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70 Vanderbilt Law Review 1303 (2017)

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70 Vand. L. Rev. 1303, 1352 (2017)

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Organizational Law as Commitment Device

Morgan Ricks*

What is the essential role of the law of enterprise organization? The dominant view among business law scholars today is that organizational law—the law of partnerships, corporations, private trusts, and their variants—serves primarily to structure relations between business owners, on the one hand, and business creditors, on the other. Under this “asset partitioning” theory, organizational law’s main purpose is to shield business assets from claims of creditors of the business’s owners, thereby giving business creditors a structurally senior claim on business assets. By relieving business creditors of the need to inspect the creditworthiness of business owners, the theory goes, organizational law allows creditors to economize on information. This Article challenges the primacy of the asset-partitioning theory. It identifies another role of organizational law that may be every bit as essential as asset partitioning. That role is property relinquishment: organizational law provides a mechanism for business co-owners to relinquish their legally cognizable property interests in specific business assets. The Article demonstrates that this property-relinquishment feature was present even in the traditional Anglo-American common law of partnership, despite outward appearances to the contrary. Unlike the asset-partitioning theory, which centers on relations with third parties, the property-relinquishment theory centers on relations among business co-owners. It is primarily concerned with commitment problems rather than information problems. The Article draws connections between the property-relinquishment theory of organizational law and three other areas of scholarly inquiry: the “anticommons” literature in property, the conceptual foundations of bankruptcy law, and the economic theory of the firm.

* Associate Professor of Law, Vanderbilt Law School. Without implicating any of them in my conclusions, I thank Adam Badawi, Margaret Blair, Anthony Casey, Henry Hansmann, Curtis Milhaupt, Beverly Moran, John Morley, Jeffrey Schoenblum, Christopher Serkin, Ganesh Sitaraman, Richard Squire, Randall Thomas, Robert Thompson, and Yesha Yadav for comments on an earlier version of this Article. I also thank participants in faculty workshops at Hastings College of Law, University of Colorado Law School, and Vanderbilt Law School for valuable feedback.

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INTRODUCTION

Does the law of enterprise organization (the law of partnerships, corporations, private trusts, and their variants) confer an ability to “do” anything that can’t be accomplished through contract alone? Until a decade and a half ago, business law scholars had no coherent answer to this question. It would probably be more accurate to say the question was seldom posed in this way. Theorists tended to describe organizational forms in vague, metaphorical terms. It was (and is) often said, for example, that a corporation can be understood as a “juridical person” or a “nexus of contracts.” While these analogies can be useful in some contexts, they are imprecise, and they lack functional content.

Since 2000, though, the field has had an answer—or so it would seem. That year saw the publication of Henry Hansmann and Reinier Kraakman’s justly celebrated article, *The Essential Role of*

Organizational Law.¹ Hansmann and Kraakman argued that organizational law does let people do something they cannot realistically do through contract alone. I will describe their thesis in some detail below, but its essence is this: organizational law lets people create a particular pattern of creditors' rights. When a business resides within an organizational form, business assets are shielded from claims of creditors of the firm's owners. (Note that this is essentially the *inverse* of the more familiar principle of limited liability, which holds that assets of firm owners are shielded from business creditors.) Hansmann and Kraakman refer to this feature as "asset partitioning"² or "entity shielding,"³ and they argue that it could not realistically be done through contracting.

What's so valuable about asset partitioning (entity shielding)? Hansmann and Kraakman find a number of advantages,⁴ but one advantage predominates: with asset partitioning, business creditors need not concern themselves with the owners' creditworthiness. They can focus exclusively on the business itself, without worrying about the personal financial circumstances of the owners. This makes credit analysis much easier and reduces firms' borrowing costs. Thus organizational law exists primarily to solve an *information* problem—to create "efficient incentives for gathering and using information."⁵ I think it is fair to say that Hansmann and Kraakman's theory has achieved unrivaled supremacy among business law scholars.

Hansmann and Kraakman's argument is not merely that asset partitioning is an important feature of organizational law. Their claim is far stronger: that asset partitioning is "the sine qua non of the legal

1. Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE L.J. 387 (2000). Aspects of their argument were foreshadowed in Henry Hansmann & Ugo Mattei, *The Functions of Trust Law: A Comparative Legal and Economic Analysis*, 73 N.Y.U. L. REV. 434 (1998).

2. Hansmann & Kraakman, *supra* note 1, at 390. More precisely, they refer to this feature as *affirmative* asset partitioning, as distinguished from *defensive* asset partitioning, which denotes the shielding of personal assets from claims of firm creditors (e.g., limited liability). *See id.* at 393–94. Because this Article does not deal with defensive asset partitioning, my use of "asset partitioning" throughout is shorthand for affirmative asset partitioning.

3. Henry Hansmann, Reinier Kraakman & Richard Squire, *Law and the Rise of the Firm*, 119 HARV. L. REV. 1333, 1336 (2006).

4. *See infra* note 26.

5. Hansmann & Kraakman, *supra* note 1, at 404. For an early gesture in the direction of the asset-partitioning theory, see Richard A. Posner, *The Rights of Creditors of Affiliated Corporations*, 43 U. CHI. L. REV. 499, 517 (1976) ("Acquiring the necessary information will become even more complicated if we allow not only the subsidiary's creditors to reach the assets of the parent, but the parent's creditors to reach the assets of the subsidiary . . .").

entity,”⁶ “[t]he essential role of all forms of organizational law,”⁷ and “the core defining characteristic of a legal entity.”⁸ Indeed, they contend that

the partitioning off of a separate set of assets in which creditors of the firm itself have a prior security interest . . . is the *only* essential contribution that organizational law makes to commercial activity, in the sense that it is the only basic attribute of a firm that could not feasibly be established by contractual means alone.⁹

While Hansmann and Kraakman do not deny that other aspects of organizational law are important, they believe “the economies involved are not of the same order as those involved in asset partitioning.”¹⁰ Asset partitioning, they submit, “is the only important feature of modern firms for which substitutes could not be crafted, at any price that is even remotely conceivable, using just the basic tools of contract, property, and agency law.”¹¹

This Article offers the first significant challenge to these strong claims. To be clear, I do not object to the claim that asset partitioning is *an* important role for organizational law. I just question whether it is *the essential* role—or even the main one. I will show that organizational law does something else that may be just as important. It solves a commitment problem—one that contract law (alongside property law and agency law) can’t realistically address. More specifically, organizational law provides a mechanism for business co-owners to *relinquish* their legally cognizable property interests in specific business assets. Such relinquishment practically eliminates the ability of co-owners (and their successors/heirs) to defect with individual business assets, thereby allowing for the creation of durable asset configurations and, hence, going-concern value. Note that this property-relinquishment function of organizational law has nothing to do with creditor priority, information problems, or anything like that. Instead, it is about relations among co-owners.

In the case of corporations, this property-relinquishment feature of organizational law may seem almost self-evident. No corporate shareholder imagines herself to have any direct property interest in—any right to possess or exclude others from—any specific business asset. Nor would any business lawyer dispute that modern U.S. partnership law has this feature. All fifty states base their partnership statutes on

6. Hansmann, Kraakman & Squire, *supra* note 3, at 1338.

7. Hansmann & Kraakman, *supra* note 1, at 390.

8. *Id.* at 393.

9. *Id.*

10. *Id.* at 437.

11. *Id.*

either the Uniform Partnership Act (“U.P.A.”),¹² promulgated in 1914, or the Revised Uniform Partnership Act (“R.U.P.A.”),¹³ promulgated in 1997. The U.P.A. provides that business assets are held in a special property estate, the “tenancy in partnership,” under which individual ownership rights are effectively extinguished.¹⁴ The R.U.P.A. is even more explicit, providing that partnerships are “entities” with direct ownership of business assets.¹⁵ Individual partners have no direct title.

The older common law of partnership, however, presents a much more difficult case. For there was no entity to speak of and nothing called “tenancy in partnership.” Formal legal title to business assets was lodged in one or more of the individual partners. This apparent exception poses a significant challenge to the property-relinquishment theory of organizational law advanced herein. Any truly essential function of organizational law should be in the law’s DNA, so to speak. Features with a more pervasive presence across organizational forms, past and present, have a better claim to being essential attributes. (Perhaps for this reason, the theoretical scholarship in this area exhibits a deep preoccupation with legal history; this Article is no exception.) The general partnership was the workhorse organizational form for business activity prior to the ascent of the corporation in the nineteenth and early twentieth centuries. If it lacked property relinquishment, my argument would lose much of its force.

It turns out, though, that traditional partnership law *did* cause individual partners to relinquish their legally cognizable property interests in specific business assets. As I show below, it did so through a set of interlocking equitable doctrines that, in combination, trumped formal legal title—depriving individual partners (and their successors/heirs) of the usual incidents of ownership. As a consequence of these doctrines, no individual partner could unilaterally remove any specific asset from the configuration; the governance structure of the partnership held effective veto power over asset diversion.¹⁶ In this way,

12. UNIF. P'SHIP ACT (amended 2013), 6 U.L.A. 1 (2015).

13. REVISED UNIF. P'SHIP ACT, 6 U.L.A. 1 (2015).

14. UNIF. P'SHIP ACT § 25, 6 U.L.A. 194–95 (2015).

15. REVISED UNIF. P'SHIP ACT § 201(a), 6 U.L.A. 56 (2015) (“A partnership is an entity distinct from its partners.”).

16. The thrust of this argument was partially anticipated by Larry Ribstein. In describing the “modern” partnership—a term that, in his usage, encompasses the nineteenth-century Anglo-American partnership—he wrote:

[P]artnership property rules preserve owners’ and creditors’ joint rights in the firm’s assets from interference by *individual owners* and their creditors. This enables the owners to *commit* common property to a collective business strategy without concern

traditional partnership law allowed venturers to commit to more durable asset configurations than would have been possible (or would today be possible) through contracting alone, thereby supporting the creation of going-concern value.¹⁷

The oft-cited “dissolvability” of the traditional partnership might initially seem to cast doubt on this conclusion. It is well known that the traditional partnership at will could be dissolved at the option of any partner and was automatically dissolved upon a partner’s bankruptcy or death.¹⁸ Implicit in much of the literature in this area is the supposition that the traditional partnership was a delicate creature, with business assets prone to sudden, disorderly scattering upon dissolution.¹⁹ But “dissolution” referred then (as it does today) to a change in legal relations among partners; it did *not* necessarily imply a piecemeal dismantling of the business. To the contrary, as we will see, traditional partnership doctrine sought to *preserve* existing configurations of business assets upon dissolution, thereby supporting business continuity and going-concern value. Crucially, these continuity-enhancing features of traditional partnership law depended upon the inability of partners (or their successors/heirs) to assert property interests in specific business assets upon dissolution. In other words, the legal technology of property relinquishment promoted going-concern value.

Some may hear echoes here of another prominent theory in organizational law: Margaret Blair’s theory of “locking in capital.”²⁰ Blair argues convincingly that the corporate form became popular

that an individual owner might divert the firm’s property to some personal use or other business.

LARRY E. RIBSTEIN, *THE RISE OF THE UNINCORPORATION* 41 (2010) (emphasis added). By contrast, Hansmann and Kraakman have emphasized that their theory has little to do with owner commitment (which they view as essentially contractual) and much more to do with creditor monitoring. See Hansmann, Kraakman & Squire, *supra* note 3, at 1341–42. This Article expands on Ribstein’s insight by showing why property relinquishment should not be viewed as purely contractual.

17. The separation of legal and beneficial ownership is of course practically the defining characteristic of the law of trusts. See *RESTATEMENT (THIRD) OF TRUSTS* ch. 1, intro. note (AM. LAW INST. 2003) (describing “[t]he distinction between legal interests and equitable interests” as “fundamental” to trust law). It is useful to conceive of the traditional partnership as a species of self-settled trust—with one or more partners serving as both settlor(s) and trustee(s), the corpus of partners serving as beneficiary, and each individual partner serving as agent of the trustee(s). As we will see in Part III, contemporaneous commentators on traditional partnership law often used the language of trusteeship.

18. See, e.g., 3 *JAMES KENT, COMMENTARIES ON AMERICAN LAW* 28–33 (Da Capo Press 1971) (1828).

19. See *infra* note 140.

20. Margaret M. Blair, *Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century*, 51 *UCLA L. REV.* 387 (2003).

among business organizers in the nineteenth century largely because the corporate form, as compared to the (readily dissolvable) partnership, offered a superior means to lock in financial capital. In essence, my claim is that the traditional partnership did in fact offer capital lock-in—albeit lock-in of a comparatively weak form when judged against the corporation. In this sense, Blair's lock-in theory is more powerful than she envisioned: it explains not only how the corporation improved on partnership, but also how, in the context of joint enterprise, organizational law—including partnership—improved on contract. It is this latter question that Hansmann and Kraakman sought primarily to answer.

The property-relinquishment theory of organizational law described herein, which focuses on inter se partner relations and commitment problems, should not be understood as displacing the Hansmann-Kraakman asset-partitioning theory, which focuses on creditor relations and information problems. The two theories are not mutually exclusive; they can be seen as complementary. My central points are: (1) that property relinquishment, like asset partitioning, is a pervasive attribute of organizational law; (2) that it could not be realistically replicated through contracting alone; and (3) that there is no obvious reason why it should be seen as any less “essential” than asset partitioning. More generally, perhaps the search for one essential role of organizational law is misguided; the right answer might be plural rather than singular.

The Article proceeds as follows. Part I describes the Hansmann-Kraakman asset-partitioning theory and subjects it to critical scrutiny along two dimensions. First, I show that the possibility of contractual upstream guarantees—which are very common in certain contexts, such as corporate groups—significantly diminishes the informational benefits that organizational law can provide to business creditors. Such guarantees override asset partitioning. Creditors must therefore monitor for the *absence* of such guarantees—a task that presents the very “moral hazard” difficulties that asset partitioning is supposed to bypass. Second, I examine the asset-partitioning theory through the lens of the law of security interests. Hansmann and Kraakman see a close kinship between organizational law and security interests: both of these legal technologies reduce information costs by giving certain creditors prior claims on particular assets. I show, however, that organizational law does *not* afford the primary informational benefit that the law of security interests offers; namely, the ability of a prospective creditor to avoid relying on (potentially unreliable) information and assurances from the debtor itself. Consequently, the

informational advantages afforded by organizational law may be somewhat less substantial than has previously been supposed.

