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I.  INTRODUCTION

Economic activity in modern societies is dominated, not by individuals, but by organizations. Most prominent among those organizations are private business firms that own assets, enter contracts, and incur liabilities as economic actors legally distinct from their owners and managers. Firms of this character are, in historical terms, a relatively recent phenomenon, dating principally from the late 17th century. If we look back further, we find not just that such firms were largely absent, but that the legal framework for forming them was missing as well. In particular, there was a lack of legal forms providing what several of us have elsewhere called “affirmative asset partitioning,”¹ and what we here term simply “entity shielding.”² Rules of entity shielding enable the owners of a firm to reserve firm assets for the firm’s creditors, and correlative, to shield those assets from the owners’ own personal creditors. Such rules are at the core of what constitutes a distinct legal entity.

Previous work in economic and legal history has focused heavily 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. But limited liability is only a secondary, and by no means universal, characteristic of legal entities. A clear understanding of the evolution of organizations requires an appreciation of the more basic role played by entity shielding.

From an historical point of view, a critical question is why commercial firms organized as distinct legal entities arose so late. The existing literature emphasizes the benefits of legal entities — in particular, their ability to facilitate the pooling of assets from multiple investors and thus to organize the capital-intensive firms of the industrial revolution. Clearly this is an important part of the explanation. But there must be more. Today, even very small businesses are routinely formed as distinct legal entities. Why was that not also true in the past?

To find the answer, one must also look to the cost side of the ledger. We argue here that, through much of Western history, entity shielding was simply too costly to provide to most commercial firms. Over the past four centuries, in contrast, a variety of legal and practical innovations have progressively reduced the costs of entity shielding. We have thus reached the point today where American business planners can chose among a half-dozen new and flexible types of legal entity, and large business firms utilize hundreds or even thousands of interconnected entities to sub-partition both assets and creditors. This does

² We also discuss entity shielding at Henry Hansmann, Reinier Kraakman & Richard Squire, The New Business Entities in Historical Perspective, 2005 U. Ill. L. Rev. xxx (forthcoming).
not mean, however, that the costs of entity shielding are no longer important. Instead, the costs associated with legal entities have shifted away from the protection of entity creditors and owners, and toward the protection of third parties whose property rights are compromised by the imposition of entity shielding.

We begin our discussion by describing entity shielding’s economic benefits and costs. We then conduct an historical survey, beginning in ancient Rome and culminating in the contemporary United States, that employs our analysis of the economics of entity shielding to explain the rise of commercial entities in Western society. We conclude by describing the relationship between the economics of entity shielding and the policy challenges that will shape the future evolution of entities.

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 to permit an unpaid creditor to seize assets owned by the defaulting promisor. In effect, when an individual enters into a contract, the law inserts a default term by which the individual pledges all his 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 the corporation’s obligations. 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 churning pool of creditors and thus can be used to bond an individual’s or business firm’s contracts.3

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 creditors have first been paid in full. As this example suggests, the distinction between the assets of a commercial firm and those of its owners means that asset partitioning comes in

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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. It is this capacity to float with respect to creditors that distinguishes legal entities such as individuals and corporations from ordinary security interests formed by contract, such as those that can be created under Article 9 of the Uniform Commercial Code. See Hansmann & Kraakman, supra note 1, at 417-23.

4 This term was introduced in Hansmann & Kraakman, supra note 1.
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 claims of the personal creditors of the firm's owners. In modern legal entities, entity shielding takes three forms:

**Weak entity shielding** imposes a rule of priority of claim for firm creditors, whereby those creditors enjoy a claim to firm assets that is prior to the claim of personal creditors. This rule characterizes the modern general partnership.

**Strong entity shielding** adds a rule of liquidation protection to the priority of claim that constitutes weak entity shielding. Liquidation protection restricts the ability of firm owners and their personal creditors to force the payout of an owner's share of the firm's net assets. Our definition of liquidation protection enfolds both liquidation protection against owners and liquidation protection against the owners' personal creditors, traits that are conceptually distinct but that, for reasons we will explore, usually come together in practice. The modern business corporation provides a familiar example: not only do corporate creditors enjoy a prior claim to the corporation's assets, but neither a shareholder nor a shareholder's personal creditors may unilaterally liquidate and seize an aliquot portion of the firm's assets.

**Super-strong 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 neither the managers nor the beneficiaries of these entities enjoy any claim to the organization's assets, which only bond contractual commitments made in the name of the organization itself.

As we indicate above, all modern entity forms used by commercial firms exhibit entity shielding. Moreover, entity shielding, unlike owner shielding, can be achieved only through the special property rules that entity law provides. 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 super-strong entities based on the degree of entity shielding they provide.6

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5 This term was introduced in Hansmann & Kraakman, supra note 1, at 403-04.

6 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 the set of entities each covers has been subject to dispute. For example, there is ongoing debate over whether and when the general partnership became a legal entity. We
B. Forms of Owner Shielding

In contrast to entity shielding, the term owner shielding refers to rules that protect the personal assets of a firm’s owners from the claims of the firm’s creditors. Owner shielding is not central to the purpose of entities in the way that entity shielding is. Not all modern entity forms provide owner shielding, the most conspicuous example being 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 is also significantly easier than entity shielding to achieve without use of a legal entity. Owner shielding nonetheless has an important supporting role to play in the story of legal entities, and so it is useful for our purposes to describe it here and to identify a few forms 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 both the U.S. and England for several centuries prior to 1978, and it continues to characterize English partnerships today.7

**Super-strong owner shielding** restricts firm creditors entirely 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 “super-strong owner shielding” and “limited liability” interchangeably throughout this essay.

We have assigned the labels “weak” and “super-strong” to these two forms of owner shielding to reflect symmetry with the similarly named forms of entity shielding. We do not include a form labeled “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.

believe that by equating the term “legal entity” with rules 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 of 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.

7 There are also two variants of weak owner shielding. In one — which characterized the general partnership in the U.S. 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 a fraction of firm debt equal to that owner’s proportional share of the firm’s equity. 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.
C. Entity Shielding Requires Law; Owner Shielding Does Not

Although the concepts of entity shielding and owner shielding are both important for describing 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.

Entity shielding entails an impairment of the rights of personal creditors with respect to assets that an individual commits to a firm. Specifically, weak entity shielding subordinates the claims of personal creditors to firm assets, while strong asset shielding, in addition, compromises the power of personal creditors 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 extremely high transaction costs — would be fraught with moral hazard. Each waiver would improve the position of firm creditors and thus enable the firm to borrow more cheaply, a benefit that would be shared among firm owners. But each waiver would also increase personal borrowing costs, and that cost would be borne entirely by the owner who negotiated the waiver. Each owner would thus face an incentive to omit the waivers from personal dealings opportunistically, a temptation that other owners and firm creditors would find difficult to police given the significant freedom individuals enjoy in personal dealings. Increases in the number of owners exacerbate 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 are freely transferable and thus the set of owners churns. These problems can be solved only by impairing the rights of personal creditors without their contractual consent (and often even without notice), a result that requires a special rule of property law respecting assets committed to the firm. Entity law provides that rule.

In contrast, owners can in practice endow a firm with a substantial degree of owner shielding — and 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. Although this system entails some moral hazard, the incentive to cheat is less than in a system of entity shielding by contract. 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

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8 This analysis is explored in greater length in Hansmann & Kraakman, supra note 1, at 406-13.

9 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 non-consensual and thus could not be achieved by contract alone. Limited liability toward involuntary creditors has, however, been 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)
borrowing costs is shared among them as well, reducing the opportunity for each owner to profit at the expense of the others. 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” in the firm’s name and letterhead to notify third parties that the authority of firm agents is circumscribed. That was, 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.

The potential for creating limited liability by contract has led some corporate law scholars to shift away from their traditional focus on limited liability and instead to assert that the corporate form is important because it, unlike the general partnership, prevents owners from unilaterally withdrawing their shares of net firm assets. We agree with these commentators that liquidation protection against owners is an important and useful trait. But the corporate form is not a prerequisite to an effective rule of liquidation protection against owners, as business partners could (and often do) contract among themselves to waive their withdrawal rights, and the resulting agreements typically are enforceable as long as they do not contain excessive penalty provisions. Such agreements

10 As others have pointed out, the symmetry between personal cost and personal benefit of waiving limited liability breaks down to the extent that owners differ in their personal wealth, and so an adverse selection problem may still arise because shares in a firm without limited liability will be more valuable to the poor than to the wealthy. See, e.g., Frank Easterbrook & Daniel Fischel, Limited Liability and the Corporation, 52 U. Chi. L. Rev. 89 (1985). Our point is not that creating owner shielding by contract lacks incentive problems, but rather that the problems are greater in the case of entity shielding because the benefits of waiving entity shielding are entirely concentrated upon the contracting party while the benefits of waiving owner shielding are largely externalized to other owners.

11 Although, as we note in Section V, it was some time before the English courts gave their clear blessing to this approach.


13 Agreements among partners to forbear from withdrawing for a specified period have always been fully enforceable, giving rise to a common law “partnership for a term.” See Larry E. Ribstein, Why Corporations?, 1 Berkeley Bus. L.J. 183, 139-94 (2003). American and English common law courts have been leery, however, of agreements among partners to forbear from withdrawing in perpetuity, primarily based upon the sound observation that rational individuals are unlikely to agree to tie up assets indefinitely, especially where shares are non-transferable. But even where a court would not grant specific performance of an agreement to create a partnership in perpetuity, withdrawal contrary to the terms of a partnership agreement is always punishable by monetary damages, and if expectation damages are unlikely to be adequate courts will usually enforce liquidated-damages provisions so long as the penalties specified are not grossly disproportionate to the actual loss. Accord Ribstein, supra, at 194 (noting that “[b]y adjusting both amount and terms of payoff [of departing partners], partnerships can achieve significant
among partners do not, however, bind their personal creditors. Moreover, as we discuss in the next section, the economic benefits of liquidation protection against owners are highly circumscribed unless backstopped by liquidation protection against personal creditors. For these reasons, our analysis of strong entities such as the corporation emphasizes their essential role in providing liquidation protection against personal creditors, which is the form of liquidation protection that — for the reasons we have set forth here — requires the special rules of property law associated with legal entities.\textsuperscript{14}

The primary virtue of legal entities is thus that they impose property rules that slice through the hazards of pursuing entity shielding by contract. But this virtue is also a potential vice, as 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.

\section*{III. THE ECONOMICS OF ENTITY SHIELDING}

Although the benefits of owner shielding — and in particular, limited liability — have been well rehearsed in recent literature,\textsuperscript{15} comparatively little attention has been paid to the economics of entity shielding. We examine the benefits and costs of entity shielding here, as they are vital to understanding both the evolution of legal entities through history and the policy issues that organizational law presents today.

\subsection*{A. The Benefits of Entity Shielding}

Enabling individuals to organize legally distinct asset pools provides important economic advantages in terms of 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 advantages of all forms of entity shielding. The remaining benefits are consequences of liquidation protection, and thus arise only in strong entities such as the business corporation.

