# THE LAW OF SOLE PROPRIETORSHIPS, PARTNERSHIPS AND FRANCHISES

***SUPPLEMENTAL READINGS***

**Class 05**

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# An Introduction To Business Organizations

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The following outline is intended to acquaint the reader with the different forms in which businesses are commonly conducted. It is greatly simplified.

## I. COMMON FORMS OF BUSINESS ORGANIZATIONS

The seven most common forms of business organizations are:

1. the sole proprietorship;
2. the general partnership;
3. the limited partnership;
4. the business trust with transferable shares;
5. the business corporation;
6. the limited liability company; and
7. the limited liability partnership.

Each of these forms of business organizations differs from the others in terms of (a) governing law, (b) the formalities of organization, (c) control and management of the business, (d) personal liability of the owners, (e) continuity of legal existence and (f) transferability of interests in the business. Each has distinctive tax advantages and disadvantages.

The distinguishing characteristics of each form of business organization under Massachusetts law are discussed in Sections II-VIII below. The principal tax consequences of each form of business organization are discussed in summary fashion in Section IX.

## II. THE SOLE PROPRIETORSHIP

The simplest form of a business organization is the sole proprietorship. A sole proprietorship consists of an individual doing business for himself or herself. For example, an individual attorney, practicing alone or with a hired associate, paralegal, or secretary, is a sole proprietor.

### A. Governing Law

No specific statute governs the formation of a sole proprietorship. A sole proprietorship, like every other form of business organization, is, of course, subject to any licensing or other requirements applicable to the kind of business or the particular activities in which it may engage. Sole proprietorships, like any other form of business not specifically exempted, must comply with the "business name statute," G. L. c. 110. The business name statute is discussed in greater detail in Section XI infra.

### B. Formalities of Organization

No formal document or filing is required for the creation of a sole proprietorship.

### C. Control and Management

The owner of a sole proprietorship is in full and absolute control of the business. No one else has a right to participate in management, although the owner may by contract delegate authority to employees or agents. A sole proprietor does not share profits and must bear all losses of the business.

### D. Liability of Owner

In the absence of a contract to the contrary, a sole proprietor is personally liable for all obligations of the business to the full extent of his personal and business assets. He or she is also liable for any torts which he personally commits, as well as for those committed by his employees within the scope of their employment. Certain potential tort liabilities may, of course, be covered by insurance.

### E. Continuity of Existence

A sole proprietorship terminates on the death of the proprietor. Thus, a sole proprietorship, technically, has no continuity of existence.

F. Transferability of Interests

The business of a sole proprietor may be transferred as a whole. However, fractional interests in the business may not be transferred to others without adopting a new form of organization.

III. THE GENERAL PARTNERSHIP

A partnership is an association of two or more persons to carry on as co-owners, a business for profit. (G. L. c. 108A, §6). Two or more attorneys, for example, may conduct their practice as a general partnership.

A. Governing Law

General partnerships are governed by the Uniform Partnership Act (G. L. c. 108A), which has been adopted, with some variations, in 48 states.

B. Formalities of Organization

A partnership may be formed either by agreement or by conduct of the parties, express or implied. Although no written agreement is necessary to establish a general partnership, it is usually desirable to define the rights and duties of the partners to one another in a written partnership agreement.

C. Control and Management

In the absence of an agreement to the contrary, each partner has an equal voice in the management and control of the partnership; in the event of disagreement, a numerical majority of the partners controls. This general principle may be varied by agreement.

D. Liability of Owners

Each partner in a general partnership has full personal liability for all partnership obligations. The partners are jointly and severally liable for the damages caused by any tort or breach of trust committed by a partner within the scope of the partnership business and are jointly liable for all other partnership obligations. (G. L. c. 108A, §15). Newly admitted partners are liable only for future obligations; retired partners only for past obligations. (G. L. c. 108A, §§17 and 36).

E. Continuity of Existence

When any partner ceases to be a member of the firm, whether through withdrawal, expulsion or death, a technical dissolution of the partnership occurs. (G. L. c. 108A, §§29 and 31). Dissolution may also be occasioned by a number of other events, including, in some instances, a court decree. (See G. L. c. 108A, §§31 and 32 for the causes of dissolution.) Thus, like the sole proprietorship, the partnership does not, at least theoretically, possess perpetual life.

F. Transferability of Interests

Partners have three types of property rights:

1. rights in specific partnership property;

2. interests in the partnership (i.e., their respective shares of partnership capital and profits); and

3. rights to participate in management. (G. L. c. 108A, §24).

A partner's rights in specific partnership property are not assignable except in connection with the assignment of the rights of all the parties to the same property. (G. L. c. 108A, §25(2)(b)).

A partner's interest in the partnership (i.e., his share of the partnership capital and profits) may be assigned; but, in the absence of agreement by the other partners, the assignment does not entitle the assignee to participate in the management or administration of the partnership business, or to require any information or account of partnership transactions, or to inspect the partnership books. It merely entitles the assignee to receive in accordance with his contract the profits to which the assigning partner would otherwise be entitled. (G. L. c. 108A, §27(1)). Thus, general partnerships have only limited transferability of interests.

IV. THE LIMITED PARTNERSHIP

A limited partnership is a partnership formed by two or more persons under a special statute, having as members one or more "general partners" and one or more "limited partners." The basic distinction between a general partnership and a limited partnership arises from the presence and status of limited partners. The status of a limited partner differs from that of a general partner in two principal respects: (i) the liability of each limited partner is limited to the amount of his capital contribution to the partnership; and (ii) a limited partner may not participate in the control and management of the partnership. A limited partnership thus encourages capital investment by persons not wishing to risk more than the amount they invest.

A. Governing Law

In Massachusetts, limited partnerships are governed by the Revised Uniform Limited Partnership Act. (G. L. c. 109).

B. Formalities of Organization

A limited partnership is formed by substantial compliance with two requirements:

1. each of the general partners desiring to form a limited partnership must execute a certificate containing the information set forth below; and

2. the certificate must be filed in the office of the Secretary of the Commonwealth. (G. L. c. 109, §8). The current filing fee in Massachusetts is $200.

Most limited partnerships are governed by a comprehensive limited partnership agreement which need not be a part of the public record.

C. Control and Management

Except for the exercise of certain limited rights, a limited partner may not take part in control and management of the partnership without risking the loss of limited liability. G. L. c. 109, §19). Accordingly, virtually all limited partnership agreements vest exclusive power over the business in the general partners. The general partners of a limited partnership have all the powers and duties of partners in a general partnership. (G. L. c. 109, §24).

D. Liability of Owners

In every limited partnership there must be at least one general partner with full personal liability. (G. L. c. 109, §1(7)). A limited partner is not liable to the creditors of the partnership beyond the amount of his contribution to the partnership unless, as indicated above, he takes part in the control of the business. (G. L. c. 109, §19).

E. Continuity of Existence

Under G. L. c. 109, §44, a limited partnership is dissolved and its affairs shall be wound up upon the happening of the first to occur of the following:

1. at the time or upon the happening of events specified in the certificate of limited partnership;

2. written consent of all partners;

3. an event of withdrawal of a general partner unless at the time there is at least one other general partner and the certificate of limited partnership permits the

business of the limited partnership to be carried on by the remaining general partner and that partner does so, but the limited partnership is not dissolved and is not required to be wound up by reason of any event of withdrawal, if, within 90 days after the withdrawal, all partners agree in writing to continue the business of the limited partnership and to the appointment of one or more additional general partners if necessary or desired; or

4. entry of a decree of judicial dissolution. (G. L. c. 109, §45).

Unless the certificate provides otherwise, however, the withdrawal of a limited partner does not bring about a dissolution of the partnership. (G. L. c. 109, §44).

F. Transferability of Interests

Except as provided in the limited partnership agreement, a partnership interest is assignable in whole or in part. An assignment of a partnership interest does not dissolve a limited partnership or entitle the assignee to become or to exercise any rights of a partner G. L. c. 109, §40). The assignee, may, however, be substituted as a limited partner only if and to the extent that (1) the assignor gives the assignee that right in accordance with authority described in the certificate of limited partnership, or (2) all other partners agree. Unless the assignee is substituted as a limited partner, an assignment entitles the assignee to receive, to the extent assigned, only the distributions to which the assignor would be entitled. Except as provided in the partnership agreement, a partner ceases to be a partner upon the assignment of all his partnership interest. (G. L. c. 109, §§ 40 and 42).

V. THE BUSINESS TRUST

The business (or "Massachusetts") trust is, essentially, a business organization in the form of a trust. More precisely, the business trust is an unincorporated business organization created by an instrument by which property is held and managed by trustees for the benefit of the holders ("shareholders") of transferable certificates evidencing the beneficial interests in the trust estate. Many public utility holding companies in Massachusetts (for example, NStar, the parent holding company for Boston Edison and Commonwealth Energy System) are organized as business trusts.

A business trust partakes of many of the characteristics of a trust, a corporation, and of a partnership. For example, as a general rule, the instrument creating the business trust should be executed to conform to the law of trusts. Like a corporation, however, the shares of beneficial interest in the trust corpus may be made fully transferable and shareholders may elect the trustees. In addition, like a limited partnerships, the beneficial owners of the trust may not engage in the management and control of the business without risking personal liability for debts of the trust.

A. Governing Law

Business trusts are governed by Chapter 182; but this statute is far less comprehensive than those governing partnerships or corporations. Most of the attributes of a business trust are defined by Massachusetts case law.

B. Formalities of Organization

A business trust is formed under a written declaration or agreement of trust. The declaration of trust and amendments thereto should be recorded in the registry of deeds (if the trust owns real estate), and copies must be filed with the Secretary of the Commonwealth and with the clerk of every municipality where the trust has a usual place of business.
(G. L. c. 182, §2).

C. Control and Management

The trustees are, customarily, the body charged with the control and management of the business trust. Management responsibilities may, of course, be delegated to one or more officers or employees. If shareholders participate in control and management, they risk being subjected to personal liability for the debts of the trust, on the analogy of limited partners who participate in control of a limited partnership. A specific stipulation to the contrary is frequently included in contracts signed by the trust. Unfortunately, the degree of control that will subject shareholders to personal liability is rather unclear. Some Massachusetts cases speak of "ultimate power of control" as the test, while others have held business trusts to be, in fact, partnerships by virtue of indirect control no greater than that available to corporate stockholders, such as the power to elect trustees or to terminate the trust. Hence, shareholders in a business trust always face the danger, however remote, of being held personally liable for the debts of the trust if they do anything more than act as mere beneficiaries to receive the income distributed to them. For this reason, many declarations of trust frequently provide that the beneficiaries have no power to elect the trustees.

D. Liability of Owners and Trustees

Unlike a corporation, a business trust cannot, in Massachusetts, own property or make contracts as an artificial person. Legal title to all trust property is in the trustees, and the trustees alone have power to make contracts. The rule in regard to such contracts is that debts may be enforced against the trust assets, but not against the trustee personally, nor against the shareholders. G. L. c. 182, §6 allows suit against the trust itself, as though it were a corporation. Shareholders who participate in the exercise, control or management of the trust may be subject to personal liability for the debts of the trust (see discussion in Section IV(C), supra).

E. Continuity of Existence

The existence of a business trust, unless the declaration of trust provides otherwise, is not interrupted by death or withdrawal of a shareholder.

F. Transferability of Interests

Shares of a business trust are freely transferable, subject to any restrictions that the declaration of trust may impose upon their transfer.

VI. THE BUSINESS CORPORATION

A corporation is a special legal entity created by statute. Its principal characteristics are centralized management in a board of directors, limited liability of stockholders, free transferability of interests by stockholders and perpetual existence. Most large business organizations, and many small ones, are conducted in the corporate form.

A. Governing Law

Each state has its own separate corporation law. In Massachusetts, business corporations are governed by G. L. c. 156B, the Massachusetts Business Corporation Law. "Foreign" corporations organized under the laws of other states must qualify to do business in Massachusetts under Chapter 181. Effective July 1, 2004, Massachusetts business corporations will be governed by new Chapter 156D, the Massachusetts Business Corporation Act. Qualifications of foreign corporations will be Part 15 of the new Act.

B. Formalities of Organization

A business corporation is created by the filing of articles of organization with the Secretary of the Commonwealth. (G. L. c. 156B, §13; G.L. c. 156D, § 2.01).

C. Control and Management

Theoretically, the board of directors is responsible for the governance of the corporation, the officers carry out the directives of the board, and the stockholders elect the directors to manage the corporation's business. In most small corporations, however, the owners actively participate in the management of the corporation. Furthermore, the articles of organization, by-laws or separate agreements among stockholders, such as voting agreements or voting trusts, may vary the traditional roles of the players. For example, stockholder agreements or voting trust agreement may limit the ability of the stockholders to exercise free choice in the election of directors and officers, or the articles of organization may require a stockholder vote for matters which in the absence of a requirement, could be determined by the board of directors without stockholder approval (such as the mortgage of substantially all of the assets of the corporation).

D. Liability of Owners

Liability of stockholders is generally limited to the consideration paid for their stock, provided that shares are fully paid and the corporation is adequately capitalized. Limited liability can be eroded by business necessities (e.g. banks may require stockholders to co-sign notes or guarantee corporate debts). In some cases, neglect of corporate recordkeeping or procedures, severe undercapitalization, or fraudulent conduct can result in loss of limited liability, a phenomenon called "piercing the corporate veil."

To maintain limited liability, corporate formalities must be observed, including the maintenance of corporate minutes, the holding of meetings, and the separation of financial records. Additional costs may be involved in establishing a business as a corporation, including incorporation and filing fees, legal and accounting expenses and the cost of preparing and filing separate tax returns.

E. Continuity of Existence

A corporation has perpetual life unless otherwise provided in its articles of organization. (G. L. c. 156B, §9; G.L. c. 156D, §3.02). The death or incapacity of a stockholder does not terminate a corporation's existence.

F. Transferability of Interests

Shares of corporate stock are freely transferable. Capital formation by corporations is thus facilitated since evidence of ownership can be transferred or pledged. The transferability of shares is, however, limited by federal and state securities laws and may be restricted by agreements among the stockholders. In a large, publicly traded company, free transferability of shares is essential; in a small corporation, transferability of shares may be disadvantageous, as when it is considered desirable to keep control within a small number of persons.

## VII. THE LIMITED LIABILITY COMPANY

A limited liability company ("LLC") is a special unincorporated legal entity organized under a state statute that offers limited liability to all of its owners. The LLC form is flexible and can provide for centralized or decentralized management, free or restricted transferability of interests, and perpetual or limited existence. Accordingly, LLCs may have both partnership and corporate characteristics. LLCs were first authorized by statute in Massachusetts effective January 1, 1996 (St. 1995, c. 281, §18).

A. Governing Law

LLCs are governed by the Massachusetts Limited Liability Company Act (G. L. c. 156C). All fifty states have now enacted LLC statutes. "Foreign" LLCs organized under the laws of other states must register to do business in Massachusetts under G. L. c. 156C, §48.

B. Formalities of Organization

An LLC is created by the filing of a certificate of organization with the Secretary of the Commonwealth. (G. L. c. 156C, §12). Like limited partnerships, most LLCs are governed by a comprehensive written operating agreement, which need not be part of the public record.

C. Control and Management

An LLC may be managed by its owners, or "members", in a manner similar to a general partnership, or by one or more "managers", who may or may not be members. The degree of centralization of management of a given LLC is therefore subject to the choice of the persons organizing the LLC.

D. Liability of Owners

None of the members or managers of an LLC is personally liable for any debts, obligations or liabilities of the LLC. (G. L. c. 156C, §22). Unlike a limited partner of a limited partnership, a member of an LLC may take part in the operation of the business of the LLC without becoming personally liable for its debts.

E. Continuity of Existence

Under G. L. c. 156C, §43, an LLC is dissolved and its affairs wound up upon the first to occur of the following:

1. the time specified in the operating agreement;

2. the happening of any event specified in the operating agreement;

3. written consent of all members;

4. except as otherwise provided in a written operating agreement, the death, insanity, retirement, etc., of a member which terminates his membership in the LLC, unless the LLC is continued either by the consent of the remaining members within 90 days after the withdrawal or pursuant to a right to continue stated in a written operating agreement; or

5. a decree of judicial dissolution.

The existence of an LLC is therefore limited in the same manner as a limited partnership (see Section IV(E) above), unless the parties otherwise provide in a written operating agreement. By eliminating the events of dissolution in the operating agreement, it is possible for an LLC to have in effect a perpetual existence.

F. Transferability of Interests

A member's interest in an LLC is freely assignable in whole or in part except as provided in a written operating agreement, but an assignee has no right to participate in the management of the LLC or otherwise exercise a member's rights except upon compliance with procedures set forth in a written operating agreement or with the approval of all members. (G. L. c. 156C, §39).

Thus, the operating agreement can provide for complete or limited freedom of transferability of interests. An LLC interest may be evidenced by a transferable certificate similar to a stock certificate. (G. L. c. 156C, §39(c)).

VIII. THE LIMITED LIABILITY PARTNERSHIP

A registered limited liability partnership ("LLP") is a general partnership which files with the Secretary of the Commonwealth a brief registration form. (G. L. c. 108A, §45). An LLP is basically a general partnership in all respects, except that the partners in an LLP are not liable for the debts, obligations or liabilities of the LLP. LLPs were first authorized in Massachusetts by legislation effective January 1, 1996 (St. 1995, c. 281, §13). Many law firms and accounting firms formerly organized as partnerships have converted to the LLP form.

A. Governing Law

LLPs are governed by various provisions of the Uniform Partnership Act (G. L. c. 108A), particularly §§45-47. "Foreign" LLPs organized under the laws of other states are recognized in Massachusetts and are required to register with the Secretary of the Commonwealth in the same manner as domestic LLPs.

B. Formalities of Organization

An LLP must file a simple registration form with the Secretary of the Commonwealth and pay a $500 filing fee. In order to retain its status, an LLP must also file an annual report with the Secretary of the Commonwealth and pay an annual $500 fee (G. L. c. 108A, §45). Special requirements apply in the case of an LLP which provides professional services, including a requirement that such LLPs carry professional liability insurance or provide an escrow or letter of credit in an amount designated by the appropriate regulatory board. (G. L. c. 108A, §45).

C. Control and Management

Identical to a general partnership. (See Section III(C) above).

D. Liability of Owners

The partners in an LLP, unlike those in a general partnership, have no personal liability for any of the debts, obligations or liabilities of the LLP so long as it is registered. (G. L. c. 108A, §15(2)).

E. Continuity of Existence

Identical to a general partnership. (See Section III(E) above).

F. Transferability of Interests

Identical to a general partnership (see Section III(F) above).

The following table summarizes the various characteristics of the common forms of business organizations.

| *Form of Business* | *Governing Law* | *Formalities of Organization* | *Control of Management* | *Liability of Owner(s)* | *Continuity of Existence* | *Transferability of Interests* |
|---|---|---|---|---|---|---|
| Sole Proprietor-ship | None (see G. L. c. 110 re: business name) | None | Vested in owner | Full personal liability | Terminates on death | None |
| General Partnership | G. L. c. 108A | None | Each general partner | Full personal liability of all partners | Terminates on death, withdrawal or change of partner | Limited |
| Limited Partnership | G. L. c. 109 | File with Secretary of State | General partner(s) | Full personal liability of general partner | Terminates on withdrawal of general partner | Limited |
| Business Trust | G. L. c. 182 | File with Secretary of State | Trustee(s) | Potential liability of beneficiaries | Rule against perpetuities | Free transferability of shares |
| Corporation | G. L. c. 156B; G.L. c. 156D | File with Secretary of State | Board of directors | None | Perpetual | Free transferability of stock |
| LLC | G. L. c. 156C | File with Secretary of State | Manager(s) or member(s) | None | Perpetual or limited | Free or limited transferability of interests |
| LLP | G. L. c.108A, §45 | File with Secretary of State | Each general partner | None | Terminates on death, withdrawal or change of partner | Limited |

## IX. TAX CHARACTERISTICS OF THE COMMON FORMS OF BUSINESS ORGANIZATIONS

### A. Sole Proprietorship

Because no separate entity is involved in the operation of a sole proprietorship, all items of income, gain, loss, deduction and credit for tax purposes are directly reported by a sole proprietor on Schedule C of his or her Federal and Massachusetts income tax returns.

Individuals are taxed on their taxable income at graduated rates for Federal income tax purposes, with a maximum rate for 2004 of 35% on ordinary income and 15% on most dividends and capital gains. For 2004, Massachusetts imposes a 5.3% tax on earned income, interest, dividends and long-term capital gains and a 12% tax on short-term capital gains.

