Law and the Rise of the Firm

Law Working Paper N°.57/2006
January 2006

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ECGI Working Paper Series in Law

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For helpful discussions and comments, we would particularly like to thank Barry Adler, John Armour, John Baker, Lucian Bebchuk, Margaret Blair, Eva Cantarella, Brian Cheffins, Charles Donahue, Wolfgang Ernst, Eilis Ferran, Bruce Frier, Francesco Galgano, Joshua Getzler, Clayton Gillette, Avner Greif, Timothy Guinane, Ehud Kamar, Louis Kaplow, Meir Kohn, Timur Kuran, John Langbein, Mike Macnair, Richard Nolan, Ulrike Malmendier, Joseph McCahrey, Randall Morck, Richard Nolan, Theo Raaijmakers, Larry Ribstein, Marina Santilli, Lynn Stout, and James Whitman. Robert Jackson offered extensive and invaluable editorial suggestions. We would also like to thank participants for their comments at the NBER Workshop on Economics of Organization (Cambridge, MA) and the CEPR Conference on Understanding Financial Architecture (Oxford); in law faculty workshops at Cambridge, Chicago, Columbia, Harvard, Michigan, Northwestern, NYU, Oxford, Pennsylvania, Texas, Tilburg, Vanderbilt, and Yale; in business faculty workshops at Harvard and Stanford; and in economics faculty workshops at CERGE-ET (Charles University, Prague) and the University of Zurich. For research assistance we are indebted to April Andersen, Elizabeth Arens, Charles Ching, Rebecca Deutsch, Ofer Eldar, Andreas Fleckner, Stacey Delich Gould, Veronica Grembi, Nikesh Jindal, Charles Korsmo, Saura Masconale, Jeanne McHale, Dustin Osborn, Jennifer Ottman, Christina Padden, Jay Readey, Alexandra Schimmer, Joshua Tate, and very especially to Jonathan Nygren and Robert Schuwerk. Generous research support was provided by the Yale Law School; by the Harvard Law School Faculty Summer Research Program and the Harvard Law School Program in Law, Economics, and Business, which is funded by the John M. Olin Foundation; and by the NYU School of Law.

Abstract

Organizational law empowers firms to hold assets and enter contracts as entities that are legally distinct from their owners and managers. Legal scholars and economists have commented extensively on one form of this partitioning between firms and owners: namely, the rule of limited liability that insulates firm owners from business debts. But a less-noticed form of legal partitioning, which we call "entity shielding," is both economically and historically more significant than limited liability. While limited liability shields owners' personal assets from a firm's creditors, entity shielding protects firm assets from the owners' personal creditors (and from creditors of other business ventures), thus reserving those assets for the firm's creditors. Entity shielding creates important economic benefits, including a lower cost of credit for firm owners, reduced bankruptcy administration costs, enhanced stability, and the possibility of a market in shares. But entity shielding also imposes costs by requiring specialized legal and business institutions and inviting opportunism vis-à-vis both personal and business creditors. The changing balance of these benefits and costs helps explain the evolution of legal entities across time and societies. To both illustrate and test this proposition, we describe the development of entity shielding in four historical epochs: ancient Rome, the Italian Middle Ages, England of the 17th – 19th centuries, and the United States from the 19th century to the present.

Keywords: Corporations, Partnerships, Companies, History of the Firm, Entity Shielding, Limited Liability, Legal Entities, Bankruptcy

JEL Classifications: D23, G32, G33, K22, L22, N23

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I. INTRODUCTION

Economic activity in modern societies is dominated, not by individuals, but rather by firms that own assets, enter contracts, and incur liabilities as entities that are legally distinct from their owners and managers. A universal characteristic of these modern business firms is that they enjoy the legal power to commit assets to bond their agreements with their creditors and, correlatively, to shield those assets from the claims of their owners' personal creditors. This legal characteristic — which two of us previously termed "affirmative asset partitioning,"[1] and which we here call "entity shielding"[2] – has deep but largely unexamined roots in the history of Western commercial law. In this Article we analyze, in economic terms, the evolution of commercial entity shielding from Roman times to the present. Our object is not only to understand the past, but also to shed light on the foundations of modern business entities and on their likely course of future development.

Previous work on the legal history of firms has focused on limited liability — a form of "owner shielding" that is the functional inverse of entity shielding because it protects the personal assets of firm owners from the claims of firm creditors. Although the matter is complex, we believe that this emphasis has been misplaced. While limited liability has evident and important functional complementarities to entity shielding, it is neither necessary nor sufficient for the creation of business firms as separate and distinct economic actors. Firms can prosper without limited liability, but significant enterprises lacking entity shielding are largely unknown in modern times.

A critical historical question is why entity shielding appeared where and when it did. We take steps toward an answer by analyzing four Western commercial societies: ancient Rome, medieval Italy, early modern England, and the contemporary United States. We view the analytical relationship between history and economics bi-directionally. On the one hand, we seek an initial explanation of the incidence of entity shielding by making a qualitative tally of its likely economic costs and benefits within each society. At the same, we also use the historical record to deepen our understanding of which economic costs associated with entity shielding were most important in constraining and shaping its development.

We begin our discussion by describing entity shielding's economic benefits and costs. We then conduct our historical survey. We conclude by

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[1] Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE L.J. 387 (2000).

[2] We also discuss entity shielding in Henry Hansmann, Reinier Kraakman & Richard Squire, *The New Business Entities in Historical Perspective,* 2005 U. ILL. L. REV. 5.

describing the relationship between the economics of entity shielding and the policy challenges that will shape the future evolution of the commercial firm.

II. ASSET PARTITIONING AND ENTITY SHIELDING

A variety of sanctions have been used across history for enforcing contracts, including debtor's prison and enslavement. The principal sanction employed by modern legal systems, however, is permitting an unpaid creditor to seize assets owned by the defaulting promisor. When an individual enters into a contract, modern law in effect inserts a default term by which the individual pledges all his personal property to bond his performance. A similar legal rule applies to business corporations: unless the contract states otherwise, all assets owned by the corporation bond its obligations. Individuals (or rather, their personal estates) and corporations are thus both examples of *legal entities*, a term we use to refer to legally distinct pools of assets that provide security to a fluctuating pool of creditors and thus can be used to bond an individual's or business firm's contracts.[3]

Special legal rules, which we term rules of *asset partitioning*,[4] are required to determine which entities bond which contracts, and which assets belong to which entities. Often, the asset partitioning between entities is complete: the creditors of one entity may not levy upon assets held by another. But asset partitioning can also be partial, as in the modern general partnership: personal creditors of partners may levy upon firm assets, but only if the partnership has first paid its creditors in full. As this example suggests, the distinction between the assets of a commercial firm and those of its owners comes in two forms, depending on which set of assets is being shielded from which group of creditors. We label the two forms *entity shielding* and *owner shielding*.

A. Entity Shielding as the Foundation of Legal Entities

The term *entity shielding* refers to rules that protect a firm's assets from the personal creditors of the owners. In modern legal entities, entity shielding takes three forms:

> ***Weak entity shielding*** merely gives the claims of firm creditors priority over those of personal creditors. This rule characterizes the modern general partnership.

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[3] When an individual enters into a contract, the new promisee joins the group of creditors whose claims are backed by the individual's assets. And when an individual satisfies his contractual obligation to a promisee, that promisee leaves this group of creditors. In effect, then, the security afforded by the individual's assets "floats" over a shifting set of creditors.

[4] We previously introduced this term in Hansmann & Kraakman, *supra* note 1.

> ***Strong entity shielding*** adds a rule of *liquidation protection*[5] to the protections of weak entity shielding. Liquidation protection restricts the ability of both firm owners and their personal creditors to force the payout of an owner's share of the firm's net assets -- traits that are conceptually distinct but that, for reasons we will explore, usually come paired. The modern business corporation provides a familiar example of strong entity shielding: not only do corporate creditors enjoy a prior claim to the corporation's assets, but they are also protected from a shareholder or his personal creditors attempting to liquidate those assets.
>
> ***Complete entity shielding*** describes a regime whereby non-firm creditors — including creditors of the firm's (beneficial) owners, if any — lack *any* claim to firm assets. Common contemporary examples of entities with this trait include nonprofit corporations and charitable trusts. The personal creditors of the manager and the beneficiaries do not enjoy any claim to the organization's assets, which only bond contractual commitments made in the name of the organization itself.

All entity forms used by modern commercial firms exhibit entity shielding. And, as we explain below,[6] entity shielding, unlike owner shielding, can be achieved only through the special property rules of entity law. For this reason, we believe that entity shielding is the sine qua non of the legal entity, and we divide legal entities into *weak entities, strong entities, and complete entities* based on the degree of entity shielding they provide.[7]

B. Forms of Owner Shielding

In contrast to entity shielding, *owner shielding* refers to the rules that protect the personal assets of a firm's owners from the firm's creditors. Owner shielding is not central to the purpose of legal entities in the way that entity shielding is. Not all modern entity forms provide owner shielding; the most conspicuous example of this is the modern American general partnership, which since 1978 has allowed partnership creditors to levy on the partners' personal assets on equal footing with the partners' personal creditors. Owner shielding, without use of a legal entity, is also significantly easier to achieve by contract

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[5] We previously introduced this term in Hansmann & Kraakman, *supra* note 1, at 403-04.

[6] <u>See</u> <u>infra</u> Section II.C.

[7] Previous literature has used various terms to describe organizational forms, including "legal entities," "legal persons," and "juridical persons." The definitions offered for each are various and vague, and scholars have disputed the set of entities included in each definition. For example, there is ongoing debate over whether and when the general partnership became a legal entity. We believe that by equating the term "legal entity" with the presence of entity shielding, we create a nomenclature that is easy to apply and that captures the primary purpose of entity law. This approach settles the controversy about the partnership: it is an entity, albeit a weak one, and has been so under Anglo-American law since it acquired a rule of weak entity shielding more than 300 years ago.

than is entity shielding. Owner shielding, nonetheless, has an important supporting role to play in the story of legal entities. It is therefore useful to identify a few forms that it can take:

> ***Weak owner shielding*** gives personal creditors a claim to personal assets that is prior to the claim of firm creditors. Weak owner shielding characterized general partnerships in the United States for two centuries prior to 1978, and it continues to characterize English partnerships today.[8]
>
> ***Complete owner shielding*** restricts firm creditors to assets held by the firm and denies them any claim to the personal assets of owners. A familiar example is the rule of limited shareholder liability in modern business corporations. We use the terms "complete owner shielding" and "limited liability" interchangeably throughout this essay.[9]

C. Entity Shielding Requires Law; Owner Shielding Does Not

Although the concepts of entity shielding and owner shielding are both important for understanding the pattern of creditors' rights in modern business firms, only entity shielding clearly requires special rules of law. Owner shielding, by contrast, can often be achieved by contract.

It would be nearly impossible to develop effective entity shielding without special rules of law. Entity shielding limits the rights of personal creditors by subordinating their claims on firm assets to those of firm creditors, and strong entity shielding additionally limits their ability to liquidate firm assets. Although a firm's owners in theory could achieve either of these results by negotiating for the requisite waivers in all contracts with their personal creditors, the negotiation of such waivers — beyond involving high transaction costs — would be fraught with moral hazard.[10] Each waiver would improve the position of firm creditors and thus benefit all firm owners by decreasing the firm's borrowing costs. But each waiver would also increase personal borrowing costs, and that cost would be

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[8] There are two important variants of weak owner shielding. In one — which characterized the general partnership in the United States before 1978 — the owners of the firm are jointly and severally liable for all firm debt. In the other — which characterized California business corporations from 1849 to 1931 — each owner is responsible only for their proportional share of firm debt. Tradable shares will tend to be more liquid when a firm has pro rata, rather than joint and several, owner liability — although, as we will show in later sections, historical examples of firms with both joint and several liability and tradable shares can be found.

[9] We have assigned the labels "weak" and "complete" to these two forms of owner shielding to reflect symmetry with the similarly named forms of entity shielding. We do not include "strong" owner shielding because the pattern of rights that it would entail — firm creditors enjoying a subordinated claim on the firm owners' personal assets but not an ability to force liquidation of those assets — is not found among standard legal entity types.

[10] This analysis is explored in greater depth in Henry Hansmann & Reinier Kraakman, *Property, Contract, and Verification: The Numerus Clausus Problem and the Divisibility of Rights*, 31 J. LEGAL. STUD. 373, 406-07 (2002).

borne entirely by the owner who negotiated the waiver. Each owner would thus face an incentive to act opportunistically by omitting the waivers from personal dealings. Moreover, other owners and firm creditors would find such omissions very difficult to police given the significant freedom individuals enjoy in their personal dealings. A large number of owners exacerbates the problem by making monitoring more difficult and by heightening the conflict between personal and collective interests. And the policing problem is further compounded if shares of ownership are freely transferable so that the set of owners is constantly changing. These problems can be solved only by impairing the rights of personal creditors without their contractual consent (and often even without notice). Doing that requires a special rule of property law respecting assets committed to the firm,[11] and entity law provides that rule.

In contrast, owners can endow a firm with a substantial degree of owner shielding — limited liability in particular — by requiring firm agents (including the owners themselves when acting on behalf of the firm) to negotiate clauses in the firm's contracts whereby firm creditors waive any recourse to the owners' personal assets.[12] Although this system entails some moral hazard, it is relatively modest. While the cost of omitting the requisite waiver is spread among all owners in terms of increased risk to their personal assets, the benefit in terms of lower firm borrowing costs is shared among them as well, reducing the opportunity for each owner to profit at the expense of the others.[13] Moreover, if basic rules of agency law are available, then owners can protect themselves by specifying that the authority of firm agents to bind the owners extends only to firm assets and not to personal assets. The effectiveness of this approach can be reinforced by inserting terms such as "limited" into the firm's name and letterhead to notify third parties that the authority of firm agents is circumscribed. That was,

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[11] For a comparison of property and contract law, see Hansmann & Kraakman, *id.* at 409-15.

[12] We are speaking here of contractual liability only. Limited liability toward most tort claimants, which is today a universal attribute of business corporations, is by nature nonconsensual and thus could not be achieved by contract alone. Limited liability toward involuntary creditors, however, has been relatively unimportant to the economics of business firms until very recently, and there is reason to doubt its efficiency. *See* Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879 (1991).

[13] As others have pointed out, the symmetry between the personal costs and benefits breaks down because an adverse selection problem may still arise since shares in a firm without limited liability will be more valuable to the poor than to the wealthy. See, e.g., Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89, 94-95 (1985). Our point is not that creating owner shielding by contract lacks incentive problems, but rather that the problems are more acute in the case of entity shielding. While the benefits of waiving entity shielding are entirely concentrated on the contracting party, the benefits of waiving owner shielding are largely externalized to other owners.

in fact, the approach used by many English joint stock companies before English common and statutory law made limited liability the default rule for such firms.[14]

Our assertion that entity law is necessary for the liquidation protection that characterizes strong entities, such as the corporation, requires a qualification. We have defined liquidation protection to comprise two components: liquidation protection against owners, which denies owners the right to make unilateral withdrawals from their share of firm assets; and liquidation protection against creditors, which bars the personal creditors of an owner from forcing such withdrawals to satisfy the owner's personal debts.[15] Though entity law has some role to play in securing both attributes, it is important primarily for shielding firm assets from personal creditors. As far back as we can see, business partners commonly entered into enforceable agreements among themselves not to withdraw from a firm prior to a defined term or without common consent.[16] Here as elsewhere, courts were sometimes reluctant to enforce restrictions on free alienation of property if made in perpetuity. In addition, sanctions for breach might be limited to provable damages, which can be inadequate to deter inefficient withdrawals.[17] Strong entities such as the corporation, whose shield against owner withdrawals is enforceable in perpetuity, thus offer a more secure commitment then partnership agreements. But the role of entity law in providing liquidation protection against owners is nonetheless one of degree rather than kind. By contrast, special rules of entity law are essential for liquidation protection against creditors since a mere contract among owners to waive their withdrawal rights would not bind their personal creditors. Furthermore, attempts to secure contractual waivers from the creditors themselves would be hindered by the moral hazard already described. For analogous reasons, special rules of entity law may be needed to deny withdrawal rights to involuntary transferees[18] of an owner's share in the firm, such as the owner's heirs.[19]

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[14] It was some time, however, before the English courts gave their clear blessing to this approach. *See infra* TAN 156.

[15] In a previous work, two of us focused principally on liquidation protection against creditors as defining strong entity shielding (there termed "strong form" affirmative asset partitioning). We observed, however, that liquidation protection against owners, in its more extreme forms, arguably requires law as well. Thus, the two forms of liquidation protection are highly complementary, and liquidation protection against owners can be properly considered an element of asset partitioning. Hansmann & Kraakman, *supra* note 1, at 434-35.

[16] *See* Larry E. Ribstein, *Why Corporations?,* 1 BERKELEY BUS. L.J. 183, 193-94 (2004) (discussing the enforceability of withdrawals from partnerships).

[17] *See* Naomi R. Lamoreaux & Jean-Laurent Rosenthal, *Corporate Governance and the Plight of Minority Shareholders in the United States Before the Great Depression,* 10 (Nat'l Bureau of Econ. Research, Working Paper No. 10900, 2004).

[18] The right to examine a firm's articles of association arguably provides purchasers with sufficient notice of restrictions on withdrawal rights, making special legal rules unnecessary for this purpose. On the other hand, providing for a form, such as the business corporation, in which liquidation protection against creditors is the default legal rule would facilitate regular trading on

Several scholars have argued recently that the corporate form was principally important historically because it, unlike the partnership, provided liquidation protection against owners and thereby enabled owners to lock in their investments.[20] We agree with these commentators -- indeed, it has long been conventional wisdom[21] — that this has been an important role for the corporate form. But, as we have indicated above, neither the corporation nor any other entity form is a prerequisite for liquidation protection against owners. Liquidation protection against creditors, by contrast, clearly depends on the special rules of property law that characterize legal entities. Moreoever, the economic benefits of liquidation protection against owners are highly circumscribed unless backstopped by liquidation protection against creditors. For these reasons, our theoretical and historical analysis of strong entities, such as the corporation, emphasizes the essential role played by such entities in shielding firm assets from the personal creditors of the firm's owners.

In summary, the primary virtue of legal entities is that they impose property rules that slice through the hazards of pursuing entity shielding by contract. But this virtue is also a potential vice, since a legal device that enables an individual to impair the rights of creditors without their consent invites abuse. In the next section we discuss the nature of that abuse, as well as other aspects of entity shielding's costs and benefits.

III. THE ECONOMICS OF ENTITY SHIELDING

Although the benefits of owner shielding — at least when it takes the form of limited liability — have been well rehearsed in recent literature,[22]

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anonymous markets. A default provides low-cost notice to all owners and creditors — including both business and personal creditors — of the nature of the liquidation rights involved.

For a general analysis of the role of law in structuring property rights, with emphasis on the issue of notice (more properly, verification) and with further discussion of situations analogous to those involved here, see Hansmann & Kraakman, *supra* note 10.

[19] Margaret Blair provides evidence that a desire to constrain the rights of an owner's heirs was an important reason for preferring corporations to partnerships in the United States during the 19th century. See Margaret M Blair, *Locking In Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century*, 51 UCLA L. REV. 387, 445-46 (2003).

[20] BLAIR, *id*; Lamoreaux & Rosenthal, *supra* note 17.

[21] See, e.g., Sobeloff, *Tax and Business Organization Aspects of Small Business* (1974), *reprinted in* DAVID R. HERWITZ, CORPORATION COURSE GAME PLAN 36-37 (1975); NORMAN D. LATTIN, LATTIN ON CORPORATIONS 15-16 (1975).

[22] *See, e.g.*, EASTERBROOK & FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW CH. 2, at 93-7 (1991); Paul Halpern, Michael Trebilcock & Stuart Turnbull, *An Economic Analysis of Limited Liability in Corporation Law*, 30 U. TORONTO L.J. 117 (1980), at 147-49; EASTERBROOK & FISCHEL, *supra* note 13; Susan Woodward, *Limited Liability in the Theory of the Firm*, 141 J. INSTITUTIONAL & THEORETICAL ECON. 601 (1985); Larry E. Ribstein, *Limited Liability and Theories of the*

comparatively little attention has been paid to the economics of entity shielding. We examine the benefits and costs of entity shielding here, since they are vital to understanding both the evolution of legal entities through history and the policy issues that organizational law presents today.

A. The Benefits of Entity Shielding

Enabling individuals to organize legally distinct asset pools provides important economic advantages by reducing information costs and solving problems associated with joint ownership. The first two benefits that we describe here require only priority of claim for firm creditors, and thus are advantageous for all forms of entity shielding. The remaining benefits result primarily from liquidation protection, and thus generally arise only in strong entities such as the business corporation.