**Reducing Creditor Monitoring Costs**

All forms of entity shielding reduce creditor monitoring costs by reducing creditors’ exposure to risks they cannot easily evaluate. We explain this point through use of an historical example:16

Imagine a hypothetical (but prototypical17) Florentine merchant of the 15th century who is a partner in several different partnerships, each of which lacks entity shielding. Among these partnerships are a wool cloth manufacturing firm in Florence, a commodity-trading firm in Bruges, and a banking firm in Rome. Because the default rule among partners is joint and several liability for partnership debt, 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 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 measure the creditworthiness of the Florence manufacturing firm, a would-be creditor — such as a raw wool supplier — 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. 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 would be vulnerable to the fortunes of all outside business affairs, as well as the 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 only the weak form, a would-be creditor of that firm could focus on that particular firm’s assets and prospects. He need 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

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

17 The Medici family’s businesses, for example, were organized in this manner. See Section IV. So were those of Francesco Datini. *IRIS ORIGO, THE MERCHANT OF PRATO: FRANCESCO DI MARCO DATINI* 1335-1410 (1957).
had been paid in full. Entity shielding would thus concentrate the value of the assets of the Florence partnership in 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 also are given entity shielding. By this means, all creditors can experience a reduction in the cost of appraising the security of their claims, and the overall cost of credit to the three firms can consequently be lowered. In short, entity shielding promotes specialization, permitting creditors to limit the risks they face to those originating in businesses in which they have special knowledge or that they can monitor with particular ease.\(^\text{18}\)

Limited liability and other forms of owner shielding have the converse effect, distributing the value of non-firm assets away from the firm’s creditors. This, too, can reduce monitoring costs.\(^\text{19}\) But owner shielding does not protect a firm’s creditors from having to share the firm’s assets with nonfirm creditors. Endowing our hypothetical Florence partnership with limited liability, for example, would not in itself prevent the creditors of the Bruges and Rome partnerships from having a claim on the assets of the Florence partnership equal to that of the latter firm’s own creditors, and consequently would not reduce monitoring costs for the creditors of that firm to the same degree that entity shielding would.\(^\text{20}\) As

\(^\text{18}\) 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 subpartitioned again and pledged to subsets of business creditors with specialized lending expertise in particular lines of business. This is among 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.

\(^\text{19}\) 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, and so owner shielding will provide benefits in that context as well.

\(^\text{20}\) 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 personal assets of the Florentine merchant notwithstanding his partial ownership of those firms, and thus they would have no claim to his share of the firm in Florence. But for a creditor of the Florence partnership to view this approach as 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 risks that the Florentine merchant might form yet another firm lacking limited liability, 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 were 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.
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.

Reducing the Administrative Costs of Bankruptcy

Just as all forms of entity shielding enable creditors to specialize in particular asset pools, they enable bankruptcy courts to specialize similarly, and with comparable benefits. To illustrate, we continue with our example of the Florentine merchant, and consider further the implications of a failure of the trading firm in Bruges to pay its debts. One approach that the legal system in Bruges could adopt would be to allow each unpaid creditor of the Bruges firm immediately to seize firm assets equal in value to his unpaid claim. Such “first to file” systems of distributing a debtor's assets have undesirable consequences, however, such as the infamous “race to the courthouse.” Most modern legal systems have thus adopted pro rata bankruptcy systems, under which each creditor who files a proper claim receives a proportionate payout based on the ratio of the debtor’s total assets to total liabilities. In the absence of entity shielding, all assets owned and debts owed by a debtor would be of equal status for this purpose. Thus, to ensure a payout according to the pro rata regime, a bankruptcy court in our example would have to assess not only the value of the Bruges trading firm, but also the ratios between assets and debts of the firms in Florence and Rome. To omit this step might impair the rights of the creditors of the Florence and Rome firms, as those creditors enjoy equal claims to all of the Florentine merchant’s assets wherever found, and the Florence and Rome firms might be in even worse financial shape than the Bruges firm. The other partners of the Bruges 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 court in Bruges 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 would significantly ameliorate these problems. Because the creditors of the Bruges trading firm would enjoy a prior claim to firm assets, a bankruptcy court in Bruges could begin distributions to firm creditors as soon as it had evaluated the Bruges 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 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 far-flung assets and creditors of the corporation’s thousands of shareholders. Entity shielding provides the means.

Protecting Going-Concern Value

When a rule of liquidation protection is combined with priority of claim for entity creditors, additional benefits can be realized, perhaps the most important of which is protection of a firm’s going-concern value. 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, and so individual owners in a multi-owner firm would face an incentive to exercise the withdrawal right when withdrawal is personally beneficial but socially inefficient. 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 degree to which the cost of withdrawal is externalized increases with the number of owners, and so liquidation protection will be more valuable as owners become more numerous.

To be fully efficient, the waiver of the withdrawal right must also bind the owners’ personal creditors. Otherwise, when an owner defaulted on personal debt, her creditors would 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, 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. It thus makes sense for liquidation protection against personal creditors to accompany liquidation protection against owners, a conclusion born out by the observation that contemporary entities that provide

21 See id. at 403-04.
22 Along these lines, Lamoreaux and Rosenthal observe that, unless liquidation protection is available to business owners, “many firms that otherwise would be socially efficient will not form.” Lamoreaux & Rosenthal, supra note 12, at 13.
23 By allowing firms to have more owners, liquidation protection also increases the amount of capital that any particular firm can raise, and thus enables a firm to achieve the optimal scale associated with an asset-intensive production technology. Blair makes the converse point about the traditional partnership, which lacks liquidation protection, when she notes that “while a few individuals known to each other and their communities might be able to sustain a modest-sized manufacturing, trading, or other business for a while as a partnership, the implicit veto power that partnership rules give to each partner, and the vulnerability of the pool of bonding assets to the fortunes, talents, and good behavior of every partner would likely become problematic as the business grew.” Blair, supra note 12, at 412.
the latter attribute provide the former as a default rule as well. For example, a shareholder of a modern business corporation cannot liquidate her investment unless she controls a majority of shares, and 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 personal creditors in our definition of strong entity shielding.

Investment Diversification

Liquidation protection also enables individuals to diversify their portfolios of equity investments. As we indicate above, the going-concern value of a firm

24 We also generally would not expect, and in fact find few examples of, firms with the converse — liquidation protection against personal creditors (“LPC”) but not liquidation protection against owners (“LPO”). 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, and so LPC is likely to be inefficient in a firm if LPO is. A rule of LPC in the absence of LPO thus might not provide significant social value, and courts would have good reason to suspect that owners seeking LPC but not LPO 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 seemed adequate to safeguard the creditors’ interests, a seeming result of increased confidence among American courts in their ability to protect those creditors by evaluating partnership interests and arbitrating internal partnership disputes. See Section VI, infra.

25 There are several reasons also to 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, and so 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, and so firm owners will 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, and the 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.
without liquidation protection is vulnerable to excessive personal borrowing by owners. If a firm lacks liquidation protection, then, each of its owners will prefer co-owners, such as relatives and close acquaintances, whose personal finances are easier to monitor. Strong entity shielding thus decreases the costs of investing in firms co-owned by strangers. This necessarily increases the number of firms in which any given individual will be willing to invest, and thus his opportunities to diversify.26

Promoting Transferability of 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 restricting 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,27 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.28 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.29 It is therefore not surprising that, though firms with freely tradable shares have sometimes lacked limited liability, the best evidence suggests 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. But, as we explain in our historical sections, commercial firms with entity shielding are in general a relatively recent phenomenon, which suggests that entity shielding creates significant costs as well. We survey the most important of those costs here.

26 Besides causing investors to prefer co-owners who are close acquaintances, the need for mutual monitoring among co-owners when firms lack liquidation protection would effectively cap the number of owners per firm. This is another way of conceptualizing how the value of liquidation protection in a firm rises with the number of owners.

27 See, e.g., EASTERBROOK & FISCHEL, supra note 15; Woodward, supra note 15.


29 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.
Opportunism

Entity shielding invites opportunistic behavior by empowering a debtor to subordinate 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 creditors to the latter firm, effectively “selling” the assets twice. Expecting such opportunistic behavior ex post, creditors of the first partnership would offer no discount on the cost of borrowing ex ante, and indeed might increase the interest rate they charge due to the possibility 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 where they are used to support further borrowing. 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 primarily 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. But, as just illustrated with our hypothetical Florentine merchant, the incentive to remove assets from a firm opportunistically also arises in firms with entity shielding, even in the absence of limited liability.

Whether opportunistic movement of assets into or out of an entity is more likely depends 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 such shifts are mutually beneficial, and so coordination costs suggest that opportunism toward creditors should decrease as a general matter 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 multiple owners, as exploitation of personal creditors under those conditions would require owners either to consent to frequent readjustments of their relative ownership shares or to be willing and able simultaneously to commit proportionate amounts of additional assets to the entity. The difficulty in using a jointly owned entity to exploit personal creditors may explain why, as we describe further below, single-owner firms with entity shielding were rare before the twentieth century, and why such entity forms present several of the most important challenges in organizational law today. By contrast, opportunistic asset distributions to the detriment of entity creditors do not require owners either to make additional assets available or, so long as the distribution is pro rata, to readjust their ownership shares, and thus may be easier to coordinate in a multi-owner entity.
The movement of assets across entity borders need not be malicious for entity shielding to generate costs. Though deliberate opportunism may be the bigger problem, mere confusion and uncertainty regarding the propriety of investments in a firm, or distributions from it, can occasion wasteful disputes and delay in settling creditors’ claims. Where 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. Which brings us to the costs of enforcement.

**Enforcement Costs**

Rules to prevent opportunism and confusion must be credible to be effective, giving rise to enforcement costs. For example, rules such as minimum capital requirements entail accounting and disclosure rules, monitoring activity by creditors, and litigation of perceived violations.

While bright-line rules for the use of a legal entity may control opportunism and confusion with only modest enforcement costs, they also might 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 they require sophisticated courts capable of sound judgments about which asset movements subvert the reliability of entities as devices for bonding contracts.

Weak entity shielding, in particular, seems to depend on the enforcement costs associated with a sophisticated bankruptcy system. This is because the right of a personal creditor to levy on the assets of a firm with weak entity shielding is contingent upon whether sufficient firm assets will remain to pay firm creditors in full, and this contingency will likely be costly for a court to evaluate. Specifically, it will most often require a court to employ the broad powers associated with a bankruptcy system: the powers to stay division of firm assets, evaluate claims of multiple creditors simultaneously, and oversee ongoing firm operations during the pendency of proceedings. A court without such powers might instead simply allow a personal creditor to seize a firm asset subject to a lien, but the ability of the personal creditor to remove and liquidate the asset would make enforcing the lien costly to firm creditors and would undermine the monitoring economies associated with entity shielding. In the alternative, a court could simply deny the personal creditor’s attempt to levy on firm assets — an approach that, as we will see, some American state courts in fact adopted in the late nineteenth century. But that in effect would be to impose liquidation protection against personal creditors, and thus to solve the problem of weak entity shielding merely by substituting strong entity shielding.

As this last point illustrates, strong entity shielding is less dependent than is weak entity shielding on the presence of a well-developed system of
bankruptcy law and administration, since the insolvency of an owner need not require an assessment of firm assets and liabilities. And, if limited liability is added to strong entity shielding, the reverse is also the case, reducing even further the complications of insolvency.