### B. General Partnership

A general partnership is a "pass through" entity for Federal and Massachusetts income tax purposes. Thus, a partnership does not itself pay income taxes. Instead, each partner reports his or her share of the partnership's income or loss on his or her individual return. A partnership files a Federal information return on Form 1065 and distributes to each partner a Schedule K-1 containing the tax information each partner needs to complete his or her personal return. Massachusetts partnerships must file a Form 3 with the Department of Revenue and distribute a Schedule 3K-1 to its partners.

A non-resident partner of a partnership doing business in Massachusetts is taxable on his or her share of income received by the partnership and allocable to Massachusetts.

### C. Limited Partnership

Generally speaking, a limited partnership is taxed in the same manner as a general partnership for Federal and Massachusetts income tax purposes. Until the adoption of the "check-the-box" regulations by the IRS on January 1, 1997, some limited partnerships could be treated as corporations for tax purposes, if corporate characteristics (limited liability, centralization of management, free transferability of interests and continuity of life) predominated. See §7701 of the Internal Revenue Code of 1986. However, these new regulations—summarized in Section X(B) below—eliminate this risk.

### D. Business Trust

A business trust is usually taxed as a corporation for Federal income tax purposes. It may, if qualified, elect to be an S corporation.

Under Massachusetts law, business trusts are subject to a special tax system applicable to "corporate trusts". (G. L. c. 62, §8). Corporate trusts with certain exceptions are subject to taxation in Massachusetts on the same basis as individuals, (i.e., 5.3% on earned income, interest,

dividends and long-term capital gains and 12% on short-term capital gains). Certain corporate trusts, such as mutual funds, REITs, REMICs and holding companies are exempt from Massachusetts tax. Corporate trusts file Form 3F with the Massachusetts Department of Revenue. Significantly, shareholders of corporate trusts are not taxed in Massachusetts on dividends received from the trust. (G. L. c. 62, §8). For Massachusetts purposes, therefore, a corporate trust is not subject to double taxation and is the "mirror image" of an S corporation, taxable on the corporate level, but not on the shareholder level.

E. Business Corporation

For Federal income tax purposes, business corporations can be classified as "S corporations" (those qualifying corporations electing favorable tax treatment under Subchapter S of the Internal Revenue Code) or "C corporations" (all others).

C corporations are subject to a Federal income tax at graduated rates with a maximum rate of 38% for 2004. Since a C corporation's shareholders are taxed again on the distribution of corporate earnings in the form of dividends, C corporation income is subject to "double taxation", first at the corporate level, and then at the shareholder level. For this reason, many corporations elect to be taxed as S corporations, which, generally speaking, are treated as "passthrough" entities similar to partnerships. S corporation income is thus subject to a single tax at the shareholder level. S corporation elections are discussed in greater detail in Section X(D) below.

C corporations doing business in Massachusetts are subject to the Massachusetts corporation excise tax under Chapter 63. This tax consists of two components: a 9.5% tax on corporate net income attributable to Massachusetts plus a tax equal to $2.60 per $1,000 of tangible property not subject to local taxation and situated in Massachusetts. A minimum tax of $456 per year is imposed.

Under Massachusetts law, "large" S corporations are subject to tax on their net income at a 3% rate if their total receipts exceed $6 million, 4.5% if total receipts exceed $9 million.

F. Limited Liability Company

Under the "check-the-box" regulations described in Section X(B) below, an LLC will be classified as a partnership for Federal and Massachusetts income tax purposes, unless it elects to be taxed as a corporation.

G. Limited Liability Partnership

Under the "check-the-box" regulations described in Section X(B) below, an LLP will be classified as a partnership for Federal and Massachusetts income tax purposes, unless it elects to be taxed as a corporation.

## X. SOME IMPORTANT TAX CONSIDERATIONS

### A. Federal Employer Identification Number

Every business organization must obtain from the Internal Revenue Service a Federal employer identification number ("EIN"). This involves the filing with the Internal Revenue Center in Andover of an IRS Form SS-4 (Application for Employer Identification Number). Massachusetts business organizations will receive a nine-digit number. In the past, EINs for Massachusetts taxpayers were assigned the prefix "04." For this reason, EINs are sometimes still referred to in Massachusetts as "04 numbers."

As a practical matter, you should ascertain at the time of formation of any business entity whether the taxpayer, its lawyer, or its accountant will be applying for the EIN. Failure to coordinate the process can result in embarrassing situations where the client has either no EIN or more than one.

The IRS Service Center will usually process a Form SS-4 application received by mail in 4 to 5 weeks. It is possible to obtain an EIN on an expedited basis by calling the IRS's "Tele-TIN" phone number ((800) 829-4933). However, the person calling the IRS must be authorized to sign Form SS-4 (i.e., the president, vice president, or "other principal officer" of a corporation, or a person authorized as a "Third-Party Designee" by the officer signing Form SS-4).

### B. "Check-the-Box"

For many years, the question of whether a non-corporate entity with limited liability (e.g., a limited partnership or LLC) should be classified as a corporation or a partnership for Federal income was a complex one, depending upon an evaluation of the four corporate attributes (limited liability, continuity of life, free transferability of interest and centralization of management) of the entity.

New IRS regulations effective January 1, 1997 eliminated the four factor test and substituted a simple elective system, under which most business organizations other than corporations may elect to be classified either as a partnership or a corporation for Federal income tax purposes. (Treas. Reg. §§301.7701-1 et seq.).

These regulations provide clear rules for classifying domestic business organizations. Certain entities are always taxable as corporations: these include domestic corporations, certain entities engaged in specialized industries (such as banking and insurance) and certain foreign entities. Business organizations that are not so classified as corporations (so-called "eligible entities") can elect their tax classification. An eligible entity with more than one member (such as a partnership, limited partnership or LLC; can elect either to be taxed as a corporation or a partnership. An eligible entity with only one member can elect either to be taxed as a corporation or to be disregarded for tax purposes. Significantly, the regulations contain certain "default" rules under which a domestic eligible entity will be deemed to be a partnership if it has more than one member.

IRS Form 8832 (Entity Classification Election) may be used by an eligible entity to elect classification as a corporation or partnership by "checking-the-box" on the form. An election on Form 8832 may be made any time, but an election can take effect no earlier than 75 days prior to filing and no later than 12 months thereafter.

Since the default rules provide that partnerships, limited partnerships, LLC's and LLP's will automatically be classified as partnerships, it is necessary to file Form 8832 only if you wish to have an eligible entity classified as a corporation.

C. Section 1244 Stock

Section 1244 of the Internal Revenue Code permits an individual or partnership investing in certain corporations to claim any loss on an investment in corporate stock as an "ordinary loss" fully deductible against taxable income, rather than a "capital loss," deductible only against capital gain or a very limited amount of ordinary income ($3,000 per year for Federal income tax purposes).

Stock issued by a corporation will qualify as Section 1244 stock if:

1. the corporation is a domestic business corporation which has issued $1,000,000 or less in capital stock;

2. the stock is common stock issued for money or other property (but not for stock, securities or services);

3. the stock is issued to an individual or partnership;

4. the corporation has derived less than 50% of its gross receipts from investment activities for the previous five years (or such shorter period as the corporation is in existence); and

5. the taxpayer claiming loss is an original investor and not a transferee of the stock.

A shareholder filing an individual tax return may not deduct more than $50,000 of ordinary loss per year ($100,000 for a husband and wife filing jointly). If the loss exceeds this amount, it is treated as a capital loss.

No formal "plan" to issue Section 1244 stock is required, as was the case under the law prior to the Revenue Act of 1978.

D. S Corporation Elections

In order to secure the benefits of S corporation status, an election on Form 2553 must be filed with the Internal Revenue Service.

Under tax legislation effective January 1, 1997, a corporation must meet certain tests in order to qualify for S corporation status:

1. it must have 75 or fewer shareholders (a husband and wife are treated as one shareholder);

2. all stockholders must be individuals (or certain permitted trusts, estates or tax-exempt organizations);

3. no shareholder may be a non-resident alien; and

4. the corporation may have only one class of stock (differences in voting rights are permissible).

The previous rule that prevented an S corporation from owning more than 80% of the stock of another corporation has been repealed. S corporations can now have subsidiaries.

An S corporation election must be filed on or before the 15th day of the third month of its tax year. A corporation's first fiscal year is considered to start on the date on which the corporation (a) has shareholders, (b) acquires assets, or (c) begins doing business, whichever is earliest.

An S corporation, in general, must adopt a calendar year as its taxable year. For example, if an S corporation is incorporated and commences business on January 25, 2004, its first fiscal year will be a "short year" of eleven months and seven days ending December 31, 2004. In this example, Form 2553 must be filed by April 9, 2004. If the form is filed on a later date (say, April 10, 2004), the election will not be effective until the following tax year (ending December 31, 2005).

Note that Form 2553 must be signed by all shareholders of the corporation, a requirement which is sometimes overlooked.

E. Qualified Small Business Stock

For non-corporate investors who hold stock of a "qualified small business corporation" ("QSB Stock") for five years or more, the Federal capital gain rate is effectively reduced to 14%, rather than the normal 20% (§1202). In addition, gain on the sale of QSB Stock held for more than six months may be rolled over tax-free into another QSB stock within 60 days (§1045).

In order to qualify for special tax treatment as QSB Stock, the following requirements must be met:

1. stock of a domestic C corporation;

2. issued after August 10, 1993;

3. original issue only (may be issued for cash, property, services or other QSB stock);

4. gross assets of corporation must not be in excess of $50 million immediately after issue of QSB stock;

5. corporation must be in the active conduct of a "qualified business" (definition excludes most service businesses, banking and finance, farming, extractive industries, hotels and restaurants); and

6. corporation may not make certain stock redemptions.

F. Massachusetts Taxpayer Registration

Every corporation which is required to withhold income, employment or sales taxes must file with the Department of Revenue an Application for Registration on Form TA-1. The Department will assign the corporation a special Massachusetts identification number which must be used for filing tax returns.

G. Massachusetts Manufacturing Corporations

Corporations which have manufacturing operations in Massachusetts may request "manufacturing corporation" classification on Form 355Q. This classification exempts the corporation's property from local taxation by the municipality in which the corporation is located. These assets are instead included in the tangible property measure of the corporation excise tax base and are taxed at a rate usually much less than the local property tax rate. A corporation with manufacturing corporation classification is also eligible for the Massachusetts investment tax credit.

## XI. SELECTING A BUSINESS NAME

### A. In General

The overriding legal concern in selecting a name for a corporation or other business organization is whether the name selected conflicts with a name used by another business organization. The consequences of carelessly selecting a name which infringes on the rights of another person are all unpleasant and range from embarrassment at one extreme to significant legal liability at the other.

The task of selecting a "free" name is complicated by the fact that infringement may arise by "confusing similarity" of names that are not identical, and by the fact that there exists no infallible central register of available names to guide the conscientious businessman.

In thinking about adopting a corporate name, it is important to distinguish several categories of business names:

- A corporate name identifies a corporation and distinguishes it from all other corporations. The Massachusetts Secretary of State requires that corporate names for business corporations in most cases include the word "incorporated," "corporation", "limited," or their abbreviations. 950 CMR 104.03(1)(b). The new Business Corporation Act will allow the use of the word “Company.” G. L. c. 156D, §4.01(a)

- A trade name, in contrast, identifies an incorporated or unincorporated business and may be different from the corporate name of the business. For example, "Bank of Boston" was for many years the well-known trade name for the business conducted by the corporation known as The First National Bank of Boston. Any type of business organization may call itself a "company."

- A trademark is a name or symbol which is used to identify and distinguish goods sold by a business. For example, "Cadillac" is a trademark for certain automobiles manufactured by General Motors Corporation. A service mark is a name or symbol which identifies services provided by a business. For example, "Greyhound" is a service mark for the transportation services provided by Greyhound Lines, Inc.

Selecting a name for a business corporation requires an awareness of several systems of regulation applicable to the different types of names.

### B. Corporate Names

Under G. L. c. 156B, §11, c. 156D, §4.01(b) and 950 CMR 104.03-104.06, the Massachusetts Secretary of State will not permit a corporation to adopt a corporate name which is (a) the same as any corporate name or trade name of any corporation, firm, association or person carrying on business in Massachusetts at present or within the past three years, or

(b) under reservation with the Secretary of State, or (c) so similar to the foregoing as to be likely to be mistaken for it, unless (d) the corporation, firm, association or person consents in writing.

In practice, this statute provides only limited protection against adopting the name of another entity. This is because the Secretary of State's Corporations Division, in approving corporate names, checks the proposed corporate name only against its database of Massachusetts corporations and foreign corporations doing business in Massachusetts. The Corporations Division does not as a rule check its records of names of limited partnerships, business trusts, or trade marks and service marks filed in Massachusetts. Moreover, the Secretary of State's records would not necessarily show trade names adopted by individuals, partnerships, business trusts or corporations unless filed as trade marks or service marks. In addition, the Secretary of State's records will not show names used in other states.

Thus, the "clearance" by the Secretary of State of a corporate name provides only partial protection against the possibility of infringement.

C. Limited Partnership Names

Under G. L. c. 109, §2(1), the name of each Massachusetts limited partnership must contain the words "limited partnership" without abbreviation ("L.P." will not suffice). A limited partnership name may not contain the name of a limited partner (unless it is also the name of a general partner or the limited partnership's name existing prior to the admission of the eponymous limited partner. (G. L. c. 109, §2(2)). A limited partnership name may not contain any word or phrase implying that it is organized for a purpose other than that stated in its certificate of limited partnership (G. L. c. 109, §2(3)), or be the same as or deceptively similar to the name of any Massachusetts corporation or limited partnership or any foreign corporation or limited partnership registered in Massachusetts, without the consent of that entity. (G. L. c. 109, §2(4)). A foreign limited partnership may do business in Massachusetts under any name which could be assumed by a Massachusetts limited partnership (G. L. c. 109, §51).

D. LLC Names

Under G. L. c. 156C, §3(1), the name of any LLC must contain the words "limited liability company", "limited company", or the abbreviation "L.L.C.", "L.C.", "LLC" or "LC". The name of an LLC may contain the name of any member or manager (G. L. c. 156C, §3(2)), but may not be the same as or deceptively similar to the name of any Massachusetts corporation, limited partnership or LLC or any foreign corporation, limited partnership or LLC registered in Massachusetts, without the consent of that entity. (G. L. c. 156C, §3(3)). A foreign LLC may register under any name that could be assumed by a Massachusetts LLC. (G. L. c. 156C, §50).

E. LLP Names

Under G. L. c. 108A, §46, the name of every registered LLP shall end with the words "registered limited liability partnership," "limited liability partnership," or the abbreviation "L.L.P." or "LLP".

F. Trade Names

G. L. c. 110, §§4-6 (the "Business Name Statute") regulates the use of trade names by business organizations in Massachusetts.

Section 4 of the Business Name Statute provides that a person shall not use in its business the name of a person formerly connected with him in partnership or the name of another person, alone or in connection with his own or another name, without the consent of that person.

Section 4A provides that no individual, unincorporated association, or partnership shall use a name including the words "corporation" or "incorporated" or abbreviations thereof, or any other word or phrase which would lead the public to believe the business is a corporation.

Section 4B provides that no business may use the words "Army", "Navy", "Marine Corps", "Coast Guard", "Government", "Post Exchange", "P.X.", or "G.I.", or other name which may lead the public to believe the business is owned or operated by the U.S. Government or an agency thereof. It also provides that no business may use the words "Massachusetts State Fair."

Section 5 is the heart of the statute. It provides that any person conducting business in Massachusetts, whether individually or as a partnership under any title other than his or its real name, must file in the office of the clerk of every city and town where an office of the person or partnership is situated a certificate stating:

(a) the full name and residence of each person conducting the business, and

(b) the place, including street and number, where the business is conducted and the title under which it is conducted.

This "business certificate" must be executed under oath by each person whose name appears thereon as conducting the business.

A person who has filed such a certificate must, upon discontinuing, retiring or withdrawing from the business, or upon changing his residence, file a statement under oath to that effect. Changes in the location where the business is conducted must also be filed. A business certificate is effective for four years and may be renewed indefinitely for additional four year periods.

Violations of the filing provisions are punishable by a fine of not more than $100 for each month during which the violation continues.

Section 6 provides that the filing requirements of §5 shall not apply to:

(a) any corporation doing business under its true corporate name;

(b) any partnership doing business under any title which includes the true surname of any partner;

(c) any business trust, provided that a business certificate is filed containing the names of such trustees with a reference to the relevant instrument or declaration of trust; or

(d) any limited partnership doing business under its true name which contains (without abbreviation) the words "limited partnership."

The following table, adopted from the Secretary of State's useful publication, "Choosing a Name for Your Business", summarizes the applicable filing requirements for business names.

| Type of Business | Filing | |
|---|---|---|
| | Secretary of State | Local City or Town Hall |
| Sole Proprietorship | X(1) | |
| General Partnership | X(1) | |
| Limited Partnership | X | |
| Business Trust | X | X(2) |
| Corporation | X | X(3) |
| Limited Liability Company | X | X(3) |
| Limited Liability Partnership | X | X(1) |

Note 1: No filing required unless business name is different from true surname of proprietor or does not contain surname of any partner.

Note 2: Names of trustees must be filed.

Note 3: No filing required unless business name is different from corporate or LLC name.

G. Trademarks and Service Marks

1. Common Law Protection

Trade names, trademarks and service marks are protected by the state common law of "unfair competition." Generally speaking, common law rights are determined by actual use of the name or mark in commerce.

2. Federal Registration

No federal or Massachusetts registration is available for trade names, as opposed to trademarks and service marks. No federal or state registration is necessary to acquire rights to a trademark or service mark, but registration has some advantages.

Recent amendments to the Lanham Act permit the owner of trademark or service mark to apply for federal registration prior to actual use, provided he has a "bona fide intention" to use the mark in commerce within six months. Federal registration also gives constructive notice of the registrant's claims, permits nationwide enforcement of rights and after five years grants so-called "incontestable" rights (subject to certain exceptions) to use of the mark.

Federal trademark or service mark registration is obtained by filing with the U.S. Patent and Trademark Office (the "PTO") of an application form and the payment of a $335.00 registration fee. The PTO will examine the application and, upon proper compliance with procedural steps, will issue a certificate of registration.

3. State Registration

Numerous states, including Massachusetts, permit registration of trademarks and service marks. Trademark registration in Massachusetts is governed by G. L. c. 110B and is administered by the Trademark Division of the Secretary of State. Applicable regulations are contained at 950 CMR 62.01 et seq.

Trademark and service mark registration in Massachusetts is very simple process, involving the filing of a simple form and payment of a $50.00 fee. Registration is effective for ten years and is renewable. Although the benefits of registration in Massachusetts are limited, state registration does provide evidence of use of the mark and can be helpful.

H. Trade Mark and Trade Name Searches

There are a number of service companies which will perform searches of various databases for prospective trade names or marks.

For example, a "full search" performed by Thompson & Thompson, a large international trademark research company based in Quincy, involves the search of trademark records in the PTO, all fifty states and Puerto Rico, trade journals, telephone directories, catalogs, and other sources, including the index of 9,000,000 company names maintained by Dun & Bradstreet. Even so, Thompson & Thompson's report does not cover corporate names filed with the various secretaries of state.

A company seeking maximum protection against infringement would be well advised to perform a full trademark search as well as a corporate name check with the Secretary of State.

######

Fundamentals of Business

# Chapter 5:

# Forms of Business Ownership

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# Chapter 5

# Forms of Business Ownership

## Learning Objectives

1) Identify the questions to ask in choosing the appropriate form of ownership for a business.
2) Describe the sole proprietorship and partnership forms of organization, and specify the advantages and disadvantages.
3) Identify the different types of partnerships, and explain the importance of a partnership agreement.
4) Explain how corporations are formed and how they operate.
5) Discuss the advantages and disadvantages of the corporate form of ownership.
6) Examine special types of business ownership, including limited-liability companies, cooperatives, and not-for-profit corporations.
7) Define mergers and acquisitions, and explain why companies are motivated to merge or acquire other companies.


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# The Ice Cream Men

Who would have thought it? Two ex-hippies with strong interests in social activism would end up starting one of the best-known ice cream companies in the country—Ben & Jerry's. Perhaps it was meant to be. Ben Cohen (the "Ben" of Ben & Jerry's) always had a fascination with ice cream. As a child, he made his own mixtures by smashing his favorite cookies and candies into his ice cream. But it wasn't until his senior year in high school that he became an official "ice cream man," happily driving his truck through neighborhoods filled with kids eager to buy his ice cream pops. After high school, Ben tried college but it wasn't for him. He attended Colgate University for a year and a half before he dropped out to return to his real love: being an ice cream man. He tried college again—this time at Skidmore, where he studied pottery and jewelry making—but, in spite of his selection of courses, still didn't like it.