Part II describes the property-relinquishment theory of organizational law, using a stylized example to convey the essence of the argument. I show that, when a business is jointly owned, it is infeasible to create a reliably durable configuration of assets (a prerequisite to going-concern value) using only the tools of property, contract, and agency law. The problem is one of defection; the co-owners cannot make a sufficiently strong commitment to one another, nor can they make a commitment that is binding on their successors and heirs. Organizational law thus plays an essential role in structuring relations among co-owners. The analysis relies in part on Guido Calabresi's and Douglas Melamed's famous distinction between "property rules" and "liability rules."²¹ As we will see, the law of contracts is by design a liability-rule system, whereas organizational law protects asset configurations with (far stronger) property rules.

What of the objection that traditional partnership law did not offer property relinquishment? Part III responds to this challenge by investigating the nineteenth-century Anglo-American common law of partnership. Through an analysis of the five leading partnership treatises of the era, I show that, contrary to what some scholars have supposed, traditional partnership law *did* divest individual partners of cognizable ownership interests in specific partnership assets—though it did so in disguise. Property relinquishment was accomplished through three equitable features of partnership doctrine, which I call the *disgorgement feature*, the *in rem feature*, and the *title-consolidation feature*. These features created a degree of commitment that would have been infeasible through contractual means.

Part IV draws connections between the property-relinquishment theory of organizational law and three other areas of scholarly inquiry: the "anticommons" literature in property, the conceptual foundations of bankruptcy, and the economic theory of the firm. I show that each of these domains is centrally concerned with the problems that arise from *fragmentary* property interests. The property-relinquishment theory thus opens the way for greater theoretical integration between these seemingly disparate fields. Concluding thoughts follow in Part V.

21. See Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089 (1972).

I. ASSET PARTITIONING AND THE PRIORITY OF CLAIMS

It is not hard to see why Hansmann and Kraakman's theory has been so influential. The theory possesses simplicity, elegance, and depth. This Part describes their theory in some detail and subjects it to critical scrutiny. I argue that the informational-efficiency benefits of asset partitioning may be somewhat more modest than advertised. This conclusion sets the stage for the next Part, which lays out a different though complementary theory: the property-relinquishment theory.

A. *The Hansmann-Kraakman Thesis*

Hansmann and Kraakman begin their analysis of organizational law with a deceptively basic set of questions:

Do [organizational forms]—as the current literature increasingly implies—play essentially the same role performed by privately supplied standard-form contracts, just providing off-the-rack terms that simplify negotiation and drafting of routine agreements? Or do the various legal entities provided by organizational law permit the creation of relationships that could not practicably be formed by contract alone? In short, what, if any, essential role does organizational law play in modern society?²²

Their answer is that organizational forms are not merely standard-form contracts, because organizational law offers something that cannot readily be accomplished through contracting alone. That something is asset partitioning: the shielding of the entity's assets from the claims of creditors of the entity's owners. Owing to organizational law, business creditors enjoy a superior claim on business assets, while the owners' personal creditors have an inferior, structurally subordinated claim.

To see how this works, it is useful first to introduce an important distinction. Hansmann and Kraakman distinguish between two types of asset partitioning: a strong form and a weak form.²³ The strong form includes a "liquidation protection" feature, whereas the weak form does not. "Liquidation protection" refers to the capacity of business owners' creditors to liquidate the firm.²⁴ The distinction between strong- and weak-form asset partitioning is best illustrated by comparing the

22. Hansmann & Kraakman, *supra* note 1, at 390 (footnote omitted).

23. *See id.* at 394–95.

24. *See id.* In their subsequent paper with Squire, the authors modify their definition of liquidation protection to include restrictions on the ability of *owners themselves* to force payout. *See* Hansmann, Kraakman & Squire, *supra* note 3, at 1338 ("Liquidation protection restricts the ability of both firm owners and their personal creditors to force the payout of an owner's share of the firm's net assets."). But they view this owner-commitment role as distinctly less important, since it can be largely accomplished through contractual means. *See id.* at 1341–43. In their original paper, the authors characterize such owner "withdrawal rights" as a useful but not essential aspect of organizational law. *See* Hansmann & Kraakman, *supra* note 1, at 434–35, 437.

corporation to the partnership at will. When a corporate shareholder becomes insolvent, the shareholder's personal creditors are not entitled to force the firm into liquidation. At most, the personal creditors step into the shareholder's shoes—they become shareholders. The corporate form, then, exhibits strong-form asset partitioning. By contrast, the partnership at will lacks liquidation protection; creditors of a bankrupt partner can force a liquidation of the partnership.²⁵ This is the defining feature of weak-form asset partitioning. Note that, even in weak-form entities like the partnership at will, owners' personal creditors are subordinated to business creditors in the distribution of business assets. This priority rule sits at the core of both strong- and weak-form asset partitioning.

Why is asset partitioning desirable? According to Hansmann and Kraakman, asset partitioning—whether strong- or weak-form—reduces businesses' cost of credit, primarily by reducing monitoring costs.²⁶ To see why, imagine a firm with numerous individual owners. In the absence of asset partitioning, the personal creditors of an insolvent owner could levy directly against firm assets on an equal footing with business creditors. (Assume for now that there are no security interests.) This means that, in order to evaluate the risk of lending to the firm, prospective *business* creditors would need to evaluate the *personal* creditworthiness of each individual owner. Obviously, this could be quite costly. And the problem goes deeper. Any subsequent changes in the creditworthiness of the owners—or in their identities, if ownership were to change hands—would impact business creditors. Furthermore, owners themselves would need to monitor other owners' creditworthiness, since the personal financial situation of individual owners would affect the firm's cost of credit.

To solve this problem—at bottom, an information problem—business creditors need assurance that their claims on business assets

25. See REVISED UNIF. P'SHIP ACT § 801(5), 6 U.L.A. 479–80 (2015); UNIF. P'SHIP ACT § 32(2), 6 U.L.A. 315 (1914); CHRISTINE HURT ET AL., 1 BROMBERG AND RIBSTEIN ON PARTNERSHIP §§ 3.05(d)(3)(v), 7.06(f) (2d ed. Supp. 2016-2).

26. See Hansmann & Kraakman, *supra* note 1, at 399–403. The authors also note that strong-form (unlike weak-form) asset partitioning protects going-concern value by preventing business owners' creditors from prematurely liquidating business assets. *See id.* at 403–04. But this appears to be less important to their analysis than the priority rule, which is present in the weak form as well as the strong form. In addition, they briefly note that asset partitioning may promote risk sharing by apportioning risk among owners and creditors according to risk appetite. *See id.* at 404. Finally, the authors, together with Squire, note that strong- and weak-form asset partitioning may reduce both managerial agency costs (another monitoring or informational function) and administrative costs of bankruptcy. *See* Hansmann, Kraakman & Squire, *supra* note 3, at 1346–48. I think it is fair to say that the authors present reductions in appraisal, monitoring, and related information costs as the main benefit of asset partitioning, at least in its weak form.

are senior to those of the owners' personal creditors. The asset-partitioning feature of organizational law gives them this assurance. Automatically, by operation of law, the claims of the owners' personal creditors on business assets are subordinated. In a follow-up article with coauthor Richard Squire, Hansmann and Kraakman demonstrate that this asset-partitioning aspect of organizational law has been ubiquitous as a historical matter, at least in the Western world.²⁷ In particular, they investigate the attributes of partnership-type organizational forms in several historical settings: ancient Rome, medieval and Renaissance Italy, early modern England, and the United States from the nineteenth century forward. They find in each case that organizational forms had this creditor-priority feature.

A pivotal question is why asset partitioning would be infeasible using just property and contract. Central to Hansmann and Kraakman's theory is that "[t]he default rules of property and contract law in effect provide that, absent contractual agreement to the contrary, each [creditor of a business owner] has an equal-priority floating lien upon the [owner]'s entire pool of assets as a guarantee of performance."²⁸ In other words, all creditors stand on an equal footing unless they specifically agree otherwise. To achieve seniority with respect to business assets, then, business creditors would need to extract from business owners credible promises that they "would obtain from all of [their] *personal* creditors, *both past and future*, agreements subordinating their claims" on business assets.²⁹

Hansmann and Kraakman argue that this would not be workable, for two reasons. First, transaction costs would be high. The subordination provisions would need to be drafted, and bargaining would have to take place with each personal creditor. One might question whether this would truly be prohibitively costly. One can imagine a standard-form provision in which personal creditors would agree to subordination in the division of any assets of the debtor that are primarily used in business enterprise. There might occasionally be some ambiguity as to precisely which assets are business assets, but this issue should be manageable. After all, as Hansmann and Kraakman acknowledge,³⁰ the same ambiguity arises in partnership

27. Hansmann, Kraakman & Squire, *supra* note 3, at 1356–99.

28. Hansmann & Kraakman, *supra* note 1, at 407.

29. *Id.* at 407 (emphasis in original).

30. *Id.* at 409 n.29; *see also id.* at 429 n.61.

law—there is often a gray area in determining what constitutes “partnership property.”³¹

Hansmann and Kraakman identify a second, more important problem: moral hazard. Business creditors would have no reliable way to monitor whether owners were in fact inserting subordination provisions into all of their agreements with personal creditors. And the owners would have a strong incentive not to procure such subordination provisions. Hansmann and Kraakman explain:

By failing to obtain a subordination agreement with a personal creditor, the entrepreneur and the personal creditor can externalize to the entrepreneur's business creditors a larger portion of the potential costs of the entrepreneur's insolvency than the business creditors had bargained for. For these reasons, in order for the entrepreneur's business creditors to have faith in the entrepreneur's compliance with his promise to give them priority in his business assets, they would have to engage in continuous monitoring of the entrepreneur's contracts with all of his individual creditors—a task that generally would be infeasible.³²

Property and contract, then, can't do the trick. According to Hansmann and Kraakman, what is needed is a way to “alter the default rules” described above.³³ This is what organizational law accomplishes. In effect, every creditor implicitly agrees that, if the borrower has an ownership stake in a business entity, the creditor's claim on the assets of the entity are automatically subordinated to the claims of entity creditors. With organizational law, the argument goes, owners cannot shirk their contractual obligations to procure subordination agreements, because no such subordination agreements are needed in the first place. Moral hazard becomes much less of an issue.

How convincing is this argument? Hansmann and Kraakman note that their moral-hazard argument hinges on the idea that “[t]his special contractual term that organizational law imposes is . . . a *mandatory* term. If it were just a default term, waivable by the parties, then the problems of moral hazard discussed above would return.”³⁴ But is it truly mandatory? There is nothing to prevent an entity from contractually guaranteeing the debts of one or more of its owners. Such intragroup guarantees are very common in the corporate context; affiliated entities within a corporate group often guarantee each other's liabilities. These guarantees are typically constructed so as to allow the

31. See, e.g., HURT ET AL., *supra* note 25, § 3.02 (“The question of whether property is owned by the partnership or by individual partners can arise in many ways.”); NATHANIEL LINDLEY, A TREATISE ON THE LAW OF PARTNERSHIP 322 (London, W. Maxwell & Son, 5th ed. 1888) (“It is often a difficult matter to determine what is to be regarded as partnership property, and what is to be regarded as the separate property of each partner.”).

32. Hansmann & Kraakman, *supra* note 1, at 408.

33. *Id.* at 409.

34. *Id.*

creditor to proceed directly against the guarantor without taking action against the primary obligor. Such upstream guarantees override the subordination supplied by asset partitioning.³⁵

It might initially seem puzzling that corporate groups would bother partitioning up their assets, only to functionally reintegrate them through the use of intragroup guarantees and other contractual arrangements. Scholars have commented on this phenomenon and offered theories to explain it. Richard Squire suggests that this practice reflects a form of shareholder opportunism—a way to take advantage of creditors.³⁶ Anthony Casey offers a more benign interpretation, suggesting that such structures afford optionality to creditors in enforcing their claims against debtors.³⁷ For present purposes, what matters is not *why* entities issue such guarantees, but the very fact that they *can* do so. This capacity means that the “special contractual term” supplied by organizational law is not mandatory—which means that moral hazard persists despite asset partitioning.³⁸ In principle, it is no easier to monitor the absence of guarantees than it is to monitor the presence of subordination agreements.

35. That upstream guarantees override asset partitioning is not merely an academic point; in fact it has major implications for modern financial stability regulation. A central component of recent financial reforms in the United States and abroad has been the development of new “Total Loss Absorbing Capacity” (“TLAC”) principles, which require the largest financial firms to maintain loss-absorbing capacity at the *holding company* level in order to provide a buffer of protection to (more sensitive) *operating subsidiary* liabilities. See FINANCIAL STABILITY BOARD, PRINCIPLES ON LOSS-ABSORBING AND RECAPITALISATION CAPACITY OF G-SIBS IN RESOLUTION: TOTAL LOSS-ABSORBING CAPACITY (TLAC) TERM SHEET (2015), <http://www.fsb.org/wp-content/uploads/TLAC-Principles-and-Term-Sheet-for-publication-final.pdf> [<https://perma.cc/B2VR-W2VN>]. In its TLAC implementing release, the Federal Reserve indicated that firms subject to the rule would be prohibited from having any “[holding company] liabilities that are guaranteed by a subsidiary of the . . . holding company (‘upstream guarantees’).” Total Loss-Absorbing Capacity, Long-Term Debt, and Clean Holding Company Requirements for Systemically Important U.S. Bank Holding Companies and Intermediate Holding Companies of Systemically Important Foreign Banking Organizations; Regulatory Capital Deduction for Investments in Certain Unsecured Debt of Systemically Important U.S. Bank Holding Companies, 80 Fed. Reg. 74,926, 74,944 (proposed Nov. 30, 2015) (to be codified at 12 C.F.R. pts. 217, 252). Structural subordination of holding company claimants, the Fed noted, “could be undermined if a liability of the covered holding company is subject to an upstream guarantee, because the effect of such a guarantee is to subject the guaranteeing subsidiary (and, ultimately, its creditors) to the losses that would otherwise be imposed on the holding company’s creditors.” *Id.* at 74,946. In other words, upstream guarantees defeat asset partitioning.

36. See Richard Squire, *Strategic Liability in the Corporate Group*, 78 U. CHI. L. REV. 605 (2011).

37. See Anthony J. Casey, *The New Corporate Web: Tailored Entity Partitions and Creditors’ Selective Enforcement*, 124 YALE L.J. 2680 (2015).

38. In other work, Hansmann acknowledges that cross-guarantees undermine the creditor-monitoring efficiencies of asset partitioning, but without explicitly recognizing that such guarantees render asset partitioning nonmandatory. See Kenneth Ayotte & Henry Hansmann, *Legal Entities as Transferable Bundles of Contracts*, 111 MICH. L. REV. 715, 722 n.9 (2013).

Now, it is true that the law imposes certain hurdles to implementing such guarantees. Where the entity has multiple owners, an individual owner may lack the legal authority to bind the entity to a guarantee of her personal obligations. The governance structure of the entity may need to authorize it. For any number of reasons, co-owners might be disinclined to grant such benefits to their colleagues, even if there is mutuality. But note the underlying source of this impediment: the co-owner cannot pledge any business assets to her personal creditors because none of the assets in question *are hers to pledge*. In other words, the hurdle is a function of property relinquishment.

B. Security Interests and the Information Problem

The law of security interests offers another vantage point for critical analysis of the asset-partitioning theory of organizational law. It should be apparent that secured credit accomplishes something very similar to weak-form asset partitioning. Secured creditors have a prior claim on the collateral; unsecured creditors are subordinated, whether or not they explicitly agree to it. As one leading scholar provocatively (if somewhat hyperbolically) puts it, "Security is an agreement between A and B that C take nothing."³⁹ (Note the divergence from Hansmann and Kraakman's "default rules of property and contract" described above.) The notion of unilateral subordination might initially seem unfair, but presumably unsecured creditors are aware of this risk and will charge a corresponding premium up front.⁴⁰ The prospect of nonconsensual subordination is part of the "rules of the game" to which every voluntary unsecured creditor implicitly consents.⁴¹ With security interests, the hypothesized problem of entering into subordination agreements with each personal creditor, and of monitoring such agreements, disappears.

Importantly, security interests *themselves* can be replicated through more primitive tools of property and contract.⁴² The point will be familiar enough to commercial lawyers, but it bears emphasis

39. Lynn M. LoPucki, *The Unsecured Creditor's Bargain*, 80 VA. L. REV. 1887, 1899 (1994).

40. See Thomas H. Jackson & Anthony T. Kronman, *Secured Financing and Priorities Among Creditors*, 88 YALE L.J. 1143, 1147-48 (1979).

41. Involuntary creditors (tort victims) are another matter, a point well-recognized in the literature. See, e.g., Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857, 882-83 (1996); LoPucki, *supra* note 39, at 1899; Elizabeth Warren, *Making Policy with Imperfect Information: The Article 9 Full Priority Debates*, 82 CORNELL L. REV. 1373, 1377-83 (1997).

42. In fact, such transactions were historical precursors to the development of security interest law. See, e.g., BARRY E. ADLER, DOUGLAS G. BAIRD & THOMAS H. JACKSON, *BANKRUPTCY: CASES, PROBLEMS, AND MATERIALS* 13 (4th ed. 2007) ("When first conceived centuries ago, the real estate mortgage took the form of a sale subject to defeasance.").

nonetheless. The repurchase agreement or “repo” transaction—ubiquitous in the financial sector—consists of the sale of a security coupled with a forward purchase of the same security at a slightly higher price.⁴³ It is economically equivalent to a secured borrowing; the “seller” (borrower) receives cash today and pays it back with interest on the maturity date. If the seller fails to make the required payment, the “buyer” (lender) has the security as collateral. Practically speaking, the repo lender has a lien on the purchased security. In the case of nonfinancial property, the sale-leaseback transaction can be used to achieve a similar result.⁴⁴ The party seeking financing sells property for cash and then leases it back; the cash proceeds are the amount “borrowed,” and the lease payments constitute the loan repayment. If the seller (borrower) defaults on its lease payments, the buyer (lender) has the underlying property as collateral. The seller may retain an option to repurchase the property at a nominal price once all the lease payments (covering principal and interest) have been made. This too is economically equivalent to a secured borrowing. The upshot of this analysis is that weak-form asset partitioning—nonconsensual subordination of a set of creditors—is, at least under some circumstances, achievable without organizational law. Indeed, it is achievable without any dedicated “law” of security interests.

While Hansmann and Kraakman acknowledge that security interests offer something resembling weak-form asset partitioning, they contend that security interests, at least as they exist today, are too cumbersome to serve as a substitute for organizational law. The reason is that operating businesses are dynamic, not static. The issue is not so much asset turnover as creditor turnover. Asset turnover can be managed through the creation of broad floating liens. The modern U.S. law of security interests—as embodied in Article 9 of the Uniform Commercial Code (“U.C.C.”)—recognizes liens of this type. A U.C.C. financing statement may specify collateral in quite general terms.⁴⁵ Once filed, the statement may cover both present and after-acquired collateral of the type described.⁴⁶ In addition, the financing statement may cover future advances from the same creditor.⁴⁷ What the U.C.C. does *not* countenance, however, is floating secured *creditors*. To fully

43. For a general overview of the repo market, see MARCIA STIGUM & ANTHONY CRESCENZI, *STIGUM'S MONEY MARKET* 531–79 (4th ed. 2007).

44. See LYNN M. LOPUCKI & ELIZABETH WARREN, *SECURED CREDIT: A SYSTEMS APPROACH* 29–30 (7th ed. 2011).

45. U.C.C. § 9-108 (AM. LAW INST. & UNIF. LAW COMM'N 2015).

46. U.C.C. § 9-204(a) (AM. LAW INST. & UNIF. LAW COMM'N 2015).

47. U.C.C. § 9-204(c) (AM. LAW INST. & UNIF. LAW COMM'N 2015).

mimic the weak-form partitioning afforded by organizational law, a new U.C.C. filing would be required for each new creditor—that is, every time the firm enters into a contract with a party not already reflected in the firm’s files.

Hansmann and Kraakman submit that this “would obviously be an infeasible burden in a business of any complexity.”⁴⁸ Interestingly, though, the authors point out that a “substantially more flexible” law of security interests “might provide a workable substitute for organizational law, at least so far as establishing priority of claims is involved (though it still would not provide liquidation protection).”⁴⁹ Indeed, with a sufficiently evolved law of security interests—in particular, one that allowed for floating secured creditors—“the line between organizational law and the law of secured interests may become quite indistinct.”⁵⁰

It is instructive to consider whether such an evolved system of security interests would be of much value to prospective creditors. Douglas Baird has persuasively argued that the principal function of Article 9’s notice-filing system is not to give notice to *unsecured* creditors—who rarely use it—but rather to allow *secured* creditors to “easily stake claims to the property of the debtor and determine the priority of competing claims.”⁵¹ The key point is that, with the notice-filing system, a prospective secured creditor can avoid relying to any substantial degree on information or assurances from the debtor. If she sees in the files that an asset of the debtor is unencumbered, she can establish a security interest in the asset with full confidence of first priority (the first-to-file rule⁵²). If she sees that an asset is encumbered, she can see the identities of the existing lienholders, and she may then negotiate directly with them to sort out priorities (e.g., by procuring subordination agreements from each of them). None of this requires any

48. Hansmann & Kraakman, *supra* note 1, at 418. It is not hard to imagine how this process could become quite routinized, adding negligible marginal cost to transactions of any size. Filings might not be economical for the smallest transactions, but the smallest creditors are not doing credit analysis in any case. Accordingly, the monitoring-cost advantages of asset partitioning do not apply.

49. *Id.* at 422. There is no doubt that security interests have a property dimension. *See, e.g.*, U.C.C. § 1-201 (b)(35) (AM. LAW INST. & UNIF. LAW COMM’N 2015) (“‘Security interest’ means an interest in personal property”); RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 1.1 (AM. LAW INST. 1997); *see also* Thomas W. Merrill & Henry E. Smith, *The Property/Contract Interface*, 101 COLUM. L. REV. 773, 833 (2001) (arguing that security interests “lie at the intersection of property and contract”).

50. Hansmann & Kraakman, *supra* note 1, at 423.

51. *See* Douglas G. Baird, *Notice Filing and the Problem of Ostensible Ownership*, 12 J. LEGAL STUD. 53, 55 (1983).

52. U.C.C. § 9-322(a) (AM. LAW INST. & UNIF. LAW COMM’N 2015).

information or assurances from the debtor itself. This is crucial, because information and assurances from the debtor may be unreliable, owing to the moral-hazard problem described above.

Compare asset partitioning in organizational law. A general claimant on a legal entity (partnership or corporation) is in a position analogous to the position of secured creditors under the hypothetical “flexible” or “evolved” system of security interests just described, in which secured creditors may float. Unlike a secured party under Article 9, the entity claimant must still rely on the debtor itself for information about the status of her claim. How much other debt does the debtor have, or plan to incur? Has the entity guaranteed third-party debts—perhaps debts of the entity’s owners—such that those other debts represent claims on business assets that are *pari passu* with entity debts? Even if the creditor is satisfied with this information at the time credit is extended, the debtor could pile on more obligations thereafter, diluting the value of the creditor’s claim. Of course, the creditor may require that the debtor agree to restrictive covenants on these matters. But the debtor has the moral-hazard incentive described above, and the claimant has the same monitoring problem. In short, when it comes to dealing with information and monitoring problems arising from moral hazard, organizational law offers but a pale shadow of what the modern law of security interests affords.⁵³

None of this is to suggest that the asset-partitioning feature of organizational law provides no informational efficiencies at all. But it does raise questions about how substantial those informational benefits are likely to be. Even with organizational law, general creditors of legal entities face major informational challenges, and such credit relationships are inherently afflicted with moral-hazard incentives. The contribution of organizational law in overcoming these problems is arguably rather incremental and modest. If we have a sense that organizational law offers something indispensable to commercial affairs, it is worth looking at other possibilities. The next Part offers a different, though complementary, theory—one that centers around not creditors’ rights but relations among co-owners.

53. Richard Squire has made the intriguing argument that, in “asymmetric” or recourse security arrangements (where the secured creditor is entitled to a deficiency claim against the debtor if the collateral proves inadequate), the informational efficiencies of security interests are in fact less substantial than is commonly supposed. See Richard Squire, *The Case for Symmetry in Creditors’ Rights*, 118 *YALE L.J.* 806, 814–35 (2009). He does not, however, specifically address Baird’s analysis of how the notice-filing system provides certainty to secured claimants regarding the status of the debtor’s property interests (i.e., absence of existing encumbrances).

II. ORGANIZATIONAL LAW AS PROPERTY RELINQUISHMENT

It is indisputable that organizational law supplies asset partitioning, but does it supply anything else that could arguably be of equal or even greater importance? This Part describes another core function of organizational law—one that could not be replicated through contracting alone.

A. A Stylized Illustration

Suppose five unique assets can be configured together to produce cash flows whose net present value exceeds the total value of the unconfigured assets—going-concern value. The five assets are owned separately by five individuals. The individuals sign a contract (assume there is no such thing as “partnership” law or any other type of organizational law) by which they agree to configure the assets and split the future business profits. Legal ownership of the assets remains unchanged. What happens if one of the individuals thereafter discovers that she can get more for her asset by deploying it elsewhere? She may choose to remove her asset from the configuration, breach the contract, and pay damages to the other four. (Set aside for now the possibility of counteroffer by the other four.)

In theory, the other four are made whole—standard contract damages leave them no worse off than if the defector had performed—and are therefore indifferent. In practice, this is unrealistic. Awarding accurate damages in this scenario requires accurate business valuation. Courts are ill-equipped to estimate such damages, and doing so is administratively expensive. Further, as a matter of black-letter contract law, plaintiffs cannot recover speculative damages.⁵⁴ Because future business earnings are inherently speculative, standard contract damages will be seriously undercompensatory in this context. (I address the possibility of nonstandard contract damages below.)

The problem goes deeper than asset diversion; it also relates to governance. Presumably the co-venturers included a governance provision in their contract—say, majority rules. And presumably each, as principal, appointed one or more of the others as agent(s) to operate the business. But what happens if one of the co-venturers thereafter declines to submit her asset to the majority’s will? The others could file suit for breach of contract, but the harm is quite speculative; how should

54. See RESTATEMENT (SECOND) OF CONTRACTS § 352 (AM. LAW INST. 1981) (“Uncertainty as a Limitation on Damages”).

damages be computed? Nor does agency law solve this governance problem. Appointing the others as agents does not nullify the errant co-venturer's property rights as principal. She still owns the asset in question and can revoke the other venturers' agency status. Their use of the asset would then constitute conversion or trespass, perhaps giving rise to *criminal* sanction. Simply put, each co-venturer's separate property right over a specific business asset "trumps" contract and agency. An excess of property rights frustrates the parties' ability to commit *ex ante*.

Can property law's concurrent estates—joint tenancy and tenancy in common—furnish a solution? Suppose that, at the inception of the venture, each co-venturer took a direct concurrent interest in each of the five assets. This would end the asymmetry; they would all be on an equal footing with respect to each specific asset. On reflection, though, concurrent estates are no panacea. In fact they might make matters worse. Three dimensions of concurrent estates render them unsuitable. First, each concurrent holder may use and possess the entire property for any lawful purpose. Second, each may convey his interest to third parties, even without the consent of the other concurrent holder(s). Third, in concurrent estates, each owner has a right to partition the underlying asset, thereby fragmenting ownership.⁵⁵ Hence, the problem of defection—the undoing of the asset configuration—still exists. The parties could of course enter into a contract not to exercise these property rights. But even if such a contract were judicially enforceable—which is doubtful⁵⁶—this only collapses us back into the problem described above: the inadequacy of contractual remedies in this context.⁵⁷

In addition to the defection problem, our co-venturers face the prospect of what might be called *involuntary* asset diversion. Suppose one of the co-venturers dies and his property passes to heirs/devisees; or suppose he is forced into bankruptcy and his property enters a bankruptcy estate for the satisfaction of personal creditors; or suppose his property becomes subject to a judgment/execution lien. The successors to his property, including any property which he has contractually dedicated to the business, are not bound by the business

55. For an overview of partition law, see Candace Reid, Note, *Partitions in Kind: A Preference Without Favor*, 7 CARDOZO L. REV. 855 (1986).

56. As Hansmann and Kraakman note (citing sources), "An agreement not to partition is unenforceable as an invalid restraint on alienation unless it is for a reasonable time only." Hansmann & Kraakman, *supra* note 1, at 412 n.32.

57. For analogous reasons, conveying all the property to one co-venturer, subject to a contract regarding governance and profit sharing, is no answer either. The power imbalance is too great.

contract; there is no contractual privity.⁵⁸ Such successors can use the property however they wish, and the business co-venturers have no contractual recourse.

What the co-venturers need, it seems, is a way for each individual, on behalf of himself and his successors/heirs, to *relinquish* any legally cognizable property interest in specific business assets. All the co-venturers must be on an equal footing as mere agents with respect to each specific business asset, with none of them having the status of principal. Contract can't get them there; contract doesn't extinguish property rights. Agency can't get them there; agency law is empowering, not disempowering. Concurrent property estates can't get them there; indeed, concurrent estates only serve to multiply ownership rights rather than nullify them.

Organizational law offers a solution: it allows the individual co-venturers to divest themselves of all direct property interests in specific business assets. As Part III will show in greater detail, this was true even in the traditional common law of partnership—despite outward appearances to the contrary. Traditional partnership law achieved property relinquishment through three complementary equitable doctrines. First, when co-venturers used the partnership form, the remedy for removing any specific asset from the configuration, or using it for personal benefit, was disgorgement: the errant partner had to forfeit any resulting (past and future) gain. This quintessentially equitable remedy generally wasn't (and isn't) available in contract, and it practically eliminates the incentive to defect in the first place. Second, a knowing *purchaser* of the wrongly diverted asset was obligated to apply the asset solely to partnership purposes. Essentially, the purchaser took the asset as trustee for the firm—and this was true even if the defecting partner held formal legal title to the asset in question before selling it. Partnership law thus infused all partnership property, both real and personal, with an implicit in rem covenant that “ran with the asset.” This was (and is) patently impossible in contract, owing to the absence of privity. Third, to top it all off, at the termination of a partnership, no partner (nor any successor/heir thereof) had any right to any specific business asset; rather, each had the option to insist on a sale of the entire business, under the supervision of a court-appointed manager/receiver if necessary. Formal legal title to business assets was

58. It is well-settled that a contract is dissolved upon the death of a party whose remaining performance obligations consisted of something more than simple payment or “mere ministerial” matters. *Kelley v. Thompson Land Co.*, 164 S.E. 667, 668 (W. Va. 1932). Such a contract therefore does not bind the estate or heirs of the deceased, though the counterparty may sometimes be entitled to monetary recovery in quantum meruit. *See id.*

thereby consolidated in the purchaser(s)—often consisting of one or more of the partners themselves⁵⁹—leaving the asset configuration undisturbed and going-concern value unimpaired. This muscular, equitable judicial intervention was (and is) entirely foreign to a contractual setting. In combination, these three doctrines divested partners of any meaningful direct property interest in specific business assets, notwithstanding formal legal title.

The foregoing stylized description is admittedly somewhat artificial, but it gets to the heart of the matter.⁶⁰ Property relinquishment, I contend, is among the central functions of organizational law, and there is no obvious reason to regard it as any less important than Hansmann-Kraakman asset partitioning. Indeed, one could reasonably argue that asset partitioning is secondary—a happy byproduct of the solution to the commitment problem.

B. Remedial Minimalism in Contract Law

Implicit in the foregoing argument is a claim about the nature of contractual remedies. The point can be illustrated through the lens of Guido Calabresi and Douglas Melamed's famous and influential distinction between property rules and liability rules.⁶¹ In the

59. This was certainly true in the traditional partnership, as shown in Section III.B.3 below. Commentators have emphasized the same point in relation to the modern partnership. See, e.g., ALAN R. BROMBERG, CRANE AND BROMBERG ON PARTNERSHIP 489–90 (1968):

Theoretically, liquidation [upon dissolution] calls for a sale of partnership property to strangers, payment of debts, and division of proceeds among the partners. Factually, the most logical buyers are often the remaining partners. . . . If the remaining partners desire to continue operations without liquidation of the business (as distinct from liquidation of the firm as a legal entity), they must settle with the outgoing interest and acquire its rights;

HURT ET AL., *supra* note 25, § 7.01(b):

Although the language of the U.P.A. appears to stress liquidation of the partnership on dissolution, in fact, after dissolution of the partnership *entity* the partners quite often continue the *business* of the partnership. . . . It is therefore more accurate to characterize the partnership business as continuing indefinitely, unless the partners decide to wind it up, than to regard winding up of the business as a necessary or even usual consequence of dissolution. When the partnership business does continue, “winding up” . . . occurs, if at all, only in the technical sense of paying off the outgoing partner or estate, just as “dissolution” occurs only in the sense of the end of the relationship among particular partners.

60. In particular, the assumption that each co-venturer contributed some *real* asset to the business is unrealistic; more likely, one or more co-venturers would commit financial capital, which would then be used to purchase business assets. But this assumption is a strategic simplification that has no bearing on the analysis. Without organizational law, property interests in any assets purchased after formation would still need to be held by one or more of the co-venturers, raising all the problems discussed above.

61. See Calabresi & Melamed, *supra* note 21.

Calabresi-Melamed framework, when an entitlement is protected by a property rule, the holder has veto power: Someone wishing to remove the entitlement must buy it from the holder in a voluntary transaction. By contrast, when an entitlement is protected by a liability rule, it may be violated so long as the violator is willing to pay an objectively determined value for it.

My argument rests in part on the proposition that Anglo-American contract law is a liability-rule rather than a property-rule system.⁶² Or, to put the point slightly differently, contract law is characterized by remedial minimalism. At a certain level, this proposition is indisputable. Contract law's remedial minimalism has several dimensions, but it is perhaps best illustrated by considering two well-established doctrines that are familiar to any law student. First, in contract disputes, courts almost always decline to enforce remedies that are more draconian than expectation damages, even when the parties agree to them (so-called "penalty clauses").⁶³ Second, specific performance is a rare and extraordinary remedy, limited to cases in which (1) damages are extremely hard to measure (for example, a contract for the sale of unique goods, such as land)⁶⁴ and (2) the transaction in question is quite discrete, such that the court need not expend effort in monitoring and enforcing ongoing compliance with its order.⁶⁵ To be sure, courts have occasionally departed from these limiting doctrines, but such exceptions only prove the rule.

Some scholars have questioned the wisdom of these limiting doctrines. The nonenforcement of penalty clauses impinges on contractual autonomy; why shouldn't courts respect the wishes of the

62. This point is well-recognized. See, e.g., Anthony T. Kronman, *Specific Performance*, 45 U. CHI. L. REV. 351, 354 (1978) ("The Anglo-American law of contracts protects most contract rights with a liability rule, only a few with a property rule."); Carol M. Rose, *The Shadow of The Cathedral*, 106 YALE L.J. 2175, 2187 ("[I]n contract law, liability rules, not property rules, do indeed constitute the background default rule.")

63. This doctrine is centuries old. See Kenneth W. Clarkson et al., *Liquidated Damages v. Penalties: Sense or Nonsense?*, 1978 WIS. L. REV. 351, 351 n.2. The preeminence of expectation damages in contract disputes dates to the sixteenth century. See E. Allan Farnsworth, *Your Loss or My Gain? The Dilemma of the Disgorgement Principle in Breach of Contract*, 94 YALE L.J. 1339, 1351 (1985).

64. See RESTATEMENT (SECOND) OF CONTRACTS §§ 358–60 (AM. LAW INST. 1981).

65. See *id.* § 366 ("Effect of Difficulty in Enforcement or Supervision"). In contrast to common law jurisdictions, civil law jurisdictions award specific performance as the standard remedy for breach of contract. It may very well be that the remedial dimension of organizational law carries less significance in civil law jurisdictions. For a comparative perspective on the functions of corporate law, covering several major common law and civil law jurisdictions, see REINIER KRAAKMAN ET AL., *THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH* (2d ed. 2009).

parties by enforcing such clauses?⁶⁶ Specific performance would give the nonbreaching party the benefit of her bargain; why shouldn't it be granted as a matter of course?⁶⁷ But these long-standing doctrines can be justified on administrative grounds: they minimize the burden on the courts. In the case of specific performance, the public resource cost is obvious and widely recognized. The court must maintain its involvement in the matter to ensure substantial compliance with its order. The promisor may have a strong incentive to shirk—especially if the relationship has soured—inviting more adjudication. By contrast, with a money judgment, the court ends its involvement with the matter, and the promisee is routed into the ordinary mechanisms of debt collection. From an administrative standpoint, money judgments are clearly less burdensome than specific performance.

In the case of penalty clauses, the analysis is somewhat less obvious but no less compelling. A true penalty clause gives the nonbreaching party a windfall in the event of breach; he prefers breach to performance. He may therefore have an incentive to identify and litigate technical breaches or take (perhaps furtive) steps to frustrate the counterparty's performance. Of course, the counterparty will have taken these incentives into account *ex ante* when agreeing to the penalty clause. Assuming both parties are rational and contractual duress is absent, the penalty clause presumably enhances the parties' joint welfare. But because such clauses create a heightened risk of litigation, they impose a negative externality on the public by consuming scarce judicial resources.⁶⁸ Lawmakers might reasonably conclude that the social cost of enforcing penalty clauses outweighs the

66. Richard Posner—famous for championing the efficiency of the common law—lists the nonenforcement of penalty clauses *first* in his catalog of “the most important contradictions to the efficiency theory of the common law.” RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 252 (7th ed. 2007).

67. A number of scholars have argued on efficiency grounds for greater availability of specific performance in contract disputes. See, e.g., Eric A. Posner, *Economic Analysis of Contract Law After Three Decades: Success or Failure?*, 112 *YALE L.J.* 829, 836 (2003); Alan Schwartz, *The Case for Specific Performance*, 89 *YALE L.J.* 271 (1979); Thomas S. Ulen, *The Efficiency of Specific Performance: Toward a Unified Theory of Contract Remedies*, 83 *MICH. L. REV.* 341 (1984).

68. For a related argument that focuses on the administrative costs of enforcing penalty clauses, see Paul H. Rubin, *Unenforceable Contracts: Penalty Clauses and Specific Performance*, 10 *J. LEGAL STUD.* 237 (1981).

social benefit.⁶⁹ (The maxim that “equity abhors a forfeiture”⁷⁰ thus has a plausible efficiency rationale, rooted in costs of administration.)

Other aspects of contract doctrine reinforce this remedial minimalism. The disallowance of speculative damages streamlines the calculation of monetary remedies; the adjudicator need not attach probabilities to endless permutations of outcomes. More fundamentally, the liability-rule nature of contract doctrine is evident in the virtual absence of punitive damages,⁷¹ and the complete absence of criminal sanctions, for contractual violations. Calabresi and Melamed described criminal punishment as a tool for deterring “attempts to convert property rules into liability rules.”⁷² The remedial minimalism of contract law embodies the reverse strategy. That is to say, contract doctrine resists attempts to convert liability rules into property rules.⁷³

69. While liability rules consume fewer judicial resources than property rules when the underlying entitlement consists of a third party's *positive* performance—as is normally the case in contract disputes—the situation is reversed when the underlying entitlement consists of a *negative* obligation (i.e., noninterference). This is because it is generally far more difficult to locate technical defects in, or to frustrate others' performance of, negative obligations; try finding technical defects in, or frustrating the performance of, my obligation not to steal your television. This analysis provides a novel answer to the question why, if “efficient breach” is tolerated, “efficient theft” is not; in the latter case, the breaching party's obligation is negative, making the property rule relatively inexpensive. (For analysis of the efficient theft problem, see Daniel Friedmann, *The Efficient Breach Fallacy*, 18 J. LEGAL STUD. 1, 4–13 (1989).) It also explains why courts are quite willing to specifically enforce those categories of contracts that *do* impose negative obligations—most notably, noncompetition agreements. See, e.g., *Walgreen Co. v. Sara Creek Prop. Co.*, 966 F.2d 273 (7th Cir. 1992) (enforcing exclusivity clause through a permanent injunction). Generally speaking, the coupling of property rule protection and *positive* performance obligations is extraordinary, and it is the province of “fiduciary” relations. Cf. Daniel Markovits, *Sharing Ex Ante and Sharing Ex Post*, in PHILOSOPHICAL FOUNDATIONS OF FIDUCIARY LAW 209, 216 (Andrew S. Gold & Paul B. Miller eds., 2014) (“A fiduciary [unlike a contractual counterparty] must take the *initiative* on her beneficiary's behalf. Indeed, the point of fiduciary relation—written into its generic structure—is for the fiduciary to take the initiative in this way.”). Like Markovits, I am skeptical of Easterbrook and Fischel's well-known contractualist interpretation of fiduciary duties; even they acknowledge that the disgorgement remedy that characterizes fiduciary law “looks distinctly anticontractual.” Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425, 441 (1993).

70. See JOHN NORTON POMEROY, JR., 1 A TREATISE ON EQUITY JURISPRUDENCE § 454 n.b (3rd ed. 1905).

71. See RESTATEMENT (SECOND) OF CONTRACTS § 355 (AM. LAW INST. 1981) (“Punitive damages are not recoverable for a breach of contract unless the conduct constituting the breach is also a tort for which punitive damages are recoverable.”).

72. Calabresi & Melamed, *supra* note 21, at 1126.

73. The main exception to minimalistic (liability-rule) protection of contractual entitlements consists of judicial recognition of tortious interference with contract. See Lillian R. BeVier, *Reconsidering Inducement*, 76 VA. L. REV. 877, 879 (1990) (noting that tortious interference reflects a “property-rule remedy” in the contractual context); Fred S. McChesney, *Tortious Interference with Contract Versus “Efficient” Breach: Theory and Empirical Evidence*, 28 J. LEGAL STUD. 131, 133 (1999) (“[T]ortious interference should be seen as part of a larger body of law designed to accord property protection to a particular entitlement, contract rights.”); Deepa Varadarajan, Note, *Tortious Interference and the Law of Contract: The Case for Specific Performance Revisited*, 111

Recognizing that contract law is imbued with remedial minimalism—that it is, arguably for good reason, a liability-rule system—is important. For there may be domains in which the social benefits of departing from this remedial minimalism outweigh the associated administrative costs. Jointly owned productive enterprise—which is immensely valuable to society—appears to be one such domain. As shown above, contractual bonds are not strong enough to provide the requisite level of commitment in this setting. Co-venturers need a reliable way to prevent a fellow co-venturer from taking her toy and going home. With organizational law, the governance structure of the entity may enforce property rules *against* any individual co-venturer, as well as against any successor/heir thereof. Asking whether organizational forms are “merely contract,” then, is something more than an empty taxonomical question.⁷⁴

III. PROPERTY RELINQUISHMENT IN TRADITIONAL PARTNERSHIP LAW

Is property relinquishment part of the “deep” structure of organizational law? This Part tackles this question by considering what is unquestionably the *hardest* case for my thesis, at least within Anglo-American law: the traditional common law of partnership. (As noted above, the corporation and the modern partnership are easy cases, because shareholders and partners, respectively, clearly have no ownership interest in specific business assets.⁷⁵) I focus in particular on the nineteenth century, which offers a kind of historical sweet spot. Partnership law had yet to be modernized through codification; at the same time, this was the heyday of treatise writing in Anglo-American law, affording modern scholars a set of contemporaneous and definitive statements of the law.

Superficially, traditional partnership law appears inconsistent with the property-relinquishment theory of organizational law articulated above, because partners held formal legal title to business assets. And the existing scholarly literature in this area, insofar as it

YALE L.J. 735, 736 (2001) (“[Tortious interference] has puzzled proponents of efficient-breach theory because it does in the three-party context what is rarely done in the two-party context under contract law: It protects the promisee’s contractual right with a property rule.”). Notably for present purposes, the modern doctrine of tortious interference is of very recent vintage—arising only in the mid-nineteenth century.

74. To the extent that the foregoing argument is vulnerable to the charge of essentializing contract law, the same charge applies to the asset-partitioning theory, which, as shown above, is premised on specified background rules that are said to be internal to property and contract.

75. See *supra* text accompanying notes 12–15. The private trust is also an easy case, since legal and equitable title are divorced. See *supra* note 17.

addresses the issue at all, largely reflects this superficial understanding. I aim to show, however, that property relinquishment was in fact a core feature of traditional partnership law. First, I show that partnership property was special: even though legal title to partnership assets was lodged in one or more individual partners, equity in effect overrode the legal formalities. I then demonstrate the underlying doctrinal basis for this conclusion. I show that partnership law had the three features noted above: the “disgorgement feature,” the “in rem feature,” and the “title consolidation” feature. In combination, these features allowed co-owners to structure their relations in a way that could not have been reliably replicated through contract, concurrent property estates, and agency law.

A. *The Status of Partnership Property*

At common law, a partnership was understood to be an “aggregate” of persons rather than a legal entity.⁷⁶ Essential to the aggregate conception was that legal title to business property was held by the partners in their individual capacities. Insofar as the incidents of ownership followed legal title, each business asset was directly “owned” by one or more partners. It is important, however, to look beneath the surface. A review of the partnership treatises of the nineteenth century reveals that the common law of partnership effectively cleaved the incidents of ownership from legal title.⁷⁷

Theophilus Parsons began his 1867 partnership treatise with a discussion of the peculiar nature of partnership property. “[P]artnership has been compared to tenancy in common, and also to joint tenancy; and has been said to be one or other of these, modified in certain ways,” he wrote.⁷⁸ “But this is no more true than that tenancy in common or joint tenancy is a modified partnership. The three things are essentially distinct. . . . [A]nd the law of each must be sought for in itself.”⁷⁹ Specifically, Parsons noted that “[p]artnership is . . . unlike tenancy in common in that each co-tenant is entitled, as against his co-tenants, to a specific share as interest in the common property *in specie*”⁸⁰ Partnership was different. “[I]t is quite clear that [a

76. See, e.g., UNIF. P'SHIP ACT commissioners' prefatory note, 6 U.L.A. 2 (2015).

77. The leading modern partnership treatise reaches a similar conclusion in describing the traditional common law of partnership. See HURT ET AL., *supra* note 25, § 3.04(a).

78. THEOPHILUS PARSONS, A TREATISE ON THE LAW OF PARTNERSHIP 2-3 (Boston, Little, Brown & Co. 1867).

79. *Id.*

80. *Id.* at 2 n.b.

partner] can appropriate nothing to himself,"⁸¹ he wrote. Indeed, "no general principle of the law of partnership is better settled than that nothing is to be considered the share of any one partner but his proportion of the residue on the balancing of the partnership accounts."⁸² Parsons concluded that every partner is obligated "to use the property for their benefit, whose property it is; that is, for the benefit of the whole as one concern, or one body, for so it is owned."⁸³ Using the language of trusteeship, Parsons suggested that legal title was divorced from beneficial ownership:

As a general principle which will sometimes be of much use in determining the rights and obligations of copartners, it may be said that all partners are regarded somewhat as trustees for the firm. . . . [A] copartner has powers, opportunities, and duties in relation to the partnership, very similar to those which a trustee has in relation to his [beneficiaries].⁸⁴

While partnership was viewed as aggregate, not entity, individual partners nevertheless lacked any cognizable ownership interest in any specific item of partnership property. Individual property rights were subsumed.

Writing a quarter of a century earlier, Joseph Story agreed. "Partners differ from mere part-owners of goods and chattels in several respects," he wrote in his partnership treatise, first published in 1841.⁸⁵ For in joint tenancy and tenancy in common "each party has a separate and distinct, although an undivided, interest" in each asset, "whereas in partnership the partners are joint owners of the whole property."⁸⁶ Story concluded:

The true nature, character, and extent of the rights and interests of partners in the partnership capital, stock, funds, and effects, is, therefore, to be ascertained by the doctrines of law applicable to that relation, and not by the mere analogies furnished by joint tenancy, or by tenancy in common.⁸⁷

Story emphasized that these principles applied with equal force to *real* property, notwithstanding the technicalities of real estate law.⁸⁸ "Nor is there in reality, as between the partners themselves, any

81. *Id.* at 167–68.

82. *Id.* at 167 n.q.

83. *Id.* at 223–24.

84. *Id.* at 231.

85. JOSEPH STORY, COMMENTARIES ON THE LAW OF PARTNERSHIP 125 (Boston, Little, Brown & Co., 7th ed. 1881).

86. *Id.* at 128–29.

87. *Id.* at 129.

88. Modern observers have not always grasped this subtlety. *See, e.g.,* Blair, *supra* note 20, at 409 n.65 ("In the case of real estate and other property held by the partnership, the partners would be considered 'tenants in common' and each would be considered to have a direct interest in the real estate, in proportion to his or her share in the profits.").

difference whether the partnership property held for the purposes of the trade or business consists of personal or movable property, or of real or immovable property, or of both," he wrote.⁸⁹ Here the distinction between legal and equitable ownership became paramount. "It is true that, at law, real or immovable property is deemed to belong to the persons in whose name the title by conveyance stands," wrote Story.⁹⁰ But equity overrode these formalities.

[H]owever the title may stand at law, or in whosoever name or names it may be, the real estate belonging to the partnership will, in equity, be treated as belonging to the partnership, like its personal funds . . . and the parties in whose names it stands, as owners of the legal title, will be held to be trustees of the partnership, and accountable accordingly to the partners . . . [as] beneficiaries of the same.⁹¹

Echoing Parsons, Story here uses language of trusteeship when discussing the nature of partnership property, thereby indicating that legal title did not imply beneficial ownership.

Niel Gow's 1830 partnership treatise accords with those of Parsons and Story. "[E]ach partner is left in possession [of partnership property] as a trustee for all," he wrote, "to the extent of enabling each to call upon all to apply the partnership effects to the purposes to which they ought to be applied."⁹² A partner has an interest in the partnership "but not a separate interest in any particular part of the partnership property . . ."⁹³ Thus "nothing is to be considered as his share but his proportion of the residue in the balance of the account."⁹⁴ To avoid any doubt: "One partner has no claim upon his individual proportion of a specific article, but is entitled only to an account of the produce of the aggregate joint effects."⁹⁵

Gow, like Story, devoted particular attention to real property, and he reached the same conclusion. "Courts of law, it is true, must look to the legal estate," he wrote.⁹⁶ "But courts of equity, unfettered by technical rules, seek to effectuate the intention of the parties . . . and they decree the person in whom the legal estate vests to be a trustee for those beneficially interested."⁹⁷ According to Gow, "[W]here real estates are purchased with the partnership funds, but conveyed only to one

89. STORY, *supra* note 85, at 129.

90. *Id.*

91. *Id.* at 130.

92. NIEL GOW, A PRACTICAL TREATISE ON THE LAW OF PARTNERSHIP 292 (Philadelphia, Robert H. Small, 2d ed. 1830).

93. *Id.* at 47.

94. *Id.* at 119.

95. *Id.* at 256-57.

96. *Id.* at 48.

97. *Id.*

partner, they are, nevertheless, partnership property.”⁹⁸ And again: “Nor . . . does it matter that the freehold interest purchased by the firm is conveyed to one partner. Such a conveyance does not alter the nature of the purchase, nor affect the rights of the other partners.”⁹⁹ All partners are on a precisely equal footing, regardless of legal title.

Nathaniel Lindley’s 1888 partnership treatise listed several differences between partnership property and mere co-ownership under concurrent property estates. Among them was that an ordinary co-owner “can, without the consent of the others, transfer his interest to a stranger, so as to put him in the same position as regards to the other owners as the transferor himself was before the transfer. A partner cannot do this.”¹⁰⁰ In addition, like the other treatise authors described above, Lindley observed that “[t]he mere fact that the property in question was purchased by one partner in his own name is immaterial,” as “he will be deemed to hold the property in trust for the firm.”¹⁰¹

A widely cited law review article published around the turn of the twentieth century summed up the common law’s treatment of partnership property. “[T]he partner’s interest in firm assets is not a tenancy in common, nor a joint tenancy, nor any other sort of a tenancy in the assets themselves; he has no ownership at all in concrete chattels, but an interest in any surplus that may remain after firm debts are liquidated and partners’ accounts balanced,” wrote the author.¹⁰² “If no one partner has any interest in the firm assets themselves, it necessarily follows that *all of them have none*.”¹⁰³ In this respect at least, the traditional partnership turns out to have been more entity than aggregate.

B. The Doctrinal Mechanisms of Property Relinquishment

But what does it mean, in functional terms, to say that individual partners relinquished their ownership rights in specific business assets, despite retaining legal title? I contend that this transformation of property rights was effectuated mainly through three

98. *Id.* at 49.

99. *Id.* at 255.

100. LINDLEY, *supra* note 31, at 52.

101. *Id.* at 323.

102. William H. Cowles, *The Firm as a Legal Person*, 57 CENTRAL L.J. 343, 348 (1903).

103. *Id.* (emphasis added); cf. Joseph H. Drake, *Partnership Entity and Tenancy in Partnership: The Struggle for a Definition*, 8 MICH. L. REV. 609, 627, 629 (1917) (noting that, in the eighteenth century, it became “firmly fixed in the minds of common law courts and lawyers . . . that a partnership holding was *sui generis*” and that the common law “established, apparently unconsciously, a ‘tenancy in partnership,’ though it did not give it a name”).

specific doctrines. These were what I called above the “disgorgement feature,” the “in rem feature,” and the “title consolidation” feature. We now examine these in turn.

1. The Disgorgement Feature

I suggested above why expectation damages are likely to be inadequate when a co-venturer diverts an individually owned productive asset from the business. The harm from breach, in terms of discounted cash flows, may be very hard to ascertain. (Business valuation is difficult and specialized work; investment bankers are paid large sums to do it.) Standard contract doctrine bars plaintiffs from recovering speculative damages, such as lost future profits. Expectation damages will therefore be undercompensatory, setting the stage for inefficient breach.

Of course, the remaining co-venturers could make a counteroffer to prevent defection. In a world with no transaction costs or bargaining breakdowns, the asset will stay in the business so long as it generates more value there than elsewhere. This would of course be true even if the state didn't enforce contracts at all.¹⁰⁴ But the real world obviously does have transaction costs and bargaining breakdowns. Even if it didn't, the ability to credibly commit one's future self—to tie oneself to the mast—is economically valuable in itself.¹⁰⁵ In a dynamic setting, such strong commitments may be necessary in order to induce others to invest in the first place. It follows that undercompensatory damages are socially costly.

Disgorgement differs fundamentally from expectation damages. In economic terms, disgorgement places the *breaching* party in the position she would be in had the breach not occurred. By contrast, expectation damages place the *nonbreaching* party in the position he would be in absent breach. The ubiquitous (if not entirely realistic) illustration of “efficient breach” shows the distinction. Party *A* agrees to sell widgets to Party *B* for \$100. The widgets are worth \$110 to Party *B*. Party *A* breaches the contract in order to sell the widgets to Party *C* for \$120. The measure of expectation damages is \$10—the amount needed to make Party *B* whole. Disgorgement would have yielded the

104. See Daniel A. Farber, *Reassessing the Economic Efficiency of Compensatory Damages for Breach of Contract*, 66 VA. L. REV. 1443, 1478 (1980) (“All measures of damages are economically equivalent in the absence of transaction costs.”).

105. The ability to make such commitments overcomes what economists call a “time inconsistency problem.”

plaintiff \$20. This is a windfall, in the sense that plaintiff prefers breach to performance.

That the law of contracts favors expectation damages, and eschews the (higher) disgorgement measure, is almost beyond dispute.¹⁰⁶ It is true that scholars have identified some isolated instances in which disgorgement has been awarded for breach of contract.¹⁰⁷ But these are extraordinary cases, and recent ones. According to one leading expert, “[D]isgorgement remedies . . . have no basis in standard contract doctrine,” and “disgorgement for breach of contract—meaning a recovery in excess of plaintiff’s loss, intended to strip the defendant of the profits of a wrong—is essentially unknown” outside a narrow class of cases.¹⁰⁸

By contrast, in partnership—as in other fiduciary relationships—the disgorgement remedy is standard.¹⁰⁹ “The remedy is prophylactic in nature,” notes the leading modern partnership treatise, “based on the need not only to compensate but also to deter conduct that poses a risk of damage to the partnership.”¹¹⁰ The same remedy was available at common law. According to Parsons: “[N]o partner can make any use of [partnership] property for his own particular benefit; but he will be held chargeable for all the profits and advantages which may accrue from such use, either as trustee, or in some other adequate way.”¹¹¹ According to Story, any such partner “will be held accountable, not only for the interest of the funds so withdrawn . . . but also for all the profits which he has made thereby.”¹¹²

The disgorgement remedy offers co-venturers a level of commitment that expectation damages can’t match. The defecting co-venturer must hand over any past and future earnings arising from defection. Note that there is no speculative aspect to this remedy—no need for the court to estimate any future cash flows. *Actual* cash flows

106. For a provocative contrary view, see Steve Thel & Peter Siegelman, *You Do Have to Keep Your Promises: A Disgorgement Theory of Contract Remedies*, 52 WM. & MARY L. REV. 1181 (2011). The authors include examples pertaining to fiduciary relations and constructive trusts, however, which are typically characterized as not wholly “contractual.”

107. See Melvin A. Eisenberg, *The Disgorgement Interest in Contract Law*, 105 MICH. L. REV. 559, 562 (2006); Farnsworth, *supra* note 63, at 1339 (noting that “[e]ven advocates of the disgorgement principle [in contract disputes] concede that judicial recognition has been rare”).

108. Andrew Kull, *Disgorgement for Breach, the “Restitution Interest,” and the Restatement of Contracts*, 79 TEX. L. REV. 2021, 2031 (2001). Kull notes that the Restatement (Second) of Contracts has engendered confusion by using the term “restitution,” but he shows beyond doubt that this was not meant to authorize disgorgement.

109. See HURT ET AL., *supra* note 25, §§ 6.07(c), (i).

110. *Id.* § 6.07(i).

111. PARSONS, *supra* note 78, at 394.

112. STORY, *supra* note 85, at 371.

are handed over. Note also that disgorgement removes the incentive to defect in the first place. In effect, the disgorgement remedy gives the venture's governance structure veto power over asset diversion. In Calabresi-Melamed terms, the asset configuration is protected by a property rule rather than a liability rule. To be sure, this type of strong commitment comes at a cost. Owing to holdup problems, property rules may sometimes obstruct *efficient* violations of the underlying entitlement.¹¹³ But this cost must be weighed against the corresponding benefit.¹¹⁴ In the context of joint enterprise—where expectation damages are systematically undercompensatory—property rules prevent co-venturers from defecting with their individually owned assets, allowing for stickier asset configurations.

But isn't this just contract, inasmuch as it is a consensual relationship, presumably reflecting the parties' *ex ante* preferences? This is true only if we treat "contract" as an abstraction rather than as a body of law with its own internal logic. As described above, contract doctrine reflects deep liability-rule norms, and it resists parties' efforts to opt out of those norms and into property-rule norms.¹¹⁵ Disgorgement is quintessentially equitable and may require ongoing judicial supervision and involvement. The court imposes a constructive trust on the breaching party; the nonbreaching party *owns* any future earnings that accrue to the breaching party as a result of breach. The disgorgement remedy sounds in property rather than contract.

2. The In Rem Feature

Consider now the second doctrinal feature that nullified individual partners' property interests at common law: what I referred to above as the "in rem" feature.¹¹⁶ When an individual partner, *holding legal title* to a partnership asset, sold the asset without partnership authorization, a knowing *purchaser* of the asset took it subject to the "equities" of the partners.¹¹⁷ That is to say, the purchaser was required

113. See Calabresi & Melamed, *supra* note 21, at 1106–10.

114. See Henry E. Smith, *Property and Property Rules*, 79 N.Y.U. L. REV. 1719 (2004) (describing information-cost advantages of property rules over liability rules). Relatedly, another scholar suggests that "[d]isgorgement awarding the plaintiff more than he lost is justified in a narrow class of cases in which the defendant's election to breach imposes harms that a potential liability for provable damages will not adequately deter." Kull, *supra* note 108, at 2052.

115. See *supra* Section II.B.

116. I use the term "in rem" to refer to situations in which "someone has a right that holds against a large and indefinite class of others, as opposed to specifically identified others." Merrill & Smith, *supra* note 49, at 782.

117. For a description of the common law partners' equities doctrine, see RIBSTEIN, *supra* note 16, at 42; HURT ET AL., *supra* note 25, § 3.05(c)(2). The in rem feature described here is analogous

to use the asset for partnership purposes—if indeed the purchaser was deemed to have title at all. The partners’ right to have the asset deployed for business purposes was thus enforceable against third parties with whom no contractual privity existed: the right “ran with the asset.”¹¹⁸

The Parsons and Story treatises treat this topic in detail. According to Parsons, knowing vendees of partnership assets sold without authorization (i.e., in contravention of partnership governance) are deemed “to be trustees thereof for the benefit of the firm”; indeed, “[s]uch a sale would pass no title whatever.”¹¹⁹ According to Story:

[W]here one partner misapplies the funds, or securities, or other effects of the partnership in discharge or payment of his own private debts, claims, or contracts . . . the creditor, dealing with the partner and knowing the circumstances, will be deemed to act *mala fide* and in fraud of the partnership, and the transaction . . . will be treated as a nullity.¹²⁰

Both Parsons and Story were clear that the doctrine applied even to real estate held in the name of the errant partner. “[H]e who happens to have the legal title, cannot sell the real estate without the consent and authority of the rest, so as to give title to a grantee having notice,” wrote Parsons.¹²¹ “[H]e cannot directly convey or appropriate it, excepting so far as he has the legal title in himself, and then a purchaser with knowledge or the means of knowledge takes the land subject to all the equities of the partners.”¹²² Indeed, “if the grantee knew or had sufficient means of knowing that it belonged to the firm, his title will be annulled, or he will be charged as trustee for the firm.”¹²³ He concluded that “[s]uch a sale would pass no title whatever.”¹²⁴ Story said much the same. “As in all cases of real estate held on trust,” he wrote, “one who

to the familiar “tracing” remedy in the law of trusts. See GEORGE T. BOGERT, TRUSTS § 161 (6th ed. 1987). In agency law, similar principles apply in the case of an agent’s unauthorized transfer of a principal’s property. It merits emphasis that this does not imply that agency law could substitute for partnership law in supplying the in rem feature. If the only available technologies were property, contract, and agency, then each specific business asset would be associated with at least one partner as “principal,” and the remaining co-owners would be unable to assert tracing-style remedies against the *principal’s* transferees.

118. In their scholarship on property and contract, Hansmann and Kraakman treat this running-with-the-asset feature as noncontractual. See Henry Hansmann & Reinier Kraakman, *Property, Contract, and Verification: The Numerus Clausus Problem and the Divisibility of Rights*, 31 J. LEGAL STUD. S373, S374 (2002) (“Property rights differ from contract rights in that a property right in an asset, unlike a contract right, can be enforced against subsequent transferees of other rights in the asset. That is, a property right ‘runs with the asset.’”).

119. PARSONS, *supra* note 78, at 164, 168.

120. STORY, *supra* note 85, at 222.

121. PARSONS, *supra* note 78, at 376–77.

122. *Id.*

123. *Id.* at 378.

124. *Id.* at 168.

purchases real estate from the partner having the legal title, with notice that it is partnership property, will take the land subject to the equities of the partners and partnership creditors”¹²⁵

Notably, this in rem feature applied equally to heirs and devisees of a deceased partner, despite the absence of privity. “The heir always takes the real estate in order to support the legal title, and is then held as trustee for all those purposes to which the land must be devoted in order to make it effectually partnership property,” wrote Parsons.¹²⁶ “If land be conveyed to partners, in fact as partnership property, but in form to them as tenants in common, and one dies, his heir becomes tenant in common with the other partners. Here, as before, he holds as trustee for the partnership”¹²⁷ According to Story: “[A]s in other trusts, partnership equities will be enforced against the heirs, devisees, or widow of the partner who held the legal title.”¹²⁸

If the disgorgement feature was foreign to contract, the in rem feature was all the more so.¹²⁹ Hansmann and Kraakman argued that asset partitioning is fundamentally noncontractual inasmuch as it binds third parties: creditors of individual partners are subordinated by operation of law to business creditors in the division of business assets. The in rem feature described here has this same noncontractual quality, but in furtherance of different ends: not the facilitation of credit analysis, but rather the maintenance of going-concern value through the cementing of partners’ ex ante commitment. In effect, each partner had the status of mere agent with respect to *all* partnership property. Equivalently stated, no individual partner was a principal with respect to any specific business asset, irrespective of legal title. The result was a far more tightly bound asset configuration than could have been achieved through contract. Like the disgorgement feature, the in rem feature promoted business continuity.

125. STORY, *supra* note 85, at 135 (coauthor’s addition).

126. PARSONS, *supra* note 78, at 373.

127. *Id.* at 374 (footnote omitted).

128. STORY, *supra* note 85, at 135 (coauthor’s addition).

129. A number of scholars have identified this in rem quality as the distinguishing feature of property entitlements. See, e.g., Kenneth Ayotte & Patrick Bolton, *Optimal Property Rights in Financial Contracting*, 24 REV. FIN. STUD. 3401, 3402 (2011); Merrill & Smith, *supra* note 49; Thomas W. Merrill & Henry E. Smith, *What Happened to Property in Law and Economics?*, 111 YALE L.J. 357, 358–59 (2001). The other leading contender is the Calabresi-Melamed property rule/liability rule distinction. It is notable that, along both of these dimensions, traditional partnership law embedded property-type features.

3. The Title Consolidation Feature

At common law, partners' relinquishment of individual property rights in specific assets was not limited to the life of the partnership. It extended through dissolution. The waiver of property rights was therefore permanent; prerogatives of ownership in specific business assets did not revert to individual partners at termination.

To put the same point another way: upon dissolution, no partner was entitled to have the firm's assets divvied up or to assert a property right in any specific business asset. The nineteenth-century partnership treatises are unanimous on this score. According to Parsons, "a mere dissolution has no effect whatever on the property of the partners."¹³⁰ Story noted that, upon dissolution, there is no "division . . . in kind" of partnership property unless all the partners agree to it.¹³¹ Gow observed that, upon dissolution, "[o]ne partner has no claim upon his individual proportion of a specific article He cannot separate his share from the bulk of the joint property."¹³² Lindley wrote that "[a] partner has no right to partition in specie, but is entitled, on a dissolution, to have the partnership property, whether land or not, sold, and the proceeds divided."¹³³ And William Watson likewise wrote that no partner can insist on an "actual division of specific effects" upon dissolution.¹³⁴

What each partner received upon dissolution was instead an *option* to insist upon a sale of the entire business, under the supervision of the court (or a court-appointed manager) if necessary.¹³⁵ The idea was to maintain going-concern value by selling the business as a whole rather than piecemeal. To preempt the auction, a deal could be—and apparently often was—struck between those partners wishing to continue the business, on the one hand, and those wishing to (or forced to) depart, on the other.¹³⁶ The result in such cases was a fixed cash payment from the continuing to the departing partner(s), paid either immediately or in installments over time. The *partnership* was

130. PARSONS, *supra* note 78, at 386.

131. STORY, *supra* note 85, at 544.

132. GOW, *supra* note 92, at 256–57.

133. LINDLEY, *supra* note 31, at 52.

134. WILLIAM WATSON, A TREATISE OF THE LAW OF PARTNERSHIP 96 (London, J. Butterworth, 2d ed. 1807).

135. See GOW, *supra* note 92, at 257; PARSONS, *supra* note 78, at 446, 525; STORY, *supra* note 85, at 544; WATSON, *supra* note 134, at 386. Business continuity could also be enhanced by the inclusion of continuation provisions in the partnership agreement, but the more important point is that even the default rule was conducive to business continuity.

136. This remains true under modern American partnership law. See *supra* note 59.

“dissolved” in such cases, but the *business* continued. As Parsons noted, upon dissolution, partners would frequently “value the property, goodwill, &c., and found their arrangements upon this estimate, one paying to the other a sum of money, without any account being taken.”¹³⁷ According to Gow, “[o]n the secession of one partner from a firm, it is, generally speaking, agreed, that he shall receive a sum of money or an annuity, proportioned to his share in the concern”¹³⁸ Watson agreed: “In these cases the partner coming in or retiring generally pays or receives a sum of money in proportion to his share in the concern.”¹³⁹ Title to business assets was thereby consolidated in the continuing partnership, and departing partners could claim no property interest in any specific asset.

To be sure, asset configurations were not always successfully protected; dissolution could be hazardous to going-concern value. Partnerships then (as today) were easily dissolvable. Absent agreement to the contrary, traditional partnerships were dissolved at the will of any partner, and dissolution was automatic upon the death or bankruptcy of any partner. But it is not the case, as some modern scholars have seemed to assume,¹⁴⁰ that business assets were liquidated piecemeal whenever a partnership was dissolved at common law. Dissolution referred to a change in legal relations; it did not necessarily mean the end of the business.¹⁴¹ By disallowing individual partners from asserting property rights in specific business assets upon dissolution, traditional partnership law increased the likelihood that the asset configuration would remain intact.

137. PARSONS, *supra* note 78, at 511.

138. GOW, *supra* note 92, at 259.

139. WATSON, *supra* note 134, at 386.

140. See, e.g., Blair, *supra* note 20, at 409 (observing that in a traditional partnership at will “any partner could terminate the relationship, and thereby force dissolution of the *assets of the business*, at any time and for any reason” (emphasis added)); Hansmann & Kraakman, *supra* note 1, at 434 (noting that, in the contemporary partnership at will, “the firm’s owners are free to withdraw *their share of the firm’s assets* at any time” (emphasis added)); Naomi R. Lamoreaux & Jean-Laurent Rosenthal, *Corporate Governance and the Plight of Minority Shareholders in the United States Before the Great Depression*, in CORRUPTION AND REFORM: LESSONS FROM AMERICA’S ECONOMIC HISTORY 125 (Edward L. Glaeser & Claudia Goldin eds., 2006) (developing a model in which partnership dissolution automatically triggered piecemeal business liquidation and loss of going-concern value).

141. As Alan Bromberg has emphasized, “dissolution itself is a technical concept of little inherent interest,” and “there may be a winding up of the *affairs* of a partnership without liquidation of the *business* as a going concern if the business is continued by some of the partners, in what is technically a new firm, with appropriate payments to settle the accounts of the old firm.” Alan R. Bromberg, *Partnership Dissolution—Causes, Consequences, and Cures*, 43 TEX. L. REV. 631, 631–32 (1965).

Modern scholars have often overlooked the features of traditional partnership law that were conducive to business continuity, in part because they have tended to compare the traditional partnership to the corporation. Indisputably, partnerships were more fragile than corporations. Corporations achieved full capital lock-in and were therefore better suited to large-scale, capital-intensive enterprise.¹⁴² The question at hand, though, is what partnership accomplished that contract alone could not. And it is highly unlikely that the forced-sale option—the linchpin by which both legal title and collective beneficial ownership were consolidated in the continuing partners upon dissolution—could have been effectuated by contract. This type of muscular, equitable judicial intervention could not have been called forth through purely contractual means.¹⁴³

The point comes through quite clearly when we consider the effects of a partner's death or bankruptcy. No mere contract between co-venturers could bind the heirs/devisees (in the case of death) or estate administrators/creditors (in the case of bankruptcy) of any co-venturer to submit to a forced sale of assets. But in partnership law they were so bound: the *in rem* and forced-sale features were interlocked. As to death, according to Parsons, “the representatives of the deceased cannot claim or take any one chattel, or any portion of the merchandise.”¹⁴⁴ The representatives stood on the same footing as a partner: according to Story, “they are entitled to have the property sold” in its entirety.¹⁴⁵ The situation in bankruptcy was analogous. According to Parsons, when a partner went bankrupt, the “court would always decree a sale where the assignees requested it for good cause.”¹⁴⁶ But typically this didn't happen: “Usually, there is no sale, but the solvent partners settle up the concern so far as to ascertain the value of the bankrupt's interest, and this they pay to the assignees.”¹⁴⁷ This result clearly could not have been effectuated by a mere contract among business co-owners; such a contract could not have bound third parties who succeeded to the property in question.

Remarkably, the same analysis applied in the case of execution by partners' individual creditors. Such creditors were entitled to exercise the forced-sale option, but generally speaking they were *not* entitled to dismantle the business through direct recourse to specific

142. See Blair, *supra* note 20.

143. See PARSONS, *supra* note 78, at 15.

144. *Id.* at 441.

145. STORY, *supra* note 85, at 537.

146. PARSONS, *supra* note 78, at 507.

147. *Id.* at 506. Lindley offered a similar analysis. See LINDLEY, *supra* note 31, at 339.

assets.¹⁴⁸ “[I]t has long since been the well established rule and practice, that no private creditor of a partner could take by his execution anything more than that partner’s share in whatever surplus remained after the partnership effects had paid the partnership debts,” wrote Parsons.¹⁴⁹ He continued:

[A] creditor of any debtor can secure to himself, and for his own benefit by attachment and levy, only the property, interest, or right which his debtor has . . . What, then, is the right, or interest, or property of a partner to or in the effects of the partnership? Certainly not a separate and exclusive right to any part or portion of it; or any right of any kind to any one part rather than to any other part; or any other right or interest than that which all the other partners have. . . . What the law permits him to do or cause to be done, without the consent of others, is to settle the concern, pay the debts, and then divide the surplus. This is, practically speaking, the whole of his right. And this, and only this, is therefore the right which his private creditor can acquire by attachment or execution. That is, his creditor may put himself exactly in the place of his debtor, both as to the power of the latter and as to its limitations. . . . The partner himself is wholly without the right (unless by agreement) of appropriating to himself in severalty anything whatever which belongs to the common stock. . . . How, then, can it be held . . . that his private creditor [may do so]?¹⁵⁰

Similarly, Story noted the following regarding the sale of partnership property upon execution by separate creditors:

[T]he sheriff may seize, and should seize, the interest of the separate partner in the property of the partnership; and that, and that alone, he is at liberty to sell upon the execution. . . . Strictly, indeed, and properly speaking, the sale does not, at least in the view of a court of equity, transfer any part of the joint property to the purchaser, so as to entitle him exclusively to take it or withhold it from the other partners; for that would be to place him in a better situation than the execution partner himself in relation to the property. But it gives him a right to a bill in equity, calling for an account and settlement of the partnership concerns, and thus to entitle himself to that interest in the property, which, upon the final adjustment and settlement of the partnership concerns, shall be ascertained to belong to the execution partner, and nothing more.¹⁵¹

Watson’s analysis was the same: Where there was execution against one partner,

148. To be sure, there was some contrary authority on this score, and confusion at common law over the process by which a separate creditor enforced process against a partner-debtor’s interest in partnership property was a major impetus behind the (statutory) creation of the “charging order” in both England and the United States. See UNIF. P’SHIP ACT § 28, 6 U.L.A. 244 (2015); English Partnership Act, 1890, 53 & 54 Vict. c. 39, § 23. J. Gordon Gose has noted that, while the old common law procedure was “artificial and confusing” and could be hazardous to going-concern value, the effect was “a procedure commencing with the seizure of property but in its later stages converted into a proceeding whereby the debtor’s beneficial interest is made available to his creditor.” J. Gordon Gose, *The Charging Order Under the Uniform Partnership Act*, 28 WASH. L. REV. 1, 1–2 (1953) (emphasis added); see also Note, *The Power of a Partner’s Individual Creditor to Reach Partnership Property*, 27 COLUM. L. REV. 436, 438–39 (1927) (describing conflicting authority).

149. PARSONS, *supra* note 78, at 343.

150. *Id.* at 350–53 (emphasis omitted).

151. STORY, *supra* note 85, at 405–08.

[t]he best opinion seems to be, that the sheriff . . . should sell only an undivided moiety of the partnership effects. Conveniency and justice certainly require this mode of proceeding, as it enables the other partner to buy in the share sold, so that the business is not broke up or disturbed; and the vendee, if a stranger, will only succeed to the share due to the defendant upon a balance being struck. . . . Courts of equity consider that the interest of each partner in the partnership effects is only what remains after the partnership accounts are taken; and as the creditor cannot be entitled to any more than what his debtor possessed, an account must be taken before the fruits of an execution upon the partnership effects can be reaped.¹⁵²

Lindley agreed that it was only “the *share* of a partner”—that is, “his proportion of the partnership assets after they have been all realised and converted into money, and all the debts and liabilities have been paid and discharged”—that “the sheriff can dispose of under a [writ of execution] issued at the suit of a separate creditor.”¹⁵³ It is clear from these passages that partnership law was instrumental not only in *subordinating* separate creditors’ claims on business assets (the essence of the asset-partitioning theory), but also in preventing separate creditors from destroying going-concern value by asserting direct property interests in specific business assets. Such a result clearly could not have been achieved by a contract among business co-owners, as such a contract would not have bound creditors.

Modern scholars often portray the traditional partnership as a fragile, impermanent relationship.¹⁵⁴ Yet the old treatises contain numerous references to long-standing partnerships. “We have in this country many ancient firms, in which there may not be one person who was a partner from the beginning,” noted Parsons.¹⁵⁵ “In England there are firms which have survived some generations, but the name has never been changed, and the business has gone on without deviation or interruption. But we still say that the partnership is dissolved by every change.”¹⁵⁶ He went on to note that, after dissolution, “[f]requently, the new firm goes on in its regular business,” and its customers “say nothing, but continue their dealings with the new firm.”¹⁵⁷ According to

152. WATSON, *supra* note 134, at 100.

153. LINDLEY, *supra* note 31, at 339–40.

154. There have been exceptions; according to one leading expert, while “the partnership is, on the surface, a fragile and temporary relationship . . . the common view of the partnership as an easily terminable relationship is overly simplistic.” Robert W. Hillman, *The Dissatisfied Participant in the Solvent Business Venture: A Consideration of the Relative Permanence of Partnerships and Close Corporations*, 67 MINN. L. REV. 1, 35–36 (1982); see also Larry E. Ribstein, *Why Corporations?*, 1 BERKELEY BUS. L.J. 183, 193 (2004) (noting that “the continuity inherent in the partnership form has long been recognized”). Blair describes some major instances of large enterprises that functioned as partnerships over long periods in the nineteenth century. See Blair, *supra* note 20, at 449–54.

155. PARSONS, *supra* note 78, at 407.

156. *Id.*

157. *Id.* at 425.

Watson, “When a partnership is dissolved, it frequently happens that it is only to make some alteration in the firm, and the partnership business goes on as before.”¹⁵⁸ Lindley wrote: “Where a change occurs in a firm by the retirement of one or more of its members, nothing is more common than for the partners to agree that those who continue the business shall take the property of the old firm and pay its debts”¹⁵⁹ In such cases, title was consolidated and the asset configuration remained undisturbed. Business assets plainly weren’t scattered to the wind.

* * *

To sum up, at common law, individual partners lacked any meaningful “property” interest in specific business assets. The three equitable doctrines described above—the disgorgement feature, the in rem feature, and the title-consolidation feature—nullified their legally cognizable ownership interests. And this legal engineering allowed for a much stronger form of commitment—a much tighter form of capital “lock-in”—than would have been possible through contract, property, and agency law. Notably, these doctrines were not designed to solve information problems, à la Hansmann and Kraakman. Instead, they were about overcoming excesses of property—the challenges of fragmented property rights.

IV. SOME IMPLICATIONS

This Part explores parallels between the property-relinquishment theory of organizational law and three other scholarly domains: the “anticommons” literature in property law, the dominant account of the conceptual underpinnings of business bankruptcy law, and the economic theory of the firm. It turns out that these disparate fields share a common deep structure, inasmuch as they are centrally concerned with the problems that arise from *fragmentary* property interests.

A. Organizational Law and the Anticommons

Among the more provocative and influential ideas in property law scholarship over the past several decades has been Michael Heller’s

158. WATSON, *supra* note 134, at 386.

159. LINDLEY, *supra* note 31, at 336.

“tragedy of the anticommons.”¹⁶⁰ Heller turns the tables on the familiar “tragedy of the *commons*,” a metaphor for a type of collective action problem.¹⁶¹ In the tragedy of the commons, too much access to a shared resource leads to overuse and depletion. To use the standard example, if every sheep herder has unlimited access to a given pasture, their sheep will overgraze the pasture in an unsustainable way. Each individual herder receives a direct benefit from adding to his flock, while the resulting costs of resource degradation are shared with others. The resource is wasted, leaving everyone worse off in the aggregate. Thus the rational but uncoordinated actions of individuals produce a bad result. A sole owner, by contrast, would use the resource in a measured and sustainable way, thereby maximizing the value of the resource. One interpretation of the tragedy of the commons is that insufficient property rights can lead to economic waste.

Heller’s insight was to identify—and attach a name to—essentially the opposite problem, which is that *excessive* property rights can lead to economic waste. The term *anticommons*, he writes, “covers any setting in which too many people can block each other from creating or using a scarce resource.”¹⁶² In these settings, the inefficiency arises not from overuse but from *underuse* of the resource. “When too many people own pieces of one thing,” writes Heller, “cooperation breaks down, wealth disappears, and everybody loses.”¹⁶³ Each owner has the right to exclude, resulting in gridlock. An important implication of Heller’s thesis is that avoiding economic waste requires more than clarity of property rights. In a world of positive transaction costs, the way such rights are bundled matters too.

To illustrate his thesis, Heller describes the control over the Rhine River in the Middle Ages.¹⁶⁴ The Rhine was an important trade route, and the Holy Roman Empire protected it, charging merchants modest tolls to use the river. When the Holy Roman Empire declined, however, hundreds of German barons established castles up and down the Rhine, charging tolls for the use of each segment. The result was gridlock: while the resource itself had not changed, its use plummeted, and everybody (even the barons) suffered as a result. Thus excessively

160. See MICHAELA A. HELLER, *THE GRIDLOCK ECONOMY: HOW TOO MUCH OWNERSHIP WRECKS MARKETS, STOPS INNOVATION, AND COSTS LIVES* (2008) [hereinafter HELLER, *GRIDLOCK ECONOMY*]; Michael A. Heller, *The Tragedy of the Anticommons: Property in the Transition from Marx to Markets*, 111 HARV. L. REV. 621 (1998).

161. The term was coined by Garrett Hardin. See Garrett Hardin, *The Tragedy of the Commons*, 162 SCIENCE 1243, 1244 (1968) (“Freedom in a commons brings ruin to all.”).

162. HELLER, *GRIDLOCK ECONOMY*, *supra* note 160, at 18.

163. *Id.* at xiv.

164. See *id.* at 3–4.

subdivided “property” rights destroyed wealth. Heller applies this insight to various modern contexts: fragmentary rights to U.S. airwaves that render most of the broadcast spectrum pointlessly idle,¹⁶⁵ expansive patent protection that impedes the creation of valuable pharmaceuticals,¹⁶⁶ and even the mismanagement of privatization in the former Soviet Union.¹⁶⁷

The property-relinquishment theory of organizational law presented herein has much in common with Heller’s anticommons concept. At the core of both theories is the problem of fragmentary ownership leading to economic waste. When it comes to joint enterprise, fragmentary ownership generates waste in two ways. First, asset diversion may destroy going-concern value. Second, and more important, in a dynamic setting, the very *prospect* of such diversion discourages the formation of joint enterprise in the first place. To prevent these forms of waste, business co-owners must be divested of property rights in specific business assets—a result that cannot be achieved through contracting alone. Organizational law thus overcomes a form of anticommons that would otherwise frustrate the creation of productive enterprise.

Intriguingly, Heller notes that property law contains a set of doctrines that impede excessive fragmentation. “Hidden within the law,” he writes, “is a boundary principle that limits the right to subdivide private property into wasteful fragments.”¹⁶⁸ This boundary principle finds expression in, among other things, zoning rules that limit subdivision;¹⁶⁹ the *numerus clausus* principle, which proscribes the creation of new property estates;¹⁷⁰ and the rule against perpetuities, which reduces “inter-temporal” fragmentation.¹⁷¹ Heller argues that it is important to embed such limits in the law itself, because fragmentation “may operate as a one-way ratchet”—it is easier to fragment than to reassemble.¹⁷²

165. *See id.* at 79–106.

166. *See id.* at 49–78.

167. *See id.* at 145–48.

168. *See* Michael A. Heller, *The Boundaries of Private Property*, 108 *YALE L.J.* 1163, 1165 (1999).

169. *See id.* at 1173.

170. *See id.* at 1176.

171. *See id.* at 1179.

172. *Id.* at 1165. Where property has already been fragmented, Heller suggests novel methods of assembly. For example, as an alternative to using eminent domain for economic development, he and a coauthor propose the creation of “land assembly districts” under which landowners would collectively decide through a self-governance arrangement whether to proceed with assembly. *See* Michael Heller & Rick Hills, *Land Assembly Districts*, 121 *HARV. L. REV.* 1465 (2008).

One way of understanding organizational law—including, but not limited to, the traditional partnership—is precisely as a property-assembly mechanism. By forfeiting property interests to the governance structure of the organization, co-owners reduce the likelihood of value-destroying defection; they thereby mutually encourage each other to join the enterprise in the first place. Note that, like Heller's anticommons concept, the property-relinquishment theory is mostly about commitment and cooperation; it has little to do with reducing monitoring costs or other information costs.

B. Organizational Law and the Logic of Bankruptcy Law

The property-relinquishment theory of organizational law finds a nice analogue in the theoretical foundations of business bankruptcy law. Among business law scholars, it is widely accepted that business bankruptcy law functions primarily as a collective debt-collection device.¹⁷³ Without bankruptcy law, creditors' remedies against nonperforming debtors would be governed by ordinary debtor-creditor law. A key feature of ordinary debtor-creditor law—what Thomas Jackson has called “grab law”—is the characteristic of first-come, first-served.¹⁷⁴ A creditor seeking repayment from a nonpaying debtor asks the court for relief; when judgment is entered, the creditor may enlist the sheriff to seize property from the debtor in satisfaction of the claim. When there aren't enough assets to satisfy all creditors, those who get in line first get paid off, while those who don't lose out.

In the context of business insolvency, first-come, first-served creditor remedies may destroy value. “The use of individual creditor remedies may lead to a piecemeal dismantling of a debtor's business by the untimely removal of necessary operating assets,” writes Jackson.¹⁷⁵ “[A] collection of assets is sometimes more valuable together than the same assets would be if spread to the winds. It is often referred to as the surplus of a going-concern value over a liquidation value.”¹⁷⁶ Grab law, then, raises the prospect of inefficiently dismantling asset configurations. The issue can be understood as a collective action problem; indeed, Jackson analogizes grab law to the tragedy of the commons. “The question at the core of bankruptcy law,” writes Jackson,

173. For an influential articulation of this view, see THOMAS H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* (1986).

174. *Id.* at 8–9.

175. *Id.* at 14.

176. *Id.*

“is whether a *better* ordering system can be devised that would be worth the inevitable costs associated with implementing a new system.”¹⁷⁷

Bankruptcy law supplants grab law—which is characterized by first-come, first-served—in favor of a collective and compulsory proceeding. Crucial to this proceeding is an automatic stay on creditor claims.¹⁷⁸ The automatic stay, effective upon the filing of a bankruptcy petition, forecloses piecemeal dismantling. The business may then be chopped up sensibly in liquidation, or it may remain intact while the firm’s capital structure is adjusted in a reorganization. Necessarily, bankruptcy law usurps individual creditor remedies. But it should nevertheless make creditors as a whole better off, primarily because it protects asset configurations. In the words of two other prominent bankruptcy scholars, “The details of the current bankruptcy system are labyrinthine, but they can be described generally as constraining the collection rights of each creditor individually in order to promote a somewhat more efficient liquidation or reorganization for the benefit of all concerned.”¹⁷⁹

It should be clear that organizational law and business bankruptcy law enjoy a deep conceptual symmetry. The property-relinquishment feature of organizational law prevents business co-owners from inefficiently dismantling asset configurations through rational, self-interested behavior—a problem that cannot be solved through contracting. Bankruptcy law prevents business *creditors* from doing the same. To put the point slightly differently, organizational law causes business co-owners to relinquish property rights in specific business assets, while bankruptcy law prevents business creditors from establishing or exercising such property rights.

Coincidentally, around the time Hansmann and Kraakman were asking what organizational law adds to contract, bankruptcy law scholarship was preoccupied with the question whether business bankruptcy law might be replaced by “contractualist” approaches.¹⁸⁰ In

177. *Id.* at 10.

178. See 11 U.S.C. § 362 (2012).

179. Elizabeth Warren & Jay Lawrence Westbrook, *Contracting Out of Bankruptcy: An Empirical Intervention*, 118 HARV. L. REV. 1197, 1200 (2005).

180. See, e.g., Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 STAN. L. REV. 311 (1993); Lucian Arye Bebchuk, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775 (1988); Robert K. Rasmussen, *Debtor’s Choice: A Menu Approach to Corporate Bankruptcy*, 71 TEX. L. REV. 51 (1992); Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 YALE L.J. 1807 (1998). Warren and Westbrook wrote in 2005 that the “contractualist” approach—or “privatization of bankruptcy”—had “dominated the academic stage” of bankruptcy scholarship “[f]or nearly a decade.” Warren & Westbrook, *supra* note 179, at 1198.

other words, the question was what bankruptcy law adds to contract. This scholarly parallelism arguably reflects a deeper, functional one. Both organizational law and bankruptcy law are concerned, in large measure, with preventing the inefficient disassembly of asset configurations. The very existence of these bodies of law testifies to the insufficiency of contract in maintaining going-concern value.

Finally, the issue of administrative costs—the costs of abandoning judicial minimalism—arises here too. In his analysis of the historical evolution of debtor-creditor law, Robert Clark has noted that the gradual shift from grab law to equity receivership to full-fledged bankruptcy reorganization law brought with it significant administrative costs.

[O]nly with the rise of very large business enterprises were there sufficiently frequent and sizable economies of scale in debt-enforcement proceedings to justify the legal innovations in question. Unless the surplus of going-concern value over liquidation value was substantial, as it might be for a large business, or the debtor business was so large and complex that it would have been impossible or quite expensive to find or to create a fair-sized pool of reasonably informed potential outside buyers, the efficiency benefits of a receivership or reorganization proceeding would not exceed the very substantial administrative, negotiation, and legal costs of the proceeding itself.¹⁸¹

Just as organizational law is, administratively speaking, more resource-intensive than contract law, bankruptcy law is more resource-intensive than grab law. In both cases, the added administrative cost is justified by the immense value that accrues to society from the creation and maintenance of going-concern value in productive enterprise.

C. Organizational Law and the Economic Theory of the Firm

The economic theory of the firm seeks to explain the nature and boundaries of business firms.¹⁸² Given that organizational forms are the legal vehicle for most productive enterprise, it is only natural that one would find connections between the economic theory of the firm and organizational law theory.¹⁸³

To see these connections, it is useful to briefly review some landmark contributions to the economic theory of the firm. In a pioneering article, Ronald Coase envisioned firms as miniature

181. Robert C. Clark, *The Interdisciplinary Study of Legal Evolution*, 90 YALE L.J. 1238, 1254 (1981).

182. For a good and mostly nontechnical (though somewhat dated) overview, see Bengt R. Holmstrom & Jean Tirole, *The Theory of the Firm*, in 1 HANDBOOK OF INDUSTRIAL ORGANIZATION 61 (Richard Schmalensee & Robert Willig eds., 1989).

183. For a previous exploration of these connections, see Edward M. Iacobucci & George G. Triantis, *Economic and Legal Boundaries of Firms*, 93 VA. L. REV. 515 (2007).

command-and-control economies residing within a more general context of market exchange.¹⁸⁴ He presented firms' existence as a puzzle. "[I]n view of the fact that it is usually argued that co-ordination will be done by the price mechanism," he asked, "why is such organisation necessary? Why are there these 'islands of conscious power'?"¹⁸⁵ His answer was, essentially, transaction costs.¹⁸⁶ If there were no transactions costs, every economic interaction would be governed by "market" terms; for example, rather than instructing an employee to perform some task, a businessperson would put the task up for bid to the market and accept the bidder who was willing to perform the task at lowest cost. The existence of transaction costs, Coase argued, makes this impracticable. It may therefore be more efficient to have dedicated employment structures. "[T]he distinguishing mark of the firm," he wrote, "is the supersession of the price mechanism."¹⁸⁷ Coase thus pictured the firm as a kind of long-term contract in which "the service which is being provided is expressed in general terms, the exact details being left until a later date."¹⁸⁸ According to Coase: "When the direction of resources (within the limit of the contract) becomes dependent on the buyer in this way, that relationship which I term a 'firm' may be obtained."¹⁸⁹ Intriguingly, Coase's theory also offered a way of thinking about the *size* of firms in marginal cost terms. "A firm will tend to expand," he wrote, "until the costs of organizing an extra transaction within the firm become equal to the costs of carrying out the same transaction by means of an exchange on the open market or the costs of organizing in another firm."¹⁹⁰

Building on Coase's foundation, Oliver Williamson has articulated a theory of the firm relying on three basic postulates. First, contracts are incomplete: it isn't feasible to write a contract that covers every possible eventuality.¹⁹¹ Second, people are opportunistic: they will behave strategically to further their own interests.¹⁹² Third, many business inputs are characterized by "asset specificity":¹⁹³ value is lost when such assets are redeployed to other uses. In combination,

184. Ronald H. Coase, *The Nature of the Firm*, 16 *ECONOMICA* 386 (1937).

185. *Id.* at 388.

186. *See id.* at 390-91.

187. *Id.* at 389.

188. *Id.* at 392.

189. *Id.*

190. *Id.* at 395.

191. *See* Oliver E. Williamson, *Transaction Cost Economics*, in *HANDBOOK OF INDUSTRIAL ORGANIZATION*, *supra* note 182, at 135, 139-40.

192. *See id.* at 139.

193. *See id.* at 142-43.

Williamson argues, these three aspects of the commercial world pose obstacles to efficient resource allocation. The reason is that holdup problems become endemic. When one party realizes that an asset owner must transact with that party or else suffer a loss—the condition of asset specificity—the party will raise the price opportunistically. The prospect of such opportunism discourages valuable asset-specific investment in the first place. Contracting provides only an imperfect solution, given contractual incompleteness. To overcome these obstacles, notes Williamson, parties may choose to implement “governance structures” such as “recourse to collective decision making under some form of combined ownership.”¹⁹⁴

Expanding on this analysis, Oliver Hart has advanced what he calls a “property rights” theory of the firm.¹⁹⁵ Like Williamson, Hart stresses the importance of contractual incompleteness, opportunism, and asset specificity.¹⁹⁶ But Hart’s theory emphasizes the *power* that accompanies property rights. “[F]irms arise in situations where people cannot write good contracts and where the allocation of power or control is therefore important,” he writes.¹⁹⁷ And “ownership is a source of power when contracts are incomplete.”¹⁹⁸ In his model, owners possess residual control rights in assets, which confers power. Owing to contractual incompleteness, contracts alone are insufficient to align incentives and create efficient resource allocations. In these circumstances, he argues, combined ownership of business assets within the firm may be more efficient than contracting under separate

194. *Id.* at 147.

195. OLIVER HART, FIRMS, CONTRACTS, AND FINANCIAL STRUCTURE (1995); see also Sanford J. Grossman & Oliver D. Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, 94 J. POL. ECON. 691 (1986); Oliver Hart & John Moore, *Property Rights and the Nature of the Firm*, 98 J. POL. ECON. 1119 (1990). Raghuram Rajan and Luigi Zingales articulate a theory of the firm built around the problem of expropriation. Raghuram G. Rajan & Luigi Zingales, *The Firm as a Dedicated Hierarchy: A Theory of the Origins and Growth of Firms*, 116 Q.J. ECON. 805 (2001). In creating an enterprise, an entrepreneur brings some “unique critical resource”—an idea, business process, set of customer relationships, or something of this nature. *Id.* at 805. The problem she faces is how to enlist cooperation from other people for production. By bringing others into the fold, the entrepreneur runs the risk that they might expropriate some or all of the critical resource. “[T]he degree of expropriability of the technology,” write Rajan and Zingales, “is a measure of the difficulty of enforcing property rights.” *Id.* at 808. Note that the problem they describe is essentially the reverse of the problem analyzed in this Article: they focus on the value of retaining, rather than relinquishing, property rights.

196. HART, *supra* note 195, at 26–27. Strictly speaking, Hart’s theory doesn’t require opportunism; “rather than being opportunistic, [the parties may] simply have different views about the returns from various asset usages and hence disagree about how the assets should be employed.” *Id.* at 88.

197. *Id.* at 1.

198. *Id.* at 29.

ownership.¹⁹⁹ Hart's theory relies crucially on the existence of business assets that are legally protectable as property. "Nonhuman assets are an essential feature of a theory of the firm," he writes.²⁰⁰ "A firm's nonhuman assets . . . represent the glue that keeps the firm together, whatever this may be."²⁰¹

The property-relinquishment theory of organizational law advanced herein enjoys a nice synergy with the theories of the firm just described. Both Williamson and Hart build their theories of the firm on assumptions regarding asset specificity, opportunism, and noncontractibility. The property-relinquishment theory of organizational law rests on similar assumptions. The existence of valuable asset configurations (going-concern value) implies that asset redeployment is costly—the condition of asset specificity. The danger that business co-owners (or their successors/heirs) will defect with specific business assets is a manifestation of opportunism. And the property-relinquishment theory presupposes contractual insufficiency, though it is insufficiency of a particular kind: not contractual "incompleteness" per se, but rather limitations stemming from remedial minimalism and from the in personam nature of contractual obligations.

Among the leading previous efforts to integrate economic and legal theories of the firm is Margaret Blair and Lynn Stout's "team production" theory of corporate law.²⁰² Blair and Stout conceive of the corporation as a tool to manage problems of team production, or production in which it is impossible to determine the marginal productivity of separate inputs solely by observing total output.²⁰³ In team-production contexts, team members have incentives to shirk if surplus-sharing rules are determined ex ante; however, ex post determinations invite rent-seeking as individuals compete to divvy a fixed amount of wealth. In the Blair-Stout theory, team members voluntarily "give up important rights," including "property rights" over business inputs, to a governance structure or "mediating hierarchy" (the board of directors) in order to overcome problems of shirking and rent-seeking, thereby encouraging firm-specific investment by team

199. See *id.* at 33 ("[T]he benefit of integration is that the acquiring firm's incentive to make relationship-specific investments increases since, given that it has more residual control rights, it will receive a greater fraction of the *ex post* surplus created by such investment.").

200. *Id.* at 56.

201. *Id.* at 57.

202. See Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999).

203. This conception of team production originated with Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777 (1972).

members.²⁰⁴ Importantly, though, the Blair-Stout theory is explicitly one of the *public corporation* and not of organizational law more generally; they explicitly exclude partnership from their analysis.²⁰⁵ By contrast, the analysis of this Article suggests that “giving up important rights”—property rights in particular—is essential to other forms of enterprise organization as well.

CONCLUSION

There is no question that asset partitioning—“the partitioning off of a separate set of assets in which creditors of the firm itself have a prior security interest,”²⁰⁶ in the words of Hansmann and Kraakman—is a pervasive and important feature of organizational law. And there can be little doubt that asset partitioning allows business creditors to economize on information—though there may be reasons to question the magnitude of those efficiencies.²⁰⁷ Undeniably, the asset-partitioning theory constitutes a major, pioneering advance in our understanding of the role that organizational law plays in commercial affairs.

But is asset partitioning really *the essential role* of organizational law, as is widely accepted among business law scholars today? This Article has suggested that there is room for doubt on this score. For organizational law performs another function that may be every bit as important as asset partitioning: property relinquishment. Unlike the asset-partitioning function, which concerns relations with third parties, the property-relinquishment function is mostly about relations among business co-owners themselves. It is about commitment problems rather than information problems. As we have seen, property relinquishment was present even in traditional Anglo-American partnership law, despite superficial appearances to the contrary. Or, to put the point slightly differently, the traditional

204. Blair & Stout, *supra* note 202, at 250. In pointing to the interplay between team production problems and firm-specific investment, *see id.* at 271–72, Blair and Stout draw on previous work by economists Raghuram Rajan and Luigi Zingales. *See* Raghuram G. Rajan & Luigi Zingales, *Power in a Theory of the Firm*, 113 Q.J. ECON 387 (1998). In the Rajan-Zingales model, team members voluntarily give power to a “completely unrelated third party” as a strategy to limit shirking and rent-seeking: “[T]he third party holds power so that the agents critical to production do not use the power of ownership against each other.” *Id.* at 422.

205. *See* Blair & Stout, *supra* note 202, at 281, 319.

206. Hansmann & Kraakman, *supra* note 1, at 393.

207. *See supra* Part I.

partnership provided more capital “lock-in”—to use Margaret Blair’s term²⁰⁸—than has heretofore been recognized.

As I noted at the outset, the asset-partitioning and property-relinquishment theories are not mutually exclusive. In fact they are quite complementary. Understanding the property-relinquishment function of organizational law opens the way for deeper theoretical integration between organizational law theory and other private law topics—including property, contract, and debtor-creditor law—as well as with the economic theory of the firm. It seems that organizational law has more than one essential role.

208. Blair, *supra* note 20, at 388.