**De-diversification of Creditor Claims**

Another cost that entity shielding entails, even in its weak form, is a reduction in the diversification of assets that back the claims of creditors. To explain this point, we again employ our hypothetical Florentine merchant. To keep things simple, we assume that the merchant is the only substantial investor in any of the three partnerships, and that he lacks meaningful wealth outside them. If the three firms lack entity shielding, then a creditor of one is effectively a creditor to 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. But if the three firms are separate entities with either weak or strong entity shielding, then the creditor’s recovery will depend mostly on the performance of the particular firm to which he lent. 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 for achieving a given level of diversification.

Another 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.

**Investment Illiquidity**

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 are unable to withdraw unilaterally 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 liquidity source.

While tradable shares reduce the illiquidity costs of strong entity shielding, they usually require institutions that entail their own costs, such as stock markets, regulation systems to protect investors, disclosure requirements for public companies, and so on. To the extent that regulatory compliance costs entail a fixed component, we would expect tradable shares and thus strong entity shielding to be more prevalent in large firms.
Exploitation by Control Persons

The second cost specific to strong entity shielding is exploitation by control persons. The right of an owner 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 punish, and limit exposure to expropriation by, controlling owners and firm agents. Strong entity shielding deprives owners of this device. Strong entities are thus likely to face greater difficulty than other entity types in attracting non-controlling investors. 30

C. Cost-Benefit Tradeoffs and Lessons from History

As our survey of the costs and benefits of entity shielding suggests, the economics of entity shielding are a story of tradeoffs. Enforcement costs are incurred to reduce opportunism costs, tradable shares are both a cost and benefit of strong entity shielding, and weak entity shielding reduces creditor information costs but requires a bankruptcy system, the administrative costs of which are mitigated by entity shielding. As we seek to demonstrate in the following sections, such tradeoffs help explain the appearance and rise of commercial entities over time. They also, we believe, inform important policy decisions regarding the continuing development of legal entities today.

The conventional approach employed by historians of entity law has been to focus on limited liability, and to explain its appearance as a response to technologies that required the aggregation of large amounts of capital from multiple investors. We agree that the appearance of capital-intensive production technologies is an important part of the history of commercial entities, and along those lines we note that several benefits of entity shielding — such as reducing creditor information and bankruptcy administration costs, and protecting going-concern value — are particularly valuable in large, multi-owner firms. But capital agglomeration is not the whole story, as today even small and wholly owned firms adopt entity forms, whereas in the past that was not the case. We believe that a focus on the economics of entity shielding helps us understand why.

In the sections that follow, we trace the path that leads from ancient Rome through medieval Italy, and then to early modern England and ultimately the contemporary United States. This is, roughly speaking, the path traced by the cutting edge of commercial development in Western history. Along that path, we take the turning point to be the late 17th century, when the English courts turned

30 Lamoreaux and Rosenthal consider “this problem of minority oppression” to be “the main cost associated with the corporate form.” Lamoreaux & Rosenthal, supra note 12, at 14. While we agree that minority oppression is a problem with the corporation given that it is a strong entity, we do not share Lamoreaux and Rosenthal’s view that this is a key difference between the corporate and partnership forms. As we indicate above, partners can contract among themselves to waive their withdrawal rights, and by doing so they will also invite exploitation by control persons.
the partnership — then the form for most commercial firms — into an entity.\footnote{Craven v. Knight, 2 Chancery Reports 226, 21 ER 664 (Ch. 1683).} We use that turning point to organize our exposition. In Section IV, we analyze the commercial forms employed prior to the 17th century, beginning in Roman times. In Section V, we explore the pivotal changes in English law and institutions from the late 17th through the early 19th centuries. And in Section VI we shift our focus to the United States, where we consider the continuing evolution of commercial entities to the present day and beyond.

IV. PRE-MODERN ORGANIZATIONAL FORMS

Pre-modern society, from ancient Rome through the Renaissance, generally lacked commercial firms organized as discrete legal entities. The types of asset partitioning that we do observe in these periods, and the substitutes for entity shielding that were adopted, suggest not that entity shielding would have been without benefit to pre-modern firms, but rather that the costs of endowing such firms with entity shielding would have been prohibitive.

In the pre-modern societies on which we focus — ancient Rome and medieval Italy — the basic legal entity was not the individual, as it is today, but rather was the family. For this purpose, the family was defined as the oldest living male — the \textit{pater familias} — and all of his male descendants. The \textit{pater familias} formally owned all family property, whatever the ages of his offspring, and all family assets bonded the contracts of each family member. As a basic entity, the family had two advantages. First, opportunism against creditors was minimized because the persons to whom family members would naturally distribute assets — close relatives, and especially descendants — were part of the entity and thus were also liable for its debts. Second, the family pooled the assets of multiple individuals and thereby eased the funding of enterprise. Adoption of the family as the basic entity thus would have reduced the need for a special commercial entity for use by multi-owner firms.\footnote{Aside from the family, Roman law recognized three types of non-commercial organizations as distinct legal entities. The first, the \textit{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." P.W. Duff, \textit{Personality in Roman Private Law} 95-158 (1971); Fritz; Schulz, \textit{Classical Roman Law} 152 (1951); accord Adolph Berger, \textit{Encyclopedic Dictionary of Roman Law} 395 (1953). The second distinct Roman legal entity was the municipal corporation (or \textit{municipium}). Finally, Rome recognized a non-commercial entity type that covered a mixed class of membership and charitable organizations. Like the family, all three of these were super-strong 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, \textit{The Role of Nonprofit Enterprise}, 89 \textit{Yale L. J.} 835 (1980).}
A. Early Forms of Partnership

Where the assets of a single family were insufficient to fund an enterprise, the only option in ancient Rome was for members of different families to form a societas. Although “societas” is commonly translated as “partnership,” the modern partnership and the societas in fact have little in common. The societas lacked mutual agency, and so each partner had to assent individually to a contract to be bound by it. Also, the liability of partners for the debts of a societas was pro rata rather than joint and several. Finally, the societas lacked entity shielding, as Roman law apparently made no distinction between the obligations and assets of the societas and those of its partners. The societas was thus in fact little more than a contract between two or more persons to share the proceeds from joint activity.

The evolutionary link between the societas and the modern partnership is the compagnia, which was the standard form for multi-owner enterprises in Italy during the Middle Ages. The compagnia at first differed from the societas only in its use of a rule of joint and several liability among partners for firm debt. Over time, the compagnia also acquired mutual agency, a development that would have made it more useful to larger firms, and which in fact coincided with a slow increase in the scale of commerce during the High Middle Ages. Our best evidence is that the medieval compagnia did not, however, take the final step of becoming an entity and acquiring entity shielding. In essence, the compagnia

The entities thus featured resilient organizational boundaries that contributed to their conspicuous success as asset-pooling devices. This was particularly true of the medieval nonprofit organizations, which descended from their Roman counterparts. Medieval monasteries, for example, were often huge in scale, collectively controlled roughly one quarter of the landed wealth of Europe, and engaged in commercial activities as varied as those of private merchants.

33 W. W. Buckland, A Text-Book of Roman Law from Augustus to Justinian 507, 510 (1921); J.A. Crook, Law and Life of Rome 233 (1967).
36 The most direct evidence we have of a lack of entity shielding in the compagnia is a 1495 lawsuit against a firm in Naples that was 95% owned by the Medici in Rome and 5% by a local manager. The plaintiff was the holder of a bill of exchange drawn in Rome and payable in Naples. The courts held that, for purposes of the litigation, the two firms could be treated as one — and hence, apparently, it was not important to decide which firm was directly liable for the debt. See Raymond de Roover, The Rise and Decline of the Medici Bank 1397-1494 139-40, 260-61 (1963). With weak entity shielding, this would not have been the case: if the Rome partnership were the only firm directly liable for the debt, then the holder of the bill would have been only a subordinated creditor of the Naples firm — an important difference, given that the Rome partnership was evidently insolvent and the Naples sub-partnership was also in financial difficulty.

Strong circumstantial evidence of the lack of even weak entity shielding in the medieval partnership is the practice, described immediately below, of barring a partner in one compagnia
(and, less effectively, the *societas*) appears to have been a means of pooling assets but not of partitioning them.

The absence of entity shielding from the *compagnia* was evidently not for want of a need in medieval Italy for an effective device for partitioning firm assets. To the contrary, members of medieval *compagnia* often mutually promised to refrain from joining other partnerships,\(^37\) most likely to insulate the *compagnia* from the spillover effect if another partnership fell bankrupt. A rule of entity shielding would have been superior for this purpose, in two ways. First, it would have provided the needed insulation without prohibiting firms with common owners. Second, it would have insulated firms more effectively because it is a rule of property law enforceable against personal 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.\(^38\)

Perhaps for these reasons, the *compagnie* proved unstable despite their contractual bars on multi-firm membership, with high failure rates through the 14th century.\(^39\)

In later years, large medieval firms that operated distinct businesses in multiple cities attempted to isolate risks by hiving off each branch in a separate partnership.\(^40\) The best-known example is the Medici Bank, which operated between 1397 and 1497.\(^41\) Each of the Medici Bank’s branches — which were located in the principal trading cities of Europe such as Naples and Bruges — was organized as a separate *compagnia*, with local managers serving as junior partners and the Medici family’s Florence firm, itself organized as a *compagnia*, in the role of the dominant partner and investor.\(^42\) This hub-and-spoke structure

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38 Although the partners in large *compagnie* typically waived their right to withdraw their assets, see Robert Lopez & Irving Raymond, *Medieval Trade in the Mediterranean World* 204 (1978), it is doubtful that such waivers would have been binding on their personal creditors.


41 This “bank” was in fact a diversified concern that dealt not just in lending and currency exchange, but also in manufacturing and commodity trading. Specifically, the Medici Bank traded heavily in staple products such as wool, spices, and citrus fruit, as well as in luxury articles such as silk and jewelry. While its textile plants and export businesses were concentrated in northern Italy, its merchant banking business had branches in Geneva, Avignon, Bruges, and London. See generally De Roover, *supra* note 36, at 142-168.

42 Id. at 81-2. The fact that the Medici family invested in multiple businesses is further evidence that the medieval compagnie lacked liquidation protection. As we indicate in Section III, above, in a firm without liquidation protection each owner will prefer co-owners who are close
insulated each branch from direct suits by creditors with claims arising from business and personal borrowing by managers of other branches. Even with this decentralization, however, the Medici family — as the contractual hub of the enterprise — remained liable on all debts of its affiliated compagnie. The resulting vulnerability to cross-partnership bankruptcy may have contributed to the successive collapse of the various branches of the organization in the final years of the 15th century.