*Figure 5.1: Ben Cohen and Jerry Greenfield in 2010.*

In the meantime, Jerry Greenfield (the "Jerry" of Ben & Jerry's) was following a similar path. He majored in pre-med at Oberlin College in the hopes of one day becoming a doctor. But he had to give up on this goal when he was not accepted into medical school. On a positive note, though, his college education steered him into a more lucrative field: the world of ice cream making. He got his first peek at the ice cream industry when he worked as a scooper in the student cafeteria at Oberlin. So, fourteen years after they first met on the junior high school track team, Ben and Jerry reunited and decided to go into ice cream making big time. They moved to Burlington, Vermont—a college town in need of an ice cream parlor—and completed a $5 correspondence course from Penn State on making ice cream. After getting an A in the course—not surprising, given that the tests were open book—they took the plunge: with their life savings of $8,000 and $4,000 of borrowed funds they set up an ice cream shop in a made-over gas station on a busy street corner in Burlington.[1] The next big decision was which form of business ownership was best for them. This chapter introduces you to their options.


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# Factors to Consider

If you're starting a new business, you have to decide which legal form of ownership is best for you and your business. Do you want to own the business yourself and operate as a sole proprietorship? Or, do you want to share ownership, operating as a partnership or a corporation? Before we discuss the pros and cons of these three types of ownership, let's address some of the questions that you'd probably ask yourself in choosing the appropriate legal form for your business.

1) In setting up your business, do you want to minimize the costs of getting started? Do you hope to avoid complex government regulations and reporting requirements?
2) How much control would you like? How much responsibility for running the business are you willing to share? What about sharing the profits?
3) Do you want to avoid special taxes?
4) Do you have all the skills needed to run the business?
5) Are you likely to get along with your co-owners over an extended period of time?
6) Is it important to you that the business survive you?
7) What are your financing needs and how do you plan to finance your company?
8) How much personal exposure to liability are you willing to accept? Do you feel uneasy about accepting personal liability for the actions of fellow owners?

No single form of ownership will give you everything you desire. You'll have to make some trade-offs. Because each option has both advantages and disadvantages, your job is to decide which one offers the features that are most important to you. In the following sections we'll compare three ownership options (sole proprietorship, partnership, corporation) on these eight dimensions.

## *Sole Proprietorship and its Advantages*

In a **sole proprietorship**, as the owner, you have complete control over your business. You make all important decisions and are generally responsible for all day-to-day activities. In exchange for assuming all this responsibility, you get all the income earned by the business.


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Profits earned are taxed as personal income, so you don't have to pay any special federal and state income taxes.

### *Disadvantages of Sole Proprietorships*

For many people, however, the sole proprietorship is not suitable. The flip side of enjoying complete control is having to supply all the different talents that may be necessary to make the business a success. And when you're gone, the business dissolves. You also have to rely on your own resources for financing: in effect, you are the business and any money borrowed by the business is loaned to you personally. Even more important, the sole proprietor bears **unlimited liability** for any losses incurred by the business. The principle of unlimited personal liability means that if the business incurs a debt or suffers a catastrophe (say, getting sued for causing an injury to someone), the owner is personally liable. As a sole proprietor, you put your personal assets (your bank account, your car, maybe even your home) at risk for the sake of your business. You can lessen your risk with insurance, yet your liability exposure can still be substantial. Given that Ben and Jerry decided to start their ice cream business together (and therefore the business was not owned by only one person), they could not set their company up as a sole proprietorship.

## *Partnership*

A **partnership** (or general partnership) is a business owned jointly by two or more people. About 10 percent of U.S. businesses are partnerships[2] and though the vast majority are small, some are quite large. For example, the big four public accounting firms are partnerships. Setting up a partnership is more complex than setting up a sole proprietorship, but it's still relatively easy and inexpensive. The cost varies according to size and complexity. It's possible to form a simple partnership without the help of a lawyer or an accountant, though it's usually a good idea to get professional advice.

Professionals can help you identify and resolve issues that may later create disputes among partners.


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### *The Partnership Agreement*

The impact of disputes can be lessened if the partners have executed a well-planned **partnership agreement** that specifies everyone's rights and responsibilities. The agreement might provide such details as the following:

- Amount of cash and other contributions to be made by each partner
- Division of partnership income (or loss)
- Partner responsibilities—who does what
- Conditions under which a partner can sell an interest in the company
- Conditions for dissolving the partnership
- Conditions for settling disputes

### *Unlimited Liability and the Partnership*

A major problem with partnerships, as with sole proprietorships, is **unlimited liability**: in this case, each partner is personally liable not only for his or her own actions but also for the actions of all the partners. If your partner in an architectural firm makes a mistake that causes a structure to collapse, the loss your business incurs impacts you just as much as it would him or her. And here's the really bad news: if the business doesn't have the cash or other assets to cover losses, you can be personally sued for the amount owed. In other words, the party who suffered a loss because of the error can sue you for your personal assets. Many people are understandably reluctant to enter into partnerships because of unlimited liability. Certain forms of businesses allow owners to limit their liability. These include limited partnerships and corporations.

### *Limited Partnerships*

The law permits business owners to form a **limited partnership** which has two types of partners: a single general partner who runs the business and is responsible for its liabilities, and any number of limited partners who have limited involvement in the business and whose losses are limited to the amount of their investment.

### *Advantages and Disadvantages of Partnerships*

The partnership has several advantages over the sole proprietorship. First, it brings together a diverse group of talented individuals who share responsibility for running the


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business. Second, it makes financing easier: the business can draw on the financial resources of a number of individuals. The partners not only contribute funds to the business but can also use personal resources to secure bank loans. Finally, continuity needn't be an issue because partners can agree legally to allow the partnership to survive if one or more partners die.

Still, there are some negatives. First, as discussed earlier, partners are subject to unlimited liability. Second, being a partner means that you have to share decision making, and many people aren't comfortable with that situation. Not surprisingly, partners often have differences of opinion on how to run a business, and disagreements can escalate to the point of jeopardizing the continuance of the business. Third, in addition to sharing ideas, partners also share profits. This arrangement can work as long as all partners feel that they're being rewarded according to their efforts and accomplishments, but that isn't always the case. While the partnership form of ownership is viewed negatively by some, it was particularly appealing to Ben Cohen and Jerry Greenfield. Starting their ice cream business as a partnership was inexpensive and let them combine their limited financial resources and use their diverse skills and talents. As friends they trusted each other and welcomed shared decision making and profit sharing. They were also not reluctant to be held personally liable for each other's actions.

### *Corporation*

A **corporation** (sometimes called a regular or C-corporation) differs from a sole proprietorship and a partnership because it's a legal entity that is entirely separate from the parties who own it. It can enter into binding contracts, buy and sell property, sue and be sued, be held responsible for its actions, and be taxed. Once businesses reach any substantial size, it is advantageous to organize as a corporation so that its owners can limit their liability. Corporations, then, tend to be far larger, on average, than businesses using other forms of ownership. As Figure 5.2 shows, corporations account for 18 percent of all U.S. businesses but generate almost 82 percent of the revenues.[3] Most large well-known businesses are corporations, but so are many of the smaller firms with which likely you do business.


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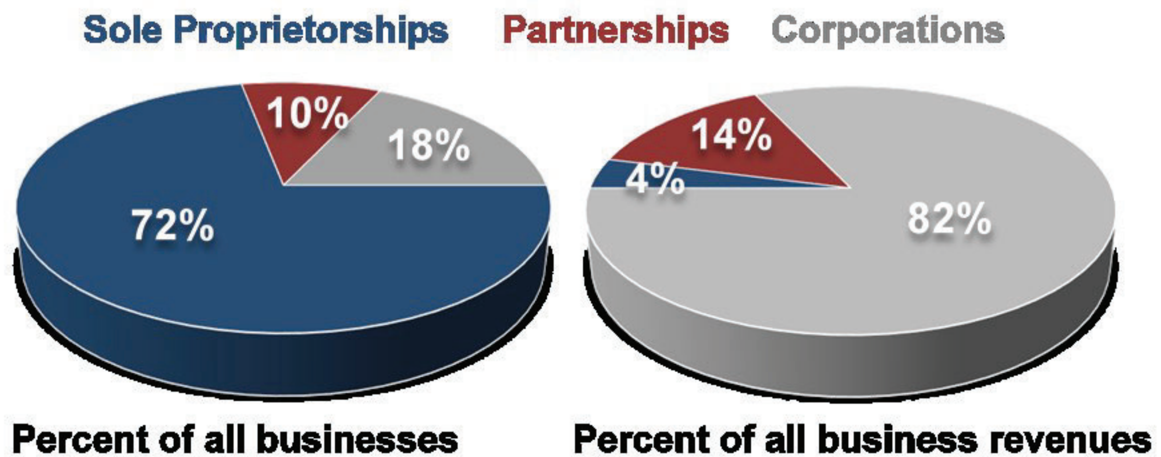
*Figure 5.2: Types of U.S. Businesses*




### *Ownership and Stock*

Corporations are owned by **shareholders** who invest money in the business by buying shares of **stock**. The portion of the corporation they own depends on the percentage of stock they hold. For example, if a corporation has issued 100 shares of stock, and you own 30 shares, you own 30 percent of the company. The shareholders elect a **board of directors**, a group of people (primarily from outside the corporation) who are legally responsible for governing the corporation. The board oversees the major policies and decisions made by the corporation, sets goals and holds management accountable for achieving them, and hires and evaluates the top executive, generally called the CEO (**chief executive officer**). The board also approves the distribution of income to shareholders in the form of cash payments called dividends.

### *Benefits of Incorporation*

The corporate form of organization offers several advantages, including limited liability for shareholders, greater access to financial resources, specialized management, and continuity.

### *Limited Liability*

The most important benefit of incorporation is the **limited liability** to which shareholders are exposed: they are not responsible for the obligations of the corporation, and they can lose no more than the amount that they have personally invested in the company. Limited liability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would have been a big plus for the unfortunate individual whose business partner burned down their dry cleaning establishment. Had they been incorporated, the corporation would have been liable for the debts incurred by the fire. If the corporation didn't have enough money to pay the debt, the individual shareholders would not have been obligated to pay anything. They would have lost all the money that they'd invested in the business, but no more.

### *Financial Resources*

Incorporation also makes it possible for businesses to raise funds by selling stock. This is a big advantage as a company grows and needs more funds to operate and compete. Depending on its size and financial strength, the corporation also has an advantage over other forms of business in getting bank loans. An established corporation can borrow its own funds, but when a small business needs a loan, the bank usually requires that it be guaranteed by its owners.

### *Specialized Management*

Because of their size and ability to pay high sales commissions and benefits, corporations are generally able to attract more skilled and talented employees than are proprietorships and partnerships.

### *Continuity and Transferability*

Another advantage of incorporation is **continuity**. Because the corporation has a legal life separate from the lives of its owners, it can (at least in theory) exist forever.

Transferring ownership of a corporation is easy: shareholders simply sell their stock to others. Some founders, however, want to restrict the transferability of their stock and so choose to operate as a privately-held corporation. The stock in these corporations is held by only a few individuals, who are not allowed to sell it to the general public.

Companies with no such restrictions on stock sales are called public corporations; stock is available for sale to the general public.

### *Drawbacks to Incorporation*

Like sole proprietorships and partnerships, corporations have both positive and negative aspects. In sole proprietorships and partnerships, for instance, the individuals who own and


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manage a business are the same people. Corporate managers, however, don't necessarily own stock, and shareholders don't necessarily work for the company. This situation can be troublesome if the goals of the two groups differ significantly.

Managers, for example, are often more interested in career advancement than the overall profitability of the company. Stockholders might care more about profits without regard for the well-being of employees. This situation is known as the **agency problem**, a conflict of interest inherent in a relationship in which one party is supposed to act in the best interest of the other. It is often quite difficult to prevent self-interest from entering into these situations.

Another drawback to incorporation—one that often discourages small businesses from incorporating—is the fact that corporations are more costly to set up. When you combine filing and licensing fees with accounting and attorney fees, incorporating a business could set you back by $1,000 to $6,000 or more depending on the size and scope of your business.[4] Additionally, corporations are subject to levels of regulation and governmental oversight that can place a burden on small businesses. Finally, corporations are subject to what's generally called "**double taxation**." Corporations are taxed by the federal and state governments on their earnings. When these earnings are distributed as dividends, the shareholders pay taxes on these dividends. Corporate profits are thus taxed twice—the corporation pays the taxes the first time and the shareholders pay the taxes the second time.

Five years after starting their ice cream business, Ben Cohen and Jerry Greenfield evaluated the pros and cons of the corporate form of ownership, and the "pros" won. The primary motivator was the need to raise funds to build a $2 million manufacturing facility. Not only did Ben and Jerry decide to switch from a partnership to a corporation, but they also decided to sell shares of stock to the public (and thus become a public corporation). Their sale of stock to the public was a bit unusual: Ben and Jerry wanted the community to own the company, so instead of offering the stock to anyone interested in buying a share, they offered stock to residents of Vermont only. Ben believed that "business has a responsibility to give back to the community from which it draws its support."[5] He wanted the company to be owned by those who lined up in the gas station to buy cones. The stock was so popular that one in every hundred Vermont families bought stock in the company.[6] Eventually, as the company continued to expand, the stock was sold on a national level.


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## *Other Types of Business Ownership*

In addition to the three commonly adopted forms of business organization—sole proprietorship, partnership, and regular corporations—some business owners select other forms of organization to meet their particular needs. We'll look at several of these options:

- Limited-liability companies
- Cooperatives
- Not-for-profit corporations

### *Limited-Liability Companies*

How would you like a legal form of organization that provides the attractive features of the three common forms of organization (corporation, sole proprietorship and partnership) and avoids the unattractive features of these three organization forms? The **limited-liability company (LLC)** accomplishes exactly that. This form provides business owners with limited liability (a key advantage of corporations) and no "double taxation" (a key advantage of sole proprietorships and partnerships). Let's look at the LLC in more detail.

In 1977, Wyoming became the first state to allow businesses to operate as limited-liability companies. Twenty years later, in 1997, Hawaii became the last state to give its approval to the new organization form. Since then, the limited-liability company has increased in popularity. Its rapid growth was fueled in part by changes in state statutes that permit a limited-liability company to have just one member. The trend to LLCs can be witnessed by reading company names on the side of trucks or on storefronts in your city. It is common to see names such as Jim Evans Tree Care, LLC, and For-Cats-Only Veterinary Clinic, LLC. But LLCs are not limited to small businesses. Companies such as Crayola, Domino's Pizza, Ritz-Carlton Hotel Company, and iSold It (which helps people sell their unwanted belongings on eBay) are operating under the limited-liability form of organization.

In a limited-liability company, owners (called members rather than shareholders) are not personally liable for debts of the company, and its earnings are taxed only once, at the personal level (thereby eliminating double taxation).


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We have touted the benefits of limited liability protection for an LLC. We now need to point out some circumstances under which an LLC member (or a shareholder in a corporation) might be held personally liable for the debts of his or her company. A business owner can be held personally liable if he or she:

- Personally guarantees a business debt or bank loan which the company fails to pay.
- Fails to pay employment taxes to the government.
- Engages in fraudulent or illegal behavior that harms the company or someone else.
- Does not treat the company as a separate legal entity, for example, uses company assets for personal uses.

## *Cooperatives*

A **cooperative** (also known as a co-op) is a business owned and controlled by those who use its services. Individuals and firms who belong to the cooperative join together to market products, purchase supplies, and provide services for its members. If run correctly, cooperatives increase profits for its producer-members and lower costs for its consumer-members. Cooperatives are fairly common in the agricultural community. For example, some 750 cranberry and grapefruit member growers market their cranberry sauce, fruit juices, and dried cranberries through the Ocean Spray Cooperative.[7] More than three hundred thousand farmers obtain products they need for production—feed, seed, fertilizer, farm supplies, fuel—through the Southern States Cooperative.[8] Co-ops also exist outside agriculture. For example, REI (Recreational Equipment Incorporated), which sells quality outdoor gear, is the largest consumer cooperative in the United States, with more than three million active members. The company shares its financial success each year with its members, who get a refund each year based on their eligible purchases.[9]

*Figure 5.3: The Ocean Spray™ logo*

## *Not-for-Profit Corporations*

A **not-for-profit corporation** (sometimes called a nonprofit) is an organization formed to serve some public purpose rather than for financial gain. As long as the organization's activity is for charitable, religious, educational, scientific, or literary purposes, it can be exempt


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from paying income taxes. Additionally, individuals and other organizations that contribute to the not-for-profit corporation can take a tax deduction for those contributions. The types of groups that normally apply for nonprofit status vary widely and include churches, synagogues, mosques, and other places of worship; museums; universities; and conservation groups.

There are more than 1.5 million not-for-profit organizations in the United States.[10] Some are extremely well funded, such as the Bill and Melinda Gates Foundation, which has an endowment of approximately $40 billion and has given away $36.7 billion since its inception.[11] Others are nationally recognized, such as United Way, Goodwill Industries, Habitat for Humanity, and the Red Cross. Yet the vast majority is neither rich nor famous, but nevertheless makes significant contributions to society.

# Mergers and Acquisitions

The headline read, "Wanted: More than 2,000 in Google Hiring Spree."[12] The largest Web search engine in the world was disclosing its plans to grow internally and increase its workforce by more than 2,000 people, with half of the hires coming from the United States and the other half coming from other countries. The added employees will help the company expand into new markets and battle for global talent in the competitive Internet information providers industry. When properly executed, internal growth benefits the firm.

An alternative approach to growth is to merge with or acquire another company. The rationale behind growth through merger or acquisition is that 1 + 1 = 3: the combined company is more valuable than the sum of the two separate companies. This rationale is attractive to companies facing competitive pressures. To grab a bigger share of the market and improve profitability, companies will want to become more cost efficient by combining with other companies.

## *Mergers and Acquisitions*

Though they are often used as if they're synonymous, the terms merger and acquisition mean slightly different things. A **merger** occurs when two companies combine to form a new


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company. An **acquisition** is the purchase of one company by another. An example of a merger is the merging in 2013 of US Airways and American Airlines. The combined company, the largest carrier in the world, flies under the name American Airlines.

Another example of an acquisition is the purchase of Reebok by Adidas for $3.8 billion.[13] The deal was expected to give Adidas a stronger presence in North America and help the company compete with rival Nike. Once this acquisition was completed, Reebok as a company ceased to exist, though Adidas still sells shoes under the Reebok brand.

### *Motives behind Mergers and Acquisitions*

Companies are motivated to merge or acquire other companies for a number of reasons, including the following.

#### Gain Complementary Products

Acquiring **complementary products** was the motivation behind Adidas's acquisition of Reebok. As Adidas CEO Herbert Hainer stated in a conference call, "This is a once-in- a-lifetime opportunity. This is a perfect fit for both companies, because the companies are so complementary…. Adidas is grounded in sports performance with such products as a motorized running shoe and endorsement deals with such superstars as British soccer player David Beckham. Meanwhile, Reebok plays heavily to the melding of sports and entertainment with endorsement deals and products by Nelly, Jay-Z, and 50 Cent. The combination could be deadly to Nike." Of course, Nike has continued to thrive, but one can't blame Hainer for his optimism.[14]

#### Attain New Markets or Distribution Channels

Gaining new markets was a significant factor in the 2005 merger of US Airways and America West. US Airways was a major player on the East Coast, the Caribbean, and Europe, while America West was strong in the West. The expectations were that combining the two carriers would create an airline that could reach more markets than either carrier could do on its own.[15]

#### Realize Synergies

The purchase of Pharmacia Corporation (a Swedish pharmaceutical company) by Pfizer


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(a research-based pharmaceutical company based in the United States) in 2003 created one of the world's largest drug makers and pharmaceutical companies, by revenue, in every major market around the globe.[16] The acquisition created an industry giant with more than $48 billion in revenue and a research-and-development budget of more than $7 billion. Each day, almost forty million people around the globe are treated with Pfizer medicines.[17] Its subsequent $68 billion purchase of rival drug maker Wyeth further increased its presence in the pharmaceutical market.[18]

In pursuing these acquisitions, Pfizer likely identified many **synergies**: quite simply, a whole that is greater than the sum of its parts. There are many examples of synergies. A merger typically results in a number of redundant positions; the combined company does not likely need two vice-presidents of marketing, two chief financial officers, and so on. Eliminating the redundant positions leads to significant cost savings that would not be realized if the two companies did not merge. Let's say each of the companies was operating factories at 50% of capacity, and by merging, one factory could be closed and sold. That would also be an example of a synergy. Companies bring different strengths and weaknesses into the merged entity. If the newly-combined company can take advantage of the marketing capabilities of the stronger entity and the distribution capabilities of the other (assuming they are stronger), the new company can realize synergies in both of these functions.

### Hostile Takeover

What happens, though, if one company wants to acquire another company, but that company doesn't want to be acquired? The outcome could be a **hostile takeover**—an act of assuming control that's resisted by the targeted company's management and its board of directors. Ben Cohen and Jerry Greenfield found themselves in one of these situations: Unilever—a very large Dutch/British company that owns three ice cream brands—wanted to buy Ben & Jerry's, against the founders' wishes. Most of the Ben & Jerry's stockholders sided with Unilever. They had little confidence in the ability of Ben Cohen and Jerry Greenfield to continue managing the company and were frustrated with the firm's social-mission focus. The stockholders liked Unilever's offer to buy their Ben & Jerry's stock at almost twice its current market price and wanted to take their profits. In the end, Unilever won; Ben & Jerry's was acquired by Unilever in a hostile takeover.[19] Despite fears that the company's social mission


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would end, it didn’t happen. Though neither Ben Cohen nor Jerry Greenfield are involved in the current management of the company, they have returned to their social activism roots and are heavily involved in numerous social initiatives sponsored by the company.


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# Key Take-Aways: Chapter 5

- A **sole proprietorship,** a business owned by only one person, accounts for 72% of all U.S. businesses.
  - Advantages include: complete control for the owner, easy and inexpensive to form, and owner gets to keep all of the profits.
  - Disadvantages include: unlimited liability for the owner, complete responsibility for talent and financing, and business dissolves if the owner dies.
- A **general partnership** is a business owned jointly by two or more people, and accounts for about 10% of all U.S. businesses.
  - Advantages include: more resources and talents come with an increase in partners, and the business can continue even after the death of a partner.
  - Disadvantages include: partnership disputes, unlimited liability, and shared profits.
- A **limited partnership** has a single general partner who runs the business and is responsible for its liabilities, plus any number of limited partners who have limited involvement in the business and whose losses are limited to the amount of their investment.
- A **corporation** is a legal entity that's separate from the parties who own it, the shareholders who invest by buying shares of stock. Corporations are governed by a Board of Directors, elected by the shareholders.
  - Advantages include: limited liability, easier access to financing, and unlimited life for the corporation.
  - Disadvantages include: the agency problem, double taxation, and incorporation expenses and regulations.


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# Key Take-Aways: Chapter 5

- A **limited-liability company** (LLC) is similar to an S-corporation, but it has fewer rules and restrictions than an S-corporation. For example, an LLC can have any number of members.
- A **cooperative** is a business owned and controlled by those who use its services. Individuals and firms who belong to the cooperative join together to market products, purchase supplies, and provide services for its members.
- A **not-for-profit corporation** is an organization formed to serve some public purpose rather than for financial gain. It enjoys favorable tax treatment.
- A **merger** occurs when two companies combine to form a new company.
- An **acquisition** is the purchase of one company by another with no new company being formed. A hostile takeover occurs when a company is purchased even though the company's management and Board of Directors do not want to be acquired.


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# Chapter 5 Text References and Image Credits

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Figure 5.2: "Types of U.S. Businesses." Data source: "Number of Tax Returns, Receipts, and Net Income by Type of Business." *Census.gov*. Retrieved from: https://www.census.gov/prod/2011pubs/12statab/business.pdf

Figure 5.3: "The Ocean Spray™ logo." Trademarked by the Ocean Spray Cooperative. Retrieved from: https://en.wikipedia.org/wiki/File:Ocean_Spray_Logo.svg

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# Corporation

A **corporation** is an organization, usually a group of people or a company, authorized to act as a single entity (legally a person) and recognized as such in law. Early incorporated entities were established by charter (i.e. by an *ad hoc* act granted by a monarch or passed by a parliament or legislature). Most jurisdictions now allow the creation of new corporations through registration. Corporations enjoy limited liability for their investors, which can lead to losses being externalized from investors to the government or general public, while losses to investors are generally limited to the amount of their investment.[1]

McDonald's Corporation is one of the most recognizable corporations in the world.

Corporations come in many different types but are usually divided by the law of the jurisdiction where they are chartered into two kinds: by whether they can issue stock or not, or by whether they are formed to make a profit or not.[2] Corporations can be divided by the number of owners: corporation aggregate or corporation sole. The subject of this article is a corporation aggregate. A corporation sole is a legal entity consisting of a single ("sole") incorporated office, occupied by a single ("sole") natural person.

Where local law distinguishes corporations by the ability to issue stock, corporations allowed to do so are referred to as "stock corporations", ownership of the corporation is through stock, and owners of stock are referred to as "stockholders" or "shareholders". Corporations not allowed to issue stock are referred to as "non-stock" corporations; those who are considered the owners of a non-stock corporation are persons (or other entities) who have obtained membership in the corporation and are referred to as a "member" of the corporation.

Corporations chartered in regions where they are distinguished by whether they are allowed to be for profit or not are referred to as "for profit" and "not-for-profit" corporations, respectively.

There is some overlap between stock/non-stock and for-profit/not-for-profit in that not-for-profit corporations are always non-stock as well. A for-profit corporation is almost always a stock corporation, but some for-profit corporations may choose to be non-stock. To simplify the explanation, whenever "Stockholder" or "shareholder" is used in the rest of this article to refer to a stock corporation, it is presumed to mean the same as "member" for a non-profit corporation or for a profit, non-stock corporation.

Registered corporations have legal personality and their shares are owned by shareholders[3][4] whose liability is generally limited to their investment. Shareholders do not typically actively manage a corporation; shareholders instead elect or appoint a board of directors to control the corporation in a fiduciary capacity. In most circumstances, a shareholder may also serve as a director or officer of a corporation.

In American English, the word *corporation* is most often used to describe large business corporations.[5] In British English and in the Commonwealth countries, the term *company* is more widely used to describe the same sort of entity while the word *corporation* encompasses all incorporated entities. In American English, the word *company* can include entities such as partnerships that would not be referred to as companies in British English as they are not a separate legal entity.

Late in the 19th century, a new form of company having the limited liability protections of a corporation, and the more favorable tax treatment of either a sole proprietorship or partnership was developed. While not a corporation, this new type of entity became very attractive as an alternative for corporations not needing to issue stock. In Germany, the organization was referred to as *Gesellschaft mit beschränkter Haftung* or *GmbH*. In the last quarter of the 20th Century this new form of non-corporate organization became available in the United States and other countries, and was known as the *limited liability company* or *LLC*. Since the GmbH and LLC forms of organization are technically not corporations (even though they have many of the same features), they will not be discussed in this article.

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**History**
- Mercantilism
- Development of modern company law
  - Deregulation
  - Limited liability
  - Further developments

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# History

The word "corporation" derives from *corpus*, the Latin word for body, or a "body of people". By the time of Justinian (reigned 527–565), Roman law recognized a range of corporate entities under the names *universitas*, *corpus* or *collegium*. These included the state itself (the *Populus Romanus*), municipalities, and such private associations as sponsors of a religious cult, burial clubs, political groups, and guilds of craftsmen or traders. Such bodies commonly had the right to own property and make contracts, to receive gifts and legacies, to sue and be sued, and, in general, to perform legal acts through representatives. Private associations were granted designated privileges and liberties by the emperor.[6]

1/8 share of the Stora Kopparberg mine, dated June 16, 1288.

Entities which carried on business and were the subjects of legal rights were found in ancient Rome, and the Maurya Empire in ancient India.[7] In medieval Europe, churches became incorporated, as did local governments, such as the Pope and the City of London Corporation. The point was that the incorporation would survive longer than the lives of any particular member, existing in perpetuity. The alleged oldest commercial corporation in the world, the Stora Kopparberg mining community in Falun, Sweden, obtained a charter from King Magnus Eriksson in 1347.

In medieval times, traders would do business through common law constructs, such as partnerships. Whenever people acted together with a view to profit, the law deemed that a partnership arose. Early guilds and livery companies were also often involved in the regulation of competition between traders.

## Mercantilism

The progenitors of the modern corporation were the chartered companies, such as the Dutch East India Company (VOC) and the Hudson's Bay Company, which were created to lead the colonial ventures of European nations in the 17th century. Acting under a charter sanctioned by the Dutch government, the Dutch East India Company defeated Portuguese forces and established itself in the Moluccan Islands in order to profit from the European demand for spices. Investors in the VOC were issued paper certificates as proof of share ownership, and were able to trade their shares on the original Amsterdam Stock Exchange. Shareholders were also explicitly granted limited liability in the company's royal charter.[22]

Replica of an East Indiaman of the Dutch East India Company/United East Indies Company. The Dutch East India Company (VOC)[8] is often considered by many to be the first historical model of the modern corporation.[9][10][11][12][13][14][15][16] The VOC was also the first permanently organized limited-liability joint-stock corporation, with a permanent capital base.[17][18][19][20][21]

In England, the government created corporations under a royal charter or an Act of Parliament with the grant of a monopoly over a specified territory. The best-known example, established in 1600, was the East India Company of London. Queen Elizabeth I granted it the exclusive right to trade with all countries to the east of the Cape of Good Hope. Some corporations at this time would act on the government's behalf, bringing in revenue from its exploits abroad. Subsequently, the Company became increasingly integrated with English and later British military and colonial policy, just as most corporations were essentially dependent on the Royal Navy's ability to control trade routes.

Labeled by both contemporaries and historians as "the grandest society of merchants in the universe", the English East India Company would come to symbolize the dazzlingly rich potential of the corporation, as well as new methods of business that could be both brutal and exploitative.[23] On 31 December 1600, Queen Elizabeth I granted the company a 15-year monopoly on trade to and from the East Indies and Africa.[24] By 1711, shareholders in the East India Company were earning a return on their investment of almost 150 per cent. Subsequent stock offerings demonstrated just how lucrative the Company had become. Its first stock offering in 1713–1716 raised £418,000, its second in 1717–1722 raised £1.6 million.[25]

A similar chartered company, the South Sea Company, was established in 1711 to trade in the Spanish South American colonies, but met with less success. The South Sea Company's monopoly rights were supposedly backed by the Treaty of Utrecht, signed in 1713 as a settlement following the War of the Spanish Succession, which gave Great Britain an *asiento* to trade in the region for thirty years. In fact the Spanish remained hostile and let only one ship a year enter. Unaware of the problems, investors in Britain, enticed by extravagant promises of profit from company promoters bought thousands of shares. By 1717, the South Sea Company was so wealthy (still having done no real business) that it assumed the public debt of the British government. This accelerated the inflation of the share price further, as did the

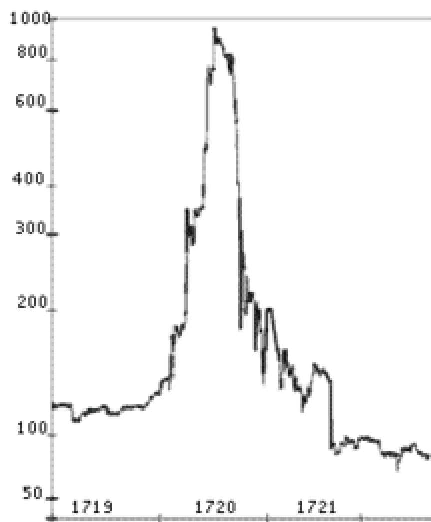
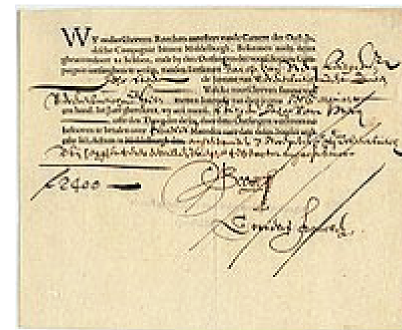



Chart of the South Sea Company's stock prices. The rapid inflation of the stock value in the 1710s led to the Bubble Act 1720, which restricted the establishment of companies without a royal charter.

Bubble Act 1720, which (possibly with the motive of protecting the South Sea Company from competition) prohibited the establishment of any companies without a Royal Charter. The share price rose so rapidly that people began buying shares merely in order to sell them at a higher price, which in turn led to higher share prices. This was the first speculative bubble the country had seen, but by the end of 1720, the bubble had "burst", and the share price sank from £1000 to under £100. As bankruptcies and recriminations ricocheted through government and high society, the mood against corporations and errant directors was bitter.



A bond issued by the Dutch East India Company (VOC), dating from 1623, for the amount of 2,400 florins

In the late 18th century, Stewart Kyd, the author of the first treatise on corporate law in English, defined a corporation as:

> a collection of many individuals united into one body, under a special denomination, having perpetual succession under an artificial form, and vested, by policy of the law, with the capacity of acting, in several respects, as an individual, particularly of taking and granting property, of contracting obligations, and of suing and being sued, of enjoying privileges and immunities in common, and of exercising a variety of political rights, more or less extensive, according to the design of its institution, or the powers conferred upon it, either at the time of its creation, or at any subsequent period of its existence.
>
> — A Treatise on the Law of Corporations, Stewart Kyd (1793–1794)

## Development of modern company law

Due to the late 18th century abandonment of mercantilist economic theory and the rise of classical liberalism and laissez-faire economic theory due to a revolution in economics led by Adam Smith and other economists, corporations transitioned from being government or guild affiliated entities to being public and private economic entities free of governmental directions.[26] Smith wrote in his 1776 work *The Wealth of Nations* that mass corporate activity could not match private entrepreneurship, because people in charge of others' money would not exercise as much care as they would with their own.[27]

### Deregulation

The British Bubble Act 1720's prohibition on establishing companies remained in force until its repeal in 1825. By this point, the Industrial Revolution had gathered pace, pressing for legal change to facilitate business activity.[28] The repeal was the beginning of a gradual lifting on restrictions, though business ventures (such as those chronicled by Charles Dickens in *Martin Chuzzlewit*) under primitive companies legislation were often scams. Without cohesive regulation, proverbial operations like the "Anglo-Bengalee Disinterested Loan and Life Assurance Company" were

undercapitalised ventures promising no hope of success except for richly paid promoters.[29]

"Jack and the Giant Joint-Stock", a cartoon in *Town Talk* (1858) satirizing the 'monster' joint-stock economy that came into being after the Joint Stock Companies Act 1844.

The process of incorporation was possible only through a royal charter or a private act and was limited, owing to Parliament's jealous protection of the privileges and advantages thereby granted. As a result, many businesses came to be operated as unincorporated associations with possibly thousands of members. Any consequent litigation had to be carried out in the joint names of all the members and was almost impossibly cumbersome. Though Parliament would sometimes grant a private act to allow an individual to represent the whole in legal proceedings, this was a narrow and necessarily costly expedient, allowed only to established companies.

Then, in 1843, William Gladstone became the chairman of a Parliamentary Committee on Joint Stock Companies, which led to the Joint Stock Companies Act 1844, regarded as the first modern piece of company law.[30] The Act created the Registrar of Joint Stock Companies, empowered to register companies by a two-stage process. The first, provisional, stage cost £5 and did not confer corporate status, which arose after completing the second stage for another £5. For the first time in history, it was possible for ordinary people through a simple registration procedure to incorporate.[31] The advantage of establishing a company as a separate legal person was mainly administrative, as a unified entity under which the rights and duties of all investors and managers could be channeled.

#### Limited liability

However, there was still no limited liability and company members could still be held responsible for unlimited losses by the company.[32] The next, crucial development, then, was the Limited Liability Act 1855, passed at the behest of the then Vice President of the Board of Trade, Mr. Robert Lowe. This allowed investors to limit their liability in the event of business failure to the amount they invested in the company – shareholders were still liable directly to creditors, but just for the unpaid portion of their shares. (The principle that shareholders are liable to the corporation had been introduced in the Joint Stock Companies Act 1844).

The 1855 Act allowed limited liability to companies of more than 25 members (shareholders). Insurance companies were excluded from the act, though it was standard practice for insurance contracts to exclude action against individual members. Limited liability for insurance companies was allowed by the Companies Act 1862.

This prompted the English periodical *The Economist* to write in 1855 that "never, perhaps, was a change so vehemently and generally demanded, of which the importance was so much overrated."[33] The major error of this judgment was recognised by the same magazine more than 70 years later, when it claimed that, "[t]he economic historian of the future... may be inclined to assign to the nameless inventor of the principle of limited liability, as applied to trading corporations, a place of honour with Watt and Stephenson, and other pioneers of the Industrial Revolution. "[34]

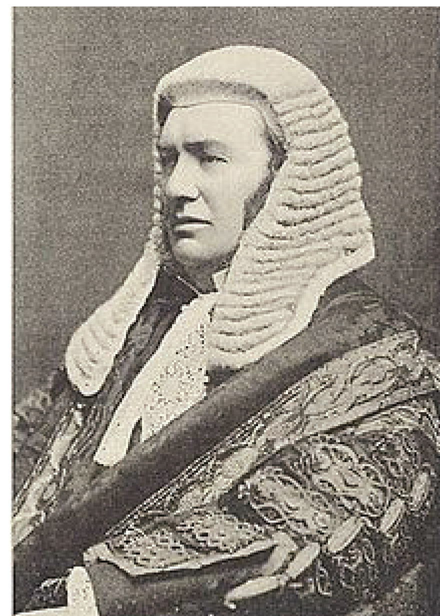
These two features – a simple registration procedure and limited liability – were subsequently codified into the landmark 1856 Joint Stock Companies Act. This was subsequently consolidated with a number of other statutes in the Companies Act 1862, which remained in force for the rest of the century, up to and including the time of the decision in

*Salomon v A Salomon & Co Ltd*.[35]

The legislation shortly gave way to a railway boom, and from then, the numbers of companies formed soared. In the later nineteenth century, depression took hold, and just as company numbers had boomed, many began to implode and fall into insolvency. Much strong academic, legislative and judicial opinion was opposed to the notion that businessmen could escape accountability for their role in the failing businesses.

### Further developments

In 1892, Germany introduced the Gesellschaft mit beschränkter Haftung with a separate legal personality and limited liability even if all the shares of the company were held by only one person. This inspired other countries to introduce corporations of this kind.



Lindley LJ was the leading expert on partnerships and company law in the *Salomon v. Salomon & Co.* case. The landmark case confirmed the distinct corporate identity of the company.

The last significant development in the history of companies was the 1897 decision of the House of Lords in *Salomon v. Salomon & Co.* where the House of Lords confirmed the separate legal personality of the company, and that the liabilities of the company were separate and distinct from those of its owners.

In the United States, forming a corporation usually required an act of legislation until the late 19th century. Many private firms, such as Carnegie's steel company and Rockefeller's Standard Oil, avoided the corporate model for this reason (as a trust). State governments began to adopt more permissive corporate laws from the early 19th century, although these were all restrictive in design, often with the intention of preventing corporations from gaining too much wealth and power.[36]

New Jersey was the first state to adopt an "enabling" corporate law, with the goal of attracting more business to the state,[37] in 1896. In 1899, Delaware followed New Jersey's lead with the enactment of an enabling corporate statute, but Delaware only became the leading corporate state after the enabling provisions of the 1896 New Jersey corporate law were repealed in 1913.[36]

The end of the 19th century saw the emergence of holding companies and corporate mergers creating larger corporations with dispersed shareholders. Countries began enacting anti-trust laws to prevent anti-competitive practices and corporations were granted more legal rights and protections. The 20th century saw a proliferation of laws allowing for the creation of corporations by registration across the world, which helped to drive economic booms in many countries before and after World War I. Another major post World War I shift was toward the development of conglomerates, in which large corporations purchased smaller corporations to expand their industrial base.

Starting in the 1980s, many countries with large state-owned corporations moved toward privatization, the selling of publicly owned (or 'nationalised') services and enterprises to corporations. Deregulation (reducing the regulation of corporate activity) often accompanied privatization as part of a laissez-faire policy.

# Ownership and control

A corporation is, at least in theory, owned and controlled by its members. In a joint-stock company the members are known as shareholders and each of their shares in the ownership, control, and profits of the corporation is determined by the portion of shares in the company that they own. Thus a person who owns a quarter of the shares of a joint-stock company owns a quarter of the company, is entitled to a quarter of the profit (or at least a quarter of the profit given to shareholders as dividends) and has a quarter of the votes capable of being cast at general meetings.

In another kind of corporation, the legal document which established the corporation or which contains its current rules will determine who the corporation's members are. Who a member is depends on what kind of corporation is involved. In a worker cooperative, the members are people who work for the cooperative. In a credit union, the members are people who have accounts with the credit union.[38]

The day-to-day activities of a corporation are typically controlled by individuals appointed by the members. In some cases, this will be a single individual but more commonly corporations are controlled by a committee or by committees. Broadly speaking, there are two kinds of committee structure.

- A single committee known as a board of directors is the method favored in most common law countries. Under this model, the board of directors is composed of both executive and non-executive directors, the latter being meant to supervise the former's management of the company.
- A two-tiered committee structure with a supervisory board and a managing board is common in civil law countries.[39]

## Formation

Historically, corporations were created by a charter granted by government. Today, corporations are usually registered with the state, province, or national government and regulated by the laws enacted by that government. Registration is the main prerequisite to the corporation's assumption of limited liability. The law sometimes requires the corporation to designate its principal address, as well as a registered agent (a person or company designated to receive legal service of process). It may also be required to designate an agent or other legal representative of the corporation.

Generally, a corporation files articles of incorporation with the government, laying out the general nature of the corporation, the amount of stock it is authorized to issue, and the names and addresses of directors. Once the articles are approved, the corporation's directors meet to create bylaws that govern the internal functions of the corporation, such as meeting procedures and officer positions.

The law of the jurisdiction in which a corporation operates will regulate most of its internal activities, as well as its finances. If a corporation operates outside its home state, it is often required to register with other governments as a foreign corporation, and is almost always subject to laws of its host state pertaining to employment, crimes, contracts, civil actions, and the like.

## Naming

Corporations generally have a distinct name. Historically, some corporations were named after their membership: for instance, "The President and Fellows of Harvard College". Nowadays, corporations in most jurisdictions have a distinct name that does not need to make reference to their membership. In Canada, this possibility is taken to its logical extreme: many smaller Canadian corporations have no names at all, merely numbers based on a registration number (for example, "12345678 Ontario Limited"), which is assigned by the provincial or territorial government where the corporation incorporates.

In most countries, corporate names include a term or an abbreviation that denotes the corporate status of the entity (for example, "Incorporated" or "Inc." in the United States) or the limited liability of its members (for example, "Limited" or "Ltd."). These terms vary by jurisdiction and language. In some jurisdictions, they are mandatory, and in others they are not.[40] Their use puts everybody on constructive notice that they are dealing with an entity whose liability is limited: one can only collect from whatever assets the entity still controls when one obtains a judgment against it.

Some jurisdictions do not allow the use of the word "**company**" alone to denote corporate status, since the word "company" may refer to a partnership or some other form of collective ownership (in the United States it can be used by a sole proprietorship but this is not generally the case elsewhere).

# Personhood

Despite not being individual human beings, corporations, as far as US law is concerned, are legal persons, and have many of the same rights and responsibilities as natural persons do. For example, a corporation can own property, and can sue or be sued. Corporations can exercise human rights against real individuals and the state,[41][42] and they can themselves be responsible for human rights violations.[43] Corporations can be "dissolved" either by statutory operation, order of court, or voluntary action on the part of shareholders. Insolvency may result in a form of corporate failure, when creditors force the liquidation and dissolution of the corporation under court order,[44] but it most often results in a restructuring of corporate holdings. Corporations can even be convicted of criminal offenses, such as fraud and manslaughter. However, corporations are not considered living entities in the way that humans are.[45]

# See also

### Law

- Commercial law
- United States corporate law
- European corporate law
- German company law
- History of company law in the United Kingdom
- United Kingdom company law

**Other**

- Anti-corporate activism
- Business attire
- Blocker corporation
- Community interest company
- Cooperative
- Corporate crime
- Corporate governance
- Corporate group
- Corporate haven
- Corporate welfare
- Corporation sole
- Corporatism
- Corporatization
- Decentralized autonomous organization
- Evil corporation

- Fascism
- Good standing
- Government-owned corporation
- History of competition law
- Incorporation (business)
- Limited liability company
- Living wage
- Megacorporation
- Multinational corporation
- Nationalization
- Nonprofit corporation
- Organizational culture
- Preferred stock
- Privatization
- Professional corporation (PC or P.C.)
- Public limited company (PLC)
- Shelf corporation
- Small business
- South Sea Company
- Tulip mania
- United States antitrust law
- Unlimited company
- Unlimited liability corporation

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# External links

- US Corporate Law at Wikibooks
- an Audio from a talk about the history of corporations and the English Law by Barrister Daniel Bennett (http://www.brh.org.uk/dwtf2008/kcc.html)

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HARVARD

LAW REVIEW.

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# HISTORY OF THE LAW OF BUSINESS CORPORATIONS BEFORE 1800.

## I.

THE most striking peculiarity found on first examination of the history of the law of business corporations is the fact that different kinds of corporations are treated without distinction, and, with few exceptions, as if the same rules were applicable to all alike. Subdivisions into special kinds are indeed made, but the classification is based on differences of fact rather than on differences in legal treatment. Thus, corporations are divided into sole and aggregate. Again, they are divided into ecclesiastical and lay, and lay corporations are again divided into eleemosynary and civil. But the division having been made, the older authors [1] proceed to treat them all together, now and then recording some minor peculiarity of a corporation sole or of an ecclesiastical corporation with one member capable.

Municipal and business corporations, so unlike according to modern ideas, are classed together as civil corporations, and treated together along with the rest. Yet the East India Company was chartered in 1600, and other trading companies had been chartered even earlier, and between 1600 and 1800 numer-

[1] *E.g.*, Coke, in Sutton's Hospital Case, 10 Rep. 1, The Law of Corporations, 1 Blacks. Com. ch. xviii., Kyd on Corporations.

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ous corporations were chartered, having for their objects, trade, fishing, mining, insurance, and other business purposes. To understand how it was that the law of business corporations was so connected with that of other corporations, and how it gradually became distinguished, it is necessary to understand how such corporations grew up, and in what way they were regarded when first they came into existence.

The general idea of a corporation, a fictitious legal person, distinct from the actual persons who compose it, is very old. Blackstone ascribes to Numa Pompilius the honor of originating the idea.[1] Angell and Ames are of the opinion that it was known to the Greeks, and that the Romans borrowed it from them.[2] Sir Henry Maine, however, shows that primitive society was regarded by its members as made up of corporate bodies, that the units "were not individuals but groups of men united by the reality or the fiction of blood relationship," and that the family, clan, tribe, were recognized as distinct entities of society before individuals were.[3] It is not surprising, therefore, to find in the Roman law the conception of corporate unity early developed. Savigny, in whose treatise[4] may be found the best connected account of corporations in the Roman law, states that villages, towns, and colonies were the earliest. "But once established definitely for dependent towns, the institution of the legal person was extended little by little to cases for which one would hardly have thought of introducing it. Thus, it was applied to the old brotherhoods of priests and of artisans; then, by way of abstraction, to the State, which, under the name of *fiscus*, was treated as a person and placed within the jurisdiction of the court. Finally, to subjects of a purely ideal nature, such as gods and temples." Savigny then enumerates the different kinds of corporations among the Romans. The present subject is concerned with but one of these, — the business associations. "To this class belong the old corporations of artisans who always continued to exist, and of whom some, the blacksmiths, for example, had particular privileges; also new corporations, such as the bakers of Rome, and the boatmen at Rome and in the provinces. Their interests were of the

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[1] 1 Blacks. Com. 468.

[2] Angell and Ames on Corp. (1st ed.).

[3] Ancient Law (4th ed.), 183.

[4] System des Heutigen Römischen Rechts, vol. ii. § 86 *et seq.*

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same nature, and this served as the basis of their association, but each one worked, as to-day, on his own account."

"There were also business enterprises carried on in common and under the form of legal persons. They were ordinarily called *societates*. Their nature was, in general, purely contractual; they incurred obligations, and they were dissolved by the will as well as by the death of a single member. Some of them obtained the right of being a corporation, keeping always, however, the name of *societates*. Such were the associations for working mines, salt-works, and for collecting taxes."[1]

This latter kind of corporation seems never to have become sufficiently numerous or important to exert a definite influence on the law. Perhaps the Romans were not a sufficiently commercial people to develop the uses of business corporations. In common with other associations the authorization of the supreme power of the State was needed to constitute them legal persons, though this might be given by tacit recognition;[2] and the assent of the sovereign was equally necessary for dissolution. Three members were requisite for the formation of a corporation, though not for its continued existence. The rights and duties of the fictitious person corresponded closely to those of an actual person, so far as the nature of the case admitted. It could hold and deal with property, enjoy *usufructus*, incur obligations, and compel its members to contribute to the payment of its debts, inherit by succession either testamentary or by patronage, and take a legacy. Whether it could commit a tort was a disputed question.

After the introduction of Christianity the church found numerous applications in its own organization for the doctrines which had been developed in regard to corporations, and through the church and its officials these doctrines strongly influenced the law of England, where they were applied to the existing associations.

The earliest corporate associations in England seem to have

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[1] Savigny, System etc., § 88.

[2] Blackstone is, therefore, in error in saying (1 Com. 472) that by the civil law the voluntary association of the members was sufficient unless contrary to law — an error probably caused by the fact that penalties were imposed on certain forbidden associations in the nature of clubs for acting without the authorization of the State, and only on these.

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been peace-guilds, the members of which were pledged to stand by each other for mutual protection.[1] Such brotherhoods would naturally be formed by neighbors or by those exercising similar occupations. From the tendency to associate on account of proximity of residence were developed municipal corporations; from the tendency to associate on account of similarity of occupation the craft guilds grew. These two classes of corporations were the earliest regularly chartered lay corporations in England. Both of them had their counterparts in the Roman law.[2] At first sight they do not seem to have much in common, but the ancient municipal corporation differed from its modern descendant. It was a real association, and membership could not be acquired simply by residing within the town limits. It exercised a minute supervision over the inhabitants, — among other things regulating trades. The guilds or companies did the same thing, only on a more restricted scale. They made by-laws governing their respective trades, which were not simply such regulations as a modern trade-union might make, since any one carrying on a trade, though not a member of the guild of that trade, was bound by its by-laws, so long as they were not opposed to the law of the land or to public policy as it was then conceived.[3] In short, the guilds exercised a power similar to that exercised by the municipal corporations, and, indeed, so late as the time of Henry VI. guildated and incorporated were synonymous terms.[4] Instead of having for its field all inhabitants of a district and local legislation of every character, the guild was confined to such inhabitants of the district as carried on a certain trade and to regulations suitable for that trade. So far as that trade was concerned the right of government belonged to the guild.

The first trades to become organized in this way were naturally the manual employments necessary to provide the community with the most fundamental necessities of civilized life. The weavers were the earliest. They received a charter from Henry II., "with all the freedom they had in the time of Henry I." The goldsmiths were chartered in 1327, the mercers in 1373, the

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[1] See History of Guilds, Luigi Brentano.

[2] For an account of guilds at Rome see "Les Sociétés Ouvrières à Rome," 96 Rev. des Deux Mondes, 626, by Gaston Boissier.

[3] Butchers' Company *v.* Morey, 1 H. Bl. 370; Kirk *v.* Nowill, 1 T. R. 118.

[4] Madox, Firma Burgi, 29.

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haberdashers in 1407, the fishmongers in 1433, the vintners in 1437, the merchant tailors in 1466.[1]

During the sixteenth century the growth of the commercial spirit, fostered by the recent discovery of the New World, the more thorough exploration of the Southern Atlantic and Indian Oceans, and the search for a North-west passage, led to the establishment and incorporation of companies of foreign adventurers, similar in all respects to the earlier guilds, except that their members were foreign instead of domestic traders. Among the earliest of these were the African Company, the Russia Company, and the Turkey Company.[2] The last two were called "regulated companies"; that is, the members had a monopoly of the trade to Russia and to Turkey, but each member traded on his own account.

A more famous company was chartered by Queen Elizabeth in 1600, under the name of the Company of Merchants of London, trading to the East Indies.[3] It had been found that the expense incident to fitting out ships for voyages, often taking several years for their completion, was too great to be borne easily by individual merchants, and it was one of the claims to favorable consideration which the East India Company put forward, that "noblemen, gentlemen, shopkeepers, widows, orphans, and all other subjects may be traders, and employ their capital in a joint stock."[4]

Sums of various amounts were subscribed, and the profits were to be distributed in the same proportions. This joint-stock adventure was not, however, identical with the corporation. Members of the corporation were not necessarily subscribers to the joint stock, and any member could, if he liked, carry on private trade with the Indies, — a privilege belonging exclusively to members. By the charter, apprentices and sons of members were to be admitted to membership in the same way as was customary in the guilds.

The East India Company was, therefore, in its early days, like the other trading companies, — an association of a class of merchants to which was given the monopoly of carrying on a particular trade, and

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[1] 1 And. Hist. of Commerce, 250. [2] Knight's Hist. of England, vol. v. 39.

[3] What follows in regard to the East India Company is based on "The History of European Commerce with India," by David Macpherson, London, 1812, and documents therein quoted.

[4] From the defence of the Company in the Privy Council, 2 And. Hist. Com. 173.

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the right to make regulations in regard to it. Till 1614 the joint stock was subscribed for each voyage separately, and at the end of the voyage was redivided. After that, for many years, the joint stock was subscribed for a longer or shorter term of years, and at the end of each term the old stock was usually taken at a valuation by the new subscribers. Membership in the corporation, however, soon became merely a formal matter, — useless, except to those interested in the joint stock, especially as regulations were passed forbidding other members from engaging in private trading ventures to India. After 1692 no private trading of any kind was allowed except to the captains and seamen of the Company's ships. The form, however, was still retained, and every purchaser of stock who was not a member of the Company was obliged to pay a fee of £5 for membership.

At this time (1692) there were but two other joint-stock companies of any importance in England, — the Royal African Company and the recently chartered[1] Hudson's Bay Company. The outline given above will serve to indicate their general nature and also to show how something like the modern joint-stock corporation grew out of the union of the ideas of association for the government of a particular trade by those who carried it on, and of combination of capital and mutual coöperation, suggested and made necessary by the great expense incident to carrying on trade with distant countries. But the corporation was far from being regarded as simply an organization for the more convenient prosecution of business. It was looked on as a public agency, to which had been confided the due regulation of foreign trade, just as the domestic trades were subject to the government of the guilds. In a little book, entitled "The Law of Corporations," published anonymously in 1702,[2] it is said: "The general intent and end of all civil incorporations is for better government, either general or special. The corporations for general government are those of cities and towns, mayor and citizens, mayor and burgesses, mayor and commonalty, etc. Special government is so called because it is remitted to the managers of particular things, as trade, charity, and the like, for government, whereof several companies and corporations for trade were erected, and several hospitals and houses for charity."[3]

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[1] 1670. [2] This is the first English book wholly devoted to the subject of corporations.
[3] Law of Corporations, p. 2.

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This idea that the object of a business corporation is the public one of managing and ordering the trade in which it is engaged, as well as the private one of profit for its members, may also be noticed in the charters granted to new corporations, especially in the recitals, and in the provisions usually found that the newly chartered company shall have the exclusive control of the trade intrusted to it.

At the end of the seventeenth century the advantages of corporate enterprises seem to have been realized, and acts of Parliament, authorizing the king to grant charters to various business associations, were more frequent. In 1692 the Company of Merchants of London trading to Greenland was incorporated; [1] the act reciting the great importance of the Greenland trade, how it had fallen into the hands of other nations, and could only be regained by a greater undertaking than would be possible for a private individual, and the consequent necessity of a joint-stock company. In 1694 the Bank of England received its first charter.[2] The act authorizing it was essentially a scheme to raise money for the government. Those who advanced money to the government were to receive a corresponding interest in the bank, the capital of which was to consist of the debt of the government. No other association of more than six persons was allowed to carry on a similar business.[3] Charters were also granted about this time to the National Land Bank,[4] the Royal Lustring Company,[5] the Company of Mine Adventurers,[6] the famous South Sea Company,[7] the Royal Exchange and the London (Marine) Assurance Companies.[8] In these charters also the public interest in having the undertaking prosecuted and the great expense incident thereto are mentioned. The capital of the South Sea Company, like that of the Bank, consisted of a debt due from the government on account of money loaned by private individuals.

The extravagant commercial speculations in joint-stock companies and the stock-jobbing in their shares which characterized the early part of the eighteenth century are well known. Anderson, in his "History of Commerce,"[9] enumerates upwards of

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[1] 4 and 5 Wm. III., c. 17.

[2] 5 and 6 Wm. III., c. 20.

[3] By Stat. 6 Anne, c. 22. § 9.

[4] 7 and 8 Wm. III., c. 31.

[5] 9 and 10 Wm. III., c. 43.

[6] See 9 Anne, c. 24.

[7] 9 Anne, c. 21.

[8] 6 Geo. I., c. 18.

[9] Vol. i. (1st ed.) 291 *et seq.*

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two hundred companies formed about the year 1720, for the prosecution of every kind of enterprise, including one for the "Insurance and Improvement of Children's Fortunes," and another for "Making Salt Water Fresh." With very few exceptions, these companies were not incorporated and in 1720 writs of *scire facias* were issued,[1] directing an inquiry as to their right to carry on business, in usurpation of corporate powers. This put a sudden end to many of these unfortunate ventures, and the consequent collapse of the enormously inflated public credit carried down others, so that only four of the long list were still in existence when Anderson wrote, — the York Buildings Company, the two Assurance Companies mentioned above, and the English Copper Company. The speculation in shares had been too great and the expectations of profit too extravagant not to cause a correspondingly great distrust in corporate enterprises when the bubble burst, and the profits realized were found to be small and extremely variable. Adam Smith, writing in 1776, was of opinion,[2] that "the only trades which it seems possible for a joint-stock company to carry on successfully without an exclusive privilege, are those of which all the operations are capable of being reduced to what is called routine, or to such a uniformity of method as admits of little or no variation. Of this kind is, *first*, the banking trade; *secondly*, the trade of insurance from fire, and from sea risk and capture in time of war; *thirdly*, the trade of making and maintaining a navigable cut or canal; and, *fourthly*, the similar trade of bringing water for the supply of a great city." To render the establishment of a joint stock reasonable, however, the author says, two other circumstances should concur: first, "that the undertaking is of greater and more general utility than the greater part of common trades; and, secondly, that it requires a greater capital than can easily be collected into a private copartnery."

But during the latter part of the eighteenth century corporations were gradually increasing in number and importance. The need for them was felt in establishing canals, water-works, and, to some extent, in conducting the growing manufactures of the kingdom. The progress was indeed slow, and was destined to be so until the introduction of gas-lighting into all the larger cities and

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[1] And. Hist. Com., Vol. ii. 296.

[2] Wealth of Nations, book v. ch. 1. art. 5.

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towns early in the present century, and later the laying of railways, created a wide-spread necessity for united capital.

The outline sketch just given of the growth of business corporations shows that they are not a spontaneous product, but are rather the result of a gradual development of earlier institutions, running back farther than can be traced. It would be strange if signs of this development were not found in the history of the law relating to them. The natural expectation would be, and such is in fact the case, that as to the points which modern business corporations have in common with the early guilds and municipalities, the law relating to them dates back farther than almost any other branch of the law, while as to the points which belong exclusively to the conception of the business corporation, the law has been formed very largely since 1800. And not only had a body of new law to be thus formed, but old doctrines laid down by early judges as true of all corporations, though in reality suited only to the kinds of corporations then existing, had to be discarded or adapted to changed conditions.

In the first place, then, the endeavor will be to examine the points which belong essentially to every kind of corporation, and afterwards to consider what was settled before the present century in regard to the peculiar relations arising from the nature of a business corporation.

In the case of Sutton's Hospital,[1] decided in 1612, the general law of corporations was considered at some length, and the following things were said to be "of the essence of a corporation:[2] 1st, Lawful authority of incorporation, and that may be by four means, viz., by the common law, as the king himself, etc.; by authority of Parliament; by the king's charter; and by prescription. The 2d, which is of the essence of the incorporation, are persons to be incorporated, and that in two manners; viz., persons natural, or bodies incorporate and political. 3d, A name by which they are incorporated. 4th, Of a place, for without a place no incorporation can be made. 5th, By words sufficient in law, but not restrained to any certain, legal, and prescript form of words."

This, then, was the mould in which every corporation had to be cast, regardless of what might be its nature or its purpose.

The first requirement, due authorization, existed in the Roman

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[1] 10 Rep. 22 b.

[2] 10 Rep. 29 b.

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law as well as in English.[1] But, since corporate bodies were recognized as facts from the earliest dawn of history, when the rule became recognized that the authority of the supreme power of the State was necessary for their formation, a theory had to be found to support the old associations, which had not been formed in accordance with the rule. This was done both in Roman and in English law by recognizing that a corporation could come into existence by prescription. It is safe to say, however, that prescriptive and common-law corporations, were of the older forms only, and that for the formation of business corporations, from the first, a charter from the king directly or by authority of Parliament was necessary.

Originally the power was exercised exclusively by the king; but his power to grant charters allowing exemptions or monopolies was gradually restricted, like many of his other powers, as little by little the House of Commons assumed the entire effective control of the government. The regulated Russia Company received its charter from the crown in 1555 without the consent of Parliament; so did the East India Company in 1600, the Canary Company in 1665, the Hudson's Bay Company in 1670. All of these companies were given monopolies. The rights of the Russia Company and of the East India Company were afterwards regulated by statute; and the patent of the Canary Company was soon withdrawn, though not before giving rise to a test case[2] on the validity of the monopoly, in which the court decided against it. The Hudson's Bay Company continued to enjoy its charter without interference, but its right to a monopoly held good so long only as nobody cared to dispute it. After the Revolution, no doubt, it was tacitly admitted that for the validity of a charter conferring a monopoly or other special privilege an act of Parliament was necessary, though for granting the simple franchise of acting as a corporation the patent of the king was sufficient.

The last of the requisites enumerated by Coke may be regarded as included within the first. "Lawful authority of incorporation" must necessarily be given "by words sufficient in law." The necessity for persons to compose the corporation results from the nature of things rather than from any rule of law. Perhaps the same may be said of the importance of a name. As an actual

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[1] See *supra*, p. 107.

[2] Horne *v.* Ivy, 1 Ventr. 47.

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person could hardly transact business or sue and be sued in the courts without a name, so the fictitious person of a corporation rests under a similar necessity. Possibly Coke meant something more, regarding a corporation as an abstraction which would have no existence without a name. "For a corporation aggregate of many is invisible, immortal, and rests only in intendment and consideration of the law."[1] But if such was his view, it was not shared by his successors, when the tinge of scholasticism which colored all the law of the period faded away. In the case of the Dutch West India Company *v.* Van Moses,[2] decided in 1724, it was held that the action was well brought, though no certain name had been given the company by the Dutch States, the name being that by which it was usually called; and there are numerous cases to the effect that a technical misnomer of a corporation had even less effect than the misnomer of an individual.[3]

When Coke wrote, it seems to have been necessary that a corporation should be named as of a certain place.[4] This requirement, apparently so fanciful, is explained by the fact that the early corporations were almost all formed for local or special government of some kind, and it was consequently necessary to designate the place where the jurisdiction was to be exercised. The requisite must very early have become merely formal in case of certain classes of corporations, and might be fictitious. Thus, such names may be found as, "The Hospital of St. Lazarus of Jerusalem in England" and "The Prior and Brothers of St. Mary of Mt. Carmel in England."[5] As the purpose for which corporations were instituted became more varied, and the modes of thought of lawyers became more reasonable, less stress was laid on the formality under consideration. It is hardly mentioned in "The Law of Corporations" or in Blackstone's chapter.[6] Kyd merely says, "It is generally denominated of some place;[7] and it may be assumed as true of business corporations, as well as of most others, that before the beginning of the present century there was no

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[1] Sutton's Hospital Case, 10 Rep. 32.

[2] 1 Stra. 612; and see the Law of Corporations, 13. Also, if the name of a corporation be changed, it retains its possessions, debts, etc. Bishop of Rochester's Case, Owen, 73; S. C. 2 And. 107; Luttrel's Case, 4 Rep. 87 b; Mayor of S. *v.* Butler, 3 Lev. 237; Haddock's Case, 1 Ventr. 355.

[3] Kyd, 236 *et seq.*

[4] Button *v.* Wrightman, Cro. Eliz. 338.

[5] Rol. 512.

[6] Blacks. Com. ch. xviii.

[7] 1 Kyd, 228.

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force in Coke's fifth essential for the existence of a corporation other than as a matter of convenience.[1]

Grant, now, that a corporation was legally called into being, what abilities and disabilities was it considered to have? Coke says:[2] "When a corporation is duly created all other incidents are tacitly annexed — . . . and therefore divers clauses subsequent in the charters are not of necessity, but only declaratory and might well be left out; as —

"1st. By the same to have authority, ability, and capacity to purchase, but no clause is added that they may alien, etc., and it need not, for it is an incident.

"2d. To sue and be sued, implead and be impleaded.

"3d. To have a seal; that is also declaratory, for when they are incorporated they may make or use what seal they will.

"4th. To restrain them from aliening or devising but in certain form; that is an ordinance testifying the king's desire, but it is but a precept and does not bind in law.

"5th. That the survivors shall be a corporation; that is a good clause to oust doubts and questions which might arise, the number being certain.

"6th. If the revenues increase, that they shall be used to increase the number of the poor, etc.; that is also explanatory.

"8th. To make ordinances; that is requisite for the good order and government of the poor, etc., but not to the essence of the incorporation.

"10th. The license to purchase in mortmain is necessary for the maintenance and support of the poor, for without revenues they cannot live, and without a license in mortmain they cannot lawfully purchase revenues, and yet that is not of the essence of the corporation, for the corporation is perfect without it."

This list of attributes laid down by Coke as necessarily belonging to all corporations is quoted with approval in "The Law of Corporations."[3] It is given by Blackstone in substance, though altered to the following form:[4]

The incidents which are tacitly annexed to every corporation as soon as it is duly erected are —

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[1] See Mayor of Stafford *v.* Bolton, 1 B. & P. 40.

[2] Sutton's Hospital Case, 10 Rep. 30, citing as authority 22 Edw. IV., Grants, 30.

[3] p. 16.

[4] 1 Blackst. Com. 475; also in Wood's Inst. of the Laws of Eng., bk. i. ch. viii.

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"1st. To have perpetual succession. This is the very end of its incorporation, for there cannot be a succession forever without an incorporation, and therefore all aggregate corporations have a power necessarily implied of electing members in the room of such as go off.

"2d. To sue or be sued, implead or be impleaded, grant or receive, by its corporate name, and do all other acts as natural persons may.

"3d. To purchase lands and hold them for the benefit of themselves and their successors, which two are consequential of the former.

"4th. To have a common seal. . . .

"5th. To make by-laws or private statutes for the better government of the corporation, which are binding on themselves, unless contrary to the law of the realm, and then they are void."

The enumeration of Blackstone is given without substantial alteration by Kyd,[1] though he adds that the last two powers are unnecessary for a corporation sole, and that the right to make by-laws is not inseparably incident to all kinds of corporations aggregate, for there are some to which rules may be prescribed; and, further, that the list is not exhaustive. The first three capacities are reducible to this, that the fictitious person of the corporation shall have, in general, the capacity of acting as an actual person, so far as the nature of the case admits. Such must have been the recognized law ever since corporations, as we understand the word, existed; for the conception of a corporation as a legal person, a conception going back farther than can be definitely traced, involves necessarily the consequence that before the law the corporation shall be treated like any other person. To this consequence there is a necessary exception in regard to such rights and duties as require an actual person for their subject.

The right and the necessity of having a corporate seal was probably in its origin simply the result of treating a corporation in the same way as an individual. The great antiquity of the custom of using seals is well known. It prevailed among the Jews and Persians,[2] as well as among the Romans. It was spread over all the countries whose systems of law were borrowed from the Romans, and it was introduced into England by the Normans.[3]

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[1] Vol. i. p. 69.

[2] 2 Blackst. Com. 305; Genesis, xxxviii. 18; Esther, viii. 8; Jeremiah, xxxii. 10.

[3] 2 Blackst. Com. 306.

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In England, owing to the generally prevailing illiteracy, the use of the seal became the ordinary way of indicating the maker of a charter. The practice, apparently, was not the result of a desire for peculiar solemnity, but merely for indentification. The use and object of a corporate seal may be assumed to have been the same as of an individual seal. It is true that Blackstone[1] finds a reason for its use in the fact that "a corporation, being an invisible body, cannot manifest its intentions by any personal act or oral discourse; it therefore acts and speaks only by its common seal." But this reason, besides bearing on its face indications of having been invented after the fact, goes altogether too far. A corporation has no hand with which to affix its seal, and if it may perform that act by an agent, there is no reason in the nature of things why it should not do anything else by the same instrumentality.[2] And in the Roman law the use of a common seal was only a possible, not a necessary, way for a corporation to act.

When writing became a general accomplishment, the use of a seal for private documents was reserved for instruments of a peculiarly formal or solemn character. That a similar transition did not take place in the use of the seal of a corporation may be ascribed to the natural conservatism of a number of men acting in a body, and to the fact that from the character of early corporations the inconvenience of sealing all corporate contracts was not likely to be felt. However this may be, it was a rule of law well settled before business corporations came into existence that a corporation could only act by deed under its common seal. To the rule some slight exceptions were allowed, but only in few cases. Such a restriction could not fail to be extremely embarrassing to corporations, when they afterwards sprang up, the object of which was to carry on trade; and the development of the law on this point in regard to such corporations shows not so much a growth of legal doctrine, as an endeavor to do away with the inconvenient restraint imposed on all aggregate corporations, which had its origin when guilds and municipal and ecclesiastical associations were the only corporate bodies,— an endeavor that met with but indifferent success.[3]

The general rule seems to have been well settled in the fifteenth

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[1] 1 Com. 475.

[2] 1 Blackst. Com. (Sharswood's ed.) 475, n. 7.

[3] Taylor on Evidence (8th ed.), § 976 *et seq.*

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century, and it also appears that there were some slight exceptions to it.[1] Just what these were, was by no means definitely marked out. In Y. B. 4 Hy. VII. 17 b, one of the judges, Townsend, said: "A body corporate cannot make a feoffment or lease or anything relating to their inheritance without deed, but of offices and things which pertain to servants they can. For they can appoint plowmen and servants of husbandry without deed, and butlers and cooks and things of that kind, and can depute their servants to do anything without deed. They can do this because it is not in disinheritance of the corporation, but only by way of service, and it is the common course to justify by command of the body corporate, and not show anything from it." Brian, however, was of a contrary opinion, saying, "A body corporate can do none of those things without deed." Townsend's opinion undoubtedly made more sweeping exceptions than were afterwards allowed, but his statement that a corporation could appoint a cook or butler without a deed was for centuries cited as indicating the extent of the power of acting without using the corporate seal.[2] In Y. B. 7 Hy. VII. 9, it was held that the defendant in an action of trespass could not justify as acting for a corporation without showing authority by deed. Wood adds: "But of little things the law is otherwise, for it would be infinite if each little act was by deed, as, a command to their servants, to light a candle in church, or to make a fire, or such things." With this the court with one exception agreed. This statement of the law is based on a principle which continued to be decisive in the eighteenth as in the sixteenth century. In transactions which from their nature could be done under seal only with great inconvenience, the formality of sealing was dispensed with. The inconvenience might arise from the pettiness of the act, or from its being of every-day occurrence and necessity, or from the importance of immediate action. The exception was wrested by common sense from the scope of the rule.

Accordingly, when business corporations arose, it must have been tacitly admitted that the daily business need not all be transacted under seal. For instance, the bills of the Bank and of the East India Company were never sealed. The right to make

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[1] Y. Bks. 9 Edw. IV. 39, 4 Hy. VII. 17 b, 7 Hy. VII. 9.

[2] Horne *v.* Ivy, 1 Vent. 47; Dunston *v.* Imp. Gas Co., 3 B. & Ad. 125, 129; Tilson *v.* Warwick Gas Co., 4 B. & C. 962, 964.

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such bills was afterward defended and explained as necessarily implied in the powers given them by Parliament. These corporations "could not carry on their business without the making of such instruments, and they would cease to be bills or notes if under seal. It is clear, however, that this indulgence is not allowed by law to be extended beyond cases of absolute necessity."[1]

A more difficult point was raised in 1717, in the case of Rex *v.* Bigg,[2] the leading case before the present century on the extent to which a business corporation could act without the use of its seal. Bigg was charged with felony in altering a bank-note signed by one Adams, an officer of the bank. It was objected that Adams did not have authority under the seal of the bank to affix his name, and that consequently the altered instrument was not a valid obligation, and the prisoner was not guilty of forgery. The argument of Peere Williams for the prisoner is fully given, and the cases which he cites seem to bear him out in his contention that such an agent could not be appointed without deed; but a majority of the court held the prisoner guilty of felony. No opinion is given. It must be admitted that the decision involved some extension of the old rule that a cook or butler or servant for some petty purpose could be retained without a sealed instrument, but after this the law was settled that the regular servants and agents of a business corporation were to be regarded in a similar way.[3]

But, granting this, how far could an agent of such a corporation act in its behalf without a deed? As mentioned above, a corporation, the charter of which authorized it to carry on a business that required for its proper exercise the issue of bills and notes, did not need to affix the common seal to such obligations. Undoubtedly, also, a large amount of routine business was transacted entirely by parol, and there is no case reported where a transaction executed on both sides was set aside because the corporation did not act by deed. But, for the rest, it may at least be said that till after the first quarter of the present century had passed, no unsealed executory contract was binding on either party;[4] and it is probable, also, that in a partially executed transaction no special

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[1] East London Waterworks Co. *v.* Bailey, 12 Moore, 532; S. C. 4 Bing. 283; and see Edie *v.* E. I. Co., 2 Burr. 1216 where assumpsit was brought against the Company on a bill of exchange, without objection.

[2] 3 P. Wms. 419.

[3] Bac. Abr., tit. Corporation (E) 3; 1 Kyd on Corp. 26.

[4] East London Waterworks *v.* Bailey, 12 Moore, 532; S. C. 4 Bing. 283.

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agreement was valid without seal. On the other hand, if the transaction was such as of itself gave rise to an obligation, it could be enforced; forfeitures and tolls could be recovered in assumpsit;[1] if land were demised without deed, and the lessee occupied the premises, he was liable for rent in an action for use and occupation; and similarly, no doubt, if goods were bought or sold by a corporation and delivery was made, the vendee could have been forced to return or pay for them.[2]

The courts were sometimes able to mitigate the hardships which followed from the necessity of doing everything under seal, by presuming, as a matter of pleading, that when performance by a corporation was averred, performance with all necessary formalities was intended,[3] and partial relief was given in special instances by act of Parliament;[4] but at best it would be hard to find a more striking instance of a rule of law which arose from the customs prevailing in an entirely different state of society still maintaining itself when every reason for its existence had ceased, and its only effect was to produce injustice.

The right to pass by-laws for the regulation of their affairs belonged to corporations in the Roman law[5] from a very early period, and also in the English law. Indeed, the right is a consequence almost necessarily following from the nature of the early corporations. Institutions to which were delegated powers of government, whether ecclesiastical or secular, whether exercised over all within a certain locality or confined to those practising a particular trade, must have been allowed appropriate means of exerting their authority, and the scope of the by-laws must have been proportioned to the jurisdiction. Thus, the by-laws of a corporate town were binding on any one who came within its limits.[6] The by-laws of a guild were binding not on its members only,

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[1] The Barber Surgeons *v.* Pelson, 2 Lev. 252; Mayor of London *v.* Hunt, 3 Lev. 37; and see Parbury *v.* Bank of England, 2 Doug. 524, where, at the suggestion of Lord Mansfield, a special action of assumpsit was brought on account of the bank's refusal to transfer stock on the books.

[2] E. I. Co. *v.* Glover, 1 Stra. 612.

[3] Edgar *v.* Sorell, Cro. Car. 169; Tilson *v.* Warwick Gas Co., 4 B. & C. 962; Rex *v.* Bigg, 3 P. Wms. 419.

[4] *E. g.*, 11 Geo. I. c. 30, § 43, which allowed the two insurance companies recently chartered to make use of the freer pleading in vogue in the action of assumpsit when sued on their policies, which were under seal.

[5] Dig. xlvii. 22, lex 4.

[6] Cuddon *v.* Eastwick, 1 Salk. 193, pl. 5.

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but on such outsiders as exercised the trade which the guild governed and regulated.[1] The power of making by-laws would be useless without means of enforcing them, and the imposition of penalties for failure to comply with its by-laws was within the power of a corporation, from an indefinite time.[2] The farther back the examination is carried the broader seems to have been the power of punishing the refractory, extending by special charter in many cases to imprisonment as well as fine.[3] By Coke's time, however, it was settled that the power of imprisonment could not be given by letters-patent from the king, but required an act of Parliament; [4] and it was further held that similar authority was needed for a by-law affixing as a penalty the forfeiture of goods; [5] but that such by-laws were formally valid may be inferred from the fact that this mode of enforcement was sometimes supported as being in accordance with an immemorial custom.[6] Further limitations on the power of making by-laws, which were more strictly construed as time went on, were that they must not be contrary, nor even cumulative, to the statutes of Parliament,[7] nor in restraint of trade,[8] nor unreasonable.[9] Business corporations, when they arose, were dealt with according to the same principles. As it was well recognized that such by-laws only could be made as were in harmony with the objects for which the corporation was created,[10] and as the purposes for which business corporations were chartered were as a rule definitely marked out, the scope of the right to make by-laws was correspondingly narrowed. A few of the earlier joint-stock companies were intrusted with the regulation of the trade in which they were engaged, and the by-laws of these were binding on all engaged in the trade, precisely as was the case with guilds.[11] But by the change in the conception of a

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[1] Butchers' Co. *v.* Morey, 1 H. Bl. 370; Kirk *v.* Nowill, 1 T. R. 118.

[2] The Law of Corp. 209.

[3] Grant on Corp. 86, especially notes d and f.

[4] Towle's Case, Cro. Car. 582; Chancey's Case, 12 Rep. 83.

[5] 8 Rep. 125 a; Horne *v.* Ivy, 1 Ventr. 47; Clarke *v.* Tuckett, 2 Ventr. 183; Nightingale *v.* Bridges, 1 Show. 135.

[6] Clearywalk *v.* Constable, Cro. Eliz. 110; Sams *v.* Foster, Cro. Eliz. 352; s. c. Dyer, 297 b.

[7] Grant on Corp. 78.

[8] Ibid. 83.

[9] Ibid. 80.

[10] Child *v.* Hudson's Bay Co., 2 P. Wms. 207; 2 Kyd on Corp. 102.

[11] *E.g.*, the East India Company in its early days regulated the right of private trading with the Indies, and soon forbade it altogether. It endeavored to enforce this rule against

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corporation from an institution for special government to a simple instrumentality for carrying on a large business, the right to pass by-laws was restricted to regulations for the management of the corporate business.[1] Such regulations, of course, like the by-laws of municipal corporations and guilds, were void if contrary to statutory or common law, or if unreasonable. Whether a certain by-law was held unreasonable or not depended in some measure on the discretion of the court. The decision might be different when judged by the standards of the eighteenth century from what it would be if judged by modern standards. Thus, a by-law of the Hudson's Bay Company giving itself a lien on its members' stock for any indebtedness due from them to the Company was held valid,[2] the court saying, "All by-laws for the benefit and advantage of trade are good unless such by-laws be unreasonable or unjust; that this, in their opinion, was neither." To-day, in a jurisdiction unfettered by authority, the conclusion would probably be otherwise.[3]

In addition to the doctrines which have just been considered, a few others may be mentioned as applicable to all corporations alike. In general, questions of rights and duties towards the outside world are much the same for all kinds of corporations. The law, it is said, makes no personal distinctions, and it is at least true that wherever considered practicable the fictitious legal person of a corporation, whatever its nature, was treated by the law in the same way as an actual person. On the other hand, the law regulating the relations of the members to each other and to the united body must differ according to the nature and objects of the corporation.

It has often been questioned whether a corporation could commit a tort or crime. The better opinion in the Roman law seems to

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a non-member by forfeiture of his vessel. He petitioned the House of Lords, which ordered the Company to put in its answer. The case finally resulted in a quarrel between the Lords and the Commons as to the right of the former to take jurisdiction. The Lords gave judgment for the plaintiff, but it was never executed. Macpherson, Hist. 127. See, also, Horne *v.* Ivy, 1 Ventr. 47.

Further illustrations of by-laws of business corporations binding on the public may be found in the regulations passed by early canal and railway companies in accordance with 6 Geo. IV. c. 71, and 8 and 9 Vict. c. 20, § 109.

[1] Child *v.* Hudson's Bay Co., 2 P. Wms. 207.

[2] Child *v.* Hudson's Bay Co., 2 P. Wms. 207, re-argued *sub nom.* Gibson *v.* Hudson's Bay Co., 1 Stra. 645; S. C. 7 Vin. Abr. 125.

[3] Lowell, Transfer of Stock, § 166.

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have been that the question should be answered in the negative, at least whenever *dolus* or *culpa* was necessary to make the act under consideration wrongful.[1] In England, however, it was very early held that corporations might be liable in actions on the case or in trespass,[2] and afterwards in trover.[3] But it is not likely that a corporate body would have been held liable for any tort of which actual malice or *dolus* was an essential part. Similarly it was held that a corporation could not be guilty of a true crime,[4] that is, it could not have a criminal intent, but it could be indicted for a nuisance or for breach of a prescriptive or statutory duty, and, in general, where only the remedy was criminal in its nature.[5]

It was generally laid down that a corporation could not hold in trust.[6] It is not very clear exactly on what reasoning the conclusion was based. There is very little to support it, except in very old cases. The view gradually became obsolete, and though there was no decision before the year 1800 definitely deciding the point, it is probable that it was recognized before that time that a corporation might hold in trust.[7]

*Samuel Williston.*

CAMBRIDGE, May 31, 1888.

*(To be continued.)*

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[1] Savigny, System, §§ 94, 95.

[2] See Grant on Corp. 277, 278, and notes, in which are cited many cases from the Year Books.

[3] Yarborough *v.* Bank of England, 16 East, 6.

[4] Anon., 12 Mod. 559; that it cannot commit treason see Vin. Abr., Corpor. Z, pl. 2.

[5] Grant on Corp. 283, 284.

[6] The authorities are collected in Gilbert on Uses, 5, 170, and Sugden's note.

[7] See Atty.-Gen. *v.* Stafford, Barnard. Ch. 33.

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# THE GENESIS OF THE CORPORATION.

A FEW years ago the writer became interested in the trust problem, and after some study of the subject reached the conclusion that the corporation furnished the only means by which trusts were able to maintain their existence.[1] This naturally suggested an examination of the contrivance which was sufficiently convenient and effective to accomplish such large results. The process of forming a corporation was of course familiar, but on close inspection the thing itself seemed to merit investigation. Several persons associate themselves and comply with certain forms prescribed by law, and the result is something having an identity and existence entirely independent from these persons, and with rights, powers, and duties of its own. All the familiarity in the world with this process does not render the result other than remarkable. Nor is the phenomenon clearly explained by the well-known statements that this mysterious something is "created by the sovereign power," and that it is "a fictitious or artificial person."[2] Inevitably the inquiry arises whether the corporation represents a natural privilege, or whether it is an arbitrarily constructed species of machinery. This in turn suggests further questions: Where did the corporation come from? Who invented it? On what basic principle does it rest? In the ultimate analysis what is the corporate idea? In considering these questions it is the single endeavor of this paper to arrive at the inherent nature of the corporation. It is proposed first to discuss the matter in the abstract, and then to illustrate that discussion by specific examples.

The germ of the corporate idea lies merely in a mode of thought; in thinking of several as a group, as one. This mental process, familiar as soon as there was any conscious thought, is so nearly elemental in its nature that it has been said to defy analysis.[3] Nevertheless, as individuals are the primary units from the point of

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[1] 16 HARV. L. REV. 791.

[2] Marshall, C. J., in Dartmouth College *v.* Woodward, 4 Wheat. (U. S.) 518; Cal. Civil Code, § 283; Georgia Code, § 1836.

[3] Morawetz, Law of Private Corporations, § 1, note.

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view of logic, if not of history,[1] a thought which embraces several individuals must be susceptible to some extent of explanation. It is the recognition of a fact, namely, that a certain number of persons are seen or heard or in some way appear as a body, as one; they are perceived by some one or more of the senses to manifest a certain cohesion. The underlying cause or motive force which produces this perceptible cohesion is that each of the individuals in question bears precisely the same relation to some aspect or phase of existence; each has an identity of relationship to a common influence or factor. This common factor may be trivial and of momentary effect, or it may be of permanent and vital significance. For example, it may consist in ties of blood or place of residence, or it may be merely the desire to see a passing street parade. In other words, there are groups of all sorts and degrees. The persons gathered to chat on a street corner, the men who row in a college boat, the statesmen who legislate at Washington, a crowd, a crew, a congress, are groups created, it is true, by accident, and evanescent, but different in degree only from such groups as families and tribes, the members of which are considered as one because of a cohesion due to a continued identity of relationship. The mental process which we have tried to analyze, expressed in written or spoken language, results in a word which stands for several but which is itself in the singular number. We suggest therefore, without fear of being accused of confusing cause with effect, that a clear, practical definition of a group is this, namely, such a collection of individuals as may be represented by a word of the singular number. That this is not a wholly accurate test is admitted; that it constitutes a good working rule is shown by the following examples: crowd, crew, team, court, board, class, regiment, army, flock, herd, audience, congregation, party, cabinet. For the persons stopping over night at a hotel, the passengers on a train, the guests at a ball, collections of individuals not manifesting a perceptible cohesion, there is no adequate word of the singular number.[2]

Having seen that the basis of all groups is merely a mode of thought, let us analyze the process by which some groups become

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[1] Sir Henry Maine intimates that the family, clan, and tribe were recognized entities of society before individuals were. Ancient Law 258.

[2] These collections of persons certainly have an identity of relationship to a common factor. It seems to the writer, however, that in the examples cited it does not produce a perceptible cohesion which leads us to think of them as groups.

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more important than others. Because several individuals are perceived to manifest a certain cohesion in respect to a single episode, as in the case of a crowd on a street corner, we think of them and name them as one. Unless something further happens, that is the end of it. Frequently, however, something further does happen, and it is this: instead of being perceived as one in a solitary instance, the same several persons act or appear together on various occasions during a considerable period of time. A simple example is a quartette of musicians. The oftener this happens, the more the oneness of these same several persons is emphasized. It is necessary to think of them as a group, not once, but frequently, perhaps continuously; the group becomes established in the minds of others as something definite and lasting, and finally as something independent of the individuals who compose it. This independence is of vital importance, for it means that the persons composing the group may change and yet the group continue. A regiment of soldiers is an example of this. As the group performs acts, it demands recognition as such, not in the mind merely, but in the conduct of others towards it. The several individuals composing the group are not only thought of and named as one, but of necessity are treated as one also. The oneness, the something produced by the cohesion of several,[1] has become something which must be dealt with in practical affairs and which under certain circumstances must be recognized by the law.

The extent to which a group is treated as one by those dealing with it depends entirely on the demands of practical convenience. Very many groups which maintain a fairly active existence require recognition as such in hardly more than nomenclature, recognition which is accorded to the simplest group. Take, for

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[1] It seems proper to speak of the oneness produced by several as something independent, having an existence of its own. It is proper, however, simply because the demands of convenience are so nearly, if not quite, peremptory that they must be complied with or the joint action of several cease to cut any figure as a practical matter. As far as tangible facts go, nothing is produced from the several in a group. In the last terms of accuracy a group name is merely a short way of describing several persons, their relation to one another, and the effect they have on outsiders. So the word "corporation" is, in strict accuracy, nothing but a short way of describing several persons who have peculiar attributes and definite, though complicated, relations with one another and with outsiders. If, however, every time the persons in a corporation were dealt with we had to think and say several pages of words, it would be impossible for them to become real factors in daily life in their group capacity. The oneness as a practical matter is nearly as real as the several and is but one step beyond them.

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example, a college football team. It is a true group, something different from any or all of its members. During the season the eleven players are thought of as one, in practice and matches are treated as one, and as one may go down to posterity as the best or worst football team ever known. But this is the only recognition this sort of group demands. It does not touch life on its practical side. It is not apt to hold property, nor likely to get into controversies which require it to sue or be sued; it has no use for legal rights, nor need for a definite status in business or law. Some groups which are active in practical affairs are treated by the law merely as so many individuals. A partnership, for example, owns property and performs acts, but in contemplation of the law does so through its members. Facts do not require recognition of the oneness of these groups to be carried to the point of recognition in law. The demands of convenience are satisfied by the law as to co-ownership. Other groups which wage war, negotiate treaties, and make laws, such as nations and states, touch life on vital points, are of necessity treated as groups in many and important affairs; and therefore the oneness of these groups must be established on an approximately exact or at least a well-defined basis. In other words, without artificial aid such as is accorded by arbitrary command of a sovereign power, that is, by a statute, a group receives just the degree of recognition which ordinary every-day circumstances make necessary. The true corporation is nothing but a marked instance of such recognition in a high degree.

It is apparent that the same fertile germ lies behind all joint action and endeavor. The corporation, though representing perhaps the most advanced attainment of the group idea, is only one manifestation of a development which has gone on in every country under the sun having a claim to be called civilized.[1] Obviously, and this cannot be too strongly insisted upon, it was not the invention of any one man or one people. No philosopher, statesman, or lawyer sat down, cogitated, and said, "It would be convenient to give several persons acting together certain attributes and call them a corporation." Nor is the cor-

[1] "Every system of law that has attained a certain degree of maturity seems compelled by the ever-increasing complexity of human affairs to create persons who are not men, or rather (for this may be a truer statement) to recognize that such persons have come or are coming into existence." Pollock and Maitland, Hist. of Eng. Law, 2d ed., i. 486.



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poration in its essentials peculiar to any country or any people, although the contrary view has been advanced by many learned writers. Blackstone, for example, says of corporations: "The honor of inventing these political constitutions entirely belongs to the Romans."[1] A study of the code and digest unquestionably had an influence on the form of the corporation of to-day, but the corporation existed in England long before Roman law-books were known in that country. There as everywhere it was the result, not of imitation, but of evolution, — a natural, though hardly inevitable, manifestation of the group idea.[2]

It is time to test our abstract discussion by the examination of facts. The truth of our inferences could be proved by the history of numberless groups which have become active at various times from the days of the Old Testament to the present. The practical importance of the oneness of groups could be shown specifically by presenting the characteristic development of the group idea manifested by the universities[3] of the middle ages, and by the great livery companies of London.[4] Naturally, however, our happiest illustration, both of the general development of the group idea and of the necessity for establishing it as something definite, lies in the story of the groups which were the immediate predecessors of the corporation.

The course of development may first be briefly indicated in general terms. When certain groups became active factors in daily life, especially in trade matters, when as groups they were accorded legal rights and were owners of property, it became necessary as a matter of practical convenience to put the several persons in their group capacity on a definite basis which could be dealt with in business and in law. The oneness, the indefinite something which is the essence of every group, in these particular groups became so accentuated and so important in respect to the most usual and practical affairs of life that it fairly vociferated for

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[1] Sharswood's Blackstone's Commentaries 468.

[2] All that we have said as to groups might be true and yet never a corporation have come into existence. There may be much associate activity not in the corporate form.

[3] Masters and scholars received privileges as a class or unit. Corporations, their Origin and Development, i. 257 *et seq.*

[4] Members received by grant from the king privileges which they held as a body. See Charter of Edward III. to the Fishmongers; Charter of Richard II. to Skinners; Charter of Richard II. to the Merchant Tailors, which says: "We . . . do for us and our heirs as much as in us is by tenor of these presents grant and confirm all and singular the premises to the aforesaid Taylors and Linen Armourers and their successors forever." And generally Stubbs, Select Charters.

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complete recognition. Not from fanciful considerations, but in response to the stern insistence of actual facts, it became necessary "to give to airy nothings a local habitation and a name."

The corporation in England was the joint result of certain groups in ecclesiastical life and certain other groups active in temporal affairs. For centuries the development of each was wholly independent of the other, and we may briefly consider each in turn.[1]

The starting-point of the corporation in temporal affairs was simply that certain people lived near one another. In at least this aspect of life they had an identity of interest. At first there was nothing but the fact of propinquity. There were no rights or duties except those appertaining to the several persons who lived in the locality as individuals. What they owned they owned as individuals, and what they did they did as individuals. They created towns and villages. Some of these settlements became more densely populated than others, and this was, at first at least, what chiefly distinguished a borough, the group which directly led to the corporation, from the ordinary village. This distinction was familiar at least from the early years of the thirteenth century. All sorts and conditions of people resorted to the larger center. Its population became heterogeneous. Some inhabitants held their land directly from the king, some from nobles; the borough would not become the property of any one person. Nothing intervened between it as a whole and the king as overlord of all the realm.[2]

Along with increased population, partly as cause and partly as effect, went increased trade both among the inhabitants themselves and with others. Life became more active, more complex; there was more contact with the rest of the world. Then, too, in these larger settlements the instinct for local self-government awoke and developed. It amounted to more to be an inhabitant of a large

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[1] The facts which are hardly more than suggested in the following pages are treated at length by Pollock and Maitland in their History of the English Law, 2d ed. in the chapters called "The Borough" and "Corporations and Churches." The writer cannot too highly express his admiration for the breadth of treatment, the keen thought, the wonderful industry indicated by these chapters. See also Stubbs' Constitutional History; Gross, The Gild Merchant; Adler, A Summary of the Law of Corporations; Davis, Corporations, their Origin and Development. It is obvious that this article does not pretend to be a work of original research; the writer nevertheless has verified statements as to facts from primary sources.

[2] Pollock and Maitland, Hist. of Eng. Law, i. 637–638.

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center than a small one. The larger place inevitably felt its strength and importance, and as a consequence reached after what might add to the power and comfort of the persons who were and should become its inhabitants. It wanted and needed special privileges. What was equally important, it was in a position by force of its numbers and wealth to secure them from the king.

The franchises acquired by the borough from the king were principally three, namely, right to hold its own courts, right to its own customs, and freedom from toll.[1] The last was the most important in bringing out the oneness of the borough, and should receive a word of explanation. It was exemption from certain mercantile taxes or imposts which were collected all over England either by the king, through his agents, or by nobles who had acquired the right from the king. The nature of these taxes is sufficiently indicated by their names: duty on buying and selling, toll exacted in markets, passage money on merchants visiting fairs and markets, toll for maintenance of bridges, stallage, or money paid for permission to have a stall in a fair; fee for permission to trade. They constituted a considerable burden on the merchants of a community, especially when their enterprises called them to other parts of the country than their own. As a part of the grant of freedom from toll, the king gave to the inhabitants of the borough, the burgesses, the right to farm their own borough. That is, he substituted for his own toll-gatherer the burgesses, who paid him a fixed annual sum in lieu of toll. He also exempted them from paying toll elsewhere in England. Usually accompanying these privileges was the right to form a merchant gild,[2] for the purpose of better securing the right of freedom from toll. A merchant of the borough traveling to other places and standing boldly on his borough rights needed the support of an active, prudent organization. Besides, the right to take toll from strangers required to be fearlessly exercised and jealously guarded. These were the primary functions of the gild merchant.[3] The possession of free-

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[1] There were many and various franchises granted. See, for privileges granted to boroughs, Charter from King John to Nottingham in 1200; from Henry II. to Lincoln in 1189; from John to Burgesses of Helleston in 1201; from Henry II. to Winchester; and generally Stubbs's Select Charters.

[2] There were other kinds of gilds long before privileges were ever granted by the king to a borough. The festive and religious gild may be traced back to the days of heathenry. Pollock and Maitland, 2d ed., i. 639; Gross, The Gild Merchant i. 174 *et seq.*

[3] A borough had two organizations, gild and governmental; each was closely con-

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dom from toll with the accompanying right to have a merchant gild naturally increased the activity of the borough in degree and in variety.

These franchises came from the king, and they came in the form of a grant.[1] The operative words of a typical charter were as follows:

> "John, by grace of God, King, etc. Be it known that we have granted and by our present charter confirmed to our burgesses of Ipswich our borough of Ipswich with all its appurtenances and all its franchises and freedom from imposts, to hold of us and our heirs, to themselves and their heirs, they paying into our exchequer each year on the feast of St. Michael, in behalf of the aforesaid Ipswich, the just and customary rent." [2]

There was nothing in the grant which expressly brought a legal person into existence, nothing which incorporated the borough. But in the very gift of these privileges there lurked a problem which sooner or later would require solution. Who really owned these franchises? No one asked the question at this time, and probably it was not the subject of much conscious speculation. Without doubt the offhand idea of the king was that the grant was to the individual burgesses living in a particular place; of the burgesses, that they received the privileges as individuals. A second thought on the part of either would hardly have sustained the offhand idea. Clearly the oneness of the burgesses was recognized, at least by implication.

Not only was the possession of these privileges from the first hardly to be accounted for on the theory of co-ownership of many individuals, but little by little this kind of property became subject to incidents wholly irreconcilable with any such theory. The burgesses died, and the privileges continued to be held by the burgesses who came after them.[3] The king, as the punishment for the act of

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nected, but not identical. "The Gild Merchant was a very important, but only a subsidiary part of the municipal administrative machinery, subordinated to the chief borough magistrates, though far more autonomous than any department of the town government of to-day." Gross, The Gild Merchant i. 63.

[1] It was in form and reality a grant, although the analogy of the Magna Charta, which used the words "to all the free men of England and their heirs," might suggest that it was a local law.

[2] King John's Charter to Ipswich. Gross, The Gild Merchant ii. 115.

[3] The preamble to Statute 15 Richard II., c. 5 (1392 A.D.), recites that an extension of the provisions of the Mortmain Statute is necessary, "because mayors, bailiffs, and commons of cities, boroughs and other terms which have a perpetual commonalty, and others which have offices perpetual, be as perpetual as people of religion."

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one or more individuals, took away the franchises he had granted to all.[1] Sometimes the punishment continued after the old inhabitants had given place to new ones. The punishment fell not on persons, but on the community. The burgesses not only profited by their franchises, but had to maintain them. It was necessary to deal with this property in daily affairs, to defend it at law if need be. In 1200 Ipswich got a common seal, and other boroughs followed suit.[2] In 1225 the burgesses of Nottingham demised to the burgesses of Retford the tolls belonging to the former borough and arising within certain geographical limits at an annual rent of twenty marks.[3] In grants from the king the phrase "and their successors, burgesses," began to supplant the phrase "and their heirs."[4] In a word, the king treated the burgesses as a group, and the burgesses in respect to their property acted as a group. The group, and not the individuals, was the property owner.

To sum up: From the temporal development we get, by reason of the association of individuals in the same locality plus an active interest therein, especially in trade matters, a unit interest which demands and receives franchises and privileges which belong to the associated persons in a way not provided for by any of the existing theories of ownership. We get the fact of a oneness which has a place in business and law without the conscious recognition of its existence.[5] The process was vague; it was not marked off by distinct steps. The oneness of the burgesses was there all the time, as it is in every group, but many years had to elapse and many unconsidered acts to be done before it emerged from the mist as something definite and real.

Meanwhile the group idea was developing in ecclesiastical life. For wholly different reasons religious groups were formed. There the association depended, not on accident of locality, but on the voluntary act of individuals. From the first there was a tendency of churchmen to come together. The basic doctrines of the Chris-

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[1] Riley, Chronicles of London 11, 15, 18, 22; P. Q. W. 160. There is record that once in such a case the Londoners prayed that only the guilty might be punished. Riley, Chronicles 84.

[2] Gross, The Gild Merchant ii. 119, 121.

[3] Pollock and Maitland, 2d ed., i. 95.

[4] King John's charter for Waterford: Chartae, Privilegia, et Immunitates, Irish Record Commission 13. Cited in Pollock and Maitland i. 677. This was a step in advance, but the idea of plurality is still suggested.

[5] Pollock and Maitland say the necessity for a new idea existed at least before the end of the thirteenth century. History of English Law, 2d ed., i. 687.

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tian church require coöperation and also continuity of thought and effort. It was inevitable that churchmen should join together to spread their belief, to do works of charity, to study, to honor a favorite saint. Monasteries, convents, and chapters[1] were the result.

These religious groups did not touch life so closely on the practical side as did the borough. At first, at any rate, they were not property owners although they managed property. As a group they were not so likely to deal with others in respect to merely business affairs. Nevertheless the members of the group were closely associated. Joint action was required; meetings were held and votes taken. In particular the oneness of the ecclesiastical groups was from the first recognized as independent; that is, the personnel of the group changed, but the group went on.[2] As the property managed by the religious groups became more valuable, the oneness of these groups became something to be reckoned with in practical affairs.

To sum up: From the ecclesiastical development we get organizations of individuals formed for different purposes and by voluntary association, which have a continuous existence and which are recognized as units.

We have then a unit interest or oneness which, as exemplified by both temporal and ecclesiastical groups, owned or managed property, dealt with outsiders, — in a word, was an active factor in affairs. It was time that the indefinite something produced by the association of several be given a name and its status established.[3] The facts called for a new legal theory. To construct one was not a simple matter. There was much blind groping after the nature of this indefinite something. For a time the idea naturally sug-

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[1] Davis, in "Corporations, their Origin and Development," says that corporations may have their origin by means "of such changes in the supreme organization of society as to leave some of its groups, retaining their old organizations, in an exceptional relation to it." He instances cathedral chapters. This may be true as to corporations. Manifestly it cannot apply to the origin of simple groups.

[2] As to this, Bracton says (f. 374 b): "If an abbot, prior, or other collegiate men demand land or an advowson or the like in the name of their church on the seizin of their predecessors they say 'and whereof such an abbot was seized in his demesne,' etc. They do not in their count trace a descent from abbot to abbot, or prior to prior, nor do they mention the abbots or priors intermediate (between themselves and him on whose seizin they rely), *for in colleges and chapters the same body endures forever, although all may die one after the other and others may be placed in their stead; just as with flocks of sheep, the flock remains the same though the sheep die.*"

[3] "The law is slowly coming to the idea of a corporation by dealing with corporations (if we may call them so) of very different kinds." Pollock and Maitland, 2d ed., i. 494.

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gested by the analogy of the human body was applied to these groups. The chief officer, as mayor or bishop, was the head, and the members were the arms, legs, etc.[1] This was called the anthropomorphic theory, and for a long time obscured the true corporate idea.[2] Finally, however, the oneness of these groups was given a definite recognition, not as a real but as an ideal or legal person.

The conception of an ideal person having legal rights and duties was borrowed directly from the early English theory as to church ownership, a theory attained not without difficulty. In very early times, several centuries at least before the reign of Edward I., there were in England what were vaguely known as church lands.[3] At first the land was given direct to God. Such a dedication came naturally and spontaneously. The Deity was vaguely conceived of as a property holder; the incidents of ownership were not considered. Sometimes the land was given to a saint;[4] such a saint was frequently buried in a particular church and was supposed to protect and guard it. So little by little the saint and the church, the actual building, became merged in each other, and finally the church itself was thought of as a property holder. The institution, the structure of stone and wood, together with its spiritual attributes, was personified. About this time church lawyers, the canonists, discovered the *universitas* in the Roman law books and applied it to the church. The theory of an ideal person was attained.

Although the church was the property owner, the functions of ownership were necessarily performed by human beings, by the clergy. The personified institution could not collect moneys, nor make conveyances, nor bring and defend suits. The group of

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[1] Abbot of Holme *v.* Mayor, etc., of Norwich, Y. B., 21 Edw. IV. f. 69. And see Y. B., 21 Edw. IV. f. 15, f. 68, per Vavisour.

[2] Pollock and Maitland, 2d ed., i. 491, 492, and citations of Year Books there given.

[3] In the earliest Christian times in England when a man built a church on his land it was his church, just as a house or shed built on his land was his. This remained true to some extent at the time of William the Conqueror (Doomsday Book II. 290 b). But the Bishop or other ecclesiastical dignitary in the locality could withhold the spiritual attributes necessary to convert the building into a true church by refusing to consecrate it unless the priest was provided for. Pollock and Maitland, 2d ed., i. 498, 499.

[4] As in charter from King Ethelbert to Rochester Cathedral, 604 A. D. "To thee, Saint Andrew, and to thy church at Rochester where Justus the Bishop presides, do I give a portion of my land." Kemble, Cod. Dipl., i. No. 1; Stubbs and Haddann, iii. 52; Councils and Ecclesiastical Documents relating to Great Britain and Ireland.

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clergy was not the *universitas*, but represented it. As the clergy advanced in practical importance while the institution receded, the theory of the ideal person was unconsciously transferred from the church to them. Being primarily the personification of an institution, the theory naturally was extended to cases where there was only one cleric. Thus was introduced that curious anomaly, not really a corporation at all, namely, the corporation sole.[1] We have shown that the theory was constructed primarily not to represent the oneness produced by the association of several, but, on the contrary, merely as a "feigned substratum for rights." This explains why the ecclesiastical corporation was called not only a person but a fictitious person.

The groups in lay and church life alike represented the genuine development of the corporate idea. In the ecclesiastical groups, however, appeared so many manifestations not germane to the development[2] that it is no wonder centuries elapsed before the two sets of groups, lay and clerical, were brought under one head. In the fourteenth and fifteenth centuries, however, church and state came more closely together. The corporate development of each became common knowledge, and lay and ecclesiastical groups were established on the same basis.

In the foregoing it has been impossible to assign precise dates to the events narrated, or to treat them in the order in which they occurred. Much that has been given in sequence, in reality went on at the same time. The effort has been to select the salient characteristics of the development and present them in a somewhat

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[1] Blackstone says (Commentaries, p. 468): "But our laws have considerably refined and improved upon the invention, according to the usual genius of the English nation, particularly with regard to sole corporations consisting of one person only, of which the Roman lawyers had no notion; their maxim being that *tres faciunt collegium*." Pollock and Maitland, on the other hand, with what seems to the writer wholly adequate reason, call the corporation sole "*that unhappy freak of English law.*" Hist. of Eng. Law, 2d ed., i. 488, note 1.

"The idea of a corporation sole has been claimed as peculiar to English law, but the novelty consists only in the name; and it has been justly remarked that, 'as so little of the law of corporations in general applies to corporations sole, it might have been better to have given them some other denomination.'" Dr. Wooddeson, Vinerian Lectures i. 471, 472.

[2] Problems which in themselves were difficult were made yet more difficult by the slow growth of the idea that the head of the monastery, though he is a natural person, is also in a certain sense an immortal, non-natural person, or corporation sole, and is likewise the head of a corporation aggregate. Pollock and Maitland, 2d ed., i. 436. In ecclesiastical affairs "the corporation aggregate was almost resolved into a mere collection of corporations sole." *Ibid.* 507.

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logical order. The facts are not important as facts, but as indicating the inherent nature of the corporation.

To sum up: The unit interest or oneness produced by the association in different ways of several persons became such an active factor in practical affairs that people were forced to recognize it as something independent. The oneness had to be given a place in business and in law as something definite.[1] It happened that the basis of a person[2] was adopted; unfortunately, through the influence of a theory entirely proper where it belonged, namely, in church ownership, this person was called a fictitious person. Unfortunately, because the word "fictitious" or "artificial" says more than is necessary, connotes something far removed from the practical everyday affairs of life; signifies feigning or make believe. A corporation is really a collection of flesh-and-blood individuals who have an identity of interest in certain affairs. Neither the individuals nor the relation they bear to one another is fictitious. The mechanical necessity of the case requires that these individuals in their group capacity be put upon some definite basis, and they are therefore treated as a single person. But there can hardly be said to be anything unreal about the matter. A nation represents merely the relationship of certain human beings to one another, but we should hardly call the United States or England a fiction.[3]

The corporation, then, grew by nature. It was the product of a natural evolution. During all the period with which our discussion has concerned itself there was no rule that the corporation must have some definite and authoritative commencement. There was no rule that the corporation must be erected, set up, made, by act of the sovereign power. By the middle of the fifteenth century, however, it was settled as a matter of positive law that the corporation must be created by the sovereign power.[4] This rule arose simply from considerations of political expediency. It was

[1] Pollock and Maitland call the personality of a corporation "a blank form of legal thought." History of English Law, 2d ed., i. 486.

[2] "Now the words 'person' and 'personality' seem to be appropriate words, and if they were not at our disposal we should be driven to coin others of a similar import." *Ibid.* 488.

[3] In an article not called to his attention until the present article was ready for the printer the writer is gratified to find certain views which seem to be in accord with those here presented. See "The Personality of the Corporation and the State," by W. Jethro Brown, 21 Law Quarterly Review 365.

[4] Y. B. 14 Henry VIII. f. 3 (Mich. pl. 2), P. Q. W. 18; Gross, The Gild Merchant ii. 34.

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recognized that boroughs, organized communities, might be dangerous. It would not do for the sovereign power to have them exist too freely. This reason also applied to the gilds which were likely to become aggressive. Here too was a good source of revenue. The privilege of being a borough or the right to form gilds would be bought. The rule of law was based, like other rules of law, on public safety and convenience.

We have seen that the oneness of the borough was definitely recognized in practice by the king and by others, by the community long before this rule of law was thought of.[1] And this recognition came by common consent as something required by the necessities of the case. When this rule of law was established, therefore, it really meant: recognition of corporations cannot continue without the king's express consent. The sovereign's act was not creation, but permission. In other words, the king's charter of incorporation performs no magic. Beyond peradventure the group person is not fashioned out of nothing by the sovereign power. If there be magic anywhere, it lies in the mode of thought which considers several persons for certain purposes as one, plus the actual happenings which make the thought important. Nevertheless, from the time when this rule of law became established the permission was given in form as though it were creation.[2] This was without doubt due not to accident, but to the necessity of defining with exactness the powers and duties of the group person permitted to exist. The oneness of several recognized by the community, even though recognized as a person, would be somewhat vague in these respects. Therefore charters of incorporation have universally said in so many words "incorporate"; that is, they have in form expressly set up or created the legal person. This made it necessary to account by some theory for the corporations already existing which had never been expressly incorporated. It was said that such were corporations by prescription.[3]

[1] "The formal incorporation of boroughs in the fourteenth and fifteenth centuries did not materially alter the town constitution; it was in most cases merely a recognition of existing franchises with a stronger accentuation and a more precise formulation of the right of independent action as a collective personality with a distinctive name, — especially as regards holding real property." Gross, The Gild Merchant ii. 95.

[2] In 1440 the first municipal charter of incorporation was granted by statute of 18 Henry VI. c. 6. By its terms the mayor, burgesses, and their successors, mayors and burgesses of the town of Kingston-upon-Hull, are incorporated so as to form "one perpetual corporate commonalty" by the title of "The Mayor and Burgesses" of the said town.

[3] Jenkins *v.* Harvey, 1 Gale 457.

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The fact that permission of the sovereign was given in the form of creation, however, had another and a far greater effect on corporate law: an effect of capital importance. If permission only were given, the corporation could never be very different from the group person called into existence by common consent, by the recognition of the community. It would be no more than a species of machinery which facts made necessary in order that complex situations might be better handled and civilization advance. The opinion as to what was necessary would change, but the corporation would always depend upon the general opinion of the community. There could never be anything arbitrary in its character. If, however, the corporation were created by the sovereign, its powers and characteristics would depend not on the consent of the community, but on the will of the sovereign. In other words, corporations came to be things made according to the ideas of the sovereign. Even so, it was long before the sovereign went in advance of the general opinion, and corporations were for a long time limited to endeavors strictly for the public.

Gradually, however, the corporation came to be used in private enterprise. It was recognized by business men as a species of machinery having great advantages over an individual, and they proceeded to adapt it for their purposes. The rule of law that the corporation is created allowed persons selfishly interested to have their own ideas recorded by sovereigns that knew little of the subject. Particularly in this country and within the last forty years the corporate idea has been seized and developed with Yankee ingenuity to a point which in the light of the genesis of the corporation is startling.

A corporation which in business affairs can do practically anything and everything that can be done by an individual and can do it anywhere and everywhere [1] is a long distance from the true corporation which was brought into existence by absolute necessity, which was recognized simply because the progress of events demanded its recognition, which was the result of natural growth, of logical evolution. The modern corporation is the product of arbitrary legislation struck off at a given time. It does not represent the natural growth of the corporate idea, but rather is a distorted application of that idea. Serving as a buffer between

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[1] See Charter of United States Steel Corporation, and, generally, forms in Dill on New Jersey Corporations.

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questionable acts and their natural consequences, it has been used to bring about a state of affairs in the commercial world which rests on neither a just nor a sound basis.[1] If existing conditions are to be improved, it must be by intelligent amendment of our corporation laws. An exact standard by which to measure proposed legislation is not to be hoped for; but in a clear understanding of what a corporation really is we may find both guidance and authority for action.

*Robert L. Raymond.*

BOSTON, February, 1906.

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[1] A Statement of the Trust Problem, 16 HARV. L. REV. 79.

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LAW AND THE RISE OF THE FIRM

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**Law and the Rise of the Firm**

Henry Hansmann, Reinier Kraakman[*], Richard Squire

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

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[*] Ezra Ripley Thayer Professor of Law, Harvard Law School.

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**Law and the Rise of the Firm**

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# I. INTRODUCTION

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

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

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

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

---

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

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

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

# II. ASSET PARTITIONING AND ENTITY SHIELDING

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

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

## A. Entity Shielding as the Foundation of Legal Entities

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

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

---

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

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

***Strong entity shielding*** adds a rule of *liquidation protection*[5] to the protections of weak entity shielding. Liquidation protection restricts the ability of both firm owners and their personal creditors to force the payout of an owner's share of the firm's net assets -- traits that are conceptually distinct but that, for reasons we will explore, usually come paired. The modern business corporation provides a familiar example of strong entity shielding: not only do corporate creditors enjoy a prior claim to the corporation's assets, but they are also protected from a shareholder or his personal creditors attempting to liquidate those assets.

***Complete entity shielding*** describes a regime whereby non-firm creditors — including creditors of the firm's (beneficial) owners, if any — lack *any* claim to firm assets. Common contemporary examples of entities with this trait include nonprofit corporations and charitable trusts. The personal creditors of the manager and the beneficiaries do not enjoy any claim to the organization's assets, which only bond contractual commitments made in the name of the organization itself.

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

## B. Forms of Owner Shielding

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

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

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

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

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

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

## C. Entity Shielding Requires Law; Owner Shielding Does Not

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

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

---

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

## III. THE ECONOMICS OF ENTITY SHIELDING

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

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

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

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

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

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

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

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

## A. The Benefits of Entity Shielding

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

*Lower Creditor Monitoring Costs*

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

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

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

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

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

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

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

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

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

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

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

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

*Reduced Administrative Costs of Bankruptcy*

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

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

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

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

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

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

*Protection of Going-Concern Value*

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

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

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

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

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

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

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

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

*Capital Accumulation and Investment Diversification*

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

*Transferable Shares*

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

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

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

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

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

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

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

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

## B. The Costs of Entity Shielding

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

*Debtor Opportunism*

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

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

The chances that owners will be able to shift assets opportunistically either into the firm (which entity shielding encourages) or out of it (which limited liability encourages) depend on several factors, perhaps the most important of which is the number of owners. An entity’s owners are unlikely to permit each other to shift assets opportunistically unless the result is mutually beneficial, suggesting that opportunistic asset shifting of both types should decrease as the number of owners rises. But opportunistic movement of personal assets into

rather than out of an entity should be particularly unlikely when the entity has numerous owners. A firm's owners are (proportionately) in the same position with respect to the creditors, so that one owner's incentive to exploit creditors will likely be shared by the others and thus lead to an opportunistic pro rata distribution to all owners. That one owner has an interest in exploiting his *personal* creditors by increasing his investment in the firm, however, does not suggest that the other owners have reason to do likewise or to enable such exploitation by accepting downward readjustments of their relative ownership shares. The difficulty in using a jointly owned entity to exploit personal creditors explains why the rise of single-owner firms presents some of the most important challenges in organizational law today.

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

*Higher Enforcement Costs*

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

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

*Creation of a Bankruptcy System*

Enforcement of weak entity shielding in particular will generally require the creation of a pro rata bankruptcy system. The typical alternative to a pro rata system is a first-to-file (or "first come, first served") system, which permit creditors to seize a debtors asset's based on the order in which those creditors file suit to enforce favorable judgments. Such prioritization is incompatible with weak entity shielding, which distinguishes between firm creditors and personal creditors. A court could attempt to reconcile weak entity shielding with a first-to-file system by

making a personal creditor's right to enforce a claim against firm assets contingent upon whether sufficient firm assets will remain to pay firm creditors in full. Assessing whether sufficient assets will indeed remain will be difficult unless the court can accurately assess the ratio between firm assets and debts. Typically, this will require the court to exercise the broad powers associated with a pro rata bankruptcy system: the powers to stay division of firm assets, evaluate the validity and worth of the claims of multiple creditors simultaneously, and oversee ongoing firm operations during the pendency of proceedings.

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

*De-diversification of Creditor Claims*

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

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

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

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

*Illiquid Investments*

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

*Exploitation by Control Persons*

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

## C. Cost-Benefit Tradeoffs and Lessons from History

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

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

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

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

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

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

We believe that each of these societies demonstrates the importance of the institutions and practices that reduce the costs of entity shielding within the frame of the period in question. At the same time, we do not wish to be

understood as proposing a monocausal account of entity shielding. At most, economic cost-benefit considerations become wholly decisive only in explaining the explosive spread of entity- and owner-shielding in the legal and commercial practices of contemporary America. As we argue below, even here the law may not yet have reached equilibrium, because it has not yet fully accommodated the more subtle costs that entity shielding can impose on creditors whose claims it impairs.

# IV. ANCIENT ROME

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

## A. The Partnership

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

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

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

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

[44] *Id.* at 505.

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

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

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

## B. The Family

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

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

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

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

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

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

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

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

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

## C. The *Peculium*

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

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

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

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

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

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

[53] *Id.* at 33.

[54] *Id.* at 35.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

[67] During the first century B.C., the *publicani* formed a cartel to demand remission of fees paid on tax farming contracts that had turned out to be unprofitable. Julius Caesar promised to heed their demands should he win the Roman Civil War, and he thereby gained their support. Their period of official favor, however, was short lived. FRANK, *supra* note 48, at 182.

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

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

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

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

# V. MEDIEVAL AND RENAISSANCE ITALY

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

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

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

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

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

[72] *Id.*

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

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

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

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

## A. Households and Partnerships

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

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

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

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

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

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

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

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

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

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

## B. Entity Shielding and Bankruptcy

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

# VI. EARLY MODERN ENGLAND

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

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

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

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

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

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

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[112] *Id.*

[113] While we do not pursue here the further evolution of law and commerce on the European continent, we note that, by the end of the 16th Century, the City of Antwerp had enacted a municipal statute that established location-based weak entity shielding, of the form described at TAN 96 *supra* for medieval Italy, for partnerships and branch offices of merchant firms. In relevant part, that statute reads as follows:

> **Title LII. Concerning the Partnership and Its Assets.**
>
> 1. Each member of a commercial partnership is jointly and severally liable for the debts of the partnership, but can seek indemnification from the partnership.
>
> 2. Each member of a partnership may, for the term of the partnership, incur debts and dispose of assets on its behalf.
>
> 3. If merchants have different partnerships in different places, one of the partnerships and its assets is not liable for the debts of the other partnerships.
>
> 4. The creditors of one of a merchant's partnerships, establishments, or shops has a claim on its assets that is prior to the claims on those assets of the merchant's other partnerships, establishments, or shops.
>
> 5. The assets of a partnership may not be seized, executed upon, or subjected to liens to satisfy the personal obligations of its individual members.
>
> 6. But a personal creditor may lay claim to, and seize, a merchant's interest in a partnership that remains after all of the company's debts are discharged.
>
> **Title IX. Concerning Partnerships and Their Assets**
>
> 25. A partnership's assets cannot be seized, pawned, or paid out in compensation because a partner is personally liable, even if he has incurred a privileged debt by, for example, contributing his wife's goods to the partnership.
>
> 26. Similarly, when merchants have different partnerships, establishments, or shops in different locations, each partnership, establishment, or shop is liable only to its own creditors. Partnerships, establishments, or shops may not compensate or cross-subsidize one another.
>
> 27. The personal creditors of a merchant or the creditors of his other businesses may be paid, in order of priority, out of the assets of one of his partnerships, establishments, or shops after the business creditors of that partnership, establishment, or shop are paid in full.

V COSTUMEN DER STADT ANTWERPEN GESEGT *IMPRESSAE* II, at 393,(1582) . Preliminary research suggests that weak entity shielding of this form, created by municipal or local statutes, was common throughout the Low Countries at that time. We are grateful to Andreas Fleckner for his enterprising research into medieval and early modern municipal and local statutes on the

seventeenth century, moreover, England became the commercial leader. It enjoyed a natural advantage in endowments of coal, which helped boost it to the van of the Industrial Revolution in the eighteenth century. Although institutional conservatism prevented English law from developing in lockstep with its commerce, economic expansion eventually brought sufficient pressure to bear, and by mid-nineteenth century the country had produced useful, general-purpose commercial entities offering both weak and strong versions of entity shielding.

## A. The Early Joint Stock Companies

England's most celebrated commercial enterprises at the beginning of the modern period were its famed joint stock companies, which led the nation's charge overseas for conquest and profit during the Age of Exploration. England was not, in fact, the joint stock company's creator — that distinction belonging to Genoa, which starting in the fourteenth century sold shares in public monopolies engaged in a variety of ventures, including salt mining, coal, and mercury importation, and, most spectacularly, the conquest of two Mediterranean islands.[114] Though innovative, these Genoese enterprises were relatively small affairs by modern standards, and indeed managed to operate under a rule whereby every owner had to consent to any sale of a firm's shares[115] — which is feasible only if owners are not numerous. By contrast, the trade opportunities that opened during the sixteenth century to European nations with ocean access required fleets of deep-water ships and large overseas posts, and thus organizational forms capable of amalgamating and organizing capital of unprecedented scale.[116] While Portugal and Spain responded by organizing and funding intercontinental trade through the state,[117] the Dutch and especially the English followed the Genoese example of combining private investment with state-granted monopoly privileges. Guilds of traders, often operating through *commenda*-like arrangements, were issued charters that included exclusive privileges to trade in a particular region of the world.[118] Although these chartered companies at first divided the cargo at the end of each voyage among the

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Continent, and to Lisenka Van Holewinckel for help with translation of the statute reproduced here.

[114] W. MITCHELL, AