning credible is to have a rule of law providing that, if the firm is formed in a certain way, affirmative partitioning is the default rule that will be applied to it – and that the rule can be waived only by the firm's creditors.[19]

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[15] Involuntary creditors such as tort victims have been unimportant except, very recently, in the U.S.
[16] Hansmann & Kraakman, and others
[17] P. Blumberg, supra note __, at 15-16.
[18] 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);
[19] To be sure, parallel arguments can be made for defensive asset partitioning. Thus, to contract for defensive asset partitioning, all business creditors must agree to subordinate or relinquish their claims on personal assets. In addition, there is the danger that, after promising personal creditors (and co-owners) to seek limited liability from the firm's creditors, a firm's owners might fail to do so in order to reduce the firm's costs of credit. These contracting problems seem less serious, however, for much the same reasons that the liquidation protection and monitoring cost problems seem less severe under a defensive partitioning regime. In the first instance, there are likely to be many fewer business creditors than personal creditors. Still more important, the moral hazard problem – the risk that owners of a firm would fail to honor a

E. Legal Entities and Legal Personality

The standard legal forms for enterprise organization – or at least some of them – are often said to create “legal entities” or “juridical persons” that have “legal personality.” Much ink has been spilled over the meaning of these terms. We offer here a simple definition. For us, a “legal entity” is an organization that exhibits AAP. Since all of the contemporary standard legal forms for enterprise organization today are characterized by at least weak form AAP, they are therefore all legal entities.

1. Three Types of Legal Entities

For clarity of exposition, we go further and define three different types of legal entities, corresponding to the three different types of AAP: (1) *weak form* legal entities, which are characterized by weak form AAP (e.g., the contemporary general partnership); (2) *strong form* legal entities, which are characterized by strong form AAP (e.g., contemporary business corporations, cooperative corporations, and business trusts); and (3) *super-strong form* legal entities, which are characterized by super-strong form AAP (e.g., nonprofit corporations and charitable trusts). We do not include DAP in our definition of legal entities because (a) in theory, DAP is not required to have a functional version of any of the three forms of legal entity we have just defined; (b) in fact, not all organizations that have AAP also have DAP (e.g., the contemporary general partnership); (3) more generally, we observe strong forms of AAP that have weaker forms of DAP (e.g., the UK’s company limited by guaranty, which today has super-strong form AAP but only weak form DAP).

In sum, we view AAP as the central legal characteristic of modern organizations. It is the historical evolution of that rule of law that is the focus of this essay. We explore when, why, and how affirmative asset partitioning became a legal characteristic of organizations, and particularly of business firms. Put differently, we seek here to describe and explain the historical evolution of legal entities, and the ways in which that doctrinal evolution has interacted with the evolution of organizations themselves.

Before turning to the historical record, however, we offer some further comments on the concept of “legal personality.”

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commitment to personal creditors to contract for limited liability with firm creditors -- is less of an obstacle to contracting for defensive asset partitioning. As before, if authority to contract on behalf of the firm is restricted to either wealthy owners or neutral managers, the firm should be able to commit credibly to a policy of negotiating for limited liability with future business creditors.

2. Legal "Personality"

Throughout most of the historical period we will be considering, the law has established individual human beings as legal entities in the sense we use that term here. An individual can contract in his own name – that is, serve as a nexus of contracts – and those contracts are, by a default rule of contract law, bonded by a lien on all of the assets owned by that individual. The concept of ownership, for these purposes, partitions off the assets that are pledged to one individual's creditors from those that are pledged to the creditors of other individuals. The affirmative partitioning involved here is effectively strong form: other individuals (such as the individual's heirs) have a claim on the individual's assets only after the individual's creditors have been satisfied, and have no right to seek liquidation of the individual's assets. If we exclude heirs from consideration, and also ignore situations of human slavery, we might even characterize the affirmative partitioning that the law establishes for individuals as super-strong form: *only* an individual's contractual creditors have a claim on that individual's assets; an individual has no owners who retain a residual claim on those assets.

It is not surprising that, when analogous attributes have been given to organizations, the metaphoric label "legal personality" or "juridical personality" has often been used to describe those attributes, and the organizations involved have been termed "legal persons." In general, the organizations that the law considers "legal persons" are "legal entities" as we use the latter term. But the reverse is not always true. Organizations, such as modern partnerships, that we would categorize as "legal entities" are not always given the (rather imprecise) label of "legal persons" by the law. One reason, perhaps, for the law's narrower usage is that, influenced by the metaphor, the law tends to restrict the concept of legal personality to organizations that have the type of strong or super-strong affirmative asset partitioning that the law employs for living persons.[20]

As we will see, the legal person metaphor (or "fiction") has probably facilitated the law's recognition of legal entities by making salient, through force of analogy, the tactic of endowing certain kinds of organizations with the same contracting powers, and supporting asset partitioning, that the law gives to individual humans. At the same time, 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 living persons. The latter organizations had to wait until the law developed legal entities with a "personality" somewhat different from that which the law endows on living individuals.

[20] Another reason is that procedure has sometimes required that suit to recover on debts incurred by an organization, such as a partnership, be brought against the individual members rather than just against the organization, hence giving the organization less of the appearance of a separate person.

The “legal person” metaphor is perhaps also partly to blame for the low level of recognition that affirmative asset partitioning has achieved in legal and economic scholarship. The super-strong form of affirmative partitioning that characterizes the assets owned by living persons deprives that partitioning of much of its salience, since there is no other conspicuous set of assets from which the individual’s assets are partitioned off, or set of claims against the individuals’ assets that are subordinated by the partitioning. When legal personality was then carried over to organizations, it was first applied – as we will see below -- to organizations that also had super-strong partitioning, thus continuing to obscure the role of the partitioning. Moreover, the partitioning was carried over with other attributes, such as the ability to contract in the organization’s own name, whose salience was much higher, and all the more so because the organizations lacked any owners on whose direct behalf the organization could be said to be acting.

The form of asset partitioning that law establishes for living persons is typically quite simple, not only in that it is super-strong, but also in that it demarcates a “unitary asset pool” – a single broad pool of assets that, as a default rule, constitute simultaneously the assets that the individual controls and uses in the affairs of his life and the pool of assets that is pledged to each of the individual’s creditors, jointly, as security for his contractual obligations. The available deviations from this simple unitary pooling generally take the form only of pledges, to specific types of creditors, of prior claims in specific types of assets – as in the case of a mortgage on real estate.

For most types of organizations recognized as legal entities, including business organizations, a similar single unitary pool of assets has also generally been the default rule. Thus, for a business firm, the basic pattern is for the assets owned by the firm to be the assets used in the firm’s business, and for that same pool of assets to serve as a unitary pool that is pledged as security to all of the firm’s creditors. In general, this identity between the assets used in the business and the assets used to bond the firm’s contracts creates useful incentives for all involved – owners, managers, and creditors. But it is not necessary that the assets that bond an organization’s contracts be the same as the assets that the organization uses in its activities. Other forms of partitioning may be more efficient in particular circumstances. For example, the medieval law merchant, as we will see, sometimes partitioned assets into pools much larger than individual firms. Contemporary organizational law, in contrast, now 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, or even positively misleading, as a characterization of the law of legal entities.

We will sometimes refer here to “legal persons” or, equivalently, to organizations to which the law has granted “legal personality.” When we do so, we mean only that the law has granted legal entity status – that is, affirmative asset partitioning – to the organizations in question.

III. ANCIENT ROME

The organizational law of ancient Rome presents a puzzle. Early on, Roman law supported at least two organizational forms that had the characteristics of legal entities with affirmative asset partitioning. However, both of these organizations were non-commercial, taking the form of what we would today call municipal corporations and nonprofit corporations. By contrast, Roman law made available only one general purpose form for jointly owned businesses, which was a partnership that lacked not only affirmative asset partitioning but even agency powers for the firm's partners. The puzzle, then, is why the early appearance of legal personality in non-commercial organizations failed to spur the development of jointly owned legal entities with affirmative asset partitioning for use in Roman commerce.

A. Roman Law of Commercial Organizations

Although, in modern economies, affirmative asset partitioning is a universal feature of the various legal forms adopted by jointly owned commercial firms, the vast majority of jointly owned Roman commercial organizations utilized a partnership arrangement that lacked that feature. If it existed at all in Roman commerce, affirmative asset partitioning was limited to special tax farming partnerships, and perhaps to situations where a master and his slave each operated a separate business.

1. The General Roman Commercial Form: The *Societas*

Roman law generally made available only one jointly owned commercial form: the *societas.* While it is typically translated as "partnership," the *societas* lacked many of the features of the modern general partnership, including most conspicuously mutual agency (allowing partners to bind one another) and affirmative asset partitioning.

Although its origins were in the law of legacies rather than commerce, [21] the *societas* was mostly a contractual arrangement, and provided only a few

[21] More particularly, the *societas* originated in the rules governing relations among common heirs to an estate. Crook, at 229. When a Roman citizen left multiple heirs, his will determined their relative shares, but the heirs (if close relatives) could choose to enjoy the estate in common instead of effecting an immediate division. *Id*. at 120. While the estate was in this undivided form, it bore any expenses necessary to maintain its value, Buckland at 511, but any disposition of undivided estate property by one heir would be charged against his share. *Id*. at 315. An heir could order dissolution of the arrangement at any time, in which case a court would undertake an accounting and valuation and pay the heirs their respective shares, adjusted if necessary for dispositions or expenses incurred. Crook at 120; Buckland at 506, 509. The *societas* emerged as

mandatory rules. For example, partners were liable *inter se* for selling or borrowing partnership property,[22] and a partner's death or renunciation immediately dissolved the partnership.[23] Beyond this, Roman law allowed partners great flexibility in structuring their firms. Partners could tailor the duration of their partnerships as they wished,[24] they could vary the ratios in which they shared profits and losses,[25] and each partner could veto every partnership decision, subject to liability to his co-partners for an unreasonable veto.[26] Finally, partnership interests – a partner's cash distribution rights -- were alienable, although buyers could not become partners without the consent of the remaining partners.[27]

Despite the flexibility of the *societas,* it failed to provide Roman commercial actors with an important feature: the ability to alter the rights of third parties.[28] This meant that the partners in the *societas* could not have arranged for affirmative asset partitioning, which requires the ability to compromise the legal rights of personal creditors. Roman bankruptcy law appears to have made no distinction between the obligations and assets of the *societas* and those of its partners: All property was owned, and debts owed, by the partners individually.[29] Without such a distinction, Roman law could not have granted partnership creditors priority of claim in partnership assets. As a matter of right, partnership and personal creditors had equal claims on a partner's assets, whether they were used in the business of the partnership or not.

A conclusion that personal creditors enjoyed no legal rule of priority does not end the inquiry into affirmative asset partitioning, because priority of claim also can arise as a practical implication of liquidation protection. The question turns on whether the exclusive right of firm creditors to force dissolution translates into an exclusive claim in the initial distribution of firm assets. This is, for example, the rule for modern corporate bankruptcy, as the corporate estate serves primarily to satisfy the claims of corporate creditors, and the personal creditors of the owners have an effective claim only in the rare event that any corporate assets remain for distribution to shareholders.

Although the issue is not free from doubt, the historic record strongly suggests that the *societas* did not enjoy a form of liquidation protection that gave rise to affirmative asset partitioning. While the partners could waive by contract

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an organizational form when a contract between the partners took the place of the testator's will. Berger at 409.

[22] Buckland at 506.
[23] *Id.* at 508.
[24] *Id.* at 505.
[25] *Id.*
[26] *Id.* at 506.
[27] Schulz at 87.
[28] Schulz at 550.
[29] Buckland at 507.

their right to dissolve the *societas*, [30] it is doubtful that a collective waiver would have prevented creditors with unsatisfied claims from splitting the firm. Before the first century B.C., a Roman debtor in default was in danger for his liberty or even his life, and so when pressed by creditors he almost certainly would have been wiling to breach a promise to his co-partners not to withdraw his partnership share.[31] And although later innovations in Roman bankruptcy law that treated the debtor's assets rather than his body as the primary source of creditor satisfaction would have reduced the urgency of unpaid debt, [32] it is doubtful that even under this later regime partners could have prevented their creditors from liquidating the firm. Roman law appears not to have provided for specific performance for contractual promises among *societas* partners. Moreover, a damages remedy, rather than preventing liquidation altogether, at most would have made the co-partners judgment creditors with a *pari passu* claim to the defaulting partner's share of the partnership and other personal assets. Personal creditors were thus guaranteed at least some fraction of the defaulting partner's assets, and thus always would have been better off to either exercise their liquidation option or demand a fraction of the partnership's going concern value as a payoff. So although partners in the *societas* could enjoy liquidation protection against each other, they generally could not enjoy such against each others' creditors, the necessary condition for affirmative asset partitioning.

2. The Special Cases: Tax Farms and Slave-Run Businesses

Although the general Roman partnership form did not provide for affirmative asset partitioning, matters stood differently with respect to one sort of Roman partnership – the tax farm, or *societates publicanorum* . For much of Roman history, partnerships formed by certain investors (known as *publicani*) bid for the rights to collect taxes on behalf of the state.[33] While the *publicani* were

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[30] In addition, a partner might be liable if he renounced at an especially disastrous time for the partnership, or if he renounced fraudulently. *Id.* at 508.

[31] For example, during this time the bankrupt partner could be physically apprehended and sold into slavery. Crook at 173-4. Of course, if the insolvent partner could not pay his damages for violating the promise not to renounce, his co-partners also could hold him in bondage, and the value of the partnership share would then go to the side that could more credibly threaten to relieve the defaulted partner of his liberty. Given that most Roman co-partners were family members or close friends, Crook at 229, they would usually be at a decided disadvantage in this regard. As a result, we suspect that most Roman partnerships enjoyed no effective protection against a liquidation forced by the personal creditors of its partners.

[32] Brunstad at 514.

[33] "The [early] Roman way of collecting taxes, particularly the land-tax, was to sell to a company of speculators for an agreed price the right to collect and retain the tax paid by individuals…These speculators were known as *publicani,* for which the English equivalent is 'tax farmers' or 'farmers of the revenue.'" Lee at 327. It should be noted that tax farming was probably not the only business of the *publicani:* there is evidence that for a time they served as general state contractors, constructing certain public works and collecting revenues from state mines. Love at 174-8. Tax farming, however, was their principal business.

often wealthy individuals,[34] huge sums were needed to buy a region's future tax revenues over multi-year periods. Perhaps for this reason, the *societates publicanorum* were the only Roman partnerships known to have had large numbers of partners, and the only partnerships subject to an industry-specific organizational law. For example, tax partnerships followed a majority decision-making rule rather than the rule of unanimity that bound other *societas*;[35] they did not automatically dissolve upon a partner's death or renunciation;[36] term agreements to continue them were fully enforceable;[37] and they usually operated under five-year contracts with the state, at the end of which they were forced to dissolve.[38]

The fact that the partners of the *societates publicanorum* were unable to force a liquidation of the partnership during its five-year term suggests that these partnerships might have possessed a degree of affirmative asset partitioning. As in the case of the *societas*, the question depends in part on whether the inability of a partner to force liquidation was a rule of property rather than mere contract, and thus applied to the partner's personal creditors. If these creditors were unable to reach a partner's share of the firm's assets upon his default on personal debt, the likely implication is that the creditors of the partnership enjoyed an exclusive claim to the assets of the partnership for its duration.[39] The evidence is circumstantial; there is no surviving legal record of a bankruptcy of a *societates publicanorum.* Nevertheless, the large scale of these partnerships and character of their special rules support a hypothesis that the *societates publicanorum* was a true legal entity.

Roman law may have also provided affirmative asset partitioning in one other commercial setting: that of a merchant whose slave operated a business distinct from his own. Although the issue is again uncertain, some sources suggest that when such a merchant entered bankruptcy, the assets of his various businesses were maintained separately for each business's distinct set of creditors.[40] Such an arrangement would constitute weak-form affirmative asset

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[34] Crook at 234. After Rome changed from a republic to an empire in the first century BC, the powers of the *publicani* drew unsympathetic attention from the emperors, who acted to limit their range of activities and their alleged abuses. During the first century BC, the *publicani* formed a cartel to demand remission of fees paid on tax farming contracts that had turned out to be unprofitable. Julius Caesar promised to heed their demands should he win the Roman Civil War, and he thereby acquired their support. Their period of official favor, however, was short lived. Frank at 182. Although the *publicani* did not disappear immediately, repeated clampdowns by the emperors had forced them almost entirely out of the Roman tax structure by the end of the second century AD. Crook at 234

[35] *Id.* at 161.

[36] Unless the death was of the particular partner who held the contract with the State. *Id.* at 160.

[37] Cf. Crook at 234 and Buckland at 510.

[38] Crook at 234, Buckland at 234.

[39] While logical, this result is not inevitable. As we indicate in our discussion of the *societas,* an alternative possibility is that only organizational creditors could force a liquidation, but upon that liquidation all creditors would be let in to share equally in the organizational assets.

[40] Levinthal at 235-37.

partitioning, because business creditors would have enjoyed a claim to business assets prior to claims of at least some of the merchant's other creditors. Instead of a rule for jointly owned businesses, this was an unusual form of affirmative asset partitioning exclusively for multiple businesses under a single owner.

B. Roman Noncommercial Organizations

While the historic record is unclear as to whether Roman commercial organizations enjoyed rules of affirmative asset partitioning even in limited circumstances, it is unequivocal with regard to noncommercial entities. At least two organizational forms – the *municipia* (townships) and the *collegia* (nonprofit associations) – clearly functioned as legal entities from an early date in Roman history. Importantly, however, legal personality in Rome developed in practice long before it was recognized in theory, and descriptions of the *municipa* and *collegia* as distinct legal persons do not first appear until the 3rd century AD.[41] A third organization, the charitable foundation, was explicitly established as a legal entity, but only in the Byzantine Empire at a much later date.

The *municipia,* or townships, were Rome's earliest legal entities. Beginning in the 4th century BC, townships enjoyed "the practical power to own property—land, houses, slaves, and other things of all kinds."[42] The senates that governed these townships appointed agents to represent their interests in commercial transactions and legal disputes.[43] Thus, under our definition the townships were legal entities, because they owned a separate pool of assets that bonded their contracts. Indeed, townships were super-strong legal entities: neither townsfolk nor their personal creditors could levy claims against municipal assets, and thus neither group could force liquidation.[44] Logically, the only parties who could make claims against township assets were creditors who transacted directly with township agents.

Rome's second category of non-commercial legal entity was the *collegia,* which were typically associations of tradesmen dedicated to social or religious functions.[45] Today these noncommercial entities would be classified as nonprofit corporations.[46] Their traditional role was to finance community institutions such as shrines and cemeteries, and to organize public events ranging from banquets and religious services to burials.[47] The colleges solicited donations from

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[41] Duff at 162.
[42] Duff at 70. See also Berger at 590. Some commentators have observed that the *populus,* a term referring to the collective people of Rome, also seemed able from early times to contract and hold property. However, Professor Duff points out that the *populus* was "never subjected itself to the private law," and thus cannot fairly be said to have had personality in a legal, rather than purely political, sense. Duff at 51.
[43] *Id.* at 70, 76.
[44] *Id.* at 64 [check cite]. See also Schulz at 92.
[45] *Id* at 102.
[46] Schulz at 95.
[47] Duff at 102.

members and wealthy benefactors to finance their activities. Importantly for our purposes, moreover, is the fact that these donations passed completely to the colleges, and could not be rescinded once made.[48] Colleges thus became *de facto* owners of separate organizational assets, much like the townships earlier. The colleges were also like the townships in that they enjoyed full liquidation protection against both their members and their members' creditors.[49] Nevertheless, the colleges were not formally recognized as legal entities until early in the 3rd century AD, when the Emperor Constantine first legitimated the formerly underground Christian colleges and subsequently empowered them to receive legacies.

During the two centuries following this emergence of state-sponsored Christianity, an expanding Church initiated many new legal entities, ranging from monasteries to charitable "houses," to meet its organizational needs and further its religious aims.[50] This surge of activity prepared the way for one last secular entity that emerged in the waning years of the empire – a form of charitable foundation that, so long as its custodian obeyed the will of its benefactor, could operate free of Church control.[51] Much like a charitable trust, this late Roman invention was used to establish social institutions such as hospitals, almshouses, and orphanages.[52] As with modern trustees of such institutions, Roman "trustees" of charitable foundations enjoyed wide latitude, including the authority to contract, sue, and alienate property from the foundation.[53]

C. Why did Rome Lack General-Purpose Commercial Entities?

What explains the pattern of development we see in Roman organizational law and, in particular, the general Roman failure to provide for jointly owned commercial entities? The record clearly indicates that both private legal entities and jointly-owned commercial firms were common in Rome. Moreover, the examples of the *societates publicanorum* and slave-owned businesses seem to demonstrate that these forms could be combined. So why were they not combined more often? In short, why did Rome fail to develop commercial entities similar to the general partnerships and corporations that dominate modern economies?

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[48] *Id.* at 130-4.
[49] It was true that upon dissolution a college's assets were distributed to its members, some of which could also 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 property among the remaining owners when they lost interest in holding more meetings. In other words, the colleges, like the towns, had no owners. Schulz at 100.
[50] *Id.* at 173-6. Long before this point, Roman benefactors recognized the advantages of nonprofit organizations with entity status. Beginning in first century AD, donors piggybacked their contributions upon a body with entity status by making charitable gifts to towns, which were encumbered with enforceable rules regarding their disposition. Duff at 168-9.
[51] *Id.,* at 184.
[52] *Id.* at188.
[53] *Id.* at 192.

1. The Supply-Side Hypothesis

One possible explanation – the "supply-side" hypothesis -- is that Rome lacked either the requisite legal innovations or enforcement mechanisms needed to make affirmative asset partitioning work in jointly-owned commercial firms. As indicated above, affirmative asset partitioning requires both legal doctrines that recognize distinct pools of assets and creditors, and also the mechanisms for enforcing entity boundaries.

An obvious and immediate objection to any supply-side hypothesis is that Rome provides several examples of affirmative asset partitioning in organizations other than jointly owned commercial firms. The townships and colleges are evidence that Roman law had developed the concept of the "legal person" capable of owning assets in its own right, a natural (although not necessary) legal foundation for affirmative asset partitioning. Moreover, the law of slave-owned businesses suggests that Rome could create a rule of affirmative asset partitioning even without resort to the concept of the legal person. Finally, the mere existence of each of these arrangements suggests that Rome had sufficiently effective boundary-enforcement mechanisms, as we would not expect a society to establish legal rules that confer no practical advantage.

One potential method for reconciling these observations with a supply-side hypothesis is to note that the concept of the legal person may have been less than fully developed in the Roman mind during the period that commercial demand for affirmative asset partitioning peaked. As indicated above, Roman law treated towns and colleges as *de facto* legal persons for centuries before it formally recognized them as such in the third century AD. Moreover, if tax farming partnerships actually were an innovative form of commercial entity, which is uncertain, they do not seem to have been understood in that way by contemporary jurists. Thus, the first and only certain addition to the roster of Roman legal entities after the townships and colleges did not occur until the introduction of the charitable foundation in the sixth century AD. This pace of development raises the question whether legal personality was a fully formed idea available for extension to the commercial world at any time before, say, the beginning of the third century AD. If not, then supply and demand may have missed one another by fifty years. While for much of Roman history the consuls and emperors intervened little in the economy,[54] the business climate changed at the end of the second century AD when the state, desperate to finance its broadening military commitments, embarked on a program of aggressive wealth confiscation that ultimately led to the nationalization of almost all significant Roman enterprises.[55] Thus, if legal personality did not emerge as a workable

[54] Rostovtzeff at 145.
[55] Frank at 484; Louis at 282-3.

concept until the third century AD, then the Roman commercial world lacked the strength to pluck it when it was ripe.[56]

A supply-side hypothesis is also supported by the observation that the asset boundaries of those Roman organizations with affirmative asset partitioning were inherently easier to enforce than the boundaries of jointly owned commercial firms. For example, in non-profit entities such as the Roman townships and colleges, the controlling persons are not the owners, and thus cannot attempt to justify improper transfers of firm assets to themselves as distributions of net earnings. This was also true of the Roman slave-controlled businesses: Slaves generally could not own property,[57] and so any assets under a slave's control presumably belonged to the business and were available for business creditors. Finally, the boundary enforcement problems with tax farming partnerships would have been less significant than those in a typical 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 and distributing this asset, after which they themselves were liquidated. Presumably these partnerships had few suppliers and little need for credit. Thus, there may have been little occasion for conflict between partners and the creditors of the partnership over the distribution of the firm's capital.

In short, while the existence of Roman entities with affirmative asset partitioning establishes a certain quality of enforcement mechanisms, the nature of those entities leaves open the possibility that the available mechanisms were insufficient to support jointly owned commercial entities.

2. The Demand-Side Hypothesis

Of course, the causal arrow could point the other way, and Rome's lack of jointly-owned commercial entities may have been the result of a lack of demand for such entities in the economy. There are several possible reasons for such a lack of demand. First, there was a substitute available. The Roman legal system provided effective rules for secured transactions,[58] including relatively sophisticated rules for imposing floating liens on pools of assets such as a merchant's inventory.[59] Since affirmative asset partitioning is itself just a floating lien on a pool of assets, the Roman law of secured transactions could have functioned as an adequate substitute for the affirmative asset partitioning that would have been provided by a legal entity. Or at least that might be true for a

[56] The fate of colleges at this juncture of Roman history is instructive. In the third century AD the Roman state effectively nationalized the professional colleges as a device for controlling labor and guaranteeing the flow of goods to the emperor and his armies. [56] Louis at 259-61. To enforce production quotas, the state made continued participation in the same industry mandatory upon each college member and his sons. *Id.* at 263. In this way, the professional colleges became the instrument of a system of serfdom that emerged while Rome declined.

[57] [Cite]

[58] *See* Buckland at 472-7.

[59] [Cite]

commercial firm that had only one or a few business creditors, with whom explicit contracting for a security interest would have been feasible. [60]

Second, the relatively small scale of Roman enterprise might have generated little demand for jointly-owned commercial entities. As we have argued above, the economic benefits of affirmative asset partitioning in commerce depend significantly on the scale of assets committed to particular organizations. A prior claim in organizational assets is of limited benefit if those assets are relatively small in value. Similarly, the scale of assets committed to an organization suggests the degree to which its going concern value could be undermined by liquidation.[61] So where the efficient scale of production is small, demand for jointly owned commercial entities will probably be limited. And indeed, the vast majority of Roman commerce did operate on a small scale. The landholdings of most farmers were small,[62] and most industrial production, such as that of ceramic lamps, ironware, lead pipes, jewelry, furniture, and clothing, occurred in small workshops or in the homes of craftsmen.[63] While some industries such as ceramics and glassblowing were based in urban factories and seemed to operate on a larger scale, these industries appeared to derive their scale economies from specialization of labor rather than capital intensiveness.[64] Thus, even these urban commercial actors had relatively little need to aggregate significant amounts of capital.

Third, concentrated wealth in Roman times might have undercut the importance of jointly-owned entities with affirmative asset partitioning even in those few Roman industries that were relatively asset-intensive, such as brick making and other ceramics, bronze smelting glass blowing, and copper smithing.[65] Notably, although these industries were unusual in their large-scale asset concentration, they retained the ownership forms favored by the more common small-scale Roman organizations: sole proprietorship and small partnerships.[66] This result is consistent with our theory of the role of affirmative asset partitioning in structuring organizations. As two of us have indicated elsewhere, the advantages of affirmative asset partitioning increase with the

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[60] The great advantage of organizing a firm as a legal entity is that it automatically gives a (shared) floating lien on all of a firm's assets to all creditors of the firm, thus making it more workable than contractual security interests when a large (or rapidly shifting) group of firm creditors must be accommodated. Hansmann and Kraakman at 418.

[61] This follows from the observation that organizational complexity and thus management costs increase with asset scale, and thus that efficiency-oriented commercial actors will not aggregate assets under one organizational roof in the absence of compensating advantages, the most salient being scale economies in production.

[62] Louis at 80.

[63] Frank, generally at 219-274.

[64] Frank at 222, 226.

[65] Frank at 223, 228; Toutain at 301-02.

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

number of owners.[67] Thus, we would expect that demand for jointly owned commercial entities will be weaker in economies where wealthy families are sufficient in number and liquid worth to individually fund entire organizations at the efficient scale. And indeed Rome did see significant concentration of wealth in certain families, especially in the owners of large plantations,[68] which probably explains why most of the large-scale workshops in the metalworking and brick making industries were found on the estates of landowners who had made fortunes in agriculture and then diversified.[69] And as for the large-scale, capital-intensive public works, the state itself provided the capital: state slaves to build the temples; legions to build the roads; and the land itself to yield the state-owned mines.[70] If these sources of concentrated wealth were sufficient to fund all possible asset-intensive industry, the need for jointly owned entities with affirmative asset partitioning would have been limited.

The odd examples of the slave-owned businesses and tax-farming partnerships also support a demand-side explanation for the absence of jointly owned commercial entities. As indicated, although the primary advantages of affirmative asset portioning arise in multi-owner organizations, it also provides benefits for multiple businesses owned by the same individual, such as the wealthy Roman landowners who diversified. And this is indeed where the rule of affirmative asset partitioning for slave-owned businesses would have applied, as wealthy individuals unable to manage personally each of their businesses delegated control to slaves. Finally, only the *societates publicanorum* required capital on a scale beyond the capabilities of individual private investors and under conditions in which the state itself could not provide the capital because the point of the investment was to capitalize state tax revenues. We would predict demand for affirmative asset partitioning to be unusually intense in such circumstances – which is precisely where Roman law may have provided its only jointly owned commercial entity.

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[67] Without affirmative asset partitioning, each additional owner increases the number of personal creditors with whom business creditors might be forced to compete for business assets. Moreover, new owners increase the possibility of an economically inefficient liquidation, because owner proliferation decreases each owners' share in an organization's going concern value and thus tilts toward liquidation each owner's personal calculus of the relative benefits of keeping his investment in the organization. Hansman & Kraakman at 410-12. Finally, while the economic benefits of affirmative asset partitioning increase with the number of owners, so does the difficulty of achieving affirmative asset partitioning merely through contract, because of the increased monitoring costs associated with ensuring that owners extract the necessarily subordination agreements from their personal creditors. *Id.*

[68] Louis at 86.

[69] Toutain at 301.

[70] Louis at 78, 202, 274.

IV. THE DARK AGES

The Germanic tribes that sacked the City of Rome in AD 476 and occupied most of Western Empire had a lasting impact on European commercial and entity law. In some parts of Europe such as England the invaders completely supplanted Roman traditions.[71] In other places, such as Southern Europe and especially Italy, the invaders allowed some aspects of Roman law to continue, including certain classical rules of commercial dealings.[72]

Among the surviving Roman rules, many received Germanic alterations. This was particularly true of the law of the *societas.* Because most Roman partnerships were family affairs, partnership law changed in the Dark Ages to reflect the Germanic tradition of collectivist familial responsibility, under which clans or even entire villages commonly shared both the property and the obligations of members.[73] So out went the Roman partnership rule of unlimited personal *pro rata* liability, under which each partner was liable only for his proportionate share of the unpaid debts of the partnership, and in came a regime that held partners jointly and severally liable for partnership debts.[74]

The change in European partnership law from *pro rata* to unlimited liability would have changed who bore the risks of the insolvency of individual partners. Under *pro rata* liability, business creditors bear much of the risk of individual partner insolvency. This is because under *pro rata* liability a business creditor must collect his claim in fractions from each partner based on that partner's share of the partnership. If a particular partner is insolvent when the business creditor comes to collect, the partner's personal assets may be insufficient to cover the business creditor's claim, especially if this claim must compete with those of the partner's personal creditors. In that case, the creditor's claim will go partly uncollected. In contrast, joint and several liability allows the business creditor to collect the full amount of his claim from the partners with the deepest pockets, who then face the prospect of seeking contribution from their less wealthy colleagues. So under joint and several liability, the partners themselves bear much of the risk of each other's insolvency.

Unlimited joint and several liability creates strong incentives for each partner to choose his or her fellow partners carefully, and to monitor carefully their business conduct and personal solvency. This makes joint and several liability most appropriate in firms that do not have freely transferable membership, and, within that category, for relatively small firms. *Pro rata* liability is more appropriate in firms with the opposite characteristics, in which a rule of joint and several liability would create a substantial incentive for individual partners to act opportunistically, not only toward firm creditors but also toward each other. This has, in fact, been the pattern followed by these two forms of

[71] 3 Holdsworth at 13.
[72] *Id*. at 3.
[73] Calisse at 528-9.
[74] Buckland at 507; Lopez (1952) at 313; Lopez (1976) at 75.

unlimited liability in recent centuries. It is therefore somewhat surprising that Roman partnerships, though small and generally without freely transferable membership, followed the *pro rata* rule.

In any event, the modest scale of economic activity during the Dark Ages seems to have provided an appropriate environment for its rule of joint and several liability. While Europe would eventually confront the problems of large partnerships with tradable shares, between approximately AD 500 and 1000 economic conditions provided little impetus for the formation of many-owner commercial enterprises. Southern Europe's population was reduced by a series of epidemics in the fifth and sixth centuries, and then held in check by a decline in agricultural productivity due to soil exhaustion, more primitive cultivation techniques, and perhaps climate change.[75] In the first century AD, Roman harvests averaged between four and ten times the crop allocated for seed; in the ninth century, the harvests yielded only twice the seed.[76] Besides restricting the size of the population, such a decline of productivity also reduced its wealth, and thus its demand for manufactured goods. Meanwhile, the cost of distributing goods increased as the great Roman roads decayed and the system of roadside inns and shops gave way to intermittent fairs.[77] The net result was a severe decrease in investment in commercial ventures during this period.[78]

As the fairs evince, trade did not disappear altogether. Nevertheless, the higher cost of travel combined with the general decline in demand meant that the only items worth shipping were luxury goods for consumption by a small upper class that had benefited from increased land concentration under feudalism.[79] The small artisan shops that supplied such luxury items required relatively little capital, obviating the need for large ownership structures. Thus, beyond the shift from *pro rata* to joint and several liability, commercial entity law changed little during the period, and the appearance of innovations supporting a rule of affirmative asset partitioning would have to await more prosperous times.

V. THE COMMERCIAL REVOLUTION (1000 TO 1346)

After half a millennium of economic stagnation, Europe's economy experienced slow but meaningful growth triggered by a rise in agricultural output and population toward the end of the tenth century.[80] Increasing wealth and new capital surpluses spurred a significant revival in trade.[81] This expanding trade

[75] Lopez (1952) at 306.
[76] Lopez (1976) at 17.
[77] Lopez (1952) at 316-7.
[78] Lopez (1976) at 18.
[79] Lopez (1952) at 315.
[80] Lopez (1976) at 27-34.
[81] *Id.* at 59.

was accompanied by changes in commercial organizations and in organizational law.

A. Trading Fairs And The Medieval Law Merchant

An important component of the growing volume of trade occurred at regularly organized fairs attended by merchants from cities all over Europe. Among the most prominent examples were the fairs of the French province of Champagne that flourished in the 12th and 13th centuries.[82]

Lacking any public system of courts with effective international jurisdiction, business at the fairs was governed by the law merchant, an international body of customary law that evolved in this period. Each fair had its own court, which remained in session for the fair's duration. Disputes between merchants at the fair were brought before this court, which decided the disputes in a matter of days before the merchants involved left the fair. The effective jurisdiction of the court did not reach beyond the fair, so that remedies could not be obtained against a merchant once he left. The principal means for making a merchant respect the judgments of the court was the threat that, if he did not, he would be barred from the fair in the future.

It was apparently common for merchants to incur debts and other contractual obligations at the fairs. If a merchant failed to meet his obligations, suit could be brought against him in the court of the fair. Beginning in the 12th century, all of the goods that a merchant held at the fair were considered mortgaged to pay his fair debts. The merchant's creditors at the fair shared *pro rata*, although an unpaid vendor had preference over any other creditor. Creditors outside the fair took what was left. Thus, fair creditors had priority over non-fair creditors. In effect, the law merchant made "the merchant at the fair" a separate legal entity, whose creditors took priority over other creditors of the owner of the entity (that owner being the merchant in his broader persona).

Moreover, under the law merchant as administered in the courts of the fairs, liability for debts incurred by a merchant at the fair extended not just to that merchant, but to all other merchants at the fair who came from the same city as the debtor. Thus the goods present at the fair belonging to all the merchants from a given city served as security for the debts of each individual merchant. Or, put differently, the goods of all of those merchants were affirmatively partitioned to bond the debts contracted at the fair by the entire group of merchants. In effect, the law merchant made the merchants from a given city who were present at a fair into a partnership with liquidation protection, and thus

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[82] 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.

legal entity status, for purposes of trading at the fair,[83] with the non-fair (i.e., “personal”) creditors of the members of this partnership subordinated to the partnership’s creditors (i.e., persons who had extended credit to the partners at the fair) so far as claims on the partnership assets (the partners’ assets present at the fair) were concerned.

This system had obvious benefits. It provided substantial support for credit-based transactions among merchants at the fair, since it provided for fairly visible and easily monitored pools of assets to back those transactions. Moreover, those asset pools were free from hard-to-observe claims, especially prior debts, that a merchant might have incurred outside the fair. The collective responsibility aspect of the arrangement naturally gave merchants from a given city a strong incentive to monitor each other, a task they could undertake effectively because they – unlike the courts at the fairs – were in a position to pursue remedies against each other in the courts of their home city.

At the same time, the creation of these *de facto* fair-based partnerships was unlikely to work to the overall detriment of non-fair creditors of the merchants involved. If, as was the purpose, trading at the fair was profitable for the average merchant, then non-fair creditors would find that a merchant debtor would return from the fair more, rather than less, able to pay off the debt, despite the temporary priority granted to fair creditors during the period of the fair. Put differently, the *de facto* partnership would effectively be liquidated upon the conclusion of the fair, and each “partner’s” non-fair creditors would then have a claim on the partner’s share of the partnership assets, which would be distributed to the partner at that point.

After the 13th century, the system of collective responsibility began to break down. There seem to have been several reasons for this. One was that merchants’ ties to their home cities became less binding as commercial mobility increased, with the result that the ability of the merchants from a given city to discipline each other was weakened. Another was that, with increasing prosperity, the merchants from a given city became more heterogeneous in terms of wealth and reputation, so that the collective responsibility system caused the more successful merchants to serve as sureties for their less creditworthy compatriots. For both reasons, the tendency of the collective responsibility system to induce freeriding outstripped its tendency to induce mutual policing. Moreover, some individual merchants became so successful and prominent that they could credibly bond their own debts at the fairs (and in the cities, where trading was often governed similarly) without need of the community responsibility system. And this latter development was aided by the

[83] In fact, the merchants present at a fair from a given city commonly formed themselves into an association to govern themselves, thus giving this *de facto* partnership some of the internal structure of a partnership as well.

development of true ongoing partnerships of merchants, which we will discuss below.

B. Maritime Firms: The *Commenda*

Although the Commercial Revolution touched all of Europe, the Mediterranean provided its most important trade routes and saw its most prosperous cities. For example, in 1293 the sea trade of Genoa was three times the state revenues of the entire Kingdom of France.[84] Not surprisingly, then, innovation in the organization of commercial firms was first concentrated in maritime trade in the Italian city-states.

The first important step in this innovation came when, after five centuries of dominance by the Germanic partnership form, the earliest recorded *commenda* contract was struck in Venice in 1072.[85] The *commenda* was a form of limited partnership with no perfect analog under Roman or Germanic law; it seems instead 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 seventh century AD.[86] The *commenda* soon came to play a dominant role in the organization of European maritime trade.

In its simplest form, the *commenda* was a contract for a single Mediterranean mercantile expedition between an active partner, who managed the voyage and thereby invested his labor, and a "passive" partner, who invested capital in the form of tradable goods or funds.[87] In some *commenda* the passive partner selected the port of destination and goods for exchange, but more often the active partner was free to follow his own initiative.[88] Upon return to homeport, the *commenda* liquidated: the active partner rendered an accounting and divided the proceeds.[89] If the expedition showed a profit, the active partner paid the passive partner his original investment plus three-fourths of the residual, keeping the last quarter for himself.[90] If instead the voyage did not recoup the

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[84] *Id.* at 94.
[85] Confusingly, the Venetians themselves called this new contract a *collegantia*, the rules for which were exactly the same as those for the contract that most of the rest of Southern Europe called the *commenda*, or a local variant—*comanda* in Barcelona, *accomendatio* in Genoa, etc. Lopez and Raymond at 176-181.
[86] Cizakca at 5.
[87] De Roover (1: 1963) at 49-50.
[88] Lopez and Raymond at 176.
[89] See Lopez and Raymond at 180 for an example of a *commenda* that gives the active partner one month from the date of returning to port to find the passive partner and make the required payments.
[90] Lopez (1976) at 76-7; de Roover (1: 1963) at 49-50. In one common variant, the active partner 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 active partner only contributed labor. 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

invested capital, the passive partner bore the loss and had no action for contribution against the active partner.[91]

The *commenda* was innovative in establishing defensive asset partitioning. That partitioning arose from the use of a contractual provision, reliably enforced by courts, [92] which provided that the passive partner's losses could never exceed his original investment even if the expedition bore additional costs not covered by its proceeds.[93] These losses were the active partner's alone. The *commenda* thus provided the passive partner with limited liability.

Did the *commenda* also have affirmative asset partitioning? As a legal matter we cannot say with certainty, because we have been unable to find cases directly addressing a conflict of claims between the business creditors of a *commenda* and the personal creditors of either the active or the passive partner. There are, however, reasons to believe that, in terms of formal legal doctrine, there was no affirmative partitioning with respect to either type of partner.

The active partner apparently contracted in his own name when conducting *commenda* business,[94] suggesting strongly that, as with partners in the general partnerships of that time (to which we turn below), no distinction was drawn between personal and firm creditors in terms of priority. A passive partner, in turn, retained legal title over the capital he invested,[95] and had the legal right to recall the active partner at any time and demand the return of his investment.[96] This strong degree of recognized ownership suggests that the passive partner's personal creditors may well have had as strong a claim on his investment in the *commenda* as on his other property.[97]

But even if the law did not endow the *commenda* with affirmative asset partitioning as a matter of formal doctrine, it is likely that the *commenda* exhibited

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Venetians made no distinction: to them it was a *collegantia* either way. Lopez and Raymond at 176-180. The lesson for researchers is that, when reading documents from this era, focus on the contractual language and ignore the title

[91] See Lopez and Raymond at 177 for a *collegantia* contract in which the partners explicitly waive their rights of contribution against each other.

[92] Cizakca at 14.

[93] *Id.*

[94] Mitchell at 127.

[95] Postan at 68, 80-82.

[96] Gies and Gies at 53.

[97] Based upon observations by some scholars that medieval partnership forms did develop at least some indicia of legal personality, Professor Mahoney has concluded that the *commenda* enjoyed affirmative asset partitioning. *See* Mahoney at 880, citing to Berman at 353-4. It is true that the *commenda* in its capacity to survive a change in passive partners displayed one feature of "corporateness," and that the roughly contemporaneous Italian partnership form called the *compagnia*, discussed below, enjoyed a degree of representation personality. But the *commenda* lacked the aspect of legal personality relevant for affirmative asset partitioning, i.e., the ability to own property in its own name. In this sense the *commenda* was no different from the Roman *societas* whose debts to third parties were owed by the partners as individuals. See Lopez (1976) at 77.

a substantial degree of affirmative partitioning as a practical matter. The firm's assets were physically segregated in the hull of the ship, which for most of the life of the firm would have been on the seas or in a foreign port, out of the reach of the personal creditors of the active partner. And while the passive partner had the legal power to recall the ship at any time, as a practical matter this undoubtedly was often difficult. The *commenda* thus would have enjoyed in practice liquidation protection against its owners' personal creditors, at least for the duration of the voyage.

As we have indicated, the withdrawal right is used by owners to protect themselves against each other's opportunistic and improper conversion of business assets into personal assets. The passive owner's willingness to temporarily part with this power as a practical matter in the *commenda* suggests that either the circumstances of this particular type of firm or the presence of some other enforcement technology provided the passive partner with a degree of protection against such asset conversion that was not present in, for example, the typical Roman *societas.* And we indeed find such protection for the *commenda's* passive partner in the fact that during the course of the voyage the active partner, although in possession of the firm assets, was physically separated from his home and personal assets. Thus, improper conversion of firm assets would have been practically difficult for the active partner; any assets he improperly "converted" from the firm will still have to come back with him on the return voyage. Thus, the physical segregation of assets in the ship's hull would have provided not only liquidation protection against the partners' personal creditors, but it also would have provided the enforcement technology upon which affirmative asset partitioning relies – and which would have made the temporary loss of the withdrawal right acceptable to the passive partner.

The short life of the *commenda* is important here. If a *commenda* had lasted for multiple voyages, then the line between the assets committed to the firm and those possessed by the individual partners would have been much more difficult to monitor, rendering liquidation protection problematic. It is thus not surprising that the passive partner required an accounting and liquidation upon the voyage's return to homeport, when the opportunity for improper conversion of assets by the active partner would have greatly increased.

That the *commenda's* passive partner enjoyed limited liability reinforces the conclusion that the *commenda* featured a degree of affirmative asset partitioning as a practical matter. Although the bulk of the firm's assets came from the passive partner, firm creditors would have known that they had no recourse to his personal assets, if indeed they even knew of his existence. And while the active partner's personal assets presumably could be pursued to satisfy the debts of the *commenda*, it seems likely that his personal wealth generally would not have been substantial. If, in these circumstances, the personal creditors of both the active and passive partners had claims on the *commenda's* assets that were as strong as the claims of business creditors, then the *commenda* presumably would have had a difficult time attracting credit.

Indeed, this logic has far broader application than just the *commenda*. As a general matter, one would not expect to find defensive asset partitioning in any type of firm in the absence of affirmative partitioning. And apparently one does not. Rather, as our discussion of later centuries will show, defensive partitioning seems to arise only after affirmative partitioning has first become well established, at least as a practical matter if not as legal doctrine.

Just as the *commenda's* physical segregation of assets and short duration underpinned the willingness of the passive partner to temporarily forgo, as a practical matter, his withdrawal right, these features would have also enabled the *commenda* to attract credit despite its partial limited liability. The short life of the *commenda*, together with its relatively risky character, undoubtedly made it much more likely that the voyage – and thus the firm – would fail than that the partners would encounter personal financial failure during the life of the voyage. Moreover, the contractual obligations incurred by the firm generally may have been confined to dealings in foreign ports, which presumably settled before the ship set sail from these ports. These factors would have reduced the possibility that the partners' personal creditors would pursue the *commenda*'s assets prior to the dissolution of the firm and settling of firm debt, and hence added to the ability of the firm's creditors to rely upon the firm's assets without being concerned about the partners' personal creditors. Again, if the *commenda* had lasted for multiple voyages, the difficulty of monitoring and defining the line between the assets committed to the firm and those possessed by the individual partners would have rendered problematic the defensive asset partitioning granted the passive partner.

In short, the *commenda* may have operated much like the *de facto* partnerships that, as we have described above, were created around merchants at the fairs in Champagne and elsewhere. In both cases, we see the development of devices that effectively provided for affirmative partitioning of assets in entity-like arrangements to facilitate commerce. And in both cases the practical feasibility – in particular, the visibility and credibility -- of the partitioning was strongly enhanced by (a) the physical segregation of the partitioned assets from their owners' other assets that could be more easily accessed by their personal creditors, and (b) a relatively short duration for the partitioning.

This pattern suggests that, in the commercial setting of the time, the success of entity-like arrangements may have been dependent on physical segregation of assets. Absent such segregation, the enforcement technology of the time was insufficient to effectively police the boundary between assets belonging to the firm and those belonging to its owners and thus to make such a boundary useful in defining creditor rights. If so, the absence of formal legal doctrine that permitted the formation of commercial firms with affirmative asset partitioning may not have been an important constraint on organizational development in the early and high Middle Ages. The apparent priority for firm creditors that such partitioning would permit might have been of no practical value for most types of commercial enterprise.

C. Non-Maritime Partnerships: The *Compagnia*

While the limited liability *commenda* was rapidly achieving predominance among maritime contracts in twelfth century Southern Europe,[98] partnerships characterized by the Germanic rule of joint and several liability maintained their hold over land-based trade.[99] Like the single-voyage *commenda,* these were short-term partnerships; they typically had fixed durations of between one and five years.[100]

The partnerships for overland commerce in the twelfth and early thirteenth centuries, like those of the Dark Ages, were small, family affairs. In some places these arrangements were called *societas,*[101] utilizing the name but not the liability rules of the Roman partnership. However, non-maritime partnerships were more commonly called *compagnia* ("company")*,* a term derived from a Venetian legal institution called the *fraterna compagnia* that governed relations among heirs to an undivided estate.[102] Liability in a *compagnia* was joint and several,[103] rendering it functionally equivalent to the medieval *societas.*

Although throughout the Commercial Revolution the vast majority of non-maritime partnerships were small affairs, in the last half of the thirteenth century a few *compagnia* grew in size to include as many as twenty partners and several hundred employees.[104] These "super companies" typically started as family partnerships involved in textile manufacturing and grain trading in inland Italian cities such as Florence and Siena.[105] As the volume of trade increased in the late thirteenth century, some of these *compagnia* established branches in various medieval European ports—certain Italian coastal cities plus Avignon, Bruges, London, and Paris—to establish regular exchange counterparts, control supply of textile inputs, and reduce price risk by negotiating terms in advance of shipment.[106]

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98 De Roover (1: 1963) at 49, 52.
99 Lopez (1976) at 74.
100 Favier at 157.
101 Mitchell at 129.
102 Lopez and Raymond at 185. 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.*
103 Lopez (1976) at 74.
104 De Roover (1: 1963) at 75; Hunt and Murray at 62, 105-9.
105 Hunt and Murray at 102-4.
106 De Roover (1: 1963) at 70-89; Hunt and Murray at 102-5.

As the great *compagnia* grew they also diversified. Many spread a portion of their capital among passive *commenda* positions with various independent merchants.[107] More famously, some of the largest stepped in to fill demand for currency exchange,[108] and thereby became the first international banking concerns.[109]

Although the international presence of the large *compagnia* created new lines of business, it also strained the law of partnership. The Roman method of binding the partnership—each partner signing his own name to a contract—was impracticable when the *compagnia* wished to transact in Marseilles but most of the partners were in Florence. Commerce-friendly courts thus began honoring procuration agreements among partners and salaried branch managers.[110] Courts also recognized as binding upon all partners debts that had been entered into the partnership ledger or that served the interests of the partnership generally.[111] Alternatively, an agent could make a debt binding upon the whole partnership if he (with authorization) signed the name of the firm itself, e.g., "Antonio Quarti et socii,"[112] or affixed the firm's special seal or logo.[113] Eventually, perhaps because clauses of procuration had become so common, courts made mutual power of agency the default rule among partners.[114]

These innovations in the area of agency constituted an important step in the evolution of European organizational law. By distinguishing between when a partner binds only himself and when he acts in "the name of the partnership," the law of the *compagnia* offered the first clear recognition in post-Roman law of a distinction that would persist and was essential to the development of partnerships and other commercial forms that were legal entities with affirmative asset partitioning.

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[107] De Roover (1: 1963) at 71.

[108] 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 Commercial Revolution (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.

[109] 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.

[110] Mitchell at 132; De Roover (1948) at 32.

[111] Mitchell at 132.

[112] Mitchell at 130-34; De Roover (1948) at 30; 8 Holdsworth at 198.

[113] Fryde at 117; Hunt and Murray at 106.

[114] Mitchell at 133.

With the new agency powers came new agency problems, as distant and hard-to-monitor agents could now incur imprudent debts binding upon the whole partnership. Distance also exacerbated the old problems associated with joint and several liability, because it made it more difficult to monitor a partner's personal affairs and thus increased the chances that, through squandering his personal wealth, he would force other partners to bear his share of partnership liabilities. Compounding the risk of rash or fraudulent action was the fact that the multi-branch *compagnia* grew too large to be staffed entirely with members of one family.[115]

These problems, which also affected the ability of the firms to give assurances to their creditors, might have been mitigated by asset partitioning. However, the judicial recognition of the power of partners in a *compagnia* to bind each other did not immediately lead courts to distinguish between the *compagnia* and its owners for purposes of asset ownership. The *compagnia* appears not to have had the capacity to own property in its own name, and thus could not be recognized or sued as a debtor in its own right. In short, affirmative asset partitioning was not available to the *compagnia*. Of necessity – following the logic laid out in our earlier discussion of the *commenda* – there was thus no potential for developing defensive asset partitioning (including limited liability).

A limited substitute for affirmative asset partitioning did, however, develop. An important benefit of affirmative asset partitioning is that, even in the absence of limited liability, it helps prevent the insolvency of one business venture from bringing insolvency to other, unrelated ventures that have one or more owners in common with the first. Absent affirmative partitioning, unsatisfied creditors of one insolvent venture can proceed against the assets of all other ventures that have owners in common, and do so on equal priority with persons who have extended credit directly to those other ventures. Since a potential creditor of any single partnership may have little ability to ascertain or control whether the various individual partners invest in other ventures, the result may be a substantial handicap to the individual partnerships in attracting credit. (There is, of course, a tradeoff here. Making all firms with common ownership sureties for each other increases and diversifies the pool of assets available to the creditors of each individual firm. Partitioning will be efficient only when this advantage is offset by the higher monitoring costs and moral hazard that comes from having all the various firms' assets held, for purposes of creditors, in a common pool.)

In apparent response to this problem, merchants of the time were forbidden from being partners in more than one *compagnia.*[116] The practical effect of this rule was to create strong-form affirmative asset partitioning among separate *compagnie*, and thus to remove the potential for a domino effect when one *compagnia* failed. Note that this rule, like the closely related rule of

[115] 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.
[116] Favier at 164.

affirmative asset partitioning, would have required adoption as a matter of law to make it effective, since it cannot be achieved just by contract. Suppose, for example, that the partners of a *compagnia*, in the absence of such a rule, were to promise to the *compagnia*'s creditors that they would invest in no other *compagnie*. And suppose that they were then to break that promise and make such investments, and that one or more of those other *compagnie* were to become insolvent. The promise made to the creditors of the first *compagnia* would presumably (at least absent notice) not bind the creditors of the insolvent one, who would still be able to proceed against the assets of the first *compagnia*, thus rendering the promise to the creditors of the latter firm nugatory.

Why was the solution of the time to attempt to prevent cross-ownership, rather than the analogous step of providing for affirmative asset partitioning for firm assets (an approach that would also have set up the necessary precondition for limited liability)? A likely answer is that which we have invoked before. Affirmative asset partitioning would have been largely unworkable because it was too difficult in the circumstances to police the boundary between assets belonging to the firm and assets belonging to the firm's owners. In contrast, it was comparatively easy to determine whether individuals were partners in more than one firm.

Despite the rule against cross-ownership, the larger *compagnia* showed signs of instability, going through bankruptcies in a boom and bust cycle that grew more vicious in the first half of the fourteenth century and culminated when the three largest *compagnie* – the Accioiuoli, the Bardi, and the Peruzzi – all failed spectacularly within thirty months of each other between 1343 and 1346.[117] The next year saw the beginning of the Black Plague, which decimated Europe's population and economy and ruined the market for merchant banking at the scale at which it had been conducted in the first half of the fourteenth century.[118] When multi-branch trading companies finally reappeared fifty years later, these partnerships were organized rather differently from the earlier *compagnie*.

Before we tell that story, however, we turn briefly to noncommercial organizations.

D. Noncommercial Organizations

The fall of the Roman Empire did not bring an end to noncommercial organizations that paralleled the collapse of commercial enterprise. In particular, those bodies associated with the Church, such as religious communities, dioceses, monasteries, and charitable foundations, persisted into the Dark Ages.[119] However, the Germanic notion of communal responsibility had a

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[117] Hunt and Murray at 113, 119; Lopez (1976) at 75; De Roover (1948) at 32. *See also* Fryde at 107-120 for a description of the bankruptcies of other large Italian merchant and banking companies earlier in the fourteenth century.

[118] Hunt and Murray at 120.

[119] Brissoud at 890.

defining impact on the legal status of these organizations.[120] In particular, religious bodies adopted the Germanic legal convention by which all community members consented to community contracts and were named in summonses for collection of community debts.[121] 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.[122]

The renewed interest in Roman law that developed toward the end of the eleventh century brought efforts to harmonize Roman, canon, and local law.[123] In this process, the medieval jurists of the canon law found some, but not all, aspects of the Roman law of legal persons useful for governing Church organizations. The Church did adopt the Roman rule that a Church body could have a head (called a rector or prelate) who could perform certain acts on its behalf, thus creating a degree of delegated agency.[124] However, his power of agency was not total: in many matters the prelate's actions required the consent of all members.[125]

As for property rights, twelfth century jurists would have been aware of the exhortations of Justinian's Digest 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."[126] Nevertheless, the Church rejected the Roman corporate rule by which an organization could own property in its own name. Rather, the Church maintained the Germanic rule that a body's assets were the common property of its members.[127] Thus, Church organizations of the time did not have the formal character of legal entities.

Nevertheless, those organizations were substantial. There were thousands of monasteries spread across Europe in the middle ages, many of which had numerous members and held substantial property, including large building complexes and extensive agricultural land. Substantial universities also arose in this period – most famously in Bologna, Paris, Oxford, and Cambridge – as did numerous guilds, schools, and hospitals. Many of these organizations – like the universities must mentioned – had great permanence.

Why such an extensive development of large nonprofit organizations while commercial firms remained relatively underdeveloped? The explanation may be partly on the demand side. The social organization and technology of the time

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[120] Berman at 217.
[121] Calisse at 529
[122] Brissaud at 891; Calisse at 530.
[123] *Id.* at 15-6; Certoma at 5.
[124] *Id.*, at 219.
[125] *Id.*, at 221.
[126] Berman at 216.
[127] Berman at 219.

may have given rise to much stronger needs for noncommercial organizations than for commercial firms. Yet we suspect that equally important reasons lay on the supply side – reasons similar to those we suggested earlier to explain the similar pattern seen in ancient Rome. As a practical matter, partitioning the assets of the noncommercial organizations from those of their members may have been relatively unproblematic. The members of the organizations had no claim to the organizations' assets outside of the context of the organizations' activities. Thus, one never had to determine whether an asset had legitimately moved from being the property of the organization to being the property of one of its members; it always remained property of the organization. Moreover, for many of these organizations – as in the monasteries whose monks had taken a vow of poverty – the members themselves did not maintain substantial personal assets that needed to be distinguished from those of the organization. It is perhaps for the latter reason that canon law doctrine did not, in this period, develop a clear distinction between property of church organizations and that of its members.

Also, pressure for clear asset partitioning may have been low because the large noncommercial organizations had few important creditors. Many were endowed organizations, operating on capital surplus. And, when credit was needed, it may not have been forthcoming, or at least not in a form that involved any threat of foreclosure. Then as now, assets of charities may have been considered dedicated to charitable purposes that kept them from being claimed by creditors for other purposes. And, even where this was not the case, creditors – again, then as now – may not have been eager to foreclose on a religious or charitable organization owing to the unseemly appearance this created.

VI. THE ITALIAN RENAISSANCE (1346 TO 1500)

Following the Black Plague, organizational law continued to develop in Europe, and particularly in Italy, during the Renaissance. Despite major advances in other fields, however, progress toward the modern forms of the partnership and corporation was slow.

A. Toward a Partnership Entity: The Medici Bank

The Italian city-states retained the *compagnie* as the principal form of business organization during the Renaissance, although the character of this partnership form continued to evolve. The Medici Bank (1397-1497) is the best-known example. Like its medieval forbearers, this "bank" was not only a merchant bank but also a diversified manufacturer and trader in commodities.[128]

[128] The Medici Bank also diversified across market segments, trading 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 mostly concentrated in northern Italy, its merchant

It differed from the medieval *compagnia* in one important respect, however. It was organized not as a single partnership, but as a network of partnerships 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.[129] (Evidently, the Medici were released from any obligation to limit their investments to a single *compagnie*.)

This multi-partnership structure had obvious advantages. It focused the incentives of local managers by tying their returns to the performance of their businesses. In addition, it allowed the Medici's junior partners to enjoy the protection of defensive asset partitioning. Thus, the local managers of the Medici's Tuscan silk operations and banking managers in Avignon were not in the same partnerships, and so bore no personal liability for one another's partnership debts.

Less certain, however, is whether the *business assets* of the Medici partnerships were also insulated from cross partnership liabilities. It is clear that the Medici could have insulated each partnership from the debts of other partnerships by adopting a novel limited partnership form, the *societá en accomandita,* which Florence first introduced by statute in 1408.[130] This form was a kind of fixed-term *commenda,*[131] in which investors were either personally liable as "general" partners, or enjoyed limited liability as "limited" partners.[132] Thus, by investing as limited partners in the *accomandita* form, the Medici might have insulated not only their personal assets, but also their share of the business assets in each of their partnerships, from cross partnership liability. By and large, however, they did not insulate their assets in this way, but instead chose the *compagnie* form over the novel *accomandita.*[133] They may have done so to

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banking business maintained branches in Geneva, Avignon, Bruges, and London**.** *See* generally De Roover (2: 1963) at 142-168.

[129] De Roover (2: 1963) at 81-2.

[130] De Roover (1: 1963) at 75.

[131] As early as the thirteenth century, merchants had struck *commenda* contracts for overland commerce. These typically served the purpose of transporting goods to a particular fair, and thus were one-voyage contracts similar to the more popular sea *commenda*. *See* Lopez and Raymond at 188-9 for examples. Before 1408, Italian authorities discouraged fixed-term C*ommenda* 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.

[132] De Roover (2: 1963) at 89. Limited partners risk personal liability if they participated in trading or allowed their names to be used in business transactions**.** *Id*. at 284

[133] The Medici seemed to use the *accomandita* only as a probationary arrangement for new managers and not as their primary partnership form**.** 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 started as a Geneva office salaried employee and was sent to run the new branch. De Roover (2: 1963) 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

reduce their borrowing cost.[134] For example, their business creditors might have insisted that they remain personally liable, given that – as we suggested earlier -- affirmative asset partitioning could not be made credible at the time without the physical segregation of business assets. Alternatively, the Medici might simply have desired to retain control over their local managers. But whatever the reason, they used the "general partnership" form, which may – or may not – also have enjoyed a measure of affirmative asset partitioning in the eyes of the law.

As the following cases suggest, exactly what cross-partnership asset partitioning the Medici partnerships enjoyed seems to have been unclear.[135] The 1455 case of *Ruffini* v. *Agnoli Tani & Co. of Bruges* appears to have granted affirmative asset partitioning to a local Medici partnership. *Ruffini* involved a damage action against the Medici's Bruges branch for the defective packing of wool bales that had been purchased from their London branch. Even though the Medici family was a member of both the Bruges and London partnerships, a Bruges court dismissed the action against the Bruges branch (while reserving the plaintiff's right of action against the London branch). Thus, the *Ruffini* decision appeared to respect the premise upon which the Medici structure depended, i.e., that one partnership could not bind another, simply because the two partnerships had an overlapping members.[136] Put differently, the Bruges judges seemed to endorse a theory that the London and Bruges branches were separate legal entities.[137]

By contrast, the 1495 case of *Carnago v. Lorenzo Tournabuoni & Co* cut against affirmative partitioning by permitting a creditor sue the Medici's banking branch in Naples on a debt owed by their Roman branch, even though the Neapolitan branch was not a party to the debt and may have had difficulty repaying its own separate creditors.[138] The fact that the Roman partnership

annual average of 24% on their capital in his first 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 the option to use their seal and from the greater security for Zampini outweighed the costs of joining him in unlimited liability for partnership debts.

[134] *Id.*

[135] Note that the Medici themselves referred to their various partnerships as if they were separate legal persons. 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 (2: 1963) at 82.

[136] The decision's historical importance rests more on the court's apparent refusal to allow Ruffini to re-file in Bruges naming just the Medici family as defendants. Neither the London nor Bruges partnerships were *accomandita* in 1455. Consequently, under the old rules of joint and several liability Ruffini should have been able to sue the Medici partners personally for debts of the London firm. It might then seem to follow that Ruffini could proceed against Medici assets wherever they were found, including in their Bruges partnership. *See id.* at 325-8.

[137] *Id*. at 84.

[138] The case grew out of the failure of the various branches of the Medici bank, which took place between 1494 and 1497. One cause of the failure was neglect of the business by the current

owned 95% of the Naples partnership[139] might have made it particularly easy for a Neapolitan court to base common liability on an overlapping ownership structure.[140] Nevertheless, to the extent that *Carnago* rather than *Ruffini* was the law of the day, general partnerships would have to wait another two centuries before they could claim independent entity status.

B. Toward a Corporate Form: The State *Carati* Monopolies of Genoa

Italy's progress toward the business corporation during this same period moved on a different track. Here the most significant developments lay in the evolution of tradable shares rather than in the development of new organizational law.

Early on, active partners in maritime commerce began dividing ships or voyages into numerous shares and selling a *commenda* on each share.[141] These *commenda* -- the first enterprises with more than a handful of owners since Rome's *societates publicanorum* – also established the preconditions for the first market in commercial equity. In 1346, the city-state of Genoa began to use the multi-share *commenda* as a device for funding state projects. Other Italian cities had issued tradable *debt* before, but Genoa was the first to issue equity. Significantly, in light of the later history of the joint stock company, Genoa sold *commenda* shares to fund the invasion and colonization of two Aegean islands, and subsequently repaid its equityholders by exploiting the resources of the conquered islands. [142]

The success of its first equity offering encouraged Genoa to make other offerings in the early fifteenth century. As in the case of the colonization venture, the new Genoese *carati* were granted valuable monopoly privileges by the state. For example, in 1407 Genoa authorized the creation of a *carati* bank and empowered it to manage the state debt and later to commercially exploit various state colonies.[143] 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.[144] Each of these state-created monoplies combined the limited liability of the *commenda* with the fixed term of the *compagnia.* This combination allowed the Genoese *carati* to

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head of the Medici family, Lorenzo the Magnificent; another was a general European banking failure.

[139] *Id.* at 140, 260.

[140] *Id.* at 261.

[141] Lopez and Raymond at 175. Such shares or *carati* (from the Genoese convention of dividing a venture into 24 parts or "carats") were transmissible by succession, and, after the thirteenth century, by sale if all partners agreed**.** Cizakca at 27

[142] Indeed the Genoese company profitably exploited its colonies for two centuries, until they were eventually seized by the Turks in the sixteenth century. See Mitchell at 138.

[143] *Id.* at 139. Gras at 105 lists the Genoese *carati* bank as one of the earliest examples of an "incorporated" joint stock company.

[144] Cizakca at 29-30.

dispense with the traditional rule baring individuals from investing in multiple partnerships,[145] even while retaining the multi-partner *commenda* rule that an owner may not sell his *carat* without the permission of the other shareholders.[146]

There is little direct evidence on whether or not the *carati* monopolies were legal entities that enjoyed affirmative asset partitioning. We know their investors enjoyed limited liability, which -- as we have argued above – suggests that affirmative asset partitioning may also have been necessary to reassure business creditors. As with the Roman tax farming partnerships, however, the question of affirmative asset partitioning may also have been rendered unimportant by the monopolistic character of the businesses that the firms conducted. The fact of monopoly itself may have assured creditors that the *carati* would remain solvent and capable of meeting their obligations. Moreover, as monopolies, these firms were almost certainly worth more as going concerns than they would have been in liquidation. Thus, personal creditors of the firm's bankrupt partners would much prefer to step into the shoes of these partners than to foreclose on a portion of the firm's underlying assets.

Finally, the city-state of Genoa invested heavily in these firms by contributing their most important assets, their monopoly franchises. Whether we view the state as lender or partner, its presence was probably critical in avoiding the question of affirmative asset partitioning. As major creditor, the state may have been able to protect its claim to the firm's value without relying upon formal rules of priority. And if viewed as partner, making an equity contribution to the *carati* monopolies, the state's own creditors were unlikely to have the legal or practical capacity to foreclose on the state's share in the firm.

In short, the low-risk nature of the assets in which the *carati* monopolies invested probably permitted them to avoid confronting directly the legal question of whether they enjoyed a rule of affirmative asset partitioning. They were entities *de facto* by virtue of their assets, if not necessarily *de jure*. As we will see, much the same might be said of the more familiar Dutch and English joint stock corporations of the 17th century.

VII. THE AGE OF EXPLORATION AND THE INDUSTRIAL REVOLUTION (1500-1850)

The period subsequent to the Renaissance saw the first widespread use of legal rules of affirmative asset partitioning in commercial enterprise. We trace that development here, focusing first on the growth during the exploration age of the joint stock companies, which came to enjoy a rule of affirmative asset partitioning through liquidation protection, and second on the roughly contemporaneous development of the modern rule of affirmative asset

[145] *Id.* at 31.
[146] *Id*.

partitioning for partnerships. We then explore the awkward evolution of these two types of commercial entities through the eighteenth century and up to the passage of the general incorporation statutes of the nineteenth century.

A. Exploration by Joint Stock Company

During the sixteenth and seventeenth centuries, European patterns of commerce were largely similar to those that of the late Renaissance, with one exception: long-distance exploration and trade. Increased contacts with Africa and South Asia, combined with the discovery of the New World, sparked a new industry that combined exploration, colonization, and conquest in the service of the State with trade in the service of private profit. The overseas posts and fleets of deep-ocean vessels necessary to effect this industry, combined with its inherent risks, created unprecedented challenges in the accumulation and organization of capital.[147] The joint stock company proved the most successful response, drawing upon the model of the Genoese *carati* companies[148] but adding innovations such as full alienability of shares that reconciled the company's need for fixed capital with the shareholders' need for liquidity. We first describe the general evolution of the firms themselves. We then explore more carefully the parallel evolution of legal doctrine, and in particular of affirmative asset partitioning.

1. The New Trading Companies

Portugal and Spain led the charge overseas in the sixteenth century, and thus were the first to confront the capital challenges of long-distance exploration. Their response was to organize and fund their exploratory institutions directly through the State. Although their central organizations were effective at rapidly establishing overseas colonies, the economic benefits flowing from these colonies would be muted by the inefficiencies of large government bureaucracies and by the attendant prohibitions on private trading.[149]

The countries of Northern Europe took a different approach. To compete with the Spanish and Portuguese, England in the sixteenth century granted charters with special privileges, such as powers of self-government and monopoly, to certain trading guilds.[150] Although these were called "companies," e.g., the African Company, the Russia Company, and the Turkey Company, they did not operate by capital pooling.[151] Instead, each member of these "regulated companies" traded on his own account on a voyage-by-voyage basis, sometimes in arrangements similar to that of the *commenda.*[152]

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[147] *See* generally Supple at 416-432.
[148] *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."
[149] Coornaert, 228-230.
[150] Williston, 109; 8 Holdsworth 201.
[151] Williston at 109.
[152] Mitchell at 139-140.

The Dutch began a similar practice in 1591, with each port city forming a regulated trading company for purposes of organizing ventures to the Indian Ocean.[153] However, competition among the companies hurt the Dutch position vis-à-vis the Portuguese and Spanish, as the various merchants bid up the prices for commodities and for political cooperation from Indian princes.[154] In response, in 1602 the Estates General consolidated the various trading companies into one, the Dutch East India Company, under a special charter that suspended the obligation of the company to return invested capital for ten years. When in 1612 the inefficiencies involved in liquidating fixed assets to pay investors became apparent, the Estates General responded by changing the law to grant the company perpetual existence.[155] Although the owners formally lost the ability to demand repayment of their investments in 1623, they were compensated with a new right to sell their shares on the open market[156] -- a compromise that preserved both the company's going concern value and the liquidity of the investors' positions. The shareholders of the Dutch East India Company also enjoyed limited liability, a feature carried over from the predecessor companies that operated under *commenda*-like rules.[157]

The success of the Dutch East India Company created a sensation in Europe and inspired imitation.[158] France created its own joint stock company for purposes of colonial expansion, the Compagnie des Iles d'Amerique, in 1626.[159] Adoption of a similar arrangement in England came in stages during this period. The joint stock principle was not new 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.[160] A "dividend" was paid to members in the form of commodities, which they sold individually.[161] Thus, these were joint stock companies for purposes of production, but "regulated" companies for purposes of retailing.[162] The British East India Company, chartered in 1600, originally operated in this manner, dividing the cargo at the end of each voyage among the members who had invested.[163] However, after witnessing the Dutch success, in 1614 the British East India Company replaced its practice of redivision at the end of each voyage with a series of terminal contracts, each

[153] Cizakca at 45.
[154] *Id.*
[155] *Id.* at 46.
[156] Coornaert at 257.
[157] Cizakca at 47.
[158] Coornaert at 234.
[159] Mitchell at 139.
[160] 8 Holdsworth at 194, 208; Supple at 441.
[161] 8 Holdsworth at 194; 206-7.
[162] *Id.* at 207.
[163] *Id.* at 194; Williston at 114

spanning several years.[164] Finally, the company adopted of a rule of perpetual existence in 1654,[165] and declared its capital fixed in 1658.[166]

Although celebrated, the joint stock company was hardly the typical commercial entity for most of the seventeenth century. Instead, its application was in filling the peculiar capital needs of an extraordinary industry. The Dutch West India Company (1623), the Hudson's Bay Company (1670), and the Royal Africa Company (1672) were the only other joint stock companies of lasting consequence founded before 1692 in either the Netherlands or England.[167] Most of the other joint stock companies of the time lasted for only a few years, often because their monopolistic charters were stripped as the principle of free trade acquired increasing political favor.[168]

However, as the seventeenth century progressed, business people became more aware of the advantages of raising capital through the joint stock principle. The vigorous trading of shares of the two Dutch India Companies in the Netherlands[169] demonstrated that increasing the liquidity of shares also raised their value and thus lowered a company's cost of capital. The English joint stock companies responded, cutting their ancestral ties with the guilds by 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.[170] These developments led to a surge in applications for corporate charters in England in the 1690's, and new joint stock companies appeared in banking, mining, and insurance.[171] In 1692 newspapers began printing share prices, and a market for futures and options appeared.[172] Speculation on shares became widespread and caused severe price fluctuations.

The frenzy in stocks produced a demand for corporate charters that Parliament could not meet. Interest in the joint stock principle extended well beyond overseas traders and bankers, and including entrepreneurs in a variety of fields, many of whom were motivated by (or just selling) dreams of fortune in the production and sale of various inventions.[173] The market responded with two practices, both of which were legally suspect. First, a market in charters themselves developed, as many charters did not clearly limit their owners to a particular business. Companies that failed or fulfilled their purpose sold their

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[164] Williston at 110.
[165] Mitchell at 140.
[166] 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.
[167] Williston at 110; 8 Holdsworth at 209.
[168] *Id.* at 209.
[169] Coornaert at 259
[170] Williston at 110; 8 Holdsworth at 202-3.
[171] Williston at 111.
[172] 8 Holdsworth at 214.
[173] Williston at 112.

charters to others who could not obtain one from Parliament.[174] Second, partnerships without charters began selling shares, a practice that was commonplace by the 1710's.[175]

Because they both competed for capital and threatened privileges of monopoly, the unincorporated companies drew the ire of the more legitimate sort. Particularly bothered were the principals of the South Sea Company, who (in a scheme reminiscent of fifteenth-century Genoa) sought to take over most of the national debt in exchange for highly valuable trading privileges.[176] In 1720, the South Sea Company's principals induced the government to issue writs of *scire facias* against several companies operating under purchased charters for alleged "usurpation of corporate powers."[177] This precipitated a stock panic of spectacular proportions that ruined hundreds of companies, including, poetically, the South Sea Company itself.[178] In response to the ensuing outcry, Parliament passed the Bubble Act, which made illegal the selling of charters, conducting of activities not explicitly described by charter, and selling transferable shares in the absence of a charter.[179] By taking firm control over joint stock companies, Parliament hoped to avoid another crash, and also to stamp out much of the fraud that had accompanied the sale of shares during the great bubble.

By 1720, the nature of the joint stock company had changed significantly from its origins. By then most of the large exploration enterprises had declined in importance or transmuted into agencies of colonial government.[180] Thus, most of the companies caught in the 1720 bubble lacked the extensive entanglement with government interests that characterized the exploration organizations, and instead were purely private enterprises founded by entrepreneurs that recognized the usefulness of the application of the joint stock principle to a variety of industries. As described below, their demand for corporate entities would survive the 1720 panic and continue to force innovation in commercial law in the ensuing centuries.

2. Affirmative Asset Partitioning in the Joint Stock Companies

For several reasons, a consistent set of legal rules regarding the joint stock companies was slow to develop. First, the number of joint stock companies was relatively small for most of the seventeenth century. Second, each company operated under a particularized charter deriving from a distinct legislative act.[181] Third, the early companies operated under grants of monopoly that made insolvency an unlikely occurrence. Finally, the early joint stock

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[174] 8 Holdsworth at 215.
[175] Williston at 112.
[176] 8 Holdsworth at 218.
[177] Williston at 112.
[178] 8 Holdsworth at 216.
[179] *Id.* at 220.
[180] *Id.* at 210.
[181] *See id. at* 215.

companies were entangled with government interests, and thus the law concerning them had a strong public component, particularly in the Netherlands.

The rules that emerged in England for the joint stock companies were drawn largely from its law of noncommercial corporations, which dated to the introduction of Roman ideas of legal personality by the Normans in the eleventh century, and which developed into coherent doctrines applied to Church and civic entities in the 1400's.[182] As in continental Europe, recognition of delegated agency authority in corporations had came early in England, and by the fifteenth century the rule was already well established that only those acts made under the corporate seal bound the corporation.[183] However, 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.[184] This statute effectively codified the implication of earlier judicial decisions, in 1440 and 1442, holding that only corporate assets could be used to satisfy a judgment against the corporation.[185] Thus, by the end of the medieval period English law had recognized corporations as legal entities, and had taken the further step of adding a principle of limited liability to the affirmative partitioning that entity status involves. Since corporations at the time were all noncommercial, these developments were relatively unproblematic, for the reasons suggested in our discussion of Roman and medieval noncommercial organizations.

Two cases from the seventeenth century show that affirmative asset partitioning had crossed over from the law of non-commercial corporations to the much more complex situation of the incorporated joint-stock companies. (The distinction between nonprofit and proprietary corporations, we should emphasize, was nowhere near so clear at that time as it is today). Both cases involved the unfortunate creditors of one Company of Woodmongers, who had not been paid when the members of the company dissolved it and divided its assets among themselves at some point in the 1660's. In the first case, *Edmnunds v. Brown* (1668),[186] a court of law dismissed a suit against two principals of the company brought by company bondholders. The bonds had been issued under the seal of the company, and thus the court would not order them satisfied from the assets of the two individuals. Soon thereafter different creditors brought suit in equity (*Naylor v. Brown,* 1673)[187] 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."[188] Recovery was to come not directly from the members, but rather

[182] Williston at 164; 2 Holdsworth 118; 8 Holdsworth 482.
[183] Williston at 118.
[184] 3 Holdsworth 488
[185] 3 Holdsworth 484.
[186] 1 Levinz 237, 83 ER 385.
[187] Finch 83, 23 ER 44.
[188] *Id*. at 84, 23 ER at 45.

from the company estate, which the members were to reconstitute by returning with interest the company funds and by making up any remaining deficiency in the creditors' debt on a *pro rata* basis. Taken together, the cases reveal three legal principles of the period. First, incorporated companies could both owe debt and own property in their own name. Second, business creditors had to look first to the company property, rather than the property of its members, to satisfy their debt. In other words, owner liability was not joint and several as it had been in the law of partnerships, but just joint: all owners had to be joined in an action against them by a business creditor. And third, courts of equity would use tools similar to those available to modern bankruptcy courts to ensure that the corporate body remained intact to satisfy the claims of business creditors.

Incorporation and its connotation of perpetual existence also enabled the joint stock companies to achieve liquidation protection. While death of a partner dissolved an English partnership,[189] seventeenth-century cases clarified that a death of shareholder did not dissolve an incorporated joint stock company,[190] the shares instead devolving to heirs.[191] 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 full liquidation protection.[192]

By virtue of liquidation protection, in turn, the creditors of the incorporated English joint stock companies enjoyed priority of claim to the corporation's assets, because when a shareholder failed his creditors would have simply taken his shares and thus stepped into his shoes as equity holders in the company. It is not clear that the full consequences of this were always honored—whether, for example, the court in the case of *Naylor v. Brown* would have forced the personal creditors of the members of the Woodmongers Company to return any assets traceable to the company estate. That it might have done so is suggested by the roughly contemporaneous recognition, discussed below, of the "jingle rule" for partnerships. However, even if the court would not have pursued entity assets against personal creditors, this would not necessarily have undermined the affirmative asset partitioning enjoyed by the joint stock companies. The Woodmongers case was exceptional, involving redress for a conspiracy among owners to defraud creditors rather than a sorting of legitimate claims in an orderly bankruptcy proceeding. In most cases, the fact that liquidation protection assured that bankruptcy of owners and bankruptcy of the joint stock company were legally distinct events would have provided business creditors with priority of claim over the owners' personal creditors vis-à-vis the enterprise assets.

In contrast to affirmative asset partitioning, the rule of limited liability did not automatically carry over to the joint stock companies from the law of non-

[189] Bisset at 83.
[190] 8 Holdsworth at 202.
[191] Williston at 163.
[192] Coornaert at 258.

commercial corporations. Because the distinction between a legal and natural person was honored, a member/owner could not be made directly liable for the company's debt.[193] However, as a matter of course a company's principals had the power to make "calls" on the stock, which were enforceable demands for further contribution on a *pro rata* basis.[194] If the business creditors could force the principals to make a call, or persuade a court to do the same (as they did on occasion),[195] the company would have in fact a rule of *pro rata,* rather than limited, liability.

However, as a legal matter, a company's power to make calls derived from the consent of the owners, and thus could be restricted or eliminated by contract.[196] Some companies used this opportunity to create full limited liability, and others specified that the owners would be liable for only certain debts under specific circumstances.[197] The system thus allowed companies to vary the degree of defensive asset partitioning to suit their particular business requirements.

This pattern of development reflects the point we have made above: affirmative asset partitioning must precede defensive asset partitioning. Limited liability, in particular, makes little sense without affirmative asset partitioning.

In one sense, the appearance of affirmative asset partitioning through liquidation protection in the exploration companies of the sixteenth century was a watershed event, in that it potentially marked the first widespread use of a legal entity in Western commerce. In another sense, however, it grew naturally out of the *commenda* partnership that had flourished since its first appearance five centuries before. As we have indicated, the *commenda* enjoyed liquidation protection as a practical matter during the course of a voyage. Thus, a merchant mariner would form a *commenda* "firm" for a voyage, dissolve it upon his return to homeport, and then form another for his next excursion. The first joint stock companies reflected a perceived need to keep the firm intact between voyages, and indeed to fold a number of ships and mariners within one firm to effect a monopoly. When a *commenda* was at sea natural barriers kept the personal creditors of owners at bay, but only rules of law could protect the assets of such a firm while on land, and hence the adoption of the corporate form by the seventeenth century's great exploration companies.

As we have indicated, rules of law are a necessary but not sufficient condition for affirmative asset partitioning; there must be enforcement technology or other circumstances that keep the entity's assets intact and thus make a legal rule of affirmative asset partitioning worthwhile. In the case of the seventeenth

[193] Williston at 160.
[194] *Id.*
[195] 8 Holdsworth at 204.
[196] *Id.*
[197] *Id.,* at 205.

century's great exploration companies, as in the case of Genoa's earlier *carati* enterprises, the combination of monopoly and state backing may have provided some security to shareholders and made them more willing to part with the withdrawal power. Meanwhile, creditors presumably still enjoyed the right to levy against the owners' personal assets, at least on a *pro rata* basis, and this combined with the monopolistic nature of the companies would have made the creditors relatively unconcerned with the occasional improper shuttling of assets across the firm boundary.

However, these explanations cannot accommodate the joint stock company's seemingly successful evolution by the beginning of the eighteenth century from a specialized form for monopolistic exploration firms into a general-purpose vehicle for corporate enterprise. The market in corporate charters and wide use of the joint stock principle by a variety of companies in the decades before the Bubble indicate broader comfort among owners and business creditors with the diminishment of recovery rights that both incurred when investing in a joint stock company instead of a general partnership. This indicates that by the early eighteenth century England had developed effective legal tools for policing firm boundaries. An alternative possibility is that early eighteenth-century England experienced its own "irrational exuberance" that resulted in a false sense of confidence in the joint stock form. An interesting but unexplored historic question is the degree to which the collapse of the Bubble was precipitated by a sudden realization that entity boundaries were still too porous to support such a wide variety of enterprises.

B. The Partnership Achieves Affirmative Partitioning

Partnerships operating under essentially the medieval rules were the dominant enterprise form in the sixteenth and early seventeenth centuries. This was true even in England, despite its infatuation with the joint stock approach. English partnership law had been significantly formed during the late Middle Ages by Italian practices, as local merchants imitated the rules used by the managers of the English branches of foreign partnerships.[198] In particular, the Italian rule of joint and several liability for partners supplanted earlier English rules deriving from local custom or Roman law.[199]

The seventeenth century saw two important changes regarding the law of partnership in England. The first was largely procedural. Earlier, most commercial cases in England were decided by merchant courts similar to those of medieval Italy, where judgments were summary and infrequently recorded.[200] However, in the seventeenth century these cases increasingly came under the jurisdiction of the regular courts of law and Chancery.[201] The change reflected a

[198] Rowley at 7-8.
[199] 1 Holdsworth at 97.
[200] Rowley at 8.
[201] *Id.,* at 8.

more vigorous internal commercial economy in England in the second half of the sixteenth century,[202] and an increased national interest in regulating trade pursuant to mercantilism.

The second change was substantive, and was marked by the case of *Craven v. Knight*[203] before a bankruptcy commission in a Court of Chancery in 1682. 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."[204] 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,"[205] 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 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 one partner retaining a claim against the other if his personal estate bore more than half of the partnership deficiency.[206]

This case appears to be the first on record in which a judge utilized the distinction between the joint and individual assets of partners to effect a rule of priority regarding creditors. And the rule created was one of affirmative asset partitioning: personal creditors were to be kept out of the joint estate unless it had satisfied the claims of partnership creditors. The reason for this development is not immediately obvious: as was the norm in courts of equity, the judge in the case provides almost no explanation for his decision, and Holdsworth's own demurral from attempting to gloss the result other than to label it "a new and important principle of law"[207] contributes to the impression that this was something of a bolt from the blue. Importantly, the judge does not invoke the fiction of legal personality in its description of the partnership, instead using traditional terms to arrive at a new rule.

One might begin an investigation into the question of why a partnership rule of affirmative asset partitioning first appeared in 1682 with the observation that, at least as regards English law, it probably could not have emerged

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[202] 5 Holdsworth at 67
[203] 2 Chancery Reports 226, 21 ER 664.
[204] *Id*.
[205] 2 Chanery Reports at 227.
[206] *Id*. at 229.
[207] 8 Holdsworth at 243.

significantly earlier. As discussed previously, rules regarding priority rights of different classes of creditors can have little practical value in non-liquidation-protected entities without reasonably sophisticated court-directed liquidation proceedings capable of tracing dispersed assets and reconstituting an entity estate, as the court did in the Woodmongers case. Although the roots of English bankruptcy doctrine burrow in the Middle Ages,[208] a thoroughgoing body of rules was not codified until a statute from 1542,[209] and commissions in bankruptcy only gained broad powers to avoid pre-insolvency conveyances in a series of acts between 1571 and 1623.[210] As indicated above, this is approximately the same time period over which the regular courts of law and equity gained jurisdiction over commercial cases from the merchant courts, whose emphasis on speedy justice was incompatible with the extensive inquiries necessary to control and classify ranges of assets and creditors and thereby effectuate entity-driven rules of priority.

However, while advances in English bankruptcy proceedings might explain why in the seventeenth century affirmative asset partitioning without liquidation protection (i.e., priority of claim for entity creditors) was *available,* it does not explain why such a rule was *desirable*. In other words, the bankruptcy advances explain supply, but not demand.

Whatever the factors underpinning this demand, they apparently were not limited to England. The partnership law of other Western European nations also appeared to develop rules of affirmative asset partitioning at approximately the same time that the Court of Chancery handed down its ruling in *Craven.* 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 also, incidentally, codified the rules for France's version of the limited liability partnership—the *société en commandite*).[211] Some scholars ascribe this development to the greater degree to which Continental, as opposed to English, jurists have conceptualized their partnerships as legal persons.[212] However, it appears that at least in the seventeenth century French and English law were similar in that only those partnerships that issued shares under a charter were characterized as legal persons.[213] This has led some to doubt that the French rule actually did originate in Continental notions of legal personality, leaving the rule's origin in France, as in England, mysterious.[214]

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[208] For example, a statute from 1267 addresses the issue of fraudulent conveyances. 2 Holdsworth at 221.
[209] I Holdsworth at 470.
[210] 8 Holdsworth at 237-9.
[211] Brissaud at 555; Goodman at 417.
[212] Brissaud at 555.
[213] *Id.*
[214] *Id.*

Another piece of the puzzle is provided by the decision in *Ex Parte Crowder* (1715)*,*[215] an English bankruptcy case that, like *Craven,* involved a petition by the personal creditors of partners to be "let in for their debts" to the disposition of the partnership estate.[216] 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.[217]

This is, of course, the "jingle rule," a feature of English partnership law to the present.[218] It does the *Craven* rule one better by establishing a parallel rule of priority for the personal creditors in the partners' personal assets, i.e., a rule of defensive asset partitioning to mirror *Craven's* rule of affirmative asset partitioning. Again, the court provides no explanation for its ruling, except perhaps for its appeal to simple notions of fairness implicit in the symmetry of its syntax: "and as…so likewise," etc. The decision might derive from nothing more than a judicial intuition, coupled perhaps with an unspoken economic insight, that the rule it articulates just makes sense. Professor Brissaud suggests this explanation with regard to the French rule, writing that it "[p]erhaps…can be accounted for by a sort of implied engagement for the benefit of the creditors of the partnership."[219]

However, if the decisions in *Craven* and *Ex Parte Crowder* and the contemporaneous French rule were all just common sense, one cannot help but ask why nobody thought of this somewhat earlier. (England enjoyed its most significant innovations in bankruptcy law in the fifteenth century, the regular courts took commercial cases from the merchant courts in the sixteenth century; thus, at least in England, the tools need to *supply* rules of priority in non-liquidation-protected entities were available for perhaps an entire century before the *Craven* decision.) In addition, it seems a massive coincidence that the law of partnership stumbled upon the advantages of an explicit rule of affirmative asset partitioning during the same relatively narrow period, between approximately 1660 and 1720, when the joint stock companies also began enjoying affirmative asset partitioning as an implication of their rules of liquidation protection. *Ex Parte Crowder* seems particularly remarkable in this regard.

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[215] Equity Cases Abridged 56, 21 ER 870.
[216] *Id*.
[217] *Id*.
[218] And a feature of U.S. partnership law until 1978, when the defensive asset partitioning aspect of the rule was eliminated
[219] Brissaud at 555.

Decided during the joint stock company frenzy in the years just before the Bubble Act, it articulated a rule of asset division for partnerships that closely tracked that of the joint stock companies. More precisely, it rendered a division of assets like that which would have resulted had the bankruptcy of the entity and its owners been separate events, which liquidation protection assured for the joint stock companies, rather than a single event, which is the traditional rule for partnerships. Because the incorporated joint stock company was a legal person, its creditors automatically satisfied their debts first from the business assets, just as under the jingle rule. Only if there was a surplus would a distribution to the owners occur, making assets available to the personal creditors. Similarly, liquidation protection forced the personal creditors of joint stock company owners to satisfy their debts first from the personal assets of the owners; only if there was a deficiency could the personal creditors claim the company assets by taking the owner's shares and thus his subordinated equity interest in the company. In this manner, the rules for disposing joint stock company assets and the jingle-rule for partnerships produced almost identical results.

This parity suggests that the new rule of creditor priority came not from a sudden outbreak of common sense across Western Europe, but rather from a recognition and importation into partnership law of one of the incidental advantages of liquidation protection in the joint stock companies. Indeed, arising as it did in England in 1715, the jingle rule appears to reflect a willingness by courts to accommodate the interests of the many businesses that desired the advantages of the joint stock form but could not achieve them directly due to the shortage of corporate charters. Once demonstrated in one setting, the economic advantages of affirmative asset partitioning apparently were clear enough to quickly supplant long-standing traditions in other areas, and in multiple countries, at roughly the same time.

Other than the presence of the joint stock companies to demonstrate the advantages of priority of claim for creditors, another potential explanation for the adoption of a rule of partnership creditor priority in the late seventeenth century was the overall growth in economic activity, especially in capital-intensive industries. This in turn would have created demand for legal rules facilitating capital pooling, e.g., rules fostering diversification economies by enabling individuals to more safely invest in more than one enterprise. As noted above, in medieval Italy an individual was not allowed to be a partner in more than one *compagnia* because of the possibility that the fall of a partnership would start a domino effect. This meant that diversification was only possible in limited liability entities such as the *commenda.* However, limited liability is not appropriate for all enterprises, and thus cannot universally satisfy the demand for diversification. Priority of claim for partnership creditors, as established in *Craven,* provided an alternative. Although such priority cannot prevent one bankruptcy from triggering others, it does ensure that when bankruptcy occurs partnership creditors will have priority of claim to the assets that they can most effectively monitor — i.e., those of the partnership to which they lent. Creditor priority thus would have mitigated the otherwise increased borrowing costs incurred by partnerships that allowed their partners to invest in multiple non-corporate entities.

We also observe here another clear instance of the pattern we have remarked on before: affirmative asset partitioning (the rule of *Craven v. Knight*) precedes defensive asset partitioning (the rule of *Ex parte Crowder*), as economic logic requires.

C. Muddling Through the Eighteenth Century

As compared with a traditional partnership, an incorporated joint stock company enjoyed several additional and potentially advantageous rules, including: (1) liquidation protection; (2) priority of claim for entity creditors; (3) heightened defensive asset partitioning; (4) “passive” equity holders who could not bind the company; and (5) transferable shares. The introduction of the jingle rule by the Court of Chancery closed the gap somewhat, providing partnerships with their own rule of priority of claim for entity creditors, as well as a degree of defensive partitioning in the form of priority of claim for personal creditors over personal assets. The Bubble Act, however, drove a wedge between the partnerships and incorporated companies, particularly with regard to the rules of limited liability and transferability of shares, which were held in general suspicion after the panic of 1720. English law and institutions remained muddled for a century with respect to organizations that had either, much less both, of these features.

In France and Italy, the gap between the traditional partnership form and the incorporated company was filled largely by the *société en commandite* and the *accomandita,* respectively, which provided both limited liability and passive equity positions, and which, like all continental partnership forms, would eventually develop rules of liquidation protection.[220] Although in the time of the Medici the *accomandita* seemed to have been used as a temporary arrangement, during the seventeenth century it grew to become the preferred organizational form in certain Italian manufacturing industries.[221]

In contrast, England’s mistrust of limited liability would prevent it from importing a version of the limited partnership until 1907.[222] This left England with just two forms to employ for commercial purposes: the specially chartered joint stock corporation and the common law partnership.

Demand for corporate charters from Parliament was strong,[223] and became particularly intense as the Industrial Revolution gained steam in England

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[220] For example, in the modern Italian law governing both ordinary and limited partnerships, a personal creditor of a partner cannot, during the life of the partnership, force the liquidation of his share. Certoma at 399.
[221] Goodman at 428.
[222] Formoy at 46.
[223] Hunt at 10.

around 1760. Parliament was amenable to the corporate form in some industries more than others: England's decision to allow its canal system to be built by private firms, 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 1791-1794.[224] However, in manufacturing, the industry most associated with the breakthrough economic activity of the Industrial Revolution, applications for corporate charters met successful opposition from competitors, who claimed that joint stock companies would displace small businesses and indeed threaten England's identity as a "nation of shopkeepers."[225] Lurking in such rhetoric was an implicit association between joint stock companies and monopoly, two concepts that would remain entangled in the England mind through the nineteenth century.[226]

The demand for joint stock companies that Parliament would not meet with special charters was met in part by the use of unincorporated firms. In particular, unincorporated joint stock companies with transferable shares were formed as partnerships. The Bubble Act nominally forbade the formation of such firms, but went largely unenforced. It is estimated that, by the beginning of the 19th century, there were at least 1000 unincorporated joint stock companies in England.[227] 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 reasonably effective in practice, though the courts avoided giving 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 some affirmatively proclaimed their partners' unlimited liability as an inducement to creditors.

England finally repealed the Bubble Act in 1825 [228] and soon thereafter English courts retreated from the position that transferable shares were illegal at common law.[229] The result was to increase the pool of unincorporated joint stock companies that were attempting to raise capital, sometimes by dishonest means. At the same time, a century of Parliamentary grants had built up a multitude of more than a thousand operating and legitimate joint stock companies[230] that had become an important and familiar feature in the English economy.

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[224] *Id.*
[225] *Id.* at 16.
[226] Hunt at 17.
[227] [Cite]
[228] Hunt at 42.
[229] The 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).
[230] Hunt at 87.

Deciding that regulating the various joint stock companies to protect the public was preferable to suppressing them, Parliament passed the Joint Stock Companies Regulation and Registration Act of 1844.[231] This Act required all partnerships with more than twenty-five members and with transferable shares to register and to follow uniform disclosure rules.[232] In return, the companies were allowed all of the traditional powers of incorporation except limited liability.[233] In particular, the 1844 Act explicitly provided for a rule of liquidation protection, and thus, by implication, strong-form affirmative asset partitioning. Specifically, bankruptcy of a shareholder was not to affect the company, its liabilities, or the liabilities of other shareholders.[234] In addition, legal capital rules were imposed to keep the firm's assets from being drained to the detriment of creditors: the company's paid-up 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.

Parliament finally provided for limited liability by statute in 1855.[235] This was not for lack of imagination. General incorporation statutes granting limited liability had already been enacted in several American states by 1844. Rather, it was because the utility of limited liability remained controversial. We see again, then, that affirmative asset partitioning was the critical first step. This was the contribution of the 1844 Act. In particular, the 1844 Act gave corporations strong form affirmative partitioning, with liquidation protection. It was this, and not limited liability, that at first distinguished the joint stock corporation from the unincorporated joint stock companies formed as partnerships. Defensive asset partitioning came only later, as a less important, and indeed optional, feature.

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

Although England probably retarded its economic development somewhat by its tardy provision for incorporated joint stock companies, 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.

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

[231] *Id*. at 94.
[232] *Id*. at 94-98.
[233] *Id*. at 97.
[234] Bisset at 188.
[235] *Id*. at 133.

parliament.[236] 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 were projects that required capital from a number of different investors. But another reason may well have been that affirmative asset partitioning – and hence protection of creditors -- was relatively unproblematic for such firms. They had substantial fixed assets, and they commonly possessed a state monopoly that would guarantee solvency.

New York passed the first general business corporation statute in 1811, passing a Manufacturing Act that allowed any manufacturing company to incorporate for a period of twenty years simply by filing a certificate.[237] 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. The fact that this statute, like some of those that followed in other states, was confined to manufacturing firms is suggestive. Such firms, in contrast to financial, trading, and service firms, would commonly have 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 affirmative asset partitioning 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 corporate form was initially used principally for just 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 rigidity of the corporate form in the 19th and early 20th centuries in the U.S., and its obsession with problems of legal capital, of course also reflect the difficulty of making affirmative asset partitioning credible. The gradual relaxation of the legal capital requirements over time undoubtedly reflects a growing ease on the part of creditors in monitoring firm assets via means such as improved financial disclosure and more sophisticated credit rating services. And much the same explanation arguably applies to the growing accommodation that the law of corporations has made in the latter twentieth century for closely held corporations. Indeed, it is the ability of the corporate form to accommodate small closely held firms that evidently accounts for the elimination of defensive asset

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[236] Dodd at 11.
[237] *Id.,* at 64.

partitioning in U.S. partnership law in 1978, thus reversing the rule adopted in 1715 in *In re Crowder*. With the corporate form now offering defensive partitioning for small firms that want it, the partnership form can be reserved just for small firms that do *not* want it – that is, whose owners wish to maximize their firm's creditworthiness by pledging their personal assets in full as backing for firm debts.

VII. THE FUTURE

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. Affirmative asset partitioning has been at the core of this contribution. The affirmative partitioning typically established by organizational law involves giving firm creditors a prior claim on those assets that are used by the firm in its productive processes. That has required both that the necessary legal rules be in place, and that the commercial environment be such that those assets can be credibly monitored.

With the accommodation of corporate subsidiaries at the end of the 19th century, and the development of ever more sophisticated forms of secured financing in the 20th century, it has become increasingly possible to differentiate between the pool of assets that a firm uses in production and the pools of assets that it pledges as security to its creditors. This allows, among other things, for far greater flexibility in designing the scope of the firm as a nexus of contracts. The future is likely to continue to take us further in this direction, with the possibility that that the contractual part of organizational law will come to be increasingly divorced from the asset partitioning part of organizational law, and that the latter function will come to be merged ever more with the general law of secured transactions.