Why did neither the societas nor the compagnia acquire entity shielding and thereby become a legal entity? For the societas, a big part of the answer may relate to the availability of substitutes. As indicated above, the family served as an asset-pool device in ancient Rome, and as a general matter the production technologies available in Roman times appear rarely to have required significantly more capital than a Roman family could provide. As a result, the societas almost never entailed more than a few members. Second, Roman commercial law was sufficiently sophisticated to provide for secured loans involving floating liens on commercial assets, thus providing an alternative device by which a firm could grant a prior claim to its most important commercial creditor.

acquaintances and thus whose personal finances are relatively easy to monitor. A person is likely to be more familiar with individuals with whom he is already in business, and so in the absence of strong entity shielding more firms will likely be owned by common sets of individuals, such as families. In other words, “internal” diversification, or diversification within a firm or group of commonly owned firms, will be more likely when strong entity shielding is unavailable. By contrast, strong entity shielding promotes “external” diversification, whereby an individual invests in multiple firms that lack common owners.

43 The effectiveness of this strategy was confirmed by Ruffini v. Portinari, decided in Bruges in 1455. In that case Ruffini, a Milanese merchant, sued the Medici’s Bruges branch for the defective packing of wool bales that had been purchased from the Medici’s London branch. The court rejected Ruffini’s argument that, since the Medici family controlled both firms, he should be able to recover from one for the debts of the other. Rather, the court accepted the defendant’s reasoning that the case against the Bruges branch should be dismissed because, given that the two branches were distinct partnerships, Ruffini must bring his action against the London branch with which he had dealt directly. See id. at 83-84.

44 The various branches of the Medici family organization closed over a period of years from roughly 1480 to 1497, and not in a rapid cascade, except for the closely connected Rome and Naples branches that gave rise to the lawsuit discussed in note 36, supra. See generally DE ROOVER, supra note 36, passim. Consequently, if the lack of asset partitioning was an important factor in limiting the creditworthiness of the various individual branches, its effects were evidently indirect.

45 The landholdings of most farmers were small, PAUL LOUIS, ANCIENT ROME AT WORK 80 (1927), and most industrial production, such as that of ceramic lamps, ironware, lead pipes, jewelry, furniture, and clothing, occurred in small workshops or in the homes of craftsmen, TENNEY FRANK, AN ECONOMIC HISTORY OF ROME 217-74 (1927).

46 R. W. LEAGE, ROMAN PRIVATE LAW 190-96 (1930).
The cost of establishing entity shielding also would have been high in the small firms that typified ancient Roman commerce, a point that likely explains the unusual pattern of asset partitioning exhibited by a special form of Roman slave-operated businesses known as the *peculium*. Under Roman law, a *pater familias* could entrust his slave (or his son\(^{47}\)) with a set of assets, termed a *peculium*, to be used to start an independent business. If the *peculium* business defaulted on its debts, its creditors could sue the *pater familias* (the formal owner of the business assets), but his liability to those creditors — so long as he never exercised direct control over the business — was limited to the value of the *peculium* plus any profits it had earned.\(^{48}\) A *peculium* business thus exhibited limited liability. It did not, however, provide entity shielding: personal creditors of the *pater familias* appear to have enjoyed a full claim to *peculium* assets that was equal in priority to the claims of the *peculium* business creditors.\(^{49}\) Entity shielding generally provides a foundation for owner shielding by conferring on firm creditors an offsetting benefit; consequently, a firm with limited liability but not entity shielding is unexpected, and indeed is unknown in modern times. A *peculium* was a wholly owned firm, however, and the opportunism hazard is much more acute in such a firm because a sole proprietor need not coordinate with others the transfer of assets into and out of the entity. If the *peculium* provided entity shielding, then a *pater familias* facing bankruptcy would have been tempted to use the *peculium* for betting his personal assets on a risky venture, with his personal creditors bearing the cost of failure. That the Romans were able to give the *peculium* owner shielding but apparently chose not to endow it with entity shielding suggests that the threat of opportunism in small Roman firms may have been too great to make entity shielding worthwhile.

Entity shielding seemingly would have been more attractive in the medieval period, as *compagnie* often had numerous owners, and they were clearly plagued by the associated risk of cross-firm bankruptcies. But even in the medieval *compagnia*, the costs of entity shielding probably would have been prohibitive. Weak entity shielding generally requires, as we indicated above, a

\(^{47}\) While the institution of the *peculium* extended to sons as well as slaves, it appears to have been used most extensively with Rome’s numerous slaves, especially when the purposes were commercial. See A. *KIRSCHENBAUM*, *SONS, SLAVES AND FREEDMEN IN ROMAN COMMERCE* (1987).

\(^{48}\) *CROOK*, *supra* note 33, at 187-89.

\(^{49}\) The secondary literature on Roman law does not address the question of entity shielding in activities financed with a *peculium*. We infer the absence of entity shielding, in part, from the treatment accorded businesses financed with a special form of the *peculium*, the *peculium castrense*, which was a *peculium* given to a son who had achieved distinction in the Roman army. Creditors of businesses financed with a *peculium castrense* were explicitly granted priority of claim in the *peculium* over the other creditors of the *pater familias* — that is, the *peculium castrense* created weak entity shielding. This explicit recognition of priority in the *peculium castrense* suggests strongly that the background rule for *peculium* creditors in general was that they had no such priority. See S. *SOLAZZI*, *SCRITTI DI DIRITTO ROMANO* (1955-1972). We are indebted to Bruce Frier for extensive help in researching this issue.
sophisticated bankruptcy system. But medieval courts were limited in their jurisdictional reach given the political fragmentation of Italy in particular and Europe generally at the time. Accordingly, evidence from the period suggests that debtors frequently could avoid legal process by fleeing with their assets. This problem would have been exacerbated 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, coin, and financial claims—that were easy to make off with. In such a setting, formal hierarchies of claims in assets probably would have had little value, and creditors would have preferred the power to seize immediately any assets of the debtor they could find.

Strong entity shielding also seems to have been out of the question for most medieval firms. Strong entity shielding entails liquidation protection, which requires owners who are willing to part with their withdrawal rights. Medieval partnership agreements, by contrast, typically specified durations of no more than five years, reflecting a perceived need among partners for frequent liquidation events in order to provide liquidity and cabin control-person opportunism. Primitive accounting methods would have exacerbated monitoring problems and thus increased the need for frequent reviews of manager performance. The threat of such expropriation would have been particularly strong in medieval firms in which agents operated at a distance from owners, the special rules of which we consider next.

B. Firms with Remote Assets

Concerns regarding control-person opportunism also likely explain the patterns of asset partitioning that we see in types of medieval firm that specialized in long-distance trade. One such arrangement was the commenda, which arose during the 10th and 11th centuries as a device for financing maritime trade out of the principal Italian port cities of Venice, Genoa, and Pisa. The prototypical commenda had two participants: a passive investor who provided capital for trade, and a ship captain who contributed labor and initiative. The commenda lasted only a single trading voyage. When the ship returned to its home port, the merchandise accumulated during the expedition was sold off, and the profits were divided among the participants in proportions specified by contract.

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50 Lopez & Raymond, supra note 38, at 291, 298-302.
51 Favier, supra note 37, at 157.
52 De Roover, supra note 40, at 49-50; Harold J. Berman, Law and Revolution: The Formation of Western Legal Tradition 352 (1983); Lopez & Raymond, supra note 38, at 176.
53 Lopez, supra note 34, at 76-7; De Roover, supra note 40, at 49-50; Murat Cizakca, A Comparative Evolution of Business Partnerships 22 (1996); Lopez & Raymond, supra note 38, at 176-180.
There is no evidence that the *commenda* provided entity shielding as a matter of law. The *commenda* did nonetheless seem to entail liquidation protection as a practical matter, as the distance at which the active partner operated, and the discretion he necessarily enjoyed during the voyage, would have made him difficult and expensive for the passive investor to recall. Two special features of the *commenda*, however, appear to have reduced or offset the costs of its *de facto* strong entity shielding and thus made the arrangement worthwhile. First, throughout the duration of the *commenda* the firm’s assets were neatly segregated within the hull of the ship, which was always either at sea or in foreign ports. So the ship itself confined the opportunity of the ship captain to expropriate the passive investor. Second, the rule for dividing up assets at the completion of the venture was that the passive investor took a cut of the profits but never had to cover any losses, the burden of unpaid firm debt falling entirely on the ship captain.54 The passive investor thus enjoyed limited liability, which would have reduced his exposure to expropriation by the captain and thus partly compensated him for his loss of an effective withdrawal right. The segregation of assets in the ship also would have protected firm creditors, and so would have made the limited liability of the passive investor more tolerable to them if they happened to learn of his existence.

Similar considerations also seem to explain the *accomandita*, a limited partnership form authorized by statute in Florence in 1408.55 In the *accomandita*, a passive investor lent a merchant a sum of money to be returned, along with a fraction of the income it generated, after a specified period. Losses for the passive investor were capped at his investment amount, provided that he refrained from lending his name to the firm and from participating in its management.56 It is not surprising, then, that the *accomandita* and *commenda* were used in analogous situations — namely, for short terms during which firm assets were remote from the limited partners.57 The Medici bank, for example, used the *accomandita* when opening a branch in a foreign city. The local manager would be the general partner, with the central Medici bank in Florence serving as the limited partner. If, within the prescribed period (typically two years), the local manager proved his reliability, the firm was reformed as a

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55 DE ROOVER, *supra* note 40, at 75.

56 DE ROOVER, *supra* note 36, at 89, 284, 325.

57 While the principal application of the *commenda* was in long-distance maritime trade, it eventually found use in for 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 38, at 188-89.
general partnership (that is, a compagnia).\textsuperscript{58} Such reliance on foreign agents in distant locations necessarily heightened the vulnerability of the Medici to incompetence and perfidy, and thus increased the desirability of both limited liability and formal liquidation events at frequent intervals. The connection between passivity and limited liability also would have benefited firm creditors, as an investor who cannot exercise control is less likely to be able to remove assets from the firm and thus, when that investor enjoys limited liability, beyond the reach of firm creditors. Once the local manager proved his trustworthiness, the calculus often changed, with the risks of full liability for the Medici outweighed by the superior terms of borrowing realizable when their name backed firm debts.

C. Early Joint Stock Companies

In addition to the medieval firms that exhibited de facto liquidation protection, a few pre-modern business forms appear to have enjoyed strong entity shielding as a legal rule. Each of these forms, which we term “proto-joint stock companies,” appears to have had unique characteristics that sharply reduced the costs of asset partitioning. In particular, such firms either were bonded with outside assets or enjoyed as their principal asset a state-granted monopoly.

The Ancient Roman societates publicanorum exhibited both of these advantages. Beginning in the fourth century B.C., the Roman Republic contracted out important public projects — such as construction of public works, provision of military supplies, and collection of taxes — to special enterprises known as societates publicanorum.\textsuperscript{59} From the available evidence, it seems that a typical pattern was roughly as follows:\textsuperscript{60} a group of investors (the socii) would form a societates publicanorum to bid on a public contract. If the bid were accepted, the state would pay a portion of the contract price in advance and the other portion on completion. One of the investors — the manceps — would bid on behalf of the group, and would accept the contract in his own name. The manceps and possibly a few other investors would then pledge their landed estates as security for performance of the contract.\textsuperscript{61} The remaining investors would simply contribute capital, which they could do as general partners who

\textsuperscript{58} See, e.g., De Roover, supra note 36, at 63, 311-2.

\textsuperscript{59} See E. Badian, Publicans and Sinners: Private Enterprise in the Service of the Roman Empire 68-69 (1972). Although the societates publicanorum were numerous, and evidently many Romans invested in them, the actual contract of association for only one such firm appears to have been found. Id.

\textsuperscript{60} See generally Badian, supra note 59, at 67-81.

remained full liable on firm debts, or as limited partners, with limited liability but without control rights.  

As this account indicates, the unique characteristic of the *societas publicanorum* as a public contractor was that it employed outside assets to bond its contractual performance. The evidence suggests that the *societas publicanorum* enjoyed strong entity shielding as a matter of law. However that may be, the firms also enjoyed a form of strong entity shielding through their use of pledged assets. The state had, in effect, a mortgage on the estates that were pledged as security for the firm’s performance, which gave the state’s claim first priority over the claims of any other creditors of the partners who owned those estates. Thus, with these borrowed assets, the *societas publicanorum* managed a kind of entity status. It was not an approach to entity shielding that was easily replicable by other firms, however, as it required a single firm creditor — the state — as contrasted with the churning pool of creditors associated with the typical business firm.

A different variant of the *societas publicanorum* used in Roman tax farming exemplifies a second attribute that frequently characterized proto-joint stock companies: possession of a state-granted monopoly. The largest Roman *societates publicanorum* were organized to lease tax farming rights from the state, sometimes over enormous geographical regions. During the first century B.C., the tax-farming syndicates appear to have approached the size and internal structure of a modern public company, with “multitudes” — presumably hundreds — of passive investors who traded limited partnership shares in a market very much like a modern stock market. With respect to these limited partners, at least, the firms evidently enjoyed strong entity shielding.

A millennium after Rome abandoned the *societas publicanorum*, the Italian city-state of Genoa resurrected the proto-joint-stock company form.

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62 Id. at 261-68.

63 Unlike the general Roman partnership (the *societas*, discussed above), the *societas publicanorum* survived the death of any partner except the *manceps*, in whose name the firm’s contract with the state was likely held. When a partner other than the *manceps* died, the deceased partner’s heir stepped into the partner’s financial rights and obligations — though the heir became a full member of the firm only if there had been prior agreement to that effect. Id. at 243-47; DUFF, *supra* note 32, at 160; CROOK, *supra* note 33, at 234. (These authors discuss such limitations on the rights of heirs only in the context of partnerships formed for tax farming, though their nature suggests that they applied to the *societates publicanorum* in general.) This protection from liquidation by heirs suggests strongly that Roman law accorded these firms strong entity shielding. Further evidence indicating entity shielding is that the *societas publicanorum* appear to have been able to receive a form of legal personality that permitted the firm to own property and transact in its own name — though the privilege may have been used only by the larger firms. BADIAN, *supra* note 59, at 69. Malmendier, *supra* note 61, argues that the *societas publicanorum* enjoyed full legal entity status by the 1st century BC (although not before). Malmendier at 252-55.

64 Malmendier, *supra* note 61, at 249-51.
Starting in the fifteenth century, Genoa sold shares in companies formed to exploit its overseas colonies and other public monopolies, which included firms that collected taxes, managed state debt, operated the state's salt mines, and imported coral and mercury. Shares in such firms were tradable, though evidently an owner could not sell his share without the permission of the other shareholders. And shareholders appear to have enjoyed a formal rule of limited liability, although it is not clear whether a bankruptcy ever put this rule to the test. Finally, these firms likely featured strong entity shielding. One indication of this is that owners were unable to withdraw their investments. Another is that shareholders were exempt from the compagnia rule that partners could not invest in other partnerships, which suggests strongly a rule of liquidation protection not only against them but also against their personal creditors.

These Genoese monopolies were the forebears of the great joint-stock companies of the Age of Exploration. In the sixteenth and seventeenth centuries, trade opportunities between Europe and other continents created an unprecedented need for deep-water ships and overseas outposts, and thus for capital agglomeration. Countries such as Portugal and Spain responded by organizing and funding overseas trade through the state. Other countries, however, followed the Genoese example of combining private enterprise with state-granted monopoly privileges, in this case the monopoly being an exclusive right to trade in a particular region of the world. Between 1550 and 1650 the English created several such firms, of which the British East India Company, formed in 1600, was the most prominent. Initially this company floated a separate joint stock for each of its fleet's voyages, as in the commenda. But the British eventually followed the example of the Dutch, whose own East India Company decided soon after its founding to void the withdrawal right of its shareholders and thereby to adopt a permanent stock. While the rights of creditors of shareholders in these companies is unclear, we can presume that such creditors generally had no greater rights in firm assets than did the

65 MITCHELL, supra note 35, at 138-9; CIZAKCA, supra note 53, at 29-30.  
66 Id. at 31.  
67 Id.  
68 Id. at 31.  
72 CIZAKCA, supra note 53, at 46.
shareholders themselves, and thus that the firms were strong entities in our parlance.\textsuperscript{73}

Owner shielding also was available to these exploration and trade companies. Their charters usually specified whether shareholders could be called to make additional capital contributions,\textsuperscript{74} and companies used this opportunity to create full limited liability or to restrict shareholder liability to certain types of debt.\textsuperscript{75} The system thereby allowed companies to vary the degree of owner liability to suit their business requirements.

It is natural to explain the emergence of these strong business entities in terms of the large amounts of capital that were needed to finance the activities involved. Strong entities, as we have indicated, solve problems associated with joint ownership and thus are suited for amassing capital. But the near ubiquity of state-granted monopolies in these firms suggests something important with respect to the costs of entity shielding as well. For one thing, the scale of enterprise that results from monopoly status would have made a robust market for their shares more likely, and thus increased the attractiveness of share transferability relative to withdrawal as a source of liquidity. Also, the fact that each of these firms enjoyed a state-granted monopoly would have reduced shareholder exposure to expropriation by control persons. The monopoly was a unity and likely would have been exploitable only by the firm to which it had been granted by the state. While the fruits of the monopoly might be diverted from time to time, the monopoly itself could not be drained out surreptitiously in small portions, nor could its ownership become confused. Shareholders could thus afford to surrender their withdrawal rights without exposing themselves to excessive risk that agents and other owners would expropriate the value of their investments.

V. THE RISE OF THE COMMERCIAL ENTITY: EARLY MODERN ENGLAND

The upshot of the success of the British and Dutch proto-joint-stock companies was that, by the early 17\textsuperscript{th} century, commercial firms had been

\textsuperscript{73} In addition to the strong economic logic involved, several other considerations suggest that courts would not have allowed a personal creditor of a shareholder to force a liquidation of a joint stock company, much less a claim in entity assets equal in priority to that of entity creditors. For one thing, courts consistently referred to chartered joint stock companies as “incorporated,” a term that in other contexts implied both perpetual existence and the notion that the entity, rather than its members, owned the joint property. 3 HOLDSWORTH, \textit{supra} note 71, at 488. Moreover, the recognition of weak entity shielding for English partnerships by the late seventeenth century, described in the following Section, clearly implies that the same priority rule would apply to chartered joint stock companies.

\textsuperscript{74} Williston, \textit{supra} note 71, at 160; 8 HOLDSWORTH, \textit{supra} note 171, at 204.

\textsuperscript{75} 8 HOLDSWORTH, \textit{supra} note 71, at 205.
established with all of the elements of the modern business corporation: strong entity shielding, limited liability, centralized management, and tradable shares. But the proliferation of such firms was slow, with only 10 charters granted in England in the half century between 1630 and 1680, and the pace of chartering only gradually picking up thereafter. Indeed, it would be more than 150 years before British firms in general were free to form as chartered joint-stock companies. Part of the explanation for this slow pace lies in interest group politics, with existing firms seeking protection against well-financed upstarts. But some of Parliament’s conservatism was clearly designed to protect creditors and small investors from the costs that strong entities can engender. Charters still were often paired with monopoly licenses, and were awarded to firms that invested in large fixed assets, such as canals, which like a monopoly license could not easily be dissipated or diverted at the expense of firm creditors and investors. Meanwhile, in manufacturing, the sector most strongly associated with the Industrial Revolution, applications for corporate charters were frequently rejected.

Parliament’s grudging policy on issuing charters forced British merchants to seek other entity types suited to the financing requirements of the Industrial Revolution. By the end of the 17th century, two such commercial entities could be found. 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. These forms represented England’s, and likely Europe’s, first general-purpose commercial entities.

A. The Transformation of the Partnership

English partnerships, like the earlier Italian partnerships on which they were modeled, possessed neither entity shielding nor owner shielding before the late 17th century. In 1683, however, the case of Craven v. Knight effected a fundamental break with prior law.

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76 Id.
78 Id. Where charters were given to manufacturing, service, or financial firms, those firms were often, in effect if not in name, mutual companies or cooperatives owned principally or exclusively by the firm’s suppliers or customers. Since these also would have been the firm’s principal creditors (or debtors), the chances were minimized that the firm would exploit its creditors (or vice versa). See, e.g., HENRY HANSMANN, THE OWNERSHIP OF ENTERPRISE CHS. 13, 14 (1996) (on the historical development and role of mutual insurance and banking companies).
79 ROWLEY, supra note 7, at 7-8. One consequence of this influence was that the Italian rule of joint and several liability for partners supplanted the earlier English rule of pro rata liability, which had origins in both local custom and Roman law. 1 HOLDSWORTH, supra note 71, at 97.
80 21 Eng. Rep. 664 (Ch. 1682-83).
In *Craven*, a case involving claims against the assets of a bankrupt partnership, a bankruptcy commission in Chancery ruled that partnership assets were to be applied first to the claims of the partnership creditors; only the excess that remained, if any, would go over to the partners’ individual estates for payment of their personal creditors. It is apparently the first case on record in which a court utilized the distinction between partners’ joint assets and their personal assets to establish a rule of priority for partnership creditors, endowing the partnership with weak entity shielding. The result of this ruling, which was reinforced by later cases to the same effect, was that English law for the first time offered a general-purpose legal entity that could be freely adopted for any type of multi-owner business activity.

A generation later, the 1715 bankruptcy case of *Ex parte Crowder* added a rule of weak owner shielding to *Craven’s* rule of weak entity shielding. Specifically, the *Crowder* court held that the claims of a partner’s personal creditors would enjoy first priority to the partner’s personal assets, and that only those personal assets that remained after the personal creditors had been paid in full would be available to the creditors of the partnership. Together, these cases established the rules of asset partitioning that continue to govern English partnerships today, and that together came to be labeled the “jingle rule,” evidently because their symmetry suggested harmony.

The entity shielding established by *Craven* is taken for granted today, and the case itself is all but forgotten. But the change in the law was conspicuous to contemporaries. Early treatises on partnership law make much of *Craven* and the subsequent decisions that reaffirmed its rule of entity shielding. These treatises do not, however, provide a clear explanation for the results in *Craven* and *Crowder*, and neither do the recorded decisions in those cases. What, then, accounts for this innovation?

An explanation relating to the capacity for entity shielding to facilitate capital pooling is suggested by the rapid increase in commercial activity in England during the seventeenth and eighteenth centuries. Yet, as we have seen, robust commercial activity in late medieval Italy also made acute the problems associated with multi-owner entities, but did not result in a rule of entity shielding. And the industrial revolution, when the need to assemble large

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82 Equity Cases Abridged 56, 21 ER 870 (Ch. 1715).

83 This case, like *Craven*, involved a petition by personal creditors of partners to be “let in for their debts” to the division of a partnership estate. *Crowder*, supra note 82.

amounts of capital would reach an unprecedented level, was still half a century in the future. These observations strongly suggest that other factors were at play as well. In particular, we believe that two important developments of the time significantly increased the value of a general-purpose commercial entity with entity shielding: increasingly sophisticated accounting practices, and fundamental improvements in bankruptcy law and procedure.

Partitioning assets into distinct pools, and pledging the different pools to distinct groups of creditors, is of only modest advantage if one cannot determine with any clarity the aggregate value of the assets in the pools. For this reason, the revolution in bookkeeping methods that began in the High Middle Ages was likely an important precursor to endowing business firms with entity status. Along these lines, paper became available in Italy for the first time in the thirteenth century, and in the late fourteenth century Hindu-Arabic numerals, which vastly simplified arithmetic operations, began to displace Roman numerals in bookkeeping. Double-entry accounting, which provided the first workable method for tracking the net worth of a firm, also appeared in the 14th century and evolved and spread thereafter. 85 These innovations enabled owners and creditors of a firm to assess more clearly the value of firm assets, and to distinguish permissible and impermissible distributions. The effect was to increase the reliability of a firm's own assets, as opposed to the assets of its owners, as the principal bond for the firm's obligations.

The most important innovation, however, probably lay in the development of English bankruptcy law during the 16th and 17th centuries. Before the 16th century, England had essentially a "first to file" system, under which defaulting debtors were held to account by individual creditors in actions that could be brought in any of a variety of courts, depending on the nature of the debt. 86 A 1542 statute, however, created the basic elements of a bankruptcy system by providing for a general accounting of a debtor's aggregate obligations and for pro rata payment of his creditors out of his assets. 87

That statute had little effect, however, until 1570, when a subsequent Parliamentary act consolidated bankruptcy jurisdiction in the Chancery and gave the Lord Chancellor the power to appoint a commission, drawn from among a


87 An Act Against Such Persons as Do Make Bankrupt, 1542, 34 & 35 Hen 8., c. 4 (Eng.).
debtor’s creditors, to oversee the debtor’s bankruptcy proceeding. The commissions, in turn, were empowered to assess the aggregate value of the debtor’s estate, determine the validity and value of creditor claims, and apportion the debtor’s assets. The powers of the commissions were further extended by statutes enacted in 1604 and 1623, which enhanced the power of commissions to compel testimony of witnesses and to avoid pre-insolvency conveyances.

By the latter part of the 17th century, the simultaneous bankruptcy of a partnership and its partners was managed by appointing separate commissions for the individual partners and a joint commission for the partnership. Creditors were required to choose a single commission — either separate or joint — before which to press their claims. The priority rules of Craven and Crowder were adopted in this setting, where they would have been relatively easy to administer. Indeed, as we indicated previously, a pro rata bankruptcy system is essentially a prerequisite to an effective rule of entity shielding (or, for that matter, weak owner shielding). Put another way, the rules of Craven and Crowder would have been nearly impossible to administer a century earlier, when England lacked bankruptcy commissions capable of aggregating and distinguishing assets and claims.

Moreover, once a system of bankruptcy administration was established, the priority rules of Craven and Crowder would have greatly simplified its operations. Before Craven, a court administering the bankruptcy of a partnership would have had to collect all of the assets of the firm and of all of its individual partners, and to value the claims of all partnership creditors and of the other creditors of the individual partners, before any creditor could be paid. Under Craven’s rule of entity shielding, by contrast, a court needed only to gain control over the partnership assets, and assess the claims of only the partnership creditors, before it began paying those assets out. An added advantage was that the partnership assets, in contrast with the personal assets of the firm’s various partners, would likely have been co-located at the partnership’s places of

88 An Act Touching Orders for Bankrupts, 1570, 13 Eliz., c. 7, (Eng.).
89 An Act for the Better Relief of the Creditors Against Such as Shall Become Bankrupts, 1604, 1 Jam. I, c. 15 (Eng.).
90 An Act for the Further Description of a Bankrupt, and Relief of Creditors, Against Such as Shall Become Bankrupts, and for Inflicting Corporeal Punishment upon the Bankrupts in some Special Cases 1623, 21 Jam. I, c.19 (Eng.).
91 See, 2 Christian, at 27-30, (noting compulsory appearance rules for witnesses, provided costs to appear were paid, in the 1604 Statute); id., at 43, n. 3 & 4. (providing for the commissioner’s power to break down doors of homes to gather information on the estate, a power not otherwise available in civil actions).
92 Archibald Cullen, Principles of the Bankrupt Law, 450-60 (1800).
business, and thus relatively easy to collect. Crowder’s additional rule of weak owner shielding offered the same benefits in mirror image, enabling a court to begin paying claims to any individual partner’s personal creditors as soon as that partner’s personal assets had been located and assessed.

While the initial motivation for weak entity shielding and owner shielding in the partnership was likely to reduce the costs of bankruptcy proceedings, those rules of asset partitioning appear to have paid broader benefits over time. Entity status for the partnership evidently made it much better suited to serve as an effective means of organizing enterprise in the rapidly expanding economy of the 18th and 19th centuries. In fact, this development seems important in explaining why the modern partnership 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 20th century. Moreover, as we argue below, the rules of asset partitioning adopted for the partnership at the end of the 17th century helped lay the legal foundations for another important form, the unincorporated joint stock company.

If the development of English bankruptcy law is the best explanation for the emergence of the partnership as a distinct entity, this in turn leads us to ask why the relevant developments in bankruptcy law took place in England in the late 16th and 17th centuries rather than, say, in the vibrant commercial economy of medieval and Renaissance Italy. One explanation may lie in the evolution of accounting techniques that we have already mentioned. A more important explanation, however, may be that, as we indicated in the previous section, medieval courts likely lacked the ability to enforce judgments over large areas, inviting debtors to avoid creditors by conveying assets out of the jurisdiction. A creditor’s legal right to levy upon firm assets ahead of personal creditors would have added little value in that setting, and the delay occasioned by a bankruptcy proceeding might simply have provided greater opportunity to abscond with assets. Britain, in contrast, had the advantage of a large and unified realm, isolated from the rest of Europe, over which centralized bankruptcy courts could exercise full jurisdiction.

Before turning to the special entity forms that gave rise to the corporation, we mention here a few points regarding the “term partnership.” So far, we have described the form of entity shielding in the English partnership as “weak.” This is because the default form for an English partnership was the partnership at will, in which any partner had the right at any time to leave the partnership and withdraw his share of the firm’s net assets. But English law, like partnership law elsewhere, also permitted the formation of term partnerships, in which partners would agree not to dissolve the partnership for a specified term of years — or even, in theory, indefinitely.

There are different degrees to which a term partnership agreement could be enforced against an individual partner who wished to withdraw before the expiration of the agreed term. At least by the late 19th century, English partnership law had settled on a very strict rule of enforcement, whereby a partner could neither withdraw early any portion of the firm’s net assets nor renounce liability for future obligations of the firm. Only where the partnership was no longer viable and the withdrawing partner was not acting opportunistically would courts order dissolution. In short, the English partnership evolved to offer liquidation protection against owners.

English law also seems to have provided term partnerships with a significant degree of liquidation protection against the partners’ personal creditors. The default rule seems to have been that the bankruptcy of a partner dissolved even a term partnership, which in turn empowered the trustee in bankruptcy to force liquidation of the partnership assets. But it also seems that courts probably would have sustained a provision in a partnership agreement specifying that a bankrupt partner’s share was to be paid out at the pace at which it would have been released through normal disbursements of partnership income. Indeed, this was the solution later reached by U.S. partnership law, as described below. It thus seems that English partners had the option of endowing term partnerships with a substantial degree of liquidation protection, making such partnerships strong entities at least for the duration of their specified terms. Unfortunately, few courts appear to have ruled on the issue, and the lack of clear authority would have made such liquidation protection against personal creditors seem less dependable to commercial actors than the liquidation protection offered by the corporation.

Such a strengthening of the partnership as an entity would have been a reasonable response both to the increasing demand in the new industrial age for

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94 Partners could collectively choose to dissolve a term partnership early without legal sanction.

95 Other less severe options would be (1) to allow the partner to withdraw his share of net assets subject to a payment of money damages to the other partners for breach of the partnership agreement, or (2) to allow the partner to renounce liability for future firm debts but not to claim his share of the firm assets until the expiration of the agreed term. In contrast with English law, U.S. partnership law of that period took an ambiguous position between these less severe options. See Section VI, infra.

96 For the pre-1890 common law rule, see NATHANIEL LINDLEY, A TREATISE ON THE LAW OF PARTNERSHIP 647-64 (1888). This rule was codified by the Partnership Act 1890 section 32 (which continues in force), as interpreted. Moss v. Elphick, 1 K.B. 846 (1910). See ERNEST SCAMELL & R. C. I’ANSON BANKS, LINDLEY ON PARTNERSHIPS 689 (1984); Demott at 884-85.

97 Section 33 of the Partnership Act 1890 provided that this would dissolve even a term partnership, unless the partnership agreement expressly provided that the partnership continued despite the bankruptcy of a partner. This was the position prior to the 1890 Act as well. LINDLEY, supra note 96, at 653-655, 661-662; Fox v. Hanbury. Given dissolution, both the trustee of the bankrupt partner and the solvent partners would have had a right to demand that the affairs of the partnership be wound up.
entity forms capable of protecting firm-specific assets, and to greater sophistication among merchants and courts in evaluating equity investments. We develop these issues more fully in Section VI, where we discuss the American versions of the general and term partnerships.

B. The Unincorporated Joint Stock Company

Besides the partnership, the other important legal entity to emerge in England during the 17th and 18th centuries was an improvised form, usually called the “unincorporated joint stock company,” that was designed to mimic the chartered companies of the time. In particular, those who created unincorporated joint stock companies attempted to achieve tradability of shares, a valued attribute of charted companies, by superimposing the trust form onto the partnership. The result was something similar to a partnership, but with firm assets held in trust for the partners by several trustees that the partners themselves selected. The resulting business form would also likely have enjoyed a significant degree of strong entity shielding, which would have greatly reduced the costs of making shares transferable.

The conventional explanation for the presence of the trust in the unincorporated joint stock company is that it enabled those firms to initiate and answer to lawsuits. The trust was indeed useful in this regard, as it allowed the firm to sue and be sued in the names of the trustees. The simple partnership, by contrast, could litigate only in the names of all of its current partners, which was a major handicap if shares were to be tradable and thus the list of partners would be in constant flux.

But a potentially more important function of the trust in the unincorporated companies was that it provided strong entity shielding, an important complement to tradable shares. Although in medieval times it was used solely for the passive holding of title to real estate, the trust by the mid-seventeenth century had come to be used for the active management of family property, including both chattels and land, on behalf of beneficiaries such as minors and incompetents. Soon thereafter it became settled doctrine that, though a trustee held trust assets in his own name, he was in effect a separate person for this purpose. In particular, the trustee’s personal assets were partitioned from those he held in trust: the trustee’s personal creditors could satisfy their claims out of the trustee’s personal assets, but not out of the trust assets. By the seventeenth century English trust law also seems to have arrived at the modern rule that, in a trust with more than one beneficiary, neither an individual beneficiary nor his creditors could force the liquidation of the beneficiary’s share of trust assets. The creditors instead could seize only the right to the periodic distributions of income that otherwise would have gone to the beneficiary. In short, the trust by the late seventeenth century offered liquidation protection, causing it to catch the eye of businessmen looking
for a way to convert their partnerships into strong entities. Not coincidentally, the unincorporated joint stock companies appeared in the 1680s, and grew rapidly in their numbers after that. Strong entity shielding was not, however, accompanied by limited liability. By dint of the Crowder decision, unincorporated joint stock companies would have enjoyed weak owner shielding beginning in 1715 due to their use of the partnership form. But the addition of the common law trust presumably did not raise the level of owner shielding to full limited liability with any degree of certainty, as indeed it would not today. Consequently, many unincorporated joint stock companies sought to obtain limited liability by contractual means, such as through provisions in firm contracts and in the personal contracts of partners, by specifying limited liability in the partnership agreement and on firm letterhead, and by including the word “limited” in the firm’s name. It was not until well into the nineteenth century, however, that courts established definitively that this strategy was effective, leaving limited liability in the unincorporated joint stock company in doubt throughout most of the period when the entity was important.

Given that the tradability of shares was the primary benefit of the unincorporated joint stock company relative to the partnership, it is interesting that the degree of limited liability that the firms enjoyed was in doubt. The attempts by partners to achieve limited liability suggest that the trait would have been useful to them, probably for multiple reasons. But the tradability of shares despite the mixed success at achieving limited liability suggests that limited liability is not, in fact, necessary to making shares transferable.

By contrast, the functional complementarities between strong entity shielding and tradable shares are very high, as we have indicated previously. Strong entity shielding provides a foundation for tradability by reducing the degree to which owners must be policed for patterns of excessive personal borrowing that might undermine the firm’s going-concern value. And tradability,

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98 The precise legal theory on which the unincorporated joint stock companies were based was never well established during the nearly two centuries that they flourished. A reason for this is that the deeds of settlement under which they were formed commonly called for disputes among their members, and between their members and their trustees, to be submitted to arbitration, and courts were willing to enforce these arbitration provisions.


100 At the same time, at least the larger unincorporated joint stock companies evidently enjoyed a substantial degree of de facto limited liability. 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. Gower at 32. 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 (called “skags”), or by neglecting to sign the company’s deed of settlement. See id.
in turn, is a source of liquidity and thus a substitute for the withdrawal right, which strong entity shielding eliminates. Thus, the trait of the unincorporated joint stock company that was perhaps most important to the tradability of its shares was likely not limited liability, but rather the strong entity shielding the firm enjoyed as a result of its appropriation of the trust.

Developments in financial markets at the time would have promoted share tradability and thus reinforced the strong entity shielding in the unincorporated companies. By the last decade of the 17th century, a trading market (and legal culture) had developed to facilitate the exchange of shares of chartered companies, and the resulting infrastructure would also have supported the distribution and trading of the shares of the companies that lacked charters. Important steps in this regard were the reorganization of the East India Company on a permanent-stock basis in the mid 17th century, and the formation of the Bank of England in 1694. In particular, the Bank of England undertook to finance the rapidly expanding national debt with capital raised from broadly dispersed shareholdings, and was joined in this role by the East India Company in 1698.101 In 1713, the recently chartered South Sea Company, having abandoned the South Seas trade, also sought to refinance a large share of the national debt through the issuance of shares. The success of these share-marketing schemes prompted the formation of large numbers of unincorporated joint companies in two waves — one that peaked in the late 1690s,102 and a second that culminated in 1719-20 when, following a huge stock promotion by the South Sea Company, hundreds of unincorporated companies made their first offerings of stock.103

To be sure, only the largest chartered companies, and evidently very few of the unchartered variety, were actively traded in a secondary market during the 18th century. The depth of the market for the shares of a typical 18th-century canal company or brewery cannot compare to the liquidity enjoyed by most firms traded on stock exchanges today. But liquidity is a relative thing, and the benchmark here was the partnership interest, which was wholly personal and almost entirely illiquid. After 1700, a share of stock in a solvent company could almost always be sold at a discount, either to the company itself or to a fellow shareholder.

A famous effort to suppress the unincorporated joint stock companies took place in 1720 with the passage of the South Sea Company Act (the "Bubble Act"). That statute forbade unchartered companies from selling shares, and chartered companies from selling their charters or engaging in lines of business

101 The resulting large offerings of stock, backed by claims on the national government rendered newly secure after the Glorious Revolution of 1688, made markets for the shares in these firms sufficiently liquid to permit, from 1698 on, daily publication of prices.

102 And was soon followed by the disappearance of many of the 150 or so companies that had just formed. See HARRIS, supra note 77, at 57.

103 Id. at 61-63.
not explicitly authorized. While the Act remained on the books until 1825, there was only a single effort to enforce it — in 1726 — during the entire 18th century. The consequence was that, though their formal legal status remained murky, the unincorporated joint stock companies continued to flourish, to the point where there were more than one thousand operating in England at the beginning of the 19th century, some with thousands of shareholder-partners. The success of these firms called into question many of the arguments for the formal restrictions on their numbers, and thereby set the stage for the sanctioning by Parliament of the modern corporate form.

C. General Incorporation Acts in the UK

Pressure for company formation eventually led Parliament in 1844 to adopt a general business corporation statute, which for the first time permitted incorporation as of right. At the same time, the statute sought to eliminate unincorporated joint stock companies by requiring all partnerships with more than twenty-five members or with transferable shares to register and to follow uniform disclosure rules.

The 1844 statute did not explicitly provide for entity shielding, apparently because by that point the link between that attribute and the company form was thought to be self-evident. This is suggested by the fact that entity shielding is made explicit in an 1837 statute that empowered the Crown to grant to unincorporated companies, by letters of patent, any of the privileges normally conferred in a charter of incorporation, including in particular the right to sue and be sued in the name of designated company officers. The reason for the explicit provision of entity shielding in the 1837 statute was evidently to make clear that, though the companies affected by the act were not fully incorporated, this was not to be interpreted as negating the asset partitioning created by the company form.

Indeed, the 1844 statute reinforced entity shielding by imposing strong legal capital rules to keep the firm’s assets from being drained to the detriment of creditors: a company’s paid-in capital could not be used for redemption of

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<td>104 Id.</td>
<td>60-81</td>
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<td>105 Hunt, supra note 93</td>
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<td>106 Id.</td>
<td>94-98</td>
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<td>107 Section 25 of the Act</td>
<td>provides as follows: “And be it enacted, That the bankruptcy,</td>
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<td>insololvency, 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, insololvency, 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, insololvency, or stopping payment, be liable to execution or diligence in the same manner as if such bankruptcy, insololvency, or stopping payment had not taken place.”</td>
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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. Such legal capital rules also would have facilitated limited liability, which the 1844 statute did not in fact permit. Only in 1855 was the statute amended to enable joint stock companies to adopt limited liability, and even then it was optional.108

Even after provision for general incorporation as of right, the partnership remained the dominant form for enterprise in the second half of the 19th century. Only during the 20th 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 catalyzed it, are most easily seen in the United States.

VI. THE MODERN PERIOD IN THE UNITED STATES: THE ASCENDANCE OF STRONG ENTITIES

Notwithstanding the development of both weak and strong entity forms for business firms by the mid-nineteenth century, the choices then 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 strong entity or owner shielding, 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 precluded its use by all but a few large, capital-intensive enterprises.

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 period between 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-form entity on the Crowder model, the American partnership by the end of the twentieth century had developed to the point where owners could opt both for liquidation protection over a defined period and for

108 ANDREW BISSET, A PRACTICAL TREATISE ON THE LAW OF PARTNERSHIP INCLUDING THE LAW RELATING TO RAIL AND OTHER JOINT STOCK COMPANIES 133 (1847).
limited liability. 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 offering strong forms of both entity and owner shielding reflects developments, such as superior accounting and valuation techniques and greater commercial sophistication among courts, that protected owners and creditors alike.

By the early nineteenth century, most American states had followed England in adopting the jingle rule for the division of partnership assets. Pursuant to this regime, courts initially held that 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. 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.

Courts were aware, however, that forced liquidation could entail significant destruction of going-concern value, and thus by the mid-nineteenth century began seeking alternative devices for accommodating the claims of personal creditors. Many courts abandoned the practice of automatically appointing a receiver whenever a partner fell into financial distress, permitting instead the remaining partners a period of time to wind up the business and fulfill prior commitments. A personal creditor’s primary form of redress became sale of the partner’s interest; forcing the partner ship to reduce that interest to cash required the additional and sometimes lengthy step of a suit for an accounting. State legislatures, in turn, empowered courts with equitable devices, such as garnishment and constructive seizure, to substitute for liquidation. 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

109 Puruant to this regime, courts initially held that 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. 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.
110 See *Randall v. Morrell*, 17 N.J. Eq. 343 (N.J. Ch. 1866).
111 See *Renton*, 9 N.J. Eq. at 62.
112 See, e.g., *Marquand*, 17 Johns at 525; *Renton*, 9 N.J. Eq. at 62.
113 See *Renton*, 9 N.J. Eq. at 62.
114 *Deal v. Bogue*, 20 Pa. 228 (1853).
unpaid claim was satisfied.\textsuperscript{116} 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.\textsuperscript{117} 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.\textsuperscript{118} Some courts were reluctant to allow foreclosure even upon a partnership at will unless the remaining partners consented or the court determined that a forced sale would not “unduly interfere with the partnership business.”\textsuperscript{119}

While the UPA did provide for dissolution of the partnership upon the formal bankruptcy of a partner,\textsuperscript{120} this seems to have been intended more to protect the remaining partners and the partnership creditors than to make assets available to personal creditors. The 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.\textsuperscript{121} Some bankruptcy courts were reluctant to grant such petitions, however, emphasizing that typically a trustee could instead convert the partner’s interest to cash by selling it.\textsuperscript{122} And when a partner underwent Chapter 11 reorganization rather than Chapter 7 liquidation, most

\begin{itemize}
\item \textsuperscript{116} J. Dennis Hynes, \textit{The Charging Order: Conflicts Between Partners and Creditors}, 25 PAC. L.J. 1 (1993).
\item \textsuperscript{117} Id.
\item \textsuperscript{118} Harold G. Rueschlein & William A. Gregory, \textit{The Law of Agency and Partnership} 516, 526 (2d ed. 1990); Unif. Partnership Act § 32(2)(a).
\item \textsuperscript{120} Unif. Partnership Act § 31(5).
\item \textsuperscript{121} Unif. Partnership Act § 37.
\item \textsuperscript{122} Cutler v. Cutler, 165 B.R. 275, 280-81 (Bankr. D. Ariz. 1994); see also In re Shearin, 224 F.3d 346, 350 fn. 6 (4th Cir. 2000) (noting that reducing a partnership interest to cash by sale or liquidation is a “problematic proposition due to the other partners’ interests”); Manning v. Nuthatch Hill Assoc., 831 F.2d 205, 210 n.5 (10th Cir. 1987) (raising the question whether the Bankruptcy Code preempts UPA’s provision that bankruptcy of a partner dissolves the partnership); but see Moody v. Seaside Lanes, 825 F.2d 81, 84 (5th Cir. 1987) (reviewing 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 Mattoon, 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).
\end{itemize}
courts held that the UPA’s automatic-dissolution provision conflicted with the purposes of the federal bankruptcy code and thus was unenforceable.\textsuperscript{123}

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.\textsuperscript{124} Accordingly, the UPA provided for full liquidation in most instances when a partner left a firm.\textsuperscript{125} 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.\textsuperscript{126} Courts initially endorsed such alternatives only when the partnership lacked outstanding debt,\textsuperscript{127} but in the late twentieth century even this qualification was relaxed.\textsuperscript{128} 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.\textsuperscript{129}

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. Under the UPA, a partner who withdrew before the expiration of a partnership for a term had the right to an immediate cash payout; the other partners’ only remedies were to deduct damages and to petition a court for permission to issue a bond instead of cash.\textsuperscript{130} RUPA, by contrast, shifts the burden to the partner who dissociates


\textsuperscript{125} UNIF. PARTNERSHIP ACT § 38(1); Driefurst v. Driefurst, 280 N.W.2d 335, 337 (Wis. Ct. App. 1979).

\textsuperscript{126} For an early example, see Dow v. Beals, 268 N.Y.S.2d 425, 427 (N.Y. Sup. Ct. 1933).


\textsuperscript{129} REV. UNIF. PARTNERSHIP ACT § 8.701.

\textsuperscript{130} UNIF. PARTNERSHIP ACT § 38(2).
“wrongfully” — i.e., 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. RUPA also states that dissociation because of a partner’s personal bankruptcy is wrongful, and thus unlike UPA 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.

Besides enhancing the power of partners to select stronger degrees of entity shielding, American law in the late twentieth century also provided a new option respecting 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. LLP statutes otherwise largely incorporate RUPA, including its provisions respecting liquidation protection. 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 trade-off: it inhibited opportunism toward firm creditors by making partners personally liable for firm debts, while also facilitating 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 it 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 wised to maximize firm creditworthiness by pledging their personal assets in full to firm creditors. By enacting the LLP statutes, the states then provided owners the further option of combining full limited liability with the other attributes of a partnership.

American partnership law thus now offers strong entity shielding for a defined term and super-strong owner shielding. These attributes come a la carte: partners in structuring their firm may opt for either, neither, or both. And even if partners do not opt for liquidation protection among themselves, the law

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131 REV. UNIF. PARTNERSHIP ACT § 8.701(h).

132 REV. UNIF. PARTNERSHIP ACT § 8.602(b)(2)(iii).

133 ALAN R. BROMBERG & LARRY E. RIBSTEIN, LIMITED LIABILITY PARTNERSHIPS, THE REVISED UNIFORM PARTNERSHIP ACT, AND THE UNIFORM LIMITED PARTNERSHIP ACT (2001) 15 (Aspen 2003). 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 199.

134 Id. at 15, 663. 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.
by use of the charging order and other innovations affords a high degree of liquidation protection against their personal creditors. In this way, American law treats liquidation protection against creditors not as a mere backstop to liquidation protection among owners, but as a valuable attribute in its own right for protecting the going-concern value of a business.

Several factors appear to explain this strengthening of the American partnership over the last two centuries. One theme running through the history is increased confidence in, and thus reliance upon, sophisticated accounting techniques and other methods for valuating 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” and were thus, by dint of their omission of going-concern value, poor alternatives to a liquidation sale. By contrast, RUPA’s buyout provision explicitly requires consideration of going-concern value, thus authorizing a potentially more accurate approach. Better valuation methods would 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 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. Courts equipped with superior valuation techniques will 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 co-partners. The availability of such judicial review would, in turn, make partners more willing to forgo the right of unilateral withdrawal as a means for policing exploitative conduct. The upshot is that better valuation techniques, combined with the power of courts to order liquidation for cause, reduce the costs of strong-form entity shielding among owners. Increased self-confidence among American courts in their ability to value partnership interests and arbitrate internal firm disputes also explains 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 both strong entity shielding and perpetual existence. 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 asset partitioning 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 only 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 only to the same kinds of firms that Parliament typically allowed to incorporate: those that built and ran canals, bridges, and turnpikes. But American states generally were less sparing 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.

These statutes imposed restrictions on the corporate form that were designed to compensate for the loss of the withdrawal right. Firms were not permitted to restrict alienation of their shares, thereby guaranteeing shareholders an alternative source of liquidity. And prohibitions on allocating control and income separately from shareholdings (such as statutory provisions forbidding firms from issuing more than one class of common stock), and on one corporation’s owning the shares of another, sought to impede blocs of shareholders from seizing or abusing control to the disadvantage of noncontrolling shareholders.

138 E. MERRICK DODD, AMERICAN BUSINESS CORPORATIONS TO 1860, WITH SPECIAL REFERENCE TO MASSACHUSETTS 11 (1954); S. J. DAVIS, ESSAYS IN THE EARLIER HISTORY OF AMERICAN CORPORATIONS (1917).

139 DODD, supra note 138, at 64. Massachusetts in 1809 had enacted a statute that facilitated incorporation by textile mills. Blair, supra note 12, at 419 n. 108.
While these restrictions may have helped firms in capital-intensive industries 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 need 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 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, few small firms incorporated during the nineteenth century, leaving the partnership as the dominant commercial entity of the period.

Another company-like entity — the limited partnership — was available in most states in the nineteenth century. Like the corporation, and also like 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 daily operations. 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 pre-modern proto-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. 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 increase in the rate of incorporation by small and closely-held firms. This trend was accompanied by the easing of formal rigidities, such as those regarding the structure of earning and control rights. The transformation continued in the twentieth century, by the middle of which a closely held business corporation could be structured with great freedom.

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140 New York again came first, enacting a limited partnership statute in 1822. Most other states enacted similar statutes over the next 30 years. UNIF. LIMITED PARTNERSHIP ACT (1916) § 1, off. cmt.

141 UNIF. LIMITED PARTNERSHIP ACT § 16.
In 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 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.\(^\text{142}\)

The LLC in its current form in fact imposes even fewer formalities on a business firm than the corporate form does.\(^\text{143}\) 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, the business trust leaves owners free to specify all other matters of organizational design, including control rights, allocation of earnings, and even fiduciary duties. In fact, the Delaware business trust statute does not even offer default terms for most of these basic structural elements. In effect, the business trust embodies the minimum required of law in creating a strong entity — i.e., asset partitioning, and in particular strong entity shielding — and leaves the rest to be determined by contract. 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, reflected 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 access to better information about firms, superior accounting and valuation methods, and greater sophistication among courts in arbitrating internal firm disputes. Access to 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 governmental 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

\(^{142}\) The LLC, for example, allows a firm to adopt strong entity shielding in perpetuity. *See Bromberg & Ribstein, supra* note 133, at 40.

\(^{143}\) Id. at 34.
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 non-controlling shareholders.\footnote{For example, while the traditional rule was that all transactions by corporate directors and officers were automatically voidable, courts in the late nineteenth century became increasingly willing to investigate the merits of such transactions before ruling on their validity. By the turn of the century, such investigations included comparisons of the amounts of payments made by corporations to market prices. See Lamoreaux & Rosenthal, \textit{supra} note 12, at 23-27.} In particular, the twentieth century saw an expansion of judicial and legislative devices for protecting equity investors, such as the recognition of fiduciary duties flowing from majority to minority owners, and mandatory buyout (with shares valued by accounting rather than liquidation sale) when a substantial minority of shareholders objects to a corporate transaction.

In general, the various factors that increased protection for non-controlling shareholders — especially better information and valuation techniques — redounded to the benefit of both noncontrolling owners and firm creditors. 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 \textit{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 their virtually unrestricted freedom 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: namely, the costs that profligate entity shielding can impose on the personal creditors of an entity’s owners. These costs, and the ways in which courts and legislatures respond to them, will likely shape the next chapter in the evolution of legal entities.

\textbf{VII. CONCLUSION: THE UNRESOLVED PROBLEMS OF ENTITY SHIELDING}

Entity shielding subordinates the claims of an individual’s personal creditors to those of entity creditors with respect to assets assigned to the entity. It does this without obtaining the consent of the personal creditors or even, indeed, by giving them explicit notice. This is what makes entity shielding 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. It is also why entity shielding requires law.
While subordination of claims without notice avoids the hazards of contracting, it also invites opportunism toward personal creditors. In this respect, entity shielding is open to greater abuse than is owner shielding, including in particular limited liability. It is relatively easy to assure 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. The new freedom in entity creation, however, 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 first the increasingly common 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 carried off of its balance sheet greatly diminishes the ability of investors to evaluate the firm’s financial condition. The ensuing risk of fraud is one cost of such profligate asset partitioning. But a second cost is just as important: unsecured lenders to parent companies in particular face increasing difficulty in monitoring the assets that bond their claims. And a third cost is the heightened complexity of bankruptcy proceedings, in which courts must reconcile the competing claims of the creditors of the parent company 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. 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, which benefits the enterprise as a whole at the expense of creditors who relied upon

\[145\] See, e.g., In re Owens Corning, 316 B.R. 168 (D. Del. 2004) (invoking substantive consolidation doctrine to void subsidiary cross-guarantees of parent debt benefiting bank creditors at the expense of tort creditors).
the entity status of individual subsidiaries. Just as the administrative costs of bankruptcy played a critical role in the emergence of strong entity shielding three centuries ago, bankruptcy law is likely to set limits on entity shielding and entity proliferation within corporate groups today. It is critical, however, that when bankruptcy courts apply entity-trimming doctrines such as substantive consolidation, that they do so with a healthy appreciation of the history and important economic functions of entity shielding.

A somewhat different set of costs — the costs of debtor opportunism vis-à-vis individual creditors — attends the proliferation of strong entities in the personal sphere. 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 was to guard against the risk that a failing Roman patriarch might stuff his personal assets into the businesses of his slaves to the detriment of his personal creditors. But precisely this maneuver has become increasingly easy for well-heeled and legally sophisticated American burghers today. States now compete in offering “asset protection trusts,” for use by households, which are designed precisely to make entity shielding available to frustrate personal creditors. The availability of such vehicles raises the question whether, in the 21st-century world of easy entities, the venerable safeguards against fraudulent transfers go far enough to protect the personal creditors of individuals. Again, the answer to opportunistic use of entity shielding in this fashion may have to come through changes in federal bankruptcy law, although the most recent amendments to the bankruptcy act are not heartening in this respect.

These observations imply that although one constraint on the formation of strong entities — the need to protect entity creditors and investors — has lifted, the law is just beginning the task of sorting through a second constraint — the need to protect third-party creditors unaffiliated with the entity itself. A rich and subtle jurisprudence, both in and out of bankruptcy, may ultimately be needed for this task. 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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146 See, e.g., In the Matter of 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 super-priority DIP financing).


148 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.