Lower Creditor Monitoring Costs

All forms of entity shielding reduce creditor monitoring costs by protecting creditors from risks they cannot easily evaluate. We explain this point through use of a historical hypothetical.[23]

Imagine a Florentine merchant of the Middle Ages who is a partner in several different partnerships.[24] Among these are a wool cloth manufacturing partnership in Florence, a commodity-trading partnership in Bruges, and a banking partnership in Rome. Suppose, further, that the law does not provide entity shielding.[25] If the default rule among partners is joint and several liability for partnership debt (which was the case then as now), creditors of the Bruges firm would have the right to levy upon all assets owned by the Florentine merchant wherever located, including his shares of the firms in Florence and Rome. Thus, a failure of the trading firm in Bruges to pay its debts would threaten the security available to creditors of the partnerships in both Florence and Rome. And because of our assumption that the partnerships in Florence and Rome lack entity shielding, the claims asserted against them by the creditors of the failed partnership in Bruges would be equal in priority to the claims of those partnerships' own creditors. To determine the creditworthiness of the Florence manufacturing firm, a would-be creditor — such as a raw wool supplier selling on credit — would thus need to assess not only that firm's prospects, but also the prospects of the trading firm in Bruges and the banking firm in Rome.

Corporation, 50 MD. L. REV. 80, 81-84 (1991); Hansmann & Kraakman, *supra* note 12; Hansmann & Kraakman, *supra* note 1.

[23] For a more thorough treatment, see Hansmann & Kraakman, *supra* note 1, at 398-403.

[24] The Medici family's businesses, for example, were organized in this manner. See Part V. So were those of Francesco Datini. IRIS ORIGO, THE MERCHANT OF PRATO: FRANCESCO DI MARCO DATINI 1335-1410 109-14 (Jonathan Cape 1957) (1992).

[25] We discuss the actual state of medieval law on these and other matters in Part V, *infra*.

But obtaining information about businesses in Bruges and Rome would likely be costly for a creditor in Florence, and a raw wool supplier would likely be in a better position to evaluate a firm in the cloth-manufacturing industry than to evaluate firms in the banking or trading industries. In short, without entity shielding, a creditor of a firm is vulnerable to the fortunes of all the business and personal financial affairs of all firm owners, regardless of his capacity to monitor those affairs.

If, however, the partnership in Florence were endowed with entity shielding, even in just the weak form, a would-be creditor of that firm could focus principally on evaluating that firm's own assets and prospects. He would need to be less concerned with the affairs of operations in Rome and Bruges, because creditors of those firms would be able to levy on the assets of the partnership in Florence only after he had been paid in full. In short, entity shielding would dedicate the Florence partnership's assets principally to that partnership's own creditors. Although this necessarily distributes value away from the creditors of the Bruges and Rome partnerships, that effect can be offset if those partnerships are also given entity shielding. By this means, all creditors could reduce the cost of appraising the security of their claims and the overall cost of credit to the three firms could consequently be lowered. In short, entity shielding promotes specialization, by permitting creditors to limit the risks they face to those businesses that they know particularly well or that they can monitor with particular ease.[26]

Limited liability and other forms of owner shielding have the converse effect, because they distribute. This, too, can reduce monitoring costs. [27] But owner shielding does not protect a firm's assets from non-firm creditors. Endowing our hypothetical Florence partnership with limited liability, for example, would not prevent the creditors of the Bruges and Rome partnerships from asserting claims to the Florence partnership's assets equal in priority to the claims of the Florence partnership's creditors, and consequently would not reduce monitoring costs for the Florence firm's creditors to the same degree that

[26] On the same principle, a firm and its owners can often reduce the monitoring costs of creditors if the firm's assets (already protected from personal creditors) can be sub-partitioned again and pledged to subsets of business creditors with specialized lending expertise in particular lines of business. This is one of the principal reasons for the formation of wholly-owned corporate subsidiaries and other special-purpose entities. *See* Hansmann & Kraakman, *supra* note 1, at 399-401.

[27] Owner shielding will reduce creditor monitoring costs if non-firm creditors have an informational advantage in non-firm assets, for the same reason that entity shielding creates value if firm creditors have an advantage in firm assets. Also, if firm creditors have an informational advantage in firm assets that decreases their perception of the variance of those assets' expected value, then claims to non-firm assets will be more valuable to non-firm creditors than to firm creditors as a source of risk diversification. As such, owner shielding will provide benefits in that context as well.

entity shielding would.[28] As between the two main forms of asset partitioning, then, entity shielding is the more effective for demarcating a subset of assets and pledging them to a specialized group of creditors.

Reduced Administrative Costs of Bankruptcy

Just as all forms of entity shielding enable creditors to specialize in particular asset pools, they also enable bankruptcy courts to specialize with comparable benefits. To illustrate, let us continue with our example of the medieval Florentine merchant, and consider further the implications of a failure of his banking firm in Rome to pay its debts. Assume that -- as was typical practice then as now[29] — the bankruptcy court in Rome employs a pro rata rule under which all creditors who file proper claims receive payouts based proportionately on the overall ratio between the debtor's assets and liabilities.[30] This means that without entity shielding all assets owned and debts owed by a debtor are of equal status. Thus, to ensure a proper payout according to the pro rata regime, the Rome bankruptcy court would have to assess not only the value of the Rome trading firm, but also the ratios between assets and debts of the firms in Florence and Bruges. To omit this step might impair the rights of the creditors of the Florence and Bruges firms, as those creditors enjoy equal claims to all of the Florentine merchant's assets wherever found, and the Florence and Bruges firms might be in even worse financial shape than the Rome firm. The other partners of the Rome firm would also probably have their own creditors from outside business and personal dealings, and the value of those creditors' claims would similarly need to be factored into the payout calculation. Even if a bankruptcy

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[28] It might be objected that, if limited liability is granted to all firms involved, the result will be the same as endowing all the firms with entity shielding. For example, if the firms in Bruges and Rome both featured limited liability, then creditors of those firms would have no right to proceed against the other assets of the Florentine merchant, and thus they would have no claim to his share of the partnership in Florence. But for a creditor of the Florence partnership to consider this approach reliable, he would have to verify that the Bruges and Rome firms have and maintain limited liability, which is likely to be expensive from a distance. Moreover, the creditor in Florence would continue to face the risk that the Florentine merchant might form yet another firm lacking limited liability, or that he might personally guarantee the debt of the Bruges or Rome firms, or that he might run up non-business, consumer debt. If, on the other hand, the firm in Florence was endowed with entity shielding, the creditor of that firm would be protected against all of these possibilities. Consequently, limited liability is not an adequate substitute for entity shielding in reducing the costs of monitoring for firm creditors.

[29] Pro rata payment of creditors was the clear rule of bankruptcy throughout Italy starting in the 13th century. UMBERTO SANTARELLI, MERCANTI E SOCIETÀ TRA MERCANTI at 84-5 (2d ed. 1992).

[30] The only other practical allocation rule that removes incentives for inefficient runs on a firm's assets is one of temporal priority, in which a creditor who lent first is paid in full before anything is paid to a creditor who lent later. Ancient Rome evidently used a variant of the latter rule, *id*. at 83, but both medieval and contemporary courts rejected it, evidently for reasons of administrative simplicity. The advantages that entity shielding offers in administering a pro rata bankruptcy system are also present in a bankruptcy system that distributes assets based on temporal priority.

court in Rome could exercise jurisdiction over all of these assets and creditors, the necessity of assessing all relevant values in order to determine the proper payout to each creditor would be highly costly in terms of time, judicial resources, and the potential for error.

Endowing the firms with entity shielding significantly ameliorates these problems. Because the creditors of the Rome banking firm would enjoy a prior claim to firm assets, a bankruptcy court in Rome could begin distributions to firm creditors as soon as it had evaluated the Rome firm's assets and debts, without concern that this might compromise the rights of creditors elsewhere. Even if firm assets remained after firm creditors were paid — an unlikely event in any case given that the firm has defaulted on its debt — those assets could be distributed to creditors with subordinated claims, such as those of the Florence and Bruges firms, in subsequent proceedings. The result would be a pro rata bankruptcy system that is cheaper to administer and that can begin paying creditors more quickly. And the prospect of faster payments to creditors should, in turn, redound to the benefit of firm owners in the form of lower borrowing costs. Carrying the thought experiment forward, it is difficult to imagine how a modern court could efficiently administer the bankruptcy of a large public corporation without some means of separating the corporation's assets and creditors from the myriad and farflung assets and creditors of the corporation's many shareholders. Entity shielding provides those means.

Protection of Going-Concern Value

When a rule of liquidation protection is added to priority of claim for entity creditors — thereby increasing the degree of entity shielding from weak to strong — additional benefits can be realized, perhaps the most important of which is protection of a firm's going-concern value.[31] The right to withdraw assets at will can be valuable to an owner of a firm. But the cost of the destruction of going-concern value caused by withdrawal would be spread across all owners, with the consequence that individual owners in a multi-owner firm would face an incentive to exercise the withdrawal right when withdrawal is personally beneficial but socially inefficient.[32] For this reason, firm owners often mutually agree to waive their withdrawal rights for a specified period (as in a partnership for a term) or until a majority of owners votes to liquidate (as in a business corporation). The

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[31] *See id*. at 403-04.

[32] The incentive to withdraw may arise from a sudden need for liquidity on the part of the individual owner. But neither asymmetry of interests among owners, nor a special need for liquidity, are necessary for the threat of inefficient withdrawal to arise. Absent liquidation protection, an inefficient run on a firm's assets by its investors can develop whenever going-concern value is greater than liquidation value, owners have agreed that the payout to a withdrawing owner should reflect the firm's going-concern value, and some owners believe, reasonably or not, that other owners may withdraw their investments. The problem is a multiperson prisoner's dilemma. *See* HENRY HANSMANN, THE OWNERSHIP OF ENTERPRISE 55-6 (1996).

degree to which the cost of withdrawal is externalized increases with the number of owners, making liquidation protection more valuable as owners become more numerous.[33]

To be fully efficient, the waiver of the withdrawal right must also bind the owners' personal creditors. Otherwise, when an owner defaults on personal debt, her creditors will face the same incentive to force an inefficient liquidation of her share. Moreover, if an owner's waiver of her withdrawal right does not bind her personal creditors, she has an incentive to engage in an inefficient level of personal borrowing — in effect, to sell her withdrawal right at too cheap a price — because part of the cost of her own insolvency will be externalized to her co-owners. Thus, contemporary entities that provide liquidation protection against owners also provide liquidation protection against creditors.[34] For example, a shareholder of a modern business corporation cannot liquidate her investment unless she controls a majority of shares, this rule also applies to the shareholder's personal creditors, who may — if the shareholder defaults on her personal debts — seize her shares but not the underlying corporate assets. We thus, as indicated above, include both liquidation protection against owners and liquidation protection against creditors in our definition of strong entity shielding.[35]

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[33] By enabling firms to have more owners, liquidation protection also increases the amount of capital that any particular firm can raise, and thus makes it less costly for a firm to achieve the optimal scale associated with an asset-intensive production technology. Blair makes the converse point about the traditional partnership when she notes that the problems associated with its lack of liquidation protection increase as the partnership grows. Blair, *supra* note 19, at 412.

[34] We also generally would not expect, and in fact find few examples of, firms with the converse: liquidation protection against creditors but not owners. Liquidation protection makes sense only if its benefits in terms of protecting going-concern value exceed its costs, which — as we explore more fully in Section III.B — consist of illiquidity and increased risk of exploitation by control persons. By dint of their typical position as strangers to the firm, personal creditors are more vulnerable to control-person opportunism than are a firm's owners. Consequently, liquidation protection against creditors is likely to be inefficient in a firm if liquidation protection against owners is. A rule of liquidation protection against creditors in the absence of similar protection against owners thus might not provide significant social value, and courts would have good reason to suspect that owners seeking such a rule intend merely to expropriate personal creditors. Despite this line of analysis, we do note that American courts in the late 19th century began denying requests by personal creditors to liquidate partnerships in cases where alternative remedies appeared adequate to safeguard the creditors' interests. This position seemingly resulted from the increased confidence of American courts in their ability to protect those creditors by evaluating partnership interests and arbitrating internal partnership disputes. *See infra* TAN 169-171.

[35] Several reasons explain why we expect a rule of priority of claim for entity creditors always to accompany a rule of liquidation protection. First, firm-specific assets that call for liquidation protection are likely to be of the type that firm creditors are in the best position to valuate and monitor. Therefore, where liquidation protection is efficient, priority of claim for firm creditors in firm assets is likely to be efficient as well. Second, in a firm with liquidation protection, firm creditors are likely to have de facto priority in firm assets as a practical matter. Any distribution of assets to one owner will increase the burden on remaining owners to cover firm debt. Firm

Capital Accumulation and Investment Diversification

By reducing the need for a firm's owners to monitor each other's non-firm financial affairs, entity shielding reduces the costs to owners of bringing on additional equity investors, particularly when they are not family, friends, or others who are particularly easy to monitor or trust. This in turn makes it easier for individuals to make equity investments in multiple firms, and hence, to diversify risk. While this is true for all types of entity shielding, it is particularly true for strong entity shielding because of the advantages of liquidation protection.

Transferable Shares

For the same reason that liquidation protection reduces the need for owners to monitor each other's personal affairs, it also reduces the importance of restrictions on who may become an owner, thereby promoting free transferability of shares. Although previous commentators have claimed that limited liability is the foundation of freely transferable shares,[36] limited liability is in fact neither necessary nor sufficient for that purpose. It is unnecessary because pro rata shareholder liability is consistent with a liquid market in shares; firms with unlimited liability have been traded in public markets into the twentieth century.[37] And it is insufficient because, unlike strong entity shielding, it does not address the risk, created by free transferability, that shares will end up in the hands of individuals likely to threaten the firm's going-concern value through excessive personal borrowing.[38] It is therefore not surprising that, though firms with freely

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owners will therefore tend to resist distributions of firm assets until firm creditors have been paid in full. Finally, transferring to firm creditors priority of claim in the assets of a firm that has liquidation protection should create social value. This is because creditors will tend to value most highly the assets that are available to them immediately upon a default event. Moreover, upshot of liquidation protection is that firm creditors but not personal creditors can levy upon firm assets immediately upon a default by their respective debtor.

This analysis seems to fit the facts, as we are unaware of an historical example of an entity form that provided liquidation protection but not priority of claim for firm creditors. For these reasons, we define strong entity shielding to include both liquidation protection and priority of claim for entity creditors.

On the other hand, as we explain below, liquidation protection entails costs not associated with priority of claim for entity creditors. Consequently, priority of claim may be efficient in firms where liquidation protection is not — an observation that seems to explain the continuing demand for the pattern of entity shielding seen in weak entities such as the general partnership.

[36] *See, e.g.*, Easterbrook & Fischel, *supra* note 22; Woodward, *supra* note 22.

[37] *See* Hansmann & Kraakman, *supra* note 12, at 1895; David Leebron, *Limited Liability, Tort Victims, and Creditors*, 91 COLUM. L. REV. 1565, 1574-84 (1991); PHILLIP I. BLUMBERG, THE LAW OF CORPORATE GROUPS: SUBSTANTIVE LAW 15-16 (1987).

[38] Even weak entity shielding would promote marketability of shares to some extent given that free transferability exacerbates the costs to firm creditors of assessing the personal finances of firm owners.

tradable shares have sometimes lacked limited liability, it appears that they have always had strong entity shielding.

B. The Costs of Entity Shielding

If entity shielding in commercial firms brought nothing but benefits, we would expect to find firms with entity shielding throughout history. As we explain in our historical sections, however, commercial firms with entity shielding arose only gradually, appearing at first in certain circumscribed contexts and forms. This suggests that entity shielding brings significant costs as well as benefits. We survey here the costs that seem most important.

Debtor Opportunism

Entity shielding invites opportunistic behavior by allowing a debtor to subordinate his creditors without their consent. The upshot may be that the availability of entity shielding increases rather than decreases the overall cost of borrowing. Suppose, for example, that our hypothetical Florentine merchant were to organize his three firms as partnerships providing weak entity shielding but not owner shielding. After investing assets in one partnership and causing that partnership to issue debt, the merchant could profit by shifting those same assets to another partnership and using them to attract more creditors, effectively "selling" the assets twice. Expecting such opportunistic behavior ex post, creditors of the first partnership might not offer better credit terms than they would in the absence of entity shielding, and indeed might increase the interest rate they charge to reflect the risk that their claims will end up subordinated. A modern merchant might employ a variation on the same theme (or scheme) by committing assets to a corporation, issuing corporate debt, and then shifting the assets to a corporate subsidiary that also borrows against them. In short, freedom to construct entities creates the potential for the same forms of opportunism toward creditors as does freedom to grant security interests, but on a much broader scale.

Owner shielding invites the reverse form of opportunism, in which an owner withdraws assets from an entity to the detriment of entity creditors. This is the principal hazard associated with limited liability, and a familiar one. As illustrated with our hypothetical Florentine merchant, however, the incentive to remove assets from a firm opportunistically also arises in firms with entity shielding, even in the absence of limited liability.

The chances that owners will be able to shift assets opportunistically either into the firm (which entity shielding encourages) or out of it (which limited liability encourages) depend on several factors, perhaps the most important of which is the number of owners. An entity's owners are unlikely to permit each other to shift assets opportunistically unless the result is mutually beneficial, suggesting that opportunistic asset shifting of both types should decrease as the number of owners rises. But opportunistic movement of personal assets into rather than out of an entity should be particularly unlikely when the entity has numerous owners. A firm's owners are (proportionately) in the same position with respect to the creditors, so that one owner's incentive to exploit creditors will likely be shared by the others and thus lead to an opportunistic pro rata distribution to all owners. That one owner has an interest in exploiting his *personal* creditors by increasing his investment in the firm, however, does not suggest that the other owners have reason to do likewise or to enable such exploitation by accepting downward readjustments of their relative ownership shares. The difficulty in using a jointly owned entity to exploit personal creditors explains why the rise of single-owner firms presents some of the most important challenges in organizational law today.

The movement of assets across entity borders need not be malicious for entity shielding to generate costs. Although deliberate opportunism may be the bigger problem, mere confusion and uncertainty regarding the propriety of a firm's investments and distributions can occasion wasteful disputes and delay in settling creditors' claims. When the means of delineating and enforcing the distinction between firm and personal assets are weak, giving firm creditors priority in firm assets may be less efficient than creating no priorities at all.

Higher Enforcement Costs

Rules to prevent opportunism and confusion must be credible to be effective. Establishing credibility gives rise to enforcement costs. For example, minimum capital requirements entail accounting and disclosure obligations, monitoring activity by creditors, and litigation of perceived violations.

Bright line rules for the use of a legal entity may control opportunism and confusion with only modest enforcement costs but may, also frequently entail high compliance costs that straightjacket owners and restrict an entity's practical applications. Consequently, modern legal systems often employ standards rather than rules for distinguishing proper and improper asset movements across entity boundaries, such as the doctrines of veil piercing, equitable subordination, and fraudulent conveyance. But while these doctrines allow flexibility, they also invite uncertainty of litigation outcomes and require sophisticated courts capable of assessing which asset movements subvert the reliability of entities as devices for bonding contracts. It follows that entity shielding inevitably imposes costs, either in the form of ex ante rigidities or ex post judicial errors.

Creation of a Bankruptcy System

Enforcement of weak entity shielding in particular will generally require the creation of a pro rata bankruptcy system. The typical alternative to a pro rata system is a first-to-file (or "first come, first served") system, which permit creditors to seize a debtors asset's based on the order in which those creditors file suit to enforce favorable judgments. Such prioritization is incompatible with weak entity shielding, which distinguishes between firm creditors and personal creditors. A court could attempt to reconcile weak entity shielding with a first-to-file system by making a personal creditor's right to enforce a claim against firm assets contingent upon whether sufficient firm assets will remain to pay firm creditors in full. Assessing whether sufficient assets will indeed remain will be difficult unless the court can accurately assess the ratio between firm assets and debts. Typically, this will require the court to exercise the broad powers associated with a pro rata bankruptcy system: the powers to stay division of firm assets, evaluate the validity and worth of the claims of multiple creditors simultaneously, and oversee ongoing firm operations during the pendency of proceedings.

Paradoxically, strong entity shielding is less dependent on the presence of a well-developed system of bankruptcy law and administration than is weak entity shielding. Because the personal creditors of an owner of a firm with strong entity shielding do not enjoy a unilateral right to levy upon firm assets, the insolvency of the owner need not precipitate an assessment of firm assets and liabilities to determine the amount that personal creditors should be paid. Personal creditors in that case are usually treated as merely stepping into the shoes of the insolvent owner, receiving a net distribution of firm assets only after a majority of owners agree to liquidate.[39] Strong entity shielding may entail lower administrative and legal costs than weak entity shielding does, but both forms incur

De-diversification of Creditor Claims

Another cost of entity shielding, even in its weak form, is a reduction in the diversification of assets that back the claims of creditors. Let us return to our hypothetical Florentine merchant. To keep things simple, assume that the merchant is the only substantial investor in any of the three partnerships, and has no meaningful wealth outside them. If the three firms lack entity shielding, then a creditor of one is effectively a creditor of all, since the assets of all three are equally available as security for the debt. The amount the creditor can recover will thus depend on the total returns to the three firms in combination. If the three firms are separate entities with either weak or strong entity shielding, however, the creditor's recovery will depend mostly on the performance of the particular firm to which he extended credit. Unless the performance of the three separate firms is perfectly correlated, the effect will be to increase the variance of the creditor's returns.

A creditor could, of course, achieve diversification even in the presence of entity shielding by extending credit to multiple firms. Thus, the relevant cost of entity shielding is not de-diversification per se, but rather the added cost of contracting necessary to achieve an efficient level of diversification.

[39] Moreover, if limited liability is added to strong entity shielding, the insolvency of a firm need not require an assessment of its owners' assets and liabilities, thereby reducing even further the complications of insolvency.

A related cost of de-diversification of assets within entities is an increased probability that firms will incur the costs of financial distress, including the administrative costs of bankruptcy.

Illiquid Investments

The costs we have discussed to this point relate to entity shielding generally or to weak entity shielding in particular. The remaining two costs we survey, however, arise only from strong entity shielding. The first such cost is investment illiquidity. Owners of strong entities cannot unilaterally withdraw their share of firm assets for purposes of personal consumption or to pursue higher investment returns elsewhere. This problem is particularly acute for minority owners who lack control over distribution decisions. For this reason, there is strong complementarity between strong entity shielding and tradable shares, as tradability provides owners with an alternative source of liquidity. While tradable shares reduce the illiquidity costs of strong entity shielding, they usually require costly institutions to implement, such as stock markets, regulatory systems to protect investors, disclosure requirements for public companies, and so on.

Exploitation by Control Persons

The second cost specific to strong entity shielding is exploitation by control persons. An owner's right to withdraw at will serves as an important investor-protection device: by threatening to withdraw assets and thus destroy going-concern value, an owner lacking a controlling share of firm equity can limit exposure to expropriation by controlling owners. Strong entity shielding deprives noncontrolling owners of this protection. All else held equal, strong entities are therefore likely to face greater difficulty than other entity types in attracting non-controlling investors.[40]

C. Cost-Benefit Tradeoffs and Lessons from History

As our survey of economic costs and benefits suggests, entity shielding is a story of tradeoffs. Weak entity shielding reduces creditor information costs but requires a bankruptcy system capable of preserving the prior claims of firm creditors to firm assets, the administrative costs of which are in turn mitigated by entity shielding; tradable shares are both a cost and benefit of strong entity shielding; and all forms of entity shielding entail enforcement costs that reduce opportunism costs. In the abstract, however, this inventory of costs and benefits tells us little about specific historical legal forms. To test its value, we must turn to history. In the following sections we trace a path through four societies that were on the cutting edge of commercial development in each of their respective

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[40] For a model of the choice between the partnership and the corporate form as a simple tradeoff between exploitation by control persons and the benefits of protecting going-concern value, see Lamoreaux & Rosenthal, *supra* note 17.

eras: Ancient Rome, Medieval Italy, early modern England, and the contemporary United States.

Our principal object in these historical vignettes is to explore how far economic logic can explain the organizational forms that provide entity shielding — and to a lesser extent, owner shielding — within each historical period. We do not deal with a single historical progression here, since Rome is discontinuous with Western legal and economic development from the Middle Ages forward. Nor do we attempt a comprehensive explanation of the level of entity shielding in any given period. As our historical narratives illustrate, many factors influence the level of entity shielding displayed by firms in any given period, including the availability of alternative structures for financing businesses (such as wealthy families), the prevalence of capital-intensive enterprise, bankruptcy law, capital markets, and even deep-seated cultural norms such as aristocratic attitudes toward commerce. Economic historians conventionally explain that limited liability arose as a response to the financing needs of capital-intensive technologies, but our examination of entity shielding suggests that the factors shaping organizational law are in fact much more complex and varied.

We leave to others the difficult task of assessing the relative contributions of these factors over time. Our focus here is twofold. First, we identify the factors that seem to promote entity shielding. Second, we explore how far economic considerations can go in making sense of the forms of entities and entity shielding that arise within a particular society.

Each society we analyze raises unique questions. In Ancient Rome, the puzzle is to explain two specialized forms of strong asset partitioning that appear in the law despite a general paucity of commercial legal entities. One is a species of limited liability that protected the Roman family, but that remained unattached — anomalously from a modern perspective — to any parallel rule of strong entity shielding. Another Roman puzzle concerns a strong entity form that Roman law made available only to commercial enterprises transacting with the state or other public entities (the *societas publicanorum*), but not to commercial enterprises in general. By contrast, in the intensely commercial culture of Medieval Italy, we consider the particular form in which entity shielding first became commercially prevalent in Western history, as well as the rise of specialized strong entities that are distant precursors of the modern business corporation. In early modern England, we trace the continued (if erratic) evolution of chartered and unchartered joint stock companies into the modern business corporation, and we examine the factors that encouraged the enfolding of weak entity shielding into the modern partnership form. Finally, in contemporary America, we address the proliferation of strong entities, the crowding out of weak entities, and the accelerated demise of nearly all restrictions on the deployment of entity and owner shielding.

We believe that each of these societies demonstrates the importance of the institutions and practices that reduce the costs of entity shielding within the frame of the period in question. At the same time, we do not wish to be understood as proposing a monocausal account of entity shielding. At most, economic cost-benefit considerations become wholly decisive only in explaining the explosive spread of entity- and owner-shielding in the legal and commercial practices of contemporary America. As we argue below, even here the law may not yet have reached equilibrium, because it has not yet fully accommodated the more subtle costs that entity shielding can impose on creditors whose claims it impairs.

IV. ANCIENT ROME

Across its millennium of history, Ancient Rome saw the rise of both sophisticated legal institutions and a vibrant economy. With the apparent exception of a class of large firms providing services to the Roman state, however, Roman commercial firms appear not to have been endowed with entity shielding.

A. The Partnership

The simplest Ancient Roman commercial form was the *societas,* a term often translated "partnership" because it referred to an agreement among Roman citizens to share an enterprise's profits and losses.[41] Beyond its aspect of joint enterprise, however, the *societas* had little in common with the modern partnership form. For one thing, the *societas* lacked mutual agency; each partner had to endorse a contract to be bound by it.[42] Partners also did not stand behind each other's obligations: the default rule of liability when they cosigned a debt was *pro rata* rather than joint and several. More generally, Roman law made no distinction between the obligations and assets of the *societas* and those of its members,[43] precluding the rules of weak asset partitioning that characterize the modern partnership. All the more did the *societas* lack strong entity shielding: although partners could agree not to withdraw firm assets before the expiration of a term,[44] Roman law enforced such contracts through damages rather than specific performance,[45] making a partner just one among many potential creditors grappling for his copartner's assets when that copartner fell

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[41] W.W. BUCKLAND, A TEXT-BOOK OF ROMAN LAW FROM AUGUSTUS TO JUSTINIAN 504-507 (1921)

[42] As Roman law developed, members of a *societas* eventually could act for each other, although for most of Roman history this innovation applied only to large banking partnerships, and may not have applied to the regular *societas* except in the Eastern (Byzantine) Empire after the sixth century AD. *Id.* at 507, 510; JOHN CROOK, LAW AND LIFE OF ROME 233 (1967).

[43] BUCKLAND, *supra* note 41, at 507.

[44] *Id.* at 505.

[45] A partner could be held liable if he renounced fraudulently or at an especially inopportune time for the firm. *Id.* at 508.

insolvent. Consistent with their lack of entity shielding, most commercial *societates* had no more than a few members.[46]

The undeveloped status of the Roman partnership — which, as we will see, contrasts starkly with the more robust form that the partnership assumed beginning in the Middle Ages — seems attributable at least in part to Rome's reliance on other forms of organization for most business activity. Chief among these alternatives were the family and the *peculium*.

B. The Family

Like the modern family, the Roman *familia* was a *complete* entity in our parlance: creditors who did not transact with persons dealing on behalf of the family had no claim to family assets. The Roman family was, however, much broader than today's simple nuclear family, comprising the oldest living male in the family line (the *pater familias)*, his wife,[47] his unmarried children, and his slaves, as well as all of his adult male descendants and their own household members. The *pater familias* formally owned all family property, whether acquired by wife, child, male descendant, or slave.

These attributes made the Roman family both large and, from a creditor's view, robust. It had an indefinitely long lifespan, remaining intact over multiple generations. And those persons to whom a family member evading creditors would be most inclined to pass his assets — close relatives, and especially descendants — were themselves part of the same entity and thus also liable for the same debts.

The wealth of a single, prosperous Roman family was apparently sufficient to finance the typical commercial firm, thus reducing the need for multi-owner enterprise forms such as the partnership.[48] The vast majority of Roman commercial firms in fact operated at a small scale. 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.[i] To be sure, large-scale production was not unknown in Roman times: industries such as brick making, bronze smelting, glass blowing, and copperware manufacture saw "extensive factory production of articles intended for wide distribution."[49] Yet the

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[46] CROOK, *supra* note 42, at 229.

[47] The degree to which the wife's assets were included among those belonging to the *pater familias* depended on the form of marriage. *See, e.g.,* AARON KIRSCHENBAUM, SONS, SLAVES AND FREEDMEN IN ROMAN COMMERCE 59 (1987).

[48] *Id.* at 301; CROOK, *supra* note 42, at 229; TENNEY FRANK, AN ECONOMIC HISTORY OF ROME 219-74 (1927). Wealth seems to have been concentrated in particular in families that owned large plantations.

[49] FRANK, *supra* note 48, at 223. In particular, certain potteries that specialized in tableware exported their products throughout the Mediterranean. JULES TOUTAIN, THE ECONOMIC LIFE OF THE ANCIENT WORLD 302-3 (1930).

large industries that operated in urban factories, such as ceramics and glassblowing, appear to have derived their scale economies from labor specialization rather than capital intensiveness.[50] For this reason, most of the large-scale workshops in the metalworking and brickmaking industries were located on the estates of landowning families that had made fortunes in agriculture and then diversified.[51]

The ability of a single family to finance and manage one or more commercial pursuits, moreover, was substantially extended by the institution of the *peculium*.

C. The *Peculium*

Slaveholding was extensive in ancient Rome, and it was to their slaves that Roman families frequently delegated commercial activity. This arrangement was congenial to Roman social mores, which considered the conduct of trade demeaning. Moreover, Rome's slaves often exhibited commercial talent, in part because they frequently were captured in colonial wars with Greek and other societies more oriented toward commercial activity than was Rome.

It was common practice for a master to provide his slave (or, sometimes, his son[52]) with a set of assets, termed a *peculium,* to be used in a business venture.[53] The *peculium,* plus any profits it generated, formally remained the property of the master. The master benefited from the arrangement either by receiving regular payments from the slave, or by permitting the slave to buy his freedom in exchange for returning to the master some or all of the enlarged *peculium*.[54]

Unlike the Roman partnership (the *societas)*, the *peculium* businesses exhibited a degree of asset partitioning. Although default on *peculium* debt enabled creditors of the *peculium* enterprise to sue the slave's master, the master's liability was capped at the value of the *peculium* (plus any distributions he had received from it) so long as he had not participated in managing the *peculium* business.[55] As with the *societas,* however, a typical *peculium* business evidently did not exhibit entity shielding: the personal creditors of a slaveholder seem to have enjoyed a claim to all his assets, including those committed to *peculia*, equal in priority to the claims of the *peculium* creditors. While direct

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[50] *See* FRANK, *supra* note 48, at 227.

[51] *See* TOUTAIN, *supra* note 49, at 301.

[52] AARON KIRSCHENBAUM, SONS, SLAVES AND FREEDMEN IN ROMAN COMMERCE 89 (1987).

[53] *Id.* at 33.

[54] *Id.* at 35.

[55] CROOK, *supra* note 42, at 187-89; FELICIANO SERRAO, IMPRESA E RESPONSABILITÁ A ROMA NELL'ETÁ COMMERCIALE, 59- 64 (2002).

statements to this effect are difficult to find in the extant sources, the rules governing a special type of *peculium* – the *peculium castrense*, given to a son who had achieved military distinction – imply a lack of equity shielding in the typical *peculium*. Creditors of businesses financed with a *peculium castrense* were explicitly granted priority of claim in the *peculium* over the father's other creditors — that is, the *peculium castrense* really was a separate fund providing weak entity shielding. This explicit recognition of priority in the *peculium castrense* suggests that the background rule for *peculium* creditors was a lack of such priority.[56]

In short, slave-managed *peculium* businesses, which were a mainstay of Roman commerce, had a highly anomalous form of asset partitioning: complete owner shielding (limited liability), but no entity shielding at all. This is a pattern that we will not see again in our historical survey, and in fact it has not, to our knowledge, appeared in any other significant class of commercial organizations in the past or present. This pattern is unusual because, in general, entity shielding lays a necessary foundation for owner shielding by providing firm creditors with an affirmative claim on firm assets to offset the limitation of their claim to the firm owners' personal assets. The lack of entity shielding in *peculium* businesses arguably made sense in the Roman context, however, and illustrates a cost as well as a benefit of entity shielding. The fact that the typical *peculium* business had a single owner (the slaveholder) would have increased the hazard of opportunism against creditors because a single owner need not coordinate with others the transfer of assets into and out of the entity. If the *peculium* had provided entity shielding, a *pater familias* facing bankruptcy — not an uncommon phenomenon evidently was not uncommon[57] — would have been tempted to assign personal assets to *peculia* and encourage his slaves (or sons) to borrow against the assets and invest in speculative ventures. Success in such ventures would have redounded to the ultimate benefit of the *pater familias*, while the cost of failure would have been borne by his personal creditors.[58] The single-owner nature of a *peculium* business would also have limited the benefits that entity shielding could have offered in terms of reducing creditor monitoring costs. As we note above, the absence of entity shielding in a multi-owner firm requires a prospective firm creditor to evaluate the personal creditworthiness of

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[56] *See* S. SOLAZZI, SCRITTI DI DIRITTO ROMANO [X] (1955-1972). We are indebted to Bruce Frier for extensive help in researching this issue.

[57] It was apparently not uncommon for substantial Romans to borrow heavily to support, among other things, the costs of candidacy for public office.

[58] Roman law did provide creditors with a remedy for fraudulent conveyances, though its effectiveness in a context such as that of the *peculium* is unclear. See Serrao**,** *supra* note 55, at 26; Joshua Getzler & Mike Macnair, *The Firm as an Entity before the Companies Acts: Asset Partitioning by Private Law,* in P. Brand, K. Costello, & W. N. Osborough, eds., ADVENTURES IN THE LAW: PROCEEDINGS OF THE BRITISH LEGAL HISTORY CONFERENCE, DUBLIN 2003 (forthcoming 2005).

each firm owner. A prospective creditor of a slave's *peculium* business, however, needed to evaluate only the creditworthiness of the slaveholder to establish appropriate terms of credit.

Moreover, the limited liability exhibited by *peculium* businesses would have effectively provided them with de facto strong entity shielding against each other's creditors. Limited liability in one *peculium* business would have prevented the creditors of that business from levying upon assets committed to other *peculia* of the same slaveholder, creating a *de facto* privileged claim for those other *peculia* creditors to the extent of those *peculia* assets. Such de facto entity shielding would have been only partial, since it would not have excluded creditors of businesses actively managed by the master, either on his own, with his slaves, or with other free citizens via a *societas*. But, given that Romans conducted a large fraction of their business via *peculium* arrangements, the degree of de facto entity shielding may have been substantial.

The availability of slave-managed *peculium* firms with a degree of de facto entity shielding may have made it less important to provide a rule of entity shielding to the Roman partnership (the *societas*), though this is an issue to which we will return below.

D. The Tradable Limited Partnership (*Societas Publicanorum)*

An apparent exception to the general lack of entity shielding in Roman commerce was a type of multi-owner firm known as the *societas publicanorum.* Dating from the third century B.C., the *societates publicanorum* consisted of groups of investors, known as *publicani,* who bid on state contracts for projects such as the construction of public works, provision of armaments, and collection of taxes.[59] The state paid a portion of the contract price upon accepting a bid, and the rest when the contract was completed. The lead investor in the group pledged his landed estates as security for performance of the contract.[60] Other investors could act either as general partners, who exercised control and were fully liable on firm debts, or as limited partners, who enjoyed limited liability but lacked control.[61] By the first century B.C., the largest *societates publicanorum* appear to have approached the size and internal structure of a modern public company, with "multitudes" — presumably hundreds — of limited partners who

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[59] *See* E. BADIAN, PUBLICANS AND SINNERS: PRIVATE ENTERPRISE IN THE SERVICE OF THE ROMAN EMPIRE 68-69 (1983). Although the *societates publicanorum* were numerous, it seems that the actual contract of association for only one such firm has been found. *Id*. at 68. *See also* A. VIGHI, LA PERSONALITA' GIURIDICA DELLE SOCIETA' COMMERCIALI 38-46 (1900).

[60] ULRIKE MALMENDIER, SOCIETAS PUBLICANORUM: STAATLICHE WIRTCHAFTSAKTIVITÄTEN IN DEN HÄNDEN PRIVATER UNTERNEHMER 273-74 (2002). A short description of the *societates publicanorum* is also provided in Ulrike Malmendier, *Roman Shares*, in THE ORIGINS OF VALUE: THE FINANCIAL INNOVATIONS THAT CREATED MODERN CAPITAL MARKETS 31 (WILLIAM GOETZMANN AND K. GEERT ROUWENHORST eds., 2005).

[61] MALMENDIER, SOCIETAS PUBLICANORUM, *supra* note 60, at 261-68.

could trade their shares on a market resembling a modern stock exchange.[62] Although we lack direct evidence, the tradability of their shares strongly suggests that the *societates publicanorum* enjoyed strong entity shielding, at least with respect to their limited partners. As we have emphasized above, tradability of shares is difficult to sustain without strong entity shielding, while tradability in turn provides the liquidity that strong entity shielding would otherwise deny to the firm's shareholders.[63]

In addition to creating liquidity problems, the liquidation protection that characterizes strong entity shielding increases the risk of opportunism by those in control. Modern societies deal with this problem through elaborate public and private mechanisms of investor protection. There is no evidence that ancient Rome developed such mechanisms. How, then, were the costs of control person opportunism kept within bounds? One answer may lie in the fact that the *societates publicanorum* evidently provided services only to the state, and not to private parties. Being a firm's only customer, the state would have had a strong interest in ensuring that the firm be efficiently and honestly managed, and would also have been in a good position to be aware of serious malfeasance and take action against it.

E. Roman Entity Law: A Case of Arrested Development?

We have seen that there is substantial apparent logic to the forms of asset partitioning exhibited by ancient Rome's best-developed enterprise forms: the family, the *peculium*, and the societas publicanorum. Taken altogether, however, the patterns of commercial organization in ancient Rome present a striking contrast. For business done in the private sector, Rome apparently had no forms of enterprise organization that provided either weak or strong entity shielding. But for business done with the state, Romans developed and made extensive

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[62] MALMENDIER, SOCIETAS PUBLICANORUM, *supra* note 60, at 249-51.

[63] Strong entity shielding in the *societates publicanorum* is suggested by the fact that, unlike a *societas*, a *societas publicanorum* survived the death of any member, except that of the lead investor whose name appeared on the contract with the state. When a member other than the lead investor died, the heir of the deceased member stepped into his financial rights and obligations, though the heir became a full firm member only if there had been a prior agreement to that effect. *Id*. at 243-47; P.W. DUFF, PERSONALITY IN ROMAN PRIVATE LAW 160 (1971); CROOK, *supra* note 42, at 234. (Although these authors discuss such limitations on the rights of heirs in the context of *societates publicanorum* formed for tax farming, the nature of the limitations suggests that they applied to other types as well.) Further evidence for strong entity shielding is that the *societas publicanorum* appears to have been able to receive a type of legal personality that permitted a firm to own property and transact in its own name, though this privilege may have been used only by the larger firms. BADIAN, *supra* note 59, at 69. Malmendier argues that the *societas publicanorum* enjoyed full legal entity status by the first century B.C., though she does not specifically address the question of entity shielding.. MALMENDIER, *supra* note 60, at 252-55.

use of an organizational form that enjoyed strong entity shielding, and in fact bore a substantial resemblance to a modern publicly traded corporation.[64]

This pattern of institutional development presents at least two significant questions. First, why did Roman law not grant weak entity shielding to the *societas*, thus offering a general-purpose commercial entity for private commerce? Second, why was the *societas publicanorum* not employed for business with the private sector as well as the public sector?

As for the first question, we have explained why even weak entity shielding may have been inefficient for *peculium* businesses. But the same reasons —most of which have to do with the fact that a *peculium* business had a single owner —do not extend to the *societas*. And though the broadly-conceived Roman family, supplemented with slave-managed *peculium* businesses, may have been an adequate vehicle for much of Roman commerce, it is hard to imagine that it would not have been advantageous to develop the *societas* into a general partnership form with weak entity shielding. The costs would seemingly have been modest. If the Roman courts were capable of sorting out creditors and assets between a slave's *peculium* and the other affairs of the slave's master, as was required by the limited liability that came with the *peculium*, then presumably courts could have done the same with the creditors and assets of a partnership and those of its various partners.

We may have to look to aspects of Roman culture other than commercial and legal costs and benefits to find an answer. Roman society perhaps placed a sufficiently strong value on the stability and status of prominent families, and a sufficiently low value on commerce, that it was largely unwilling to risk the former for the sake of the latter. Hence Roman law placed all power over a family's wealth in the *pater familias*, and then made it difficult for the *pater familias* to delegate the power to put that wealth at risk. Roman law famously had no general concept of agency. This meant that a *pater familias* could not delegate to a business partner the authority to commit family assets, which in turn perhaps made further development of the partnership as an entity infeasible. In general, only sons and slaves could be delegated agency authority over family assets. Yet they could generally only bind the assets in their *peculium*, and even there could not give the creditors they dealt with priority over the family's personal creditors. Facilitating commercial credit may simply not have been of great importance in the Roman system of priorities.

In any event, one thing is clear. It was not for lack of imagination that the Romans failed to develop general-purpose commercial entity forms. The

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64 More accurately, the Roman *societates publicanorum* closely resembled the publicly traded limited partnerships that played a strong role in the economy of nineteenth century France. *See* Naomi R. Lamoreaux and Jean-Laurent Rosenthal, *Legal Regime and Business's Organizational Choice: A Comparison Of France and the United States during the Mid-Nineteenth Century* (Nat'l Bureau of Econ. Research, Working Paper No. 10288, 2004), available at http://www.nber.org/papers/w10288.

Romans clearly understood the concept of entity shielding in both its weak and strong forms. As we have noted, Romans employed weak entity shielding in the *peculium castrense*.[65] And they evidently employed strong entity shielding in the *societas publicanorum*. Moreover, well before the Republic ended in the first century B.C., Roman law had come to recognize noncommercial legal entities such as municipalities and nonprofit organizations.[66]

This observation leads us to our second question: why was the *societas publicanorum* not used for private business? Perhaps the ratio of benefits to costs was too low. Unlike the state, few private parties may have needed services that could be provided only by heavily capitalized firms. Moreover, as suggested above creating publicly traded firms not confined to public contracting may, have required the costly development of institutions for investor protection. Part of the answer may, however, also lie in political considerations. When Rome changed from a republic to an empire in the first century B.C., the wealth and thus the influence of the *publicani* drew jealous attention from the emperors,[67] who ordered the state to take over much of the construction of public works. The *publicani* persisted for a time as tax collectors, but repeated

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[65] Rome also had a law of secured transactions sophisticated enough to handle floating liens on commercial assets. R. W. LEAGE, ROMAN PRIVATE LAW 190-96 (1937). Because it generally bonds only named creditors, and not a shifting group of creditors, a security interest is a much more restrictive device than a legal entity. *See* Hansmann and Kraakman, *supra* note 1, at 418. But floating liens certainly signify a system of commercial law with a sophisticated approach to creditors' rights. (At the same time, we note that the availability of floating liens might have reduced somewhat the demand for weak entities, for which they can serve as something of a substitute.)

[66] Aside from the family, Roman law recognized three types of noncommercial organizations as distinct — and, in our terms, complete — legal entities. The first, the *collegium*, was employed originally for fraternal associations. "[I]t is almost certain that the property of a corporate college was protected against the creditors of individual members…." DUFF, *supra* note 63, at 152. *See also id.* at 95-158; *accord* ADOLF BERGER, ENCYCLOPEDIC DICTIONARY OF ROMAN LAW 395 (1953). The second distinct Roman legal entity was the municipal corporation (or *municipium*). Finally, Rome recognized a noncommercial type of entity that covered a mixed class of membership and charitable organizations. Like the family, all three of these were complete entities: neither members nor their creditors enjoyed a claim to entity assets. Unlike the family, however, these entities were controlled by persons who held property of their own outside the entity, thus creating a hazard of asset distributions to the detriment of entity creditors. Distributions of net assets to controlling persons were formally barred, however, by virtue of the "nondistribution constraint" that remains today the defining characteristic of a nonprofit organization. *See* Henry Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835 (1980). The entities thus featured resilient organizational boundaries that contributed to their conspicuous success as asset-pooling devices.

[67] During the first century B.C., 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 gained their support. Their period of official favor, however, was short lived. FRANK, *supra* note 48, at 182.

clampdowns eliminated them from even this role by the end of the second century A.D.[68]

The *publicani* were not the only victims of the Roman state's willingness to intervene in the economy. For much of Roman history, the consuls and emperors took a hands-off attitude toward commerce, leaving market participants free to innovate.[69] But beginning in the reign of Commodus (A.D. 180 to 192), the empire entered a period of despotism, in which the state seized expanses of private land and plundered stores of urban wealth to fund its ceaseless wars against foreign and domestic enemies.[70] The ultimate consequence was a total economic collapse in the fourth century A.D., to which the state reacted by seizing almost all remaining enterprises, establishing its own factories for arms production, and imposing a system of serfdom to man the state industries.[71] Thus, even if Roman legal institutions had provided a commercial entity, the Roman economy after the second century A.D. would likely have lacked the strength to pluck it:

> [M]anufactures were but one piece of the machine of which, from the third to the fourth century, each part had been slowly forged, with the result that the last vestiges of liberty had been crushed and the springs of initiative, weak and terrorized as it already was, had been completely dried.[72]

Soon after came the collapse of the Western Empire, followed by the Dark Ages. General-purpose commercial firms with entity shielding would have to wait for Europe's next boom economy, several centuries away.

V. MEDIEVAL AND RENAISSANCE ITALY

Europe's economy in the centuries after the fall of Rome provided little impetus for the formation of commercial firms with multiple owners. Southern Europe's population was reduced by a series of epidemics in the fifth and sixth centuries A.D., and then held in check by a decline in agricultural productivity caused by soil exhaustion and, possibly, climatic changes.[73] Among the consequences was a severe decrease in investment in commercial ventures during the period.[74]

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[68] CROOK, *supra* note 42, at 234.

[69] *See* M. ROSTOVTZEFF, THE SOCIAL & ECONOMIC HISTORY OF THE ROMAN EMPIRE 145 (1926).

[70] FRANK, *supra* note 48, at 483-84.

[71] PAUL LOUIS, ANCIENT ROME AT WORK 282-83 (1927).

[72] *Id.*

[73] Robert S. Lopez, *The Trade of Medieval Europe: The South,* 2 CAMBRIDGE ECONOMIC HISTORY OF EUROPE 306 (1952).

[74] ROBERT S. LOPEZ, THE COMMERCIAL REVOLUTION OF THE MIDDLE AGES 950-1350 18 (1976).

Agricultural yields and thus population levels finally began a slow rally at the end of the tenth century A.D., in turn stimulating a revival of trade.[75] The decay of the great Roman roads had pushed most of the remaining long-distance commerce into the Mediterranean, and so the political center of gravity when trade revitalized had shifted outward to Italian ports such as Amalfi, Pisa, Genoa, and Venice.[76] Unlike in ancient Rome, mercantile families composed much of the ruling class in these new city-states, as they did in the inland cities, such as Florence and Sienna, whose own prosperity began in the thirteenth century. The result was a cluster of legal regimes that were highly responsive to the needs of commerce.[77] The renewed importance of long-distance trade, combined with merchants' influence over lawmaking gave rise to the *law merchant* — a set of commercial rules that exhibited substantial homogeneity across jurisdictions.[78]

The most important forms of medieval trade were supported by extensive debt financing, commonly in the form of short and long-term credit extended by customers and suppliers. Many of the innovations of the law merchant were thus designed to make merchants more creditworthy. In particular, commercial law was heavily pro-creditor, dealing harshly with merchants who failed to pay their debts. Litigation involving merchants commonly took place in special merchant courts in which process was rapid, with disputes often decided in a matter of days.[79]

A. Households and Partnerships

As in Rome, the family — or, more accurately, the household — was the basic legal entity. There were, however, some significant differences between Roman and Medieval Italian households. First, sons, like their father, were capable of entering into contracts that would commit the family's assets.[80] Second, while adult sons sharing the father's household were presumed part of the family entity, sons who neither shared the household nor participated in the family business could be considered outside the family entity.[81] Both changes made the medieval Italian family more like a modern commercial partnership

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[75] *Id.* at 27-34.

[76] Lopez, *supra* note 73, at 316-17.

[77] FRANCESCO GALGANO, LEX MERCATORIA 38-69 (1993); SANTARELLI, *supra* note 29, at 41-53; Vighi, *supra* note 59, at 60-63 .

[78] The degree of homogeneity is subject to debate. *See* J.H. Baker, *The Law Merchant and the Common Law Before 1700*, 38 Camb. L.J. 295 (1979).

[79] ALESSANDRO LATTES, IL DIRITTO COMMERCIALE NELLA LEGISLAZIONE STATUTARIA DELLE CITTA ITALIANE . STUDII DI ALESSANDRO LATTES at 259-260, 298 (1884).

[80] MAX WEBER, THE HISTORY OF COMMERICAL PARTNERSHIPS IN THE MIDDLE AGES 86 (1889).

[81] *Id.* at 109; Santarelli, *supra* note 29, at 129.

than its Roman counterpart was, and reflected the fact that productive enterprise and trade were commonly conducted at the level of the household.

The medieval Italian partnership — termed the *compagnia* — evolved gradually out of the laws and customs governing the household, as merchants' businesses initially grew by adding unrelated persons to the household.[82] At first the *compagnia* differed from the Roman *societas* only in its use of a rule of joint and several -- rather than pro rata -- liability among partners for firm debt.[83] Over time, however, the *compagnia* also acquired mutual agency,[84] a development that would have made it more useful to larger firms, and which in fact coincided with the increased scale of commerce that came with the High Middle Ages.[85]

B. Entity Shielding and Bankruptcy

Most importantly for our purposes, the medieval law merchant was an innovator with respect to entity shielding. Though the rule evidently developed only gradually,[86] and to different degrees in different places, medieval Italy eventually arrived at a regime whereby partnership creditors enjoyed a claim to partnership assets that was prior to the claim of the partners' personal creditors.[87] This rule of weak entity shielding for partnerships was not matched by a symmetric rule of weak owner shielding: personal creditors not only had no

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[82] WEBER, *supra* note 80, at 106-08; Santarelli, *supra* note 29, at 34.

[83] LOPEZ, *supra* note 73, at 74; ARMANDO SAPORI, LE COMPAGNIE MERANTILI TOSCANE DEL DUGENTO E DEI PRIMI DEL TRECENTO-LA RESPONSABIILITA' DEI COMPAGNI VERSO I TERZI, II STUDI DI STORIA ECONOMICA, 766 (1955); ARMANDO SAPORI, STORIA INTERNA DELLA COMPAGNIA MERCANTILE DEI PERUZZI , II 664.

[84] *See* W. MITCHELL, AN ESSAY ON THE EARLY HISTORY OF THE LAW MERCHANT 132-33 (1904); RAYMOND DE ROOVER, MONEY, BANKING AND CREDIT IN MEDIEVAL BRUGES 32 (1948).

[85] While the typical *compagnia* was a small firm with a fixed term of one to twelve years, JEAN FAVIER, GOLD & SPICES: THE RISE OF COMMERCE IN THE MIDDLE AGES 157 (1998), increases in the scale of commerce by the last half of the thirteenth century led to *compagnie* with as many as twenty (often unrelated) partners and several hundred employees. For example, in 1312 only eight of the seventeen partners of the large Peruzzi *compagnia* of Florence were members of the Peruzzi family, and by 1331 the family had only a minority interest in the firm. RAYMOND DE ROOVER, THE RISE AND DECLINE OF THE MEDICI BANK 1397-1494, 77-78 (1963) [hereinafter DE ROOVER, MEDICI BANK]. *See also* Raymond de Roover, *The Organization of Trade*, 3 CAMBRIDGE ECONOMIC HISTORY OF EUROPE 42, 75 (1963) [herein after de Roover, *Organization of Trade*]; EDWIN S. HUNT & JAMES M. MURRAY, A HISTORY OF BUSINESS IN MEDIEVAL EUROPE 1200-1500, at 62, 105-09 (1999). Typically the largest of these *compagnie* originated as traders of grain or textiles in central Italy, *See* LOPEZ, *supra* note 74, at 106-13, and grew principally by establishing new branches in foreign cities, de Roover, *Organization of Trade*, *supra*, at 70-89; HUNT & MURRAY, *supra,* at 102-05. Once these partnerships established a network of international branches, they were well placed to trade in international currencies as well. Consequently, they soon also became Europe's dominant international bankers.

[86] Vighi, *supra* note 59, at 50, 57-60.

[87] Galgano, *supra* note 77, at 45; Lattes, *supra* note 79.

prior claim on a merchant's personal assets,[88] but their claims were also disadvantaged in general with respect to those of business creditors, reflecting the broad disposition to facilitate trade credit.

The evolution of weak entity shielding in the Italian *compagnia* reflected not just the increasing salience of the rule's benefits in terms of reducing the costs of credit, but also the development of a system of bankruptcy law. As we indicated in Section III, a bankruptcy regime both makes possible and benefits from a rule of weak entity shielding. Consistent with this, procedures for handling merchant bankruptcies began to develop in the Italian city-states by the early thirteenth century.[89] The basic rule was division of a bankrupt merchant's assets among his creditors pro rata, according to the size of their claims. This regime constituted a deviation from the Roman rule of priority for earlier-arising debts – a deviation that presumably was called for because of the speed and simplicity that it offered in handling the claims of commercial creditors.[90]

In formal terms, only an individual merchant could be the subject of bankruptcy, not a *compagnia*.[91] As the partnership developed, however, rules evolved that, in effect, provided for firms to go bankrupt. If a member of a partnership became subject to bankruptcy in connection with a debt of the partnership (for example by failing to pay — or fleeing from — such a debt), then all other partners of that firm would also be declared bankrupts regardless of their individual solvency.[92] The result was that when a partnership failed to pay its debts, all partners could be thrown into bankruptcy, and all creditors of the partnership would be able to seize a portion of each partner's assets, including assets held by the partnership. Moreover, the partnership creditors would first have to exhaust partnership assets before taking the partners' personal assets.[93]

In addition to bankruptcy proceedings, another likely contributor to the rise of entity shielding in the Middle Ages was the medieval revolution in bookkeeping methods. Recordkeeping became cheaper with the introduction of inexpensive

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[88] There were some forms of personal assets that were unavailable to a merchant's creditors in a bankruptcy proceeding, including his wife's dowry, family real estate, and some personal possessions. But these assets were evidently unavailable to personal creditors as well. Lattes *supra* note 79, at 339 nn. 11-12; U. SANTARELLI, PER LA STORIA DEL FALLIMENTO NELLE LEGISLAZIONI ITALIANE DELL'ETA' INTERMEDIA 242 (1964).

[89] SANTARELLI, *supra* note 88, at 33-39; Francesco Galgano, *L'iniziativa del Debitore nel Fallimento delle Societa' Personali*, 5 Rivista di Diritto Civile 289, 304 n.74 (1958).

[90] SANTARELLI, *supra* note 88, at 264.

[91] Galgano, *supra* note 89, at 300-05, 310; SANTARELLI, *supra* note 88, at 187.

[92] Galgano, *supra* note 89 at 300-05, 310; Santarelli, *supra* note 88, at 187. If a merchant was a partner in two different *compagnie*, -- A and B -- and committed an act of bankruptcy in connection with A, then the partners of B would not be thrown into bankruptcy, though B would be subject to dissolution.

[93] Galgano, *supra* note 89, at 327 n141; Vighi, *supra* note 59, at 135.

paper in Italy in the thirteenth century, and arithmetic became easier with the displacement of Roman numerals by Hindu-Arabic digits in the late fourteenth century. Double-entry accounting, which provided the first workable method for tracking a firm's net value, also appeared in the fourteenth century and spread thereafter.[94] These innovations made it easier for owners and creditors to assess the value of firm assets and to distinguish permissible from impermissible distributions. The effect was an increase in the reliability of a firm's business assets, as opposed to the personal assets of its owners, as the principal bond for the firm's obligations.

The form of weak entity shielding imposed on medieval merchants differed from the analogous modern rule for partnerships in two important respects. First, it applied not just to partnerships, but to businesses owned by individual merchants as well. A sole proprietorship today, in contrast, brings no entity shielding: there is no distinction between the owner's personal assets and creditors and those of her business. An individual can obtain strong entity shielding for her business only if she forms a business corporation or other entity of which she is the sole shareholder (a "corporation sole").

Why did medieval law, in contrast to modern law, endow sole proprietorships with entity shielding? To begin with, the lack of any form of owner shielding meant that entity shielding had only benefits and no costs for business creditors. Thus, it unequivocally increased a merchant's creditworthiness while increasing only slightly the burdens faced by personal creditors, who already operated under strong limitations.[95] Moreover, given that other male members of a merchant's household were considered his partners, the contrary rule would have made creditors' rights depend rather arbitrarily on the current composition of a merchant's household. Finally, guild rules, which constrained closely the forms and methods of merchant activity, made the nature of a merchant's business activities difficult to obfuscate and hence inhibited opportunistic use of entity shielding to avoid personal — or other business — creditors.

The second difference between medieval and modern entity shielding is that the medieval form was heavily locational in its operation. If a merchant was engaged in businesses at different locations, or had several branches of the

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[94] ALFRED W. CROSBY, THE MEASURE OF REALITY: QUANTIFICATION AND WESTERN SOCIETY, 1250-1600, at 199-222 (1997); RAYMOND DE ROOVER, *The Commercial Revolution of the Thirteenth Century*, ENTERPRISE AND SECULAR CHANGE: READINGS IN ECONOMIC HISTORY 81 (1953). The spread of new commercial practices would have been aided significantly by the development of movable type in the mid-fifteenth century.

[95] So far as personal credit was concerned, medieval law, like Roman law generally, strongly favored debtors over creditors, for example by forcing unpaid creditors to accept compromises and substantial extensions of time to pay. Lattes, *supra* note 79, at 310 (noting that, from a creditor's viewpoint, insolvent nonmerchant debtors (*debitori civili*) were treated more indulgently than merchant debtors).

same business at different locations, creditors at one location enjoyed priority of claim to the assets held there.[96] The consequence was that each branch of a merchant's business was effectively a distinct entity. This is in contrast to the contemporary rule whereby all creditors of a partnership have equal priority in all the assets of the partnership wherever they may be located.

The fine-grained character of this asset partitioning, relative to that which we see today, was presumably an adaptation to the highly fragmented nature of the political jurisdictions of the time, and the difficulties that this fragmentation created for the effective administration of bankruptcy law. Because the geographic reach of trade was far wider than the jurisdictional reach of the courts in the small city-states of medieval Italy, merchants had a strong incentive to flee to another jurisdiction in order to avoid their creditors — an incentive that was frequently acted upon.[97] In fact, "merchant in flight" was the term generally used to refer to a bankrupt merchant. This incentive to flee was reinforced by the fact that the largest firms of the time engaged primarily in trading and banking, and thus held non-fixed assets — such as marketable goods, coins, and financial claims — that were easy to make off with. Furthermore, the courts' limited jurisdiction meant that a single court often could not reach, or even discover, assets that a merchant held in other jurisdictions.

In light of these jurisdictional limitations, there was probably little to be gained by establishing a bankruptcy process that would seek to assemble all of a firm's business assets wherever held, and all of its debts wherever they arose, and then divide all the assets ratably among all the creditors. To take the time necessary to do this, even for assets held within a single jurisdiction, would simply increase the opportunity for the firm's owners to flee the jurisdiction, and to take with them a substantial portion of the assets previously held there. Rather, it was logical to provide for a relatively rapid procedure whereby all of a bankrupt firm's creditors that had claims arising locally could immediately seek satisfaction of their claims with the firm's local assets. This procedure would have permitted a local court to seize local assets and divide them up quickly, without concerning itself with assets held, or claims arising, in other locations.[98]

While the resulting system of location-based asset partitioning would have been relatively easy to administer, it deprived merchants of the ability to set up a different partitioning if they chose to do so. In effect, it meant that a creditor

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[96] Galgano, *supra* note 77, at 63 n.36; Vighi, *supra* note 59, at 134-138.

[97] ROBERT S. LOPEZ & IRVING W. RAYMOND, MEDIEVAL TRADE IN THE MEDITERRANEAN WORLD 291, 298-302 (1978).; Lattes, *supra* note 79, at 329 n.16. *See also* SANTARELLI, *supra* note 88, at 34-39

[98] While we have little direct evidence, one suspects that the system was administered with more speed than precision and that the division of assets among creditors was relatively crude. *See, e.g.*, LATTES, *supra* note 79, at 311, 330.

could be given a first priority claim only on the assets of the local branch with which he dealt. It did not permit the owners of a multi-city firm to give all firm creditors an equal priority claim on all the firm's assets, wherever located.

There is evidence that, at least in the thirteenth and fourteenth centuries, the entity shielding given to partnerships by the law was weaker than merchants would have wished. Members of a medieval *compagnia* often promised in their partnership agreement to refrain from joining other partnerships,[99] and under some early statutes this commitment was imposed as a matter of law.[100] These commitments may have been intended, at least in part, to prevent partners from diverting firm opportunities to themselves. But the particular bar on joining other partnerships probably also served, and was intended to serve, to insulate the firm from the spillover effect if another firm with an overlapping partner became insolvent, forcing that partner into bankruptcy. These promises appear to have reflected a need for strong entity shielding that would protect not just firm creditors' priority but also going concern value. A legal rule of entity shielding would have been superior to these contractual commitments in two ways. First, it would have provided the needed insulation without barring merchants from becoming members of more than one firm. Second, it would have insulated firms more effectively because it would have been enforceable against nonfirm creditors without their consent, whereas a mere contract among partners presumably would not have bound the creditors of outside firms that a partner joined in violation of the agreement.

There is also evidence that a stronger degree of owner shielding in the *compagnia* would have been beneficial as well, but that cost-side considerations again precluded it. The movement from pro rata to joint and several liability in the medieval partnership shifted from firm creditors to partners the risk that any particular partner would be unable to pay his share of firm debt. This assignment of risk was probably efficient in the eleventh and twelfth centuries, when the typical *compagnia* consisted of a small group of relatives who would have been well positioned to monitor each other's personal finances. But when *compagnie* grew into large, multi-branch ventures in the thirteenth century, mutual monitoring among partners became more difficult, and thus joint and several liability more onerous. In 1310 the city of Sienna, which at that point dominated European banking, responded by enacting a statute that restored the earlier regime of pro rata liability. But instead of advancing the local merchant interest, this statute handicapped Senese firms in attracting credit so badly that, by the time of the

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[99] ARMANDO SAPORI, DALLA COMPAGNIA ALLA HOLDING, III STUDI DI STORIA ECONOMICA 87, at 125 (1955), cites for this and other "standard" clauses in partnership agreements the 1310 contract of the societa' dei Tolomei as "standars contract" ("contratto tipo"). FAVIER, *supra* note 85, at 164; LOPEZ & RAYMOND, *supra* note 97, at 204.

[100] Constituto del Comune di Siena del 1262, II, 123; II, 82, cited in A. Arcangeli, *Gli Istituti del Diritto Commerciale nel Costituto Senese del 1310*, VI Rivista di Dirtto Commerciale 243, at 348 (1906).

statute's repeal in 1342, Florence had permanently displaced Siena as Europe's banking capital.[101] Firm creditors were evidently no better placed to monitor a partner's financial condition than his co-partners were, and so the costs of even the modest move along the owner-shielding spectrum from joint and several to pro rata liability well exceeded the benefits.

The famous Medici Bank took a different approach to the owner shielding problem. Until the middle of the fourteenth century, each of the largest Italian firms, including those with branches in many countries, was organized as a single partnership. In the early 1340s, the largest of these firms — then located in Florence — all collapsed, evidently as a consequence of macroeconomic factors. When the Medici started putting together their own international firm about fifty years later they formed it not as a single partnership, but rather as a series of firm that overlapped at a common point like spokes in a wheel. Each branch office had its own partnership in which local managers signed on as junior partners, and the Medici family — placed as the firm's hub — took the majority position.[102] By hiving of each branch into a separate firm in this way, the Medici relieved junior partners in one location from joint and several liability for debts incurred elsewhere, thus according each junior partner a degree of owner shielding not available in the large *compagnie* of the early fourteenth century. Of course, the Medici's particular solution to the problem presupposed a family wealthy enough to stand at the firm's contractual intersection, and thus was not widely replicable.

Even the Medici, moreover, seem not to have been able to make owner shielding work on an ongoing basis in its strongest form — that is, in the form of full limited liability. At the time of the Medici Bank the law merchant made available a limited partnership form, termed the *societa' in accomandita*,[103] in which passive partners enjoyed limited liability so long as they refrained from lending their name to the firm and participating in its management.[104] By operating their firm as a series of *accomanditi* with themselves as the passive partners, the Medici in theory could have prevented the failure of one branch of the firm from destabilizing its center. But the Medici instead used the

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[101] EDWARD D. ENGLISH, ENTEPRISE AND LIABILITY IN SIENESE BANKING, 1230-1350, at 91-92 (1988); WILLIAM M. BOWSKY, A MEDIEVAL ITALIAN COMMUNE: SIENA UNDER THE NINE 1287-1355, at 254-57 (1981).

[102] *See* DE ROOVER, MEDICI BANK, *supra* note 85, at 81-82.

[103] The form was well developed at least by 1408, when it was adopted by statute in Florence. DE ROOVER, MEDICI BANK, *supra* note 85, at 75. It derived from the *commenda,* discussed *infra.* Although the principal application of the *commenda* was in long-distance maritime trade, it eventually found use in overland trading expeditions in which the active partner traveled with goods supplied by the passive partner. As in the sea-borne version, the land-based *commenda* was liquidated and all debts paid when the active partner returned to his home city. LOPEZ & RAYMOND, *supra* note 97, at 188-89.

[104] DE ROOVER, MEDICI BANK, *supra* note 85, at 89, 284, 325.

accomandita only as a kind of probationary device, with the managers of a new branch in the position of the general partner and the Medici's central bank in Florence as the limited partner. If, within a period of two years or so the new managers proved their reliability and acumen, their partnership was reformed as a *compagnia* in which the Medici faced unlimited liability[105] The decrease in borrowing costs that occurred when the Medici stood behind the debts of a local branch was evidently more valuable, at least in the estimation of the Medici, than the protection against the local manger's business decisions offered by the *accomandita*. The Medici Bank is thus further evidence that the fluid and fungible assets of the great trading firms were a weak basis for firm credit, and therefore that pledges of personal liability by partners were essential if a firm was to be creditworthy.

C. Forebear of the Modern Company: the *Commenda*

The exception to the general lack of strong entities in medieval times was the *commenda*, which arose during the tenth and eleventh centuries as a device for financing maritime trade. The prototypical *commenda* had two partners: a passive investor who provided capital for trade, and a traveling trader (often the ship captain) who contributed labor and initiative.[106] A *commenda* lasted only a single, round-trip voyage, at the end of which the merchandise obtained in foreign ports was sold off and the profits divided between the active and passive partners according to pre-specified proportions.[107]

Scholarly interest in the *commenda* has derived primarily from the fact that the passive partner usually enjoyed limited liability, which arose from a standard contractual term whereby the active partner waived all claims to the assets of the passive partner (beyond the initial investment) in case of loss.[108] Given the passive partner's lack of control over firm matters, his insistence upon limited liability made sense as a way of shielding him from imprudent borrowing by the active partner. At the same time, the passive partner's lack of control would have made limited liability more acceptable to firm creditors, as is the case in limited partnerships generally. Because firm assets were at sea or in foreign ports for the duration of the venture, the passive (or limited) partner would have been disabled from causing the firm to make opportunistic distributions to himself that

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[105] *See, e.g., id.* at 63, 311-2.

[106] De Roover, *Organization of Trade*, *supra* note 85, at 49-50; HAROLD J. BERMAN, LAW AND REVOLUTION: THE FORMATION OF THE WESTERN LEGAL TRADITION 352-53 (1983); LOPEZ & RAYMOND, *supra* note 97, at 175.

[107] LOPEZ, *supra* note 73, at 76-7; de Roover, *Organization of Trade*, *supra* note 85, at 49-50; LOPEZ & RAYMOND, *supra* note 97, at 175-180.

[108] *See* MURAT CIZAKCA, A COMPARATIVE EVOLUTION OF BUSINESS PARTNERSHIPS 14 (1996); *see also* WEBER, *supra* note 80, at 78; John H. Pryor, *The Origins of the Commenda Contract*, SPECULUM 9, at 7 (1997).

might compromise the firm's creditworthiness. And the active (or general) partner, personally liable for any shortfall in firm assets, would have had no incentive to make distributions to the passive partner that might compromise firm solvency.

While the partial limited liability of the *commenda* was important historically, an equally significant, but to now largely unnoticed, feature of the arrangement was a rule whereby the *commenda* had *strong* entity shielding with respect to the passive partner.[109] This arrangement was likely acceptable to the passive partner because in the *commenda,* unlike the typical *compagnia,* the firm's assets were sequestered in the hull of the ship or in foreign ports, so that anything the active partner wished to expropriate he still would likely have to bring back with him. Once the voyage touched home, and windows of opportunism thereby opened to the active partner, the contract dissolved and the passive partner was immediately owed his due. The hull of the ship thus acted as a resilient firm boundary that reduced the costs of both limited liability and liquidation protection, making the *commenda* uniquely configured to realize the benefits of strong asset partitioning in the medieval period.

Besides control-person opportunism, the other primary cost of liquidation protection is loss of liquidity. This problem is normally solved today by permitting trade in a firm's shares. And so it was in the Middle Ages as well: shares in a *commenda*, which could be multiple because the passive *commenda* position was divisible, were transmissible by succession, and, after the thirteenth century, by sale if all investors agreed.[110] Moreover, the tradability of shares would have been reinforced by the limited liability and liquidation protection exhibited by the *commenda* with respect to its passive investors. The mutual causality that we described in Part III among strong entity shielding, owner shielding, and tradable shares explains why these attributes arose as a package in the medieval period. They also form the link between the *commenda* and the great joint stock companies of early modern times, to which we turn in our next section.

VI. EARLY MODERN ENGLAND

In contrast to the vibrant city-states along the medieval Italian peninsula, the English realm of the Middle Ages can be fairly called an economic backwater.[111] Native industry was inconsiderable, and the nation's international trade, based almost entirely on export of raw materials such as wool, was mostly

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[109] Weber, *supra* note 80, at 77. This rule may not have been universal; *see* JOSEPH GIES AND FRANCES GIES, MERCHANTS AND MONEYMEN: THE COMMERCIAL REVOLUTION 1000-1500, 53 (1972). Like the *compagnia*, the *commenda* also would have had weak entity shielding with respect to the active partner.

[110] CIZAKCA, *supra* note 108, at 27.

[111] *See, e.g.,* 5 W.S. HOLDSWORTH, A HISTORY OF ENGLISH LAW 67 (1924).

in the hands of foreign merchants living in enclaves such as London's Lombard Street.[112] The consequence was that English merchant law during that period lagged behind Italy's innovative practices.

With the Atlantic eclipsing the Mediterranean during the sixteenth and seventeenth centuries as the source of new avenues of trade, economic fortunes shifted northward, first toward the Low Countries and then in England's direction. The development of entity shielding proceeded apace.[113] By the end of the

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[112] *Id.*

[113] While we do not pursue here the further evolution of law and commerce on the European continent, we note that, by the end of the 16th Century, the City of Antwerp had enacted a municipal statute that established entity shielding for partnerships., In relevant part, that statute reads as follows:

> **Title LII. Concerning the Partnership and Its Assets.**
>
> 1. Each member of a commercial partnership is jointly and severally liable for the debts of the partnership, but can seek indemnification from the partnership.
>
> 2. Each member of a partnership may, for the term of the partnership, incur debts and dispose of assets on its behalf.
>
> 3. Likewise, whenever merchants have different commercial partnerships in different places, one partnership and its assets are not liable for the debts of the other partnership.
>
> 4. Also, the creditors of one partnership, establishment, or shop has a claim on its assets that is prior to the claims of the creditors of another partnership, establishment, or shop.
>
> 5. The assets of a partnership may not be seized, executed upon, or subjected to liens to satisfy the personal obligations of its individual members.
>
> 6. But a personal creditor may lay claim to, and seize, a merchant's interest in a partnership that remains after all of the company's debts are discharged.
>
> **A. Title IX. Concerning Partnerships and Their Assets**
>
> 25. So if one of the partners is indebted in his own name, even with regard to the dowry of his wife or similar privileged debts, the assets of the partnership are not liable, and may not be seized, paid out, or pawned, nor can they be paid out as compensation.
>
> 26. Similarly, when merchants have different partnerships, establishments, or shops in different locations, each partnership, establishment, or shop is liable only to its own creditors. Partnerships, establishments, or shops may not compensate or cross-subsidize one another.
>
> 27. But when the creditors of a partnership, establishment, or shop have been paid, if there is anything left over, those who are owed debts by individual partners or by their other partnerships, establishments, or shops may make their claim, whether this is by way of compensation or by the seizure and paying out of the assets, and each is to be paid according to the occasion, preference, or advantage of his debt.

V COSTUMEN DER STADT ANTWERPEN GESEGT *IMPRESSAE* II, at 393,(1582) . Though it is not entirely clear, the reference in the statute to "partnership, *establishment, or shop*" (our translation of "compaignie, negotiatie, comptoor oft winckele") appears to establish location-based entity shielding of the form, described at TAN 96 *supra,* found in medieval Italy. Preliminary research suggests that entity shielding of this form, created by municipal or local statutes, was common seventeenth century, moreover, England became the commercial leader. It enjoyed a natural advantage in endowments of coal, which helped boost it to the van of the Industrial Revolution in the eighteenth century. Although institutional conservatism prevented English law from developing in lockstep with its commerce, economic expansion eventually brought sufficient pressure to bear, and by mid-nineteenth century the country had produced useful, general-purpose commercial entities offering both weak and strong versions of entity shielding.

A. The Early Joint Stock Companies

England's most celebrated commercial enterprises at the beginning of the modern period were its famed joint stock companies, which led the nation's charge overseas for conquest and profit during the Age of Exploration. England was not, in fact, the joint stock company's creator — that distinction belonging to Genoa, which starting in the fourteenth century sold shares in public monopolies engaged in a variety of ventures, including salt mining, coal, and mercury importation, and, most spectacularly, the conquest of two Mediterranean islands.[114] Though innovative, these Genoese enterprises were relatively small affairs by modern standards, and indeed managed to operate under a rule whereby every owner had to consent to any sale of a firm's shares[115] — which is feasible only if owners are not numerous. By contrast, the trade opportunities that opened during the sixteenth century to European nations with ocean access required fleets of deep-water ships and large overseas posts, and thus organizational forms capable of amalgamating and organizing capital of unprecedented scale.[116] While Portugal and Spain responded by organizing and funding intercontinental trade through the state,[117] the Dutch and especially the English followed the Genoese example of combining private investment with state-granted monopoly privileges. Guilds of traders, often operating through *commenda*-like arrangements, were issued charters that included exclusive

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throughout the Low Countries at that time. We are grateful to Andreas Fleckner for his enterprising research into medieval and early modern municipal and local statutes on the Continent, and to Lisenka Van Holewinckel and Emily Kadens for help with translation of the statute reproduced here.

[114] W. MITCHELL, AN ESSAY ON THE EARLY HISTORY OF THE LAW MERCHANT 138-39 (1904); Guido Ferrarini, *Origins of Limited Liability Companies and Company Law Modernisation in Italy: A Historical Outline*, in VOC 1602-2002: 400 YEARS OF COMPANY LAW (ELLA GEPKEN-JAGER, GERARD VAN SOLINGE, & LEVINUS TIMMERMAN eds., 2005); CIZAKCA, *supra* note 108, at 29-30.

[115] CIZAKCA, *supra* note 108, at 31.

[116] *See generally* Barry Supple, *The Nature of Enterprise*, in 5 The CAMBRIDGE ECONOMIC HISTORY 393, 416-23 (E.E. Rich & C.H. Wilson eds., 1977) (discussing new challenges of scale in financing faced by merchants engaged in international trade at the close of the Middle Ages).

[117] E.L.J. Coornaert, *European Economic Institutions and the New World: the Chartered Companies*, in 4 THE CAMBRIDGE ECONOMIC HISTORY OF EUROPE 220, 228-29 (E.E. RICH & C.H. WILSON eds., 1967).

privileges to trade in a particular region of the world.[118] Although these chartered companies at first divided the cargo at the end of each voyage among the members who had invested,[119] the inefficiency of such frequent asset liquidations led the Dutch Estates General in 1623 to grant the Dutch East India Company perpetual existence.[120] While shareholders lost their right to withdraw at will, they were compensated with a new right to sell their shares without the consent of other owners,[121] a compromise that reconciled a company's need for fixed capital with a shareholder's need for liquidity. The success of this arrangement prompted imitation in England's own East India Company, as well as in several other joint stock enterprises chartered by the English Crown or Parliament in the seventeenth century.[122]

The best evidence is that the English and Dutch joint stock companies featured strong entity shielding, which would have equipped the companies to amalgamate large volumes of capital because it solves problems that arise when firms have many owners. These companies enjoyed liquidation protection against shareholders, who, as we have indicated, were required to surrender their withdrawal rights. And while direct evidence on the point is not abundant, circumstances and logic suggest that these firms enjoyed liquidation protection against shareholders' personal creditors as well. The strongest evidence that these chartered joint stock companies enjoyed liquidation protection against personal creditors, and thus strong entity shielding, is the fact that their shares were tradable. In the absence of liquidation protection against personal creditors, excessive borrowing by any owner could threaten the firm's going-concern value, which would give owners a collective interest in restricting membership in the firm. Fully tradable shares, by contrast, are consistent with a lack of concern about any given shareholder's personal borrowing habits, and thus with liquidation protection against personal creditors.[123] And the fact that shares could be seized and then sold by personal creditors would have provided a means to pay off the claims of the personal creditors of a bankrupt owner without forcing a payout from the firm itself. Similar logic explains why the death of a shareholder did not dissolve an English joint stock company,[124] the shares

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[118] 8 WILLIAM HOLDSWORTH, A HISTORY OF ENGLISH LAW 200-02 (2d ed. 1937); Samuel Williston, *History of the Law of Business Corporations Before 1800 (pt. 1)*, 2 HARV. L. REV. 105, 109 (1888).

[119] 8 HOLDSWORTH, *supra* note 118, at 194; Williston, *supra* note 118, at 110.

[120] CIZAKCA, *supra* note 108, at 46; Coornaert, *supra* note 117, at 257.

[121] Coornaert, *supra* note 117, at 257.

[122] *See* WILLISTON, *supra* note 118, at 110; 8 HOLDSWORTH, *supra* note 118, at 209.

[123] Another factor suggestive of strong entity shielding in the joint stock companies is that courts consistently referred to those companies as "incorporated," a term implying at the time both perpetual existence and that the entity rather than its members owned the joint property. 3 W. HOLDSWORTH, A HISTORY OF ENGLISH LAW 488 (6 ed. 1938).

[124] 8 HOLDSWORTH, *supra* note 118, at 202.

instead devolving to heirs,[125] even though the demise of a partner did dissolve an English partnership.[126]

A notable common feature of these Genoese, Dutch, and English firms is that they typically enjoyed monopoly privileges, which was likely due to the fact that the state considered the activities in which they engaged to be of national importance. An interesting and open question is whether there is also a relationship between their monopoly privileges and the fact these firms were among the first in Europe to feature strong entity shielding. One possibility is that the scale of enterprise that results from monopoly would have deepened the market for a firm's shares, thus increasing the attractiveness of share transferability relative to withdrawal as a source of liquidity. Another (and potentially complementary) hypothesis is that the state had an independent reason to endow these firms with liquidation protection, such as that the firms as going concerns provided significant public benefits, and that the possibility of monopoly revenues in turn attracted investors otherwise leery of firms in which control-person opportunism could not be disciplined through shareholder withdrawal threats.

Owner shielding — in the form of full limited liability — was also available in the joint stock companies, a trait that carried over from their origins in the *commenda*. Importantly, however, full limited liability was not universal, at least in the English companies. Rather, the charters of English companies specified whether and when shareholders could be called upon to make additional capital contributions, a mechanism by which the degree of owner shielding could be varied to suit a company's business requirements.[127] Not all chartered joint stock companies in fact opted for full limited liability, an early illustration that limited liability is not a prerequisite of tradable shares.

An important implication of the English and Dutch chartered joint stock companies is that commercial firms had been established by the early seventeenth century with all of the elements of the modern business corporation: strong entity shielding and owner shielding, and tradable shares. We have emphasized the complementarily among these elements, and it is thus unsurprising that they arose as a package. And this package proved popular, setting off a surge in applications for company charters.[128] The English Parliament was, however, restrained in its response, issuing only ten new charters in the half century between 1630 and 1680,[129] and only gradually picking

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[125] Samuel Williston, *History of the Law of Business Corporations Before 1800* (pt. 2), 2 Harv. L. Rev. 149, 163 (1888).

[126] ANDREW BISSET, A PRACTICAL TREATISE ON THE LAW OF PARTNERSHIP INCLUDING THE LAW RELATING TO RAILWAY AND OTHER JOINT STOCK COMPANIES 83 (London, V & R Stevens 1847).

[127] *See* Williston, *supra* note 125, at 160; 8 HOLDSWORTH, *supra* note 118, at 204.

[128] Williston, *supra* note 118, at 111-12.

[129] *Id.*

up the pace thereafter. Indeed, it would not be until the nineteenth century that English enterprises enjoyed a general right to the company form. Part of the explanation lies with interest-group politics, as incumbent firms sought protection against well-financed upstarts.[130] But the selection of charters that Parliament did grant implies that it was also concerned to protect creditors and small shareholders from the opportunism that rules of strong asset partitioning invite. Charters were most often awarded to firms that invested in large fixed assets, such as canals, which could not easily be opportunistically dissipated or diverted by control persons at the expense of owners or of firm creditors. Meanwhile, in manufacturing, the sector most strongly associated with the Industrial Revolution, applications for corporate charters were usually rejected.[131]

Parliament's grudging policy on charters would have created demand among merchants for other entity forms suited to the financial demands of England's commercial expansion. By the end of the seventeenth century, two such commercial entities had been developed. One was the general partnership, reformed by common law courts to provide weak entity shielding. The other was the unincorporated joint stock company, constituted as a strong entity by the grafting of the trust form onto the partnership. The availability of entity shielding in both of these forms would have made them conducive to combining the capital of multiple owners, thus increasing their usefulness as the scale of enterprise increased during the seventeenth, eighteenth, and nineteenth centuries. We address these entity forms in turn.

B. Bankruptcy and Partnership in England

As theory we set forth in Part III suggests, and the commercial history of medieval Italy corroborates, a bankruptcy system is a precursor to the rule of weak entity shielding that characterizes the traditional partnership. But while the merchant class that controlled Italian city-states began constructing sophisticated bankruptcy systems in the thirteenth century, England's courts, less under the sway of the local commercial interest,[132] relied during the Middle Ages on more primitive customs for coaxing assets out of debtors. Throughout the medieval period, England more than most parts of Europe used imprisonment to pressure

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[130] *Id.* at 112; RON HARRIS, INDUSTRIALIZING ENGLISH LAW: ENTREPRENEURSHIP AND BUSINESS ORGANIZATION, 1720-1844 (2000).

[131] BISHOP C. HUNT, THE DEVELOPMENT OF THE BUSINESS CORPORATION IN ENGLAND 16 (1936). Manufacturing, service, or financial firms that received charters were often, in effect if not in name, mutual companies or cooperatives owned principally or exclusively by suppliers or customers, who also would have been the firm's principal creditors. The identity of owners and creditors eliminated the problem experienced by firms that one group would exploit the other. *See, e.g.*, HENRY HANSMANN, THE OWNERSHIP OF ENTERPRISE 246-86 (1996) (discussing the historical development and role of mutual insurance and banking companies).

[132] 5 HOLDSWORTH, *supra* note 111, at 120.

defaulting debtors into making good on obligations.[133] And an insolvent debtor's assets went to the creditors who sued to attach them first, a procedure resulting in what a sixteenth-century Londoner described as a "first come, first served" system that conferred windfalls on whichever creditors were best positioned to learn of a merchant's misfortunes.[134] It is thus unsurprising that England unlike Italy appears not to have developed rules of weak entity shielding during the Middle Ages.[135]

The prosperity of the sixteenth century brought heightened demand for reception of Southern Europe's more sophisticated rules of commercial law, including those of bankruptcy.[136] As with company charters, however, bankruptcy reform issued from Parliament sluggishly. A 1542 statute provided for the basic elements of a *pro rata* bankruptcy system,[137] and an act in 1571 empowered the Chancery to appoint commissions, constituted in part of creditors, for valuing debtor estates, approving creditor claims, and apportioning assets.[138] But this system was at first used infrequently, in part because it applied only to traders (a classification that did not include, for example, farmers, inn-keepers, and mere shareholders of joint stock companies),[139] and in part because commissions, upon distributing an estate, could not discharge a debtor's remaining unpaid obligations, and thus offered little reason for debtors to invoke them voluntarily.[140] The narrow powers of commissions also limited their appeal to creditors, although things gradually improved in this regard over the seventeenth century. Statutes enacted in 1604 and 1623 enhanced the power of commissions to compel testimony and avoid pre-insolvency conveyances.[141] And the Chancery became active in reviewing the work of commissions during the late seventeenth century, leading to the articulation of rules that increased the predictability of bankruptcy outcomes.[142]

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[133] 8 HOLDSWORTH, *supra* note 118, at 231, *see also* 2 EDWARD CHRISTIAN, THE ORIGIN, PROGRESS, AND PRESENT PRACTICE OF THE BANKRUPT LAW 8-9 (1814).

[134] 8 Holdsworth, *supra* note 118, at 231.

[135] *See* 1 GERARD MALYNES, *CONSUETUDO, VEL, LEX MERCATORIA:* OR, THE ANCIENT LAW-MERCHANT 160-61 (Professional Books 1981) (1622) (suggesting that the rules of asset partitioning under the medieval law merchant were confined to the European Continent).

[136] 5 HOLDSWORTH, *supra* note 111, at 145.

[137] An Acte Againste Suche Persones as Doo Make Bankrupte, 1542, 34 & 35 Hen. 8, c. 4 (Eng.).

[138] An Acte Touchyng Orders for Banckruptes, 1571, 13 Eliz., c. 7 (Eng.).

[139] 8 HOLDSWORTH, *supra* note 118, at 237 n.4.

[140] *Id.* at 240. Their additional powers to imprison, pillory, and cut ears off debtors also probably limited the commissions' voluntary use. *Id.* at 238-39.

[141] An Acte for the Better Reliefe of the Creditors Againste Suche as Shall Become Bankrupts, 1604, 1 Jac., c. 15 (Eng.); An Acte for the Discripcon of a Bankrupt and Reliefe of Credytors, 1623, 21 Jac., c. 19 (Eng.) *see also*, 2 CHRISTIAN, *supra* note 133, at 27-30, 43 n. 3 & 4.

[142] 8 HOLDSWORTH, *supra* note 118, at 244.

The most important such rule for our purposes was weak entity shielding for partnerships, announced by Chancery in the 1683 case *Craven v. Knight*.[143] In that case, the Chancery held that the assets of a bankrupt partnership must be applied first to the claims of partnership creditors, and that only the excess, if any, could be made available to the partners' personal creditors.[144] The *Craven* result was paired with a rule of weak owner shielding in 1715, when Chancery in the case *Ex parte Crowder* held that a partner's personal creditors enjoyed first claim to the partner's personal assets, and that only those personal assets remaining after the personal creditors had been paid in full could be given over to creditors of the partnership.[145] The regime created by the combined holdings of *Craven* and *Crowder* is known as the "jingle rule" because its symmetrical treatment of partnership and personal creditors makes it easy to remember. It remains in force in England today, and was in force in the United States until 1978.

The rule of weak entity shielding established by *Craven* is taken for granted by modern scholars, and the case itself is all but forgotten.[146] But the change in the law was conspicuous to contemporaries. Early treatises on bankruptcy law make much of *Craven* and the subsequent decisions that reaffirmed its rule of entity shielding.[147] These treatises do not, however, provide a clear explanation for the result in *Craven,* nor for that matter the result in *Crowder,* and neither do the recorded opinions in those cases.

The strong degree of complementarity between a bankruptcy system and rules of weak asset partitioning is a likely explanation for the timing of the *Craven* and *Crowder* decisions. Weak asset partitioning is likely unworkable under a "first come, first served" system because asset partitioning prioritizes creditors according to the nature of creditor claims rather than when the creditors assert them. England's adoption of these rules thus probably could not have preceded the country's construction of an effective bankruptcy system during the sixteenth and seventeenth centuries. And the formalization of these rules was not possible

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143 21 Eng. Rep. 664 (Ch. 1682-83).

144 *Id.* at 664.

145 Ex parte Crowder, 23 Eng. Rep. 1064 (Ch. 1715).

146 Notable exceptions are Joshua Getzler and Mike Macnair, who in a recent paper examine the case law development of the jingle rule in detail, and — using our terminology of asset partitioning — explore the sharp doctrinal struggles within the Court of Chancery over the rule. Joshua Getzler & Mike Macnair, *The Firm as an Entity Before the Companies Act: Asset Partitioning by Private Law, in* ADVENTURES IN THE LAW: PROCEEDINGS OF THE BRITISH LEGAL HISTORY CONFERENCE, DUBLIN 2003 (P. Brand, K. Costello, & W.N. Osborough eds., 2005).

147 *See* SOAME WHITTAKER, THE LAW OF BANKRUPTS, THEIR CREDITORS, AND ASSIGNEES: FROM THE ISSUING THE COMMISSION TO THE ALLOWANCE OF THE CERTIFICATE BY THE LORD CHANCELLOR 67 (London, T. Cadell & W. Davies 1801); ARCHIBALD CULLEN, PRINCIPLES OF THE BANKRUPT LAW 459-73 (1800); 1 EDWARD CHRISTIAN, THE ORIGIN, PROGRESS, AND PRESENT PRACTICE OF THE BANKRUPT LAW 297 (1814).

before judicial review of the rulings of bankruptcy commissions became common in the late seventeenth century. (Given that the members of commissions included merchants,[148] many of whom would likely have been familiar with Italian commercial practices,[149] the possibility that commissions had been applying rules of weak asset partitioning on an ad hoc basis before *Craven* was decided cannot be dismissed.) Once, in turn, an effective *pro rata* bankruptcy system was established, rules of weak asset partitioning would have reduced the costs of administering it, increasing their likelihood of adoption. Indeed, the jingle rule made the procedures used in the seventeenth century for the bankruptcy of English partnerships particularly easy to administer. Under that practice, the simultaneous bankruptcy of a partnership and its partners resulted in the appointment of a joint commission for the partnership and a separate commission for each individual partner. Creditors were required to choose only one commission — separate or joint — before which to press their claims.[150] The jingle rule enabled each commission to distribute the assets under its purview independent of the decisions made by other commissions appointed upon the bankruptcy of the same partnership.

Further developments during the eighteenth and nineteenth centuries permitted the English partnership to add a degree of liquidation protection, thus transitioning from the rule of weak entity shielding imparted by *Craven* to a rule of strong entity shielding. Specifically, liquidation protection in the partnership arose through judicial enforcement of agreements among partners not to withdraw before the expiration of a specified term. Such agreements give rise to a so-called term partnership, as contrasted with the default rule of partnership at will, under which any partner may leave the partnership and withdraw his share of firm assets at any time. Term partnership agreements can be enforced in various ways,[151] but at least by the late nineteenth century England had settled on the particularly strict rule whereby a partner could neither withdraw any portion of firm assets nor renounce liability for future firm obligations before the expiration of a specified term.[152] This rule allowed English partners to opt for a

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[148] 5 HOLDSWORTH, *supra* note 111, at 150.

[149] *See id.* at 129-35; 8 HOLDSWORTH, *supra* note 118, at 207.

[150] ARCHIBALD CULLEN, PRINCIPLES OF THE BANKRUPT LAW, 451-59 (1800).

[151] Options less severe than that in effect in England by the late nineteenth century include allowing the partner to withdraw his share of net assets subject to an offset of money damages for breach of the partnership agreement, and to allow the partner to renounce liability for future but not past firm debts. In contrast with English law, American partnership law during the nineteenth century took an ambiguous position among such milder alternatives. *See infra* Section VII. A, TAN 163-192.

[152] Only when the partnership was no longer viable and the withdrawing partner was not acting opportunistically would courts order dissolution. *See* NATHANIEL LINDLEY, A TREATISE ON THE LAW OF PARTNERSHIP 649-50 (1888) (describing the pre-1890 common law rule); *Moss v. Elphick*, [1910] All E.R. Rep. Ext. 1202, 1203 (K. B.) (noting the rule's codification by the Partnership Act 1890, section 32).

significant degree of liquidation protection among themselves, at least for the duration of their agreement. And a measure of liquidation protection against personal creditors appears to have been possible as well, by use of a clause in a partnership agreement specifying that a bankrupt partner's share would be paid out only through disbursements of partnership income made in the normal course of business. The best evidence is that courts would have allowed partnerships to modify the default rule, under which the bankruptcy of a partner dissolved even a term partnership and empowered the bankruptcy trustee to liquidate the partnership assets. Indeed, American courts later reached a similar conclusion, as we describe in the next section.[153]

We defer our analysis of the likely reasons for the strengthening of the partnership to our discussion of the United States, where the partnership form underwent a similar transformation during the nineteenth century. For present purposes, we note that the addition of entity shielding to the partnership in England may at least partially explain why it was able to give the joint stock company such a long run for the money, remaining the dominant form of jointly owned enterprise until the twentieth century.

C. England's Proto-Corporation: The Unincorporated Joint Stock Company

The so-called unincorporated — meaning unchartered — joint stock company was a business form improvised to mimic the chartered companies during a time when demand for the company form and parliamentary obduracy had combined to create a shortage of charters. The particular attribute of the chartered companies that appear to have been in highest demand was the tradability of their ownership shares, which was achieved with some success in the unincorporated companies through a union of the trust form and the partnership. The result was a partnership-like form whose assets were held in trust for the partners by trustees that the partners had themselves selected.

The use of the trust form to achieve tradable shares is normally explained in terms of ease of litigation. A standard English partnership of the time could initiate and answer lawsuits only through use of the names of all partners, which was a problem if by virtue of tradable shares the list of partners was in constant flux. The trust permitted suit in the names of the trustees, who remained the same even when shares changed hands.

While the trust certainly would have been useful in the litigation context, we believe that it may have enabled tradability of shares more directly by providing the unincorporated companies with strong entity shielding. As we have

[153] Unfortunately, few English courts appear to have ruled on the issue, and the lack of clear authority would have made such liquidation protection against personal creditors less dependable than the liquidation protection offered by the corporation.

noted above, strong entity shielding facilitates share tradability because it, by dint of liquidation protection, allows shareholders to be unconcerned if shares are acquired by an insolvent investor. During the seventeenth century it became settled doctrine that a trustee's personal creditors could not levy upon trust assets, even though the trustee held those assets in his own name.[154] English trust law also seems to have arrived by the seventeenth century at the modern rule for multi-beneficiary trusts whereby neither a beneficiary nor his creditors can force liquidation of trust assets -- such creditors enjoying at most a right to seize the beneficiary's share of the trust's periodic income distributions. In short, the trust by the late seventeenth century offered full liquidation protection, a trait that would have caught the eye of businessmen looking for a way to convert their partnerships into strong entities. For these reasons, we believe it is no coincidence that the unincorporated joint stock companies first appeared in the 1680s, and proliferated thereafter.

Strong entity shielding was not, however, accompanied in the unincorporated companies by limited liability. The companies would have enjoyed weak owner shielding no later than the *Crowder* decision of 1715 due to their utilization of the partnership form. But the mere addition of the common law trust probably was not a reliable means for raising the level of owner shielding to full limited liability, as indeed it would not be today.[155] Many unincorporated companies therefore sought limited liability contractually, such as through clauses in agreements with firm and personal creditors, by specifying limited liability in the partnership agreement and on firm letterhead, and by including "limited" in the firm's name. But courts did not definitively endorse these measures until well into the nineteenth century, leaving a rule of limited liability for the unincorporated companies in doubt during most of the period that they were important.[156] The success of unchartered joint stock companies in

[154] In contrast to the English trust, the Islamic analogue, the *waqf*, was a highly rigid device that permitted little innovation and did not draw a bright line between the personal assets of the trustee and the assets of the trust. It has been argued that these limitations prevented the *waqf* from evolving into a proto-business entity. See Timur Kuran, *The Provision of Public Goods Under Islamic Law: Origins, Impact, and Limitations of the Waqf System*, 35 L. & SOC'Y. REV. 841, 861-69 (2001); Timur Kuran, *Why the Islamic Middle East Did not Generate an Indigenous Corporate Law*, (USC Law and Economics Working Paper Series, Paper No. 04-21, 2005).

[155] *See* HENRY HANSMANN & UGO MATTEI, *The Functions of Trust Law: A Comparative Legal and Economic Analysis*, 73 N.Y.U. L. REV. 434, 459-63 (1998).

[156] The larger unincorporated joint stock companies probably did enjoy a substantial degree of limited liability as a practical matter. As Gower puts it, personal shareholder liability was "largely illusionary" because litigating against a large and shifting pool of investors was very costly under the partnership law of the time. PAUL L. DAVIES, GOWER'S PRINCIPLES OF MODERN COMPANY LAW 32 (6th ed. 1977); *see also* R. R. FORMOY, THE HISTORICAL FOUNDATIONS OF MODERN COMPANY LAW 36 (1923). In addition, wealthy shareholders with liability concerns could protect their personal assets by investing through intermediaries (known as skags) or neglecting to sign the company's deed of settlement. *See id.*

achieving tradable shares, despite the doubtful nature of limited liability in the unincorporated companies, further illustrates that limited liability is not necessary for making shares tradable.

In addition to strong entity shielding, contemporaneous developments in financial markets would likely have catalyzed the trade in unincorporated company shares. Shares in the chartered companies were trading vigorously by the 1690s, largely due to an undertaking by the Bank of England and the East India Company to finance the rapidly expanding national debt through stock offerings. The chartered South Sea Company, having abandoned overseas trade, attempted the same in 1713. Each of these schemes was quickly followed by spikes in the number of unincorporated companies,[157] which likely were able to piggyback their share distributions on the stock market infrastructure that had arisen to support trade in the chartered firms. And as with the chartered companies, robust trade in the shares of the unincorporated companies would have reduced the cost of liquidation protection by making tradable shares a more effective substitute to withdrawal as a source of liquidity.

To be sure, only the largest chartered companies, and evidently very few of the unchartered variety, saw an active trade in their shares during the eighteenth century. The depth of the market for shares in, for example, a typical eighteenth-century canal company or brewery does not compare to the level of liquidity enjoyed by most firms listed on stock exchanges today. But liquidity is relative, and the benchmark here was the typical partnership interest, which in early modern England would have been largely illiquid due to its personal nature.

A famous effort to suppress the unincorporated companies took place in 1720 with the passage of the South Sea Company Act, better known as the Bubble Act. That statute forbade unincorporated companies from selling shares, and chartered companies from selling their charters or engaging in lines of business their charters did not authorize. While the Act remained on the books until 1825, there was only one effort to enforce it — in 1726 — during the entire eighteenth century. The upshot was that the unincorporated companies continued to flourish despite their doubtful legality, to the point that more than one thousand were operating in England at the beginning of the eighteenth century,[158] some with thousands of shareholder-partners. The success of these firms was an embarrassment to the paternalistic arguments of the Bubble Act's defenders, and thus set the stage for Parliament's accession to the modern corporate form.

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[157] See HARRIS, *supra* note 130, at 57-63.

[158] *Id.* at 60-81.

D. General Incorporation Acts in the United Kingdom

More than a century's worth of pressure for a company form featuring both free availability and unclouded legitimacy finally induced Parliament in 1844 to enact a statute permitting incorporation as a matter of right.[159] The statute also sought to remove the unincorporated companies from the margins of legality by requiring all partnerships with more than twenty-five members, or with transferable shares, to register as public corporations and follow uniform disclosure rules.[160]

The 1844 statute did not explicitly provide for strong entity shielding, apparently because by the nineteenth century that attribute was understood to be inherent in the company form. For example, an 1837 statute empowering the Crown to grant unincorporated companies any of the privileges normally conferred in a charter of incorporation,[161] made strong entity shielding explicit, presumably to make clear that such companies, though not fully incorporated, would nonetheless enjoy the company form's standard rules of asset partitioning. Also, the 1844 statute reinforced entity shielding by imposing strong legal capital rules designed to prevent the draining of firm assets to the detriment of firm creditors. In particular, a company's paid-in capital could not be used for redemption of shares unless new shares were issued for the same amount, and a net reduction of capital was prohibited unless all objecting creditors were first paid off. Although such legal capital rules would also have facilitated limited liability, the 1844 statute did not in fact permit that attribute. Only in 1855 was the statute amended to endorse limited liability, and even then it was optional.[162]

Even after Parliament had provided for incorporation as a matter of general right, the partnership remained the dominant form for enterprise for approximately another fifty years. Only during the twentieth century did the corporate form become commonplace among even small and medium-sized firms. The steps by which this change occurred, and the economic developments that likely impelled it, are most easily seen in the United States.

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[159] *See* EDWIN S. HUNT, THE MEDIEVAL SUPER-COMPANIES: A STUDY OF THE PERUZZI COMPANY OF FLORENCE 94 (1994).

[160] *Id.* at 94-98.

[161] Section 25 of the Act provides: "And be it enacted, That the bankruptcy, insolvency, or stopping payment of any officer or member of such company or body in his individual capacity shall not be construed to be the bankruptcy, insolvency, or stopping payment of such company or body; and that the property and effects of such company or body, and the persons, property, and effects of the individual members or other individual members thereof, (as the case may be,) shall, notwithstanding such bankruptcy, insolvency, or stopping payment, be liable to execution or diligence in the same manner as if such bankruptcy, insolvency, or stopping payment had not taken place."

[162] HUNT, *supra* note 131, at 133-34.

VII. THE MODERN PERIOD IN THE UNITED STATES

Notwithstanding the development of both weak and strong entity forms for business firms by the mid-nineteenth century, the choices available to commercial actors remained limited. Although almost any jointly owned commercial firm could be (and by default usually was) a partnership, limitations on that form — such as a lack of complete liquidation protection and limited liability, shares that were not easily transferable, and the presumption that every owner was a firm agent — made it unsuitable for many businesses. The only other important option was the corporate form, and while that form generally lacked the limitations of the partnership, it was burdened with other restrictions that hampered its use by small-scale enterprise.

At the end of the twentieth century, by contrast, commercial actors in many Western countries could fashion entities with almost any combination of key structural attributes. The intervening period was one of rapid transformation, in which legal systems both increased freedom of contract for internal firm affairs and broadened the supply of entity forms. The jurisdiction that best illustrates this transformation is the United States, both because the period corresponds with the nation's emergence as the world's leading commercial power, and because America ultimately experienced the greatest proliferation of commercial entity forms.

A. The Strengthening of the American Partnership

Initially a weak entity on the model of *Craven* and *Crowder*, the American partnership by the end of the twentieth century had developed to the point where owners could opt both for strong entity shielding over a defined period and for limited liability.[163] Even where partners chose to retain their unilateral withdrawal right, American law provided the partnership a high degree of liquidation protection against personal creditors, thereby frequently preserving the firm's going-concern value upon a partner's insolvency. The growth of the partnership into a modern commercial entity both strong entity shielding and complete owner shielding entity and owner shielding corresponds with developments, such as superior accounting and valuation techniques and greater commercial sophistication among courts, that protected owners and creditors alike.

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[163] As observed above, *see supra* note 40, Professors Lamoreaux & Rosenthal explain the choice between the partnership and corporate forms in the late nineteenth and early twentieth century United States as a tradeoff between the protection from minority oppression offered by the partnership and the ability to lock in capital offered by the corporation, both consequences of the absence of a withdrawal right (liquidation protection against owners) in the corporation as opposed to the partnership. Though that is a reasonable rough view, in fact, liquidation protection in the partnership was, as we discuss here, a more complicated matter. So, too, was minority protection via the withdrawal right in the corporation, as we note in our references to appraisal rights and the oppression remedy. *See supra* note 210 and accompanying text.

By the early nineteenth century, most American states had followed England in adopting the jingle rule for the division of partnership assets, thus lending the American partnership weak degrees of both entity and owner shielding.[164] Pursuant to this regime, courts initially held that personal judgment creditors of a partner could demand immediate liquidation of partnership assets and reduction of the partner's share to cash, even if the partnership was for a defined term that had yet to expire or the partners had otherwise agreed among themselves to restrict liquidation.[165] To reconcile a personal creditor's right to demand liquidation with the partnership creditors' prior claim to partnership assets, courts as a matter of course appointed a receiver and assumed oversight of partnership assets when a partner became insolvent.[166]

Courts were aware, however, that forced liquidation could entail significant destruction of going-concern value,[167] and thus by the mid-nineteenth century began seeking alternative devices for accommodating the claims of personal creditors. A personal creditor's primary form of redress became sale of the partner's interest; forcing the partnership to reduce that interest to cash required the additional and sometimes lengthy step of a suit for an accounting.[168] State legislatures, in turn, empowered courts with equitable devices, such as garnishment and constructive seizure, to substitute for liquidation.[169] This culminated in the late nineteenth century in the creation of the judicial charging order, under which a defaulting partner's management and control rights were preserved but his income stream was diverted to a personal creditor until the unpaid claim was satisfied.[170] Although a creditor with a charging order could compel liquidation of the partnership after foreclosing on the partner's share, foreclosure required judicial approval, which normally was denied unless the income stream was unlikely to suffice in a reasonable time.[171] Moreover, under the Uniform Partnership Act (UPA) — promulgated in 1914 and thereafter adopted by almost every state — the holder of a foreclosed-upon share could not force liquidation of a partnership for a term until the term had expired.[172] Some

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[164] See, e.g., *Pierce v. Jackson*, 6 Mass. 242, 243 (1810).

[165] *Marquand v. President & Dirs. of the N.Y. Mfg. Co.,* 17 Johns. 525, 528-29 (N.Y. 1820) ; *Renton v. Chaplain*, 9 N.J. Eq. 62, 64 (N.J. Ch. 1852).

[166] See *Randall v. Morrell*, 17 N.J. Eq. 343, 346 (N.J. Ch. 1866).

[167] See, e.g., cases cited *supra* note 165.

[168] *See, e.g., Deal v. Bogue,* 20 Pa. 228 (1853).

[169] THOMAS D. CRANDALL, RICHARD B. HAGEDORN & FRANK W. SMITH, JR., THE LAW OF DEBTORS AND CREDITORS § 6.86 (2004).

[170] J. Dennis Hynes, *The Charging Order: Conflicts Between Partners and Creditors*, 25 PAC. L.J. 1, 3-4 (1993).

[171] *Id* at 4-5.

[172] HAROLD GILL REUSCHLEIN & WILLIAM A. GREGORY, THE LAW OF AGENCY AND PARTNERSHIP 516, 526 (2d ed. 1990); UNIF. P'SHIP ACT § 32(2)(a).

courts applying UPA have recently demonstrated a reluctance to allow foreclosure even upon a partnership at will unless the remaining partners have consented or the court determines that a forced sale will not "unduly interfere with the partnership business."[173]

While UPA did provide for dissolution of the partnership upon the formal bankruptcy of a partner,[174] this seems to have been intended more to protect the remaining partners and the partnership creditors than to make assets available to personal creditors. UPA did not explicitly allow a bankrupt partner's trustee to force liquidation, although it did empower him to petition a court for a liquidation order.[175] Some bankruptcy courts have recently been reluctant to grant such petitions, however, emphasizing that typically a trustee can instead convert the partner's interest to cash by selling it.[176] And when a partner undergoes Chapter 11 reorganization rather than Chapter 7 liquidation, most courts have held that state laws adopting UPA's automatic-dissolution provision conflict with the purposes of the federal bankruptcy code and thus are unenforceable.[177]

An interesting aspect of these developments is the possibility of partnerships exhibiting a degree of liquidation protection against partners' personal creditors that is even stronger than the degree exhibited against the partners themselves. The question whether partners enjoy a withdrawal right is primarily one of contractual interpretation, and courts normally would have little reason to override an agreement among partners to permit dissolution at will. But a personal creditor's right to force dissolution of a partnership is ultimately a question of property law, leaving courts (and legislatures) greater latitude to

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[173] *Centurion Corp. v. Crocker Nat'l Bank,* 255 Cal. Rptr. 794, 797 (Cal. Ct. App. 1989); *Hellman v. Anderson,* 284 Cal. Rptr. 830, 838 (Cal. Ct. App. 1991); see also *FDIC v. Birchwood Builders, Inc.,* 573 A.2d 182, 185 (N.J. Super. Ct. App. Div. 1990) (holding that courts should be "circumspect" in ordering foreclosure pursuant to a charging order).

[174] UNIF. PARTNERSHIP ACT § 31(5).

[175] UNIF. PARTNERSHIP ACT § 37.

[176] *Cutler v. Cutler,* 165 B.R. 275, 280-81 (Bankr. D. Ariz. 1994); see also *Manning v. Nuthatch Hill Assocs.,* 831 F.2d 205, 210 n.10 (10th Cir. 1987) (raising the question whether the Bankruptcy Code preempts Colorado's provision that bankruptcy of a partner dissolves the partnership). But see *Moody v. Seaside Lanes*, 825 F.2d 81, 84, 89 (5th Cir. 1987) (upholding bankruptcy court's order that a partnership liquidate and pay out a partner's share to his trustee); *Turner v. Cent. Nat'l Bank of Matoon, Ill.,* 468 F.2d 590, 591 (7th Cir. 1972) (stating in dicta that the trustee of a partner may demand payout of the partnership interest after an accounting and the payment of partnership debts).

[177] *See Siegal v. Siegal,* 190 B.R. 639, 646 (Bankr. D. Ariz. 1996); *Leroux v. Summit Inv. & Dev. Corp.,* 167 B.R. 318, 322-323 (Bankr. D. Mass. 1994); *Nizny v. Nizny*, 175 B.R. 934, 939 (Bankr. S.D. Ohio 1994); *In re Cardinal Indus., Inc.,* 116 B.R. 964, 982 (Bankr. S.D. Ohio 1992); *In re Corky Foods Corp.,* 85 B.R. 903, 904 (Bankr. S.D. Fla. 1988); *In re Rittenhouse Carpet, Inc.,* 56 B.R. 131, 133 (Bankr. E.D. Pa. 1985). But see *Durham v. Sw. Developers Joint Venture,* 996 P.2d 911, 917 (N.M. Ct. App. 1999); *In re Catron,* 158 B.R. 624, 628-29 (Bankr. E.D. Va. 1992); *Harms v. Harms,* 10 B.R. 817, 821 (Bankr. D. Colo. 1981).

fashion remedies that seek to both protect the interests of personal creditors and preserve a firm's going-concern value. Hence the possibility of liquidation protection against personal creditors even when such protection against partners themselves is, by their own choice, lacking. In this way, American law treats liquidation protection against personal creditors not as a mere backstop to liquidation protection among owners, but as a valuable device in its own right for protecting the going-concern value of a business.

As American law moved away from automatic payout of an insolvent partner's share, it also became more tolerant of alternatives to liquidation for fixing the value of that share. Courts had traditionally viewed conversion of all assets to cash through public auction as the most accurate way to ascertain a firm's value.[178] Accordingly, UPA provided for full liquidation in most instances when a partner left a firm.[179] During the twentieth century, however, courts began permitting less costly valuation methods, such as division of assets in kind or buyout of the departing partner's share according to a formula.[180] Courts initially endorsed such alternatives only when the partnership lacked outstanding debt,[181] but in the late twentieth century even this qualification was relaxed.[182] Accordingly, the Revised Uniform Partnership Act of 1994 (RUPA) provides for buyout of a partner's share — by either the partnership or a third party — rather than liquidation in many instances where the partner dissociates but the partnership continues.[183]

With liquidation no longer viewed as the only or even best way to accommodate the interests of personal creditors, the conceptual path was clear for full enforcement, against partners as well as third parties, of agreements among partners to waive their withdrawal rights and thereby imbue a partnership with strong entity shielding. Partners had long been able to create a significant degree of liquidation protection among themselves, largely because they could deduct damages from the cash payout owed a partner who withdrew early from a partnership for a term.[184] But UPA codified an even better remedy by recognizing a term partnership's ability, with leave of court, to dispatch a

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[178] See *Creel v. Lilly,* 729 A.2d 385, 392 (Md. 1999) (discussing traditional preference for liquidation); accord *Davis v. Davis,* 366 P.2d 857, 859 (Colo. 1961).

[179] UNIF. PARTNERSHIP ACT § 38(1); see also *Driefurst v. Driefurst,* 280 N.W.2d 335, 337 (Wis. Ct. App. 1979).

[180] For an early example, see *Dow v. Beals,* 268 N.Y.S.2d 425, 427 (N.Y. Sup. Ct. 1933).

[181] See *Rinke v. Rinke,* 48 N.W.2d 201, 207 (Mich. 1951); *Wanderski v. Nowakowski,* 49 N.W. 2d 139, 146 (Mich. 1951); *Logoluso v. Logoluso,* 43 Cal. Rptr. 678, 682 (Cal. Dist. Ct. App. 1965); *Nicholes v. Hunt,* 541 P.2d 820, 827-28 (Or. 1975).

[182] See *Arnold v. Burgess,* 747 P.2d 1315, 1322 (Idaho Ct. App. 1987); *Manning v. Nuthatch Hill Assocs.,* 37 B.R. 755, 760 (Bankr. D. Colo. 1984), *modified,* 831 F.2d 205 (10th Cir. 1987).

[183] See REV. UNIF. PARTNERSHIP ACT § 701.

[184] See Ribstein, *supra* note 16.

prematurely exiting partner with a bond rather than cash.[185] And RUPA goes even further by shifting the burden to the partner who disassociates "wrongfully" (early) to prove that immediate buyout will not cause "undo hardship to the business"; otherwise, the partner gets nothing until completion of the specified term or undertaking.[186] RUPA also states that dissociation because of a partner's personal bankruptcy is wrongful,[187] and thus makes clear that the trustee of a bankrupt partner in a defined-term partnership has no right to immediate payout of the partner's share. The upshot is that partners now may opt for strong entity shielding, including liquidation protection against both themselves and their personal creditors, at least for the duration of a specified term or undertaking.

Besides continuing to enhance the power of partners to achieve strong entity shielding, American law in the late twentieth century also provided a new option with respect to owner shielding. Although states have made the limited partnership available since the nineteenth century, that form provided limited liability to only the passive partners. During the 1990s, however, every state enacted a Limited Liability Partnership (LLP) statute that empowered active partners to opt for limited liability as well.[188] LLP statutes otherwise largely incorporate RUPA, including its provisions with respect to entity shielding.[189] Interestingly, the introduction of the LLP came shortly after federal law had eliminated even weak owner shielding for partnerships. These movements by federal and state law, pushing owner shielding and entity shielding in seemingly opposite directions, are reconcilable when understood as pursuing the common goal of increasing options for business owners. When the partnership form was the only option for small firms, weak owner shielding provided a reasonable tradeoff: it inhibited opportunism toward firm creditors by making partners personally liable for firm debts, and it also facilitated personal borrowing by granting a partner's creditors first claim to his personal assets. But changes in the corporate form during the twentieth century made that form more useful to small-business owners. Because the corporation provides limited liability, these changes allowed federal lawmakers to refashion the partnership for dedicated use by owners who wish to maximize firm creditworthiness by pledging their personal assets in full to firm creditors. By enacting the LLP statutes, the states

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185 UNIF. PARTNERSHIP ACT § 38(2).

186 REV. UNIF. PARTNERSHIP ACT § 701(h).

187 REV. UNIF. PARTNERSHIP ACT § 602(b)(2)(iii).

188 ALAN R. BROMBERG & LARRY E. RIBSTEIN, Bromberg and Ribstein on LIMITED LIABILITY PARTNERSHIPS, THE REVISED UNIFORM PARTNERSHIP ACT, AND THE UNIFORM LIMITED PARTNERSHIP ACT 2001 15 (Aspen 2005). The LLP form is also available to limited partnerships, giving rise to the Limited Liability Limited Partnership (LLLP), in which both general and limited partners enjoy owner shielding. *Id.* at 198-99.

189 *Id.* at 15, 666. Four states — California, Nevada, New York, and Oregon — allow the LLP form to be used only by professional firms, such as those of lawyers or accountants. Id. at 15.

then provided owners the further option of combining complete owner shielding with the other attributes of a partnership.

American partnership law thus now offers strong entity shielding for a defined term and complete owner shielding. These attributes come *a la carte*: partners may opt for either, neither, or both. And even if partners do not opt for liquidation protection among themselves, the law — by use of the charging order and other innovations — affords a high degree of liquidation protection against their personal creditors.

Several contemporaneous developments appear to have contributed to the strengthening of the American partnership over the last two centuries. One theme running through the history is increased reliance upon sophisticated accounting techniques and other methods for valuing a business. For example, in the early twentieth century courts and legislatures generally would only countenance valuations based on book value or other methods that excluded "good-will"[190] and were thus, by dint of their omission of going-concern value, no better than a liquidation sale. By contrast, RUPA's buyout provision explicitly requires consideration of going-concern value,[191] thus authorizing a potentially more accurate approach. Increases in the accuracy and reliability of valuation methods may also explain RUPA's increased reliance on buyout rather than liquidation for paying out a departing partner's share. Similarly, more accurate valuation methods would tend to decrease the implied discount rate applied to a business's future income stream, thus making courts more willing to rely upon the charging order to satisfy claims of personal creditors. For the same reason, a partner's share should now fetch a higher price if sold, increasing the attractiveness of sale relative to withdrawal as a device for providing liquidity to the claims of an owner or his personal creditors.

A related trend is an increase in the effectiveness, and thus the usefulness, of courts as arbitrators of internal partnership disputes. Both UPA and RUPA enable judges to order dissolution on "equitable" grounds, including for conduct by a partner that makes continuing the business impracticable.[192] Courts equipped with superior valuation techniques should be better able — and thus more willing — to undertake an assessment of whether a partner's conduct as a firm manager should be enjoined as contrary to the interests of his copartners. The availability of such judicial review would, in turn, make partners more willing to forego the right of unilateral withdrawal as a means for policing exploitative conduct.

Better valuation techniques, combined with the power of courts to order liquidation for cause, should reduce the costs of strong entity shielding among

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[190] UNIF. PARTNERSHIP ACT § 38(2)(c)(II); *see also, e.g., Beals,* 268 N.Y.S. 425-27;

[191] REV. UNIF. PARTNERSHIP ACT § 701(b).

[192] UNIF. PARTNERSHIP ACT § 32(1)(d);.REV. UNIF. PARTNERSHIP ACT § 801(5)(ii).

owners. Increased confidence among American courts in their ability to value partnership interests and arbitrate internal firm disputes would also increase their willingness to deny attempts by personal creditors to force liquidation of even a partnership at will — that is, to impose a rule of liquidation protection against personal creditors even in the absence of a rule of liquidation protection against owners. American courts seem to view themselves as competent to make an independent assessment of whether devices such as the charging order are sufficient to protect the interests of personal creditors and thus render liquidation unnecessary.

American law has not yet taken the seemingly final step of permitting partnerships featuring strong entity shielding in perpetuity rather than just for a specified term or undertaking. One possible reason is that perpetual existence may seem inappropriate in a form in which the identity of the individual owners is critical, since each is also a presumptive firm agent. But whatever the cause, the inconvenience to commercial actors may be slight. By the late twentieth century, American law had developed alternatives to the partnership that were useful to small firms and that combine strong entity shielding with the possibility of perpetual existence. We turn to those alternatives now.

B. The Company Form in the United States

As in the case of the partnership, the history of the company form in the United States is a story of widening choices for owners and thus of greater power for firms of all sizes to opt for strong forms of owner and entity shielding. Although at first useful primarily to large and capital-intensive firms, the American company form evolved to become a preferred means of legal organization for even small and closely-held businesses.

In the late eighteenth and early nineteenth centuries, American state legislatures granted charters primarily to the same kinds of firms that Parliament typically allowed to incorporate: those that built and ran canals, bridges, and turnpikes.[193] But American states generally were less tightfisted than Parliament in granting charters, and they were also quicker to enact general incorporation statutes. New York led the way in 1811, and other states quickly followed.[194]

These statutes imposed restrictions on the corporate form that were designed to compensate for the loss of the withdrawal right that attends upon strong entity shielding. Firms were not permitted to restrict alienation of their

[193] See EDWIN MERRICK DODD, AMERICAN BUSINESS CORPORATIONS UNTIL 1860, 11 (1954). *See generally* JOSEPH STANCLIFFE DAVIS, ESSAYS IN THE EARLIER HISTORY OF AMERICAN CORPORATIONS (1917).

[194] DODD, *supra* note 193, at 64. Massachusetts in 1809 had enacted a statute that facilitated incorporation by textile mills. Blair, *supra* note 19, at 419 n. 108.

shares,[195] thereby guaranteeing shareholders an alternative source of liquidity. And prohibitions on allocating control and income separately from shareholdings (such as statutory provisions restricting the issuance of preferred stock),[196] and on one corporation's owning the shares of another,[197] sought to impede blocs of shareholders from seizing or abusing control to the disadvantage of noncontrolling shareholders. Such forms of investor protection help explain why firms in capital-intensive industries sought incorporation in the nineteenth century notwithstanding the significant degree of liquidation protection offered by the term partnership at that time.[198]

While formal rigidities in the corporate form may have helped larger firms raise equity capital, they also made incorporation unattractive to smaller firms. Flexibility in allocating ownership, control, and income rights is important in small firms, as is the ability to restrict alienation of shares given that the identity of individual shareholders can be significant for firm governance. The greater risk that a small firm will be commandeered, or incapacitated by deadlock if two or more owners have equal holdings, also makes loss of the withdrawal right more costly, as does the fact that an efficient market in a small firm's shares is less likely to form. Finally, the benefits of strong entity shielding tend to be lower when owners are fewer and thus better able to monitor each other's patterns of personal borrowing. In these ways, capital intensiveness, diffuse ownership, and strong entity shielding are mutually reinforcing. Consequently, relatively few small firms incorporated during the nineteenth century, leaving the partnership as the dominant commercial entity of the period.[199]

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[195] See, e.g., *Chouteau Spring Co. v. Harris*, 20 Mo. 382-388 (Mo. 1855) *Brightwell v. Mallory*, 18 Tenn. (1 yer.) 196-198 (Tenn. 1836); *Sargent v. Franklin Ins. Co.,* 25 Mass. 90, 96-97 (Mass. 1829).

[196] Massachusetts, New Jersey, New York, and Pennsylvania all imposed restrictions on the issuance of preferred stock between the years 1870 and 1900. These restrictions chiefly consisted of requirements of supermajority approval by shareholders of issuances of preferred stock (3/4 in Massachusetts; 2/3 in New Jersey) and limitations on the proportion of stock that could be special or preferred. Public Statutes of Mass., Title XV, § 42 (1882); N.J. Corporations Law §§ 25, 33 (1875).

[197] See *De La Vergne Refrigerating Mach. Co. v. German Sav. Inst.*, 175 U.S. 40, 54-55 (U.S.1899) (noting that New York statutory law then prohibited a corporation from owning the shares of another, and that purchases of stock in other firms generally are considered beyond the power of a corporation absent a specific statutory grant); accord *Robotham v. Prudential Ins. Co. of Am.*, 53 A. 842, 846 (N.J.Ch.1903); *People ex rel. Peabody v. Chicago Gas Trust Co.*, 22 N.E. 798, 799 (Ill. 1889); *Hazelhurst v. Savannah*, Griffin & N. Ala. R.R. Co., 43 Ga. 13, 57-58 (1871).

[198] Another reason for preferring incorporation would have included its default rule of limited liability, which would in turn have facilitated share tradability.

[199] Lamoreaux & Rosenthal, *supra* note 17, at 6 (noting that partnerships remained the dominant business form in the nineteenth century even in manufacturing, and that partnerships tended to be much smaller than corporations). Partnership then, as it is today, would also have been a better option for owners who wished to pledge their personal assets in support of firm debt.

Another company-like entity — the limited partnership — was available in most states in the nineteenth century.[200] Like the corporation and its medieval forebear, the *accomandita*, the American limited partnership allows for the separation of management from ownership, as limited partners are not firm agents and may not participate in management. Indeed, limited partners originally could not vote on partnership matters, making them even weaker than corporate shareholders. Disabling limited partners was seen as necessary to their limited liability at a time when creditors expected that those engaged in a firm's operations could be called to account for firm debts. But, as we described in our discussion of premodern limited partnerships, passivity also made limited partners particularly vulnerable to exploitation by general partners. Perhaps to accommodate this vulnerability, limited partners usually enjoyed a circumscribed statutory withdrawal right, such as payout after six months' notice as long as the firm clearly retained enough capital to pay its debts.[201] But such attempts to balance protection of passive investors with maintenance of going-concern value — resulting in a semi-strong form of entity shielding — were apparently insufficient, as the limited partnership was not widely adopted in America in the nineteenth century.

The transformation of the American company form began in the late nineteenth century with an easing of the corporation's formal rigidities, such restrictions on the free alienability of shares.[202] This made the form more attractive to small and closely held firms, whose rates of incorporation rose accordingly. The transformation continued during the twentieth century, by the middle of which a closely held business corporation could be structured with great freedom.[203]

Over the second half of the twentieth century, repeated cuts in the top personal income tax rate ultimately brought that rate well below the corporate tax rate. The result was to make incorporation of small firms much less attractive, and hence to create demand among small businesses for entity forms that provided the strong entity and owner shielding of the corporation but that were

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[200] New York again came first, enacting a limited partnership statute in 1822. Most other states enacted similar statutes over the next thirty years. *See* UNIF. LIMITED P'SHIP ACT, Explanatory Note at 3 (1916).

[201] See Id. § 16.

[202] See, e.g., *Johnston v. Laflin*, 103 U.S. 800, 803-04 (1880), (noting the power of firms to place reasonable restrictions on the transfer of shares); *Bloomingdale v. Bloomingdale*, 177 N.Y.S. 873, 878 (N.Y.Sup.Ct. 1919) (upholding a right of first refusal in current shareholders for proposed stock sales).

[203] See, e.g., *State ex rel. Manlin v. Druggists' Addressing Co.*, 113 S.W.2d 1061, 1063 (Mo.App. 1938) (permitting "reasonable" restrictions on a shareholder's right to transfer stock); *Searles v. Bar Harbor Banking & Trust Co.*, 145 A. 391, 393 (Me. 1929) (holding that bylaws restricting alienation of stock, accepted with knowledge thereof, will be upheld, particularly when the restraint is for a limited period).

not taxed like one. One response was the introduction by state legislatures of new strong entity forms such as the limited liability company (LLC) and the statutory business trust. Another was to graft limited liability onto the existing partnership forms, resulting in the limited liability partnership (LLP) and the limited liability limited partnership (LLLP). Among these new forms, the LLC has proven far more popular than the LLP and the LLLP for general enterprise, evidently in part because it provides a stronger degree of entity shielding.[204]

The LLC in its current form in fact imposes even fewer formalities on a business firm than does the corporate form.[205] But the most flexible entity of them all is the statutory business trust, which Delaware introduced in mature form in 1988. While it explicitly provides for both strong entity shielding and full limited liability,[206] the business trust leaves owners free to specify all other matters of organizational design, including control rights, allocation of earnings, and even fiduciary duties.[207] In fact, the Delaware business trust statute does not even offer default terms for most of these basic structural elements. The business trust effectively represents the minimum required of law in creating a strong entity — asset partitioning, and in particular strong entity shielding — and leaves the rest to be determined by contract.[208] The business trust can thus be seen as the final step in the historical evolution of commercial entities.

The formal restrictions on the traditional corporate form were designed to protect noncontrolling shareholders from the hazards of strong entity shielding, and firm creditors from the hazards of limited liability. The easing of these restrictions, and consequent wider use of the company form, reflect the development of effective alternatives for protecting both groups. As in the transformation of the partnership, the new sources of protection appear to have been better information about firms, superior accounting and valuation methods, and greater sophistication of courts in arbitrating internal firm disputes. The

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[204] The LLC, for example, allows a firm to adopt strong entity shielding in perpetuity. *See* BROMBERG & RIBSTEIN, *supra* note 188, at § 1.04(c).

[205] *Id.* at 34.

[206] Del. Code Ann. tit. 12, §§ 3805(b) (2001) ("No creditor of the beneficial owner shall have any right to obtain possession of, or otherwise exercise legal or equitable remedies with respect to, the property of the statutory trust."); 3805(g) (same as (b) but for trustees); 3808(b) ("[T]he death, incapacity, dissolution, termination or bankruptcy of a beneficial owner shall not result in the termination or dissolution of a statutory trust."); 3803(a)-(b) (providing for limited liability for beneficial owners and no personal liability to third parties for trustees).

[207] Most provisions in Delaware's Statutory Trust Act (formerly the Business Trust Act), including those pertaining to ownership and management structure, fiduciary duties, and the allocation of trust property, contain the qualification "[e]xcept to the extent otherwise provided in the governing instrument of the statutory trust," or words to similar effect. See. e.g., *id.* §§ 3805(a), 3806(a), 3808(a).

[208] The Delaware Statutory Trust Act specifies that its policy is "to give maximum effect to the principle of freedom of contract and to the enforceability of governing instruments." *Id.* § 3825(b).

better information resulted from multiple factors, including federal income tax reporting (following adoption of the corporate income tax in 1913), mandated disclosure under stock exchange rules and government regulation, and broader use of credit rating agencies. Such information, when combined with the superior valuation techniques that resulted from improvements in financial theory and analysis, deepened equity markets and increased the effectiveness of transferability of shares as a liquidity substitute for withdrawal in smaller firms. Better information and valuation also impeded controlling shareholders from siphoning off firm assets through self-dealing and fraud. For the same reasons, courts were better equipped to rule on petitions for relief from exploitation by noncontrolling shareholders.[209] In particular, the twentieth century saw an expansion of judicial and statutory devices for protecting equity investors, such as the recognition of fiduciary duties flowing from majority to minority owners; appraisal (i.e., buyout) rights, with shares valued by accounting rather than liquidation sale, when a firm undergoes a significant transaction; and "shareholder oppression" remedies — including forced dissolution — for noncontrolling shareholders of closely held corporations.[210]

In general, the various factors that increased protection for noncontrolling shareholders — especially better information and valuation techniques — have redounded to the benefit of both noncontrolling owners and firm creditors.

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[209] Rather contrary to the analysis we offer here, Lamoreaux & Rosenthal, *supra* note 17, at 21-28, suggest that judicial enforcement of fiduciary duties of controlling shareholders and corporate managers became weaker over the late nineteenth and early twentieth centuries. They argue that the shift from the partnership to the corporate form occurred despite this change principally because of an increase in profitable opportunities for firms capable of locking in capital. *Id*. at 28-29. The primary support they offer for this increasing legal laxity is a claim that all transactions by corporate directors and officers involving a conflict of interest were automatically voidable in the early nineteenth century, while courts by the late nineteenth century had become willing to investigate the merits of such transactions before ruling on their validity. *Id*. at 23-28. This doctrinal shift, if it in fact occurred, seems better explained not as an increase in laxity, but rather — consistent with our thesis here — as the replacement of a rigid rule with a more sophisticated standard for preventing abuse by control persons. Indeed, Lamoreaux and Rosenthal note that substantive judicial investigations into conflicted transactions included comparisons of amounts paid by corporations to market prices, *id.* at 27, a fact suggesting greater judicial comfort with financial analysis. We are, moreover, skeptical that early fiduciary duty doctrine was as rigid as they suggest. *See, e.g.,* NORWOOD P. BEVERIDGE, JR., "The Corporate Director's Fiduciary Duty of Loyalty: Understanding the Self-Interested Director Transaction," 41 DEPAUL L. REV. 655, 660 (1992) (quoting an 1843 treatise that expressly sanctions self-dealing by corporate managers and directors). We note, finally, that our own view regarding the evolution of legal oversight of corporate affairs is more consistent with Lamoreaux and Rosenthal's basic theory, which focuses on a subset of the factors we consider here.

[210] For thorough documentation of the rise of such devices for protecting shareholders, see ROBERT B. THOMPSON, *The Shareholder's Cause of Action for Oppression,* 48 BUS. LAW. 699, (1993) Other useful sources include EDWARD B. ROCK & MICHAEL L. WACHTER, *Waiting for the Omelet to Set: Match-Specific Assets and Minority Oppression in Close Corporations*, 24 J. CORP. L. 913 (1999); ROBERT B. THOMPSON, *Corporate Dissolution and Share-Holders' Reasonable Expectations,* 66 Wash. U. L.Q. 193 (1988).

Noncontrolling owners are in important respects more vulnerable than are creditors to control-person opportunism, as the value of their residual claim on assets depends more on accounting and reporting practices by firm managers than does the value of the prior and fixed claims of creditors. A firm able to attract equity investors notwithstanding liquidation protection thus *a fortiori* should be able to attract creditors notwithstanding limited liability. This helps explain why the new strong entity forms such as the LLC and the statutory business trust, with the virtually unrestricted freedom they allow in structuring ownership rights, can offer limited liability as the default rule.

Success in protecting entity creditors and investors, however, has exacerbated another entity-related problem: the costs that profligate entity shielding can impose on an owner's personal creditors. These costs, and the ways courts and legislatures respond to them, will likely shape the next chapter in the evolution of legal entities.

VIII. CONCLUSION: THE UNRESOLVED PROBLEMS OF ENTITY SHIELDING

The nearly unlimited plasticity of strong entities made possible by contemporary U.S. business law is the inverse of Roman law's insistence on the flesh-and-blood individual, and especially the *pater familias*, as the only legitimate holder of assets and obligor on debts. As we have seen, a confluence of legal, accounting, and valuation developments, as well as the widespread availability of low-cost credit information, have made the costs of protecting creditors and owners manageable for even the smallest American LLCs and closely-held corporations. This confluence of factors has made contemporary America qualitatively different in some ways from previous societies, as exemplified by the severing, in the United States, of the traditional tie between a business owner's enjoyment of limited liability and his passivity – a tie strong enough to persist from the time of Ancient Rome to well into the modern era. Although Rome obviously lacked many of modern America's tools for protecting those who invest in an enterprise, the widespread Roman institution of the *peculium* indicates that Rome's courts were fully capable of distinguishing between the assets of slave-managed firms and the personal assets of the *pater familias*. Nevertheless, Roman law used entity shielding sparingly, apparently largely restricting it to the specialized *societas publicanorum.* Whether this reluctance to deploy entity shielding reflected a deep anticommercial cultural norm, a low demand for legal entities, or something else remains an important unanswered question in our view.

Notwithstanding the reasons underlying Rome's reticence to embrace entity shielding, it seems clear that lack of demand for merchant credit was not an impediment to the rise of strong entity shielding in the intensely commercial cultures of medieval Italy and early modern England. Rather, the strong demand for credit in medieval Italy and early modern England suggests that cost factors were binding constraints on the supply of entity shielding in those societies. For example, weak entity shielding was “locational” rather than firm-based in medieval Italy because the jurisdiction of bankruptcy courts and the monitoring abilities of merchants were inevitably local. Similarly, strong entity shielding was facilitated during the Middle Ages by the single-voyage nature of merchant ventures and the clear boundaries on firm assets provided by the hulls of merchant ships. The relationship between strong entity shielding and monopoly also manifests itself in the special medieval Genoese companies and forms a bridge to the joint stock companies of the early modern period. This is a relationship that is persistent but whose specific, cost-side mechanics demand further historical inquiry.

In England, the expanding jurisdiction of nationwide courts during the seventeenth century dramatically reduced the cost of introducing firm-wide weak entity shielding into partnership law, and may even have forced this innovation as a means of reducing the costs of administering bankruptcies. Similarly, the development of trading markets in the shares of chartered joint stock companies, as well as the development of partnership and trust law, allowed entrepreneurs to create homemade strong entities in the form of unchartered joint stock companies. Thus the role of declining costs is clear in the rise of entity shielding under English law, even if an account of complex interest group politics is necessary to explain the delayed appearance of general incorporation statutes 125 years after passage of England’s Bubble Act in 1720.

It thus appears that supply-side cost factors have played a prominent role in the development of entity shielding in every society we have investigated, although in each period -- and in Ancient Rome in particular -- they must share the stage with other factors. A point worth noting, however, is that in every period except Rome, we have been concerned chiefly with the costs and benefits of entity shielding either to the owners and creditors of firms or to the courts. We have focused on these particular costs and benefits because they have the greatest capacity to explain the rise of entity shielding in the West over the last millennium. But the strange case of the Roman *peculium* is a reminder that entity shielding affects not only a firm’s creditors but also the personal creditors of its owners. Moreover, it is the costs that entity shielding imposes on personal creditors that provide a point of intersection between the Roman *peculium* and the flexible rules of entity formation found in the contemporary United States.

These particular costs arise because entity shielding subordinates the claims to entity assets of an individual’s personal creditors without obtaining their consent or even, indeed, giving them explicit notice. This is why entity shielding requires organizational law rather than just contract, and why it is so effective in solving the transaction cost and moral hazard problems that would otherwise attend the creation of the pattern of creditors’ rights seen in contemporary business forms. But the ability to impair the interests of personal creditors without their consent is also why entity shielding presents a greater opportunism hazard than does owner shielding, including in particular limited liability. It is relatively easy to ensure that creditors know in advance that they are dealing with a limited liability entity, thereby enabling them to adjust the interest rate they charge and to impose contractual limitations on the entity's structure and conduct. The experience of the past two centuries has established the effectiveness of legal rules that assist entity creditors in forming and protecting their expectations regarding firm assets. But the subordination of personal creditors without notice presents different and perhaps thornier problems. These problems have not been central to the evolution of organizational law in the past, since they are strongly constrained in firms with multiple owners and relatively rigid structures. However, the increasing freedom in entity creation has brought them to the fore.

Two important manifestations of these problems are already apparent: the rise of elaborate group structures with tangles of entities that mar the transparency of business enterprises, and the increasing use of entity forms by wealthy individuals to thwart the legitimate claims of personal creditors.

Consider the first of these -- the increasing occurrence of unitary enterprises subpartitioned into hundreds or even thousands of separate asset pools, each protected by some degree of entity shielding. As the recent bankruptcies of Enron and WorldCom demonstrate, this subpartitioning of assets and liabilities into entities controlled by the firm but often absent from the firm's balance sheet greatly diminishes investors' ability to evaluate the firm's financial condition. An elevated risk of fraud is one cost of such profligate asset partitioning. A second, equally important, cost is that unsecured lenders to parent companies face increased difficulty in monitoring the assets that bond their claims. A third cost is the heightened complexity of bankruptcy proceedings, in which courts must reconcile the competing claims of the parent company's and the creditors of hundreds of subsidiaries.

One response to these costs is the unsettled doctrine of substantive consolidation, by which a bankruptcy court sets aside part or all of the subsidiary structure of a corporate group, and thus in effect scales back or entirely cancels the entity shielding within the overall asset pool.[211] Another response is to override the subsidiary structure of a corporate group by making security in all of a group's subsidiaries available for debtor-in-possession financing, a measure which benefits the enterprise as a whole at the expense of those creditors who relied upon the entity status of individual subsidiaries.[212] Just as the administrative costs of bankruptcy played a critical role in the emergence of

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[211] See, e.g., *In re Owens Corning*, 316 B.R. 168 (Bkrtcy.D.Del. 2004) (invoking substantive consolidation doctrine to void subsidiary cross-guarantees of parent debt benefiting bank creditors at the expense of tort creditors).

[212] See, e.g., *In re Babcock and Wilcox Co.*, 250 F.3d 955 (5th Cir. 2001) (extending DIP financing to entire group, although particular subsidiaries may not require financing, and the attendant use of their assets as collateral for superpriority DIP financing).

strong entity shielding three centuries ago, bankruptcy law is likely to set limits on entity shielding and entity proliferation within today's corporate groups. It is critical, however, that when bankruptcy courts apply entity-trimming doctrines such as substantive consolidation, they do so with a healthy appreciation of the history and important economic functions of entity shielding.

The second manifestation of the notice problem implicates a somewhat different set of costs — the costs of debtor opportunism vis-à-vis individual creditors. Recall from Section IV that Roman law withheld entity shielding from the *peculium,* an institution that limited the liability of the *pater familias* for the debts of a slave-managed business. As we argue above, the presumptive reason for withholding shielding was to guard against the risk that a failing Roman patriarch might stuff his personal assets into the businesses of his sons and slaves to the detriment of his personal creditors. But precisely this maneuver has today become increasingly easy for well-heeled and legally sophisticated American burghers today. States now compete in offering "asset protection trusts," for use by households, mechanisms designed precisely to make entity shielding available in order to frustrate personal creditors.[213] The availability of such vehicles raises the question whether, in the twenty-first-century world of easy entities, the venerable safeguards against fraudulent transfers go far enough to protect the personal creditors of individuals. Again, the response to this kind of opportunistic use of entity shielding may have to come through federal bankruptcy law, although the most recent amendments to the Bankruptcy Act are not heartening in this respect.[214]

These observations imply that although the law has lifted one constraint on the formation of strong entities -- the need to protect entity creditors and investors -- it is just beginning the task of sorting through a second constraint -- the need to protect third-party creditors unaffiliated with the entity itself. This task may ultimately require a rich and subtle jurisprudence, both inside and outside of bankruptcy. We expect these problems of entity shielding to play a dominant role in the next phase of the evolution of organizational law.

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[213] See Robert H. Sitkoff & Max Schanzenbach, *Jurisdictional Competition for Trust Funds: An Empirical Analysis of Perpetuities and Taxes, 115 Yale L.J. (forthcoming* 2005); Larry E. Ribstein, *Reverse Limited Liability and the Design of Business Associations, 30 Del. J. Corp. L. 199 (2005)*.

[214] The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 generally strengthens the position of creditors at the expense of consumer debtors, in large part by shifting individual cases from chapter 7 to chapter 13. Despite the crackdown on consumer debtors, however, nothing in the 2005 Act deters the limits of asset protection trusts, except the extension of the Bankruptcy Code's fraudulent conveyance "reachback" provision from one to two years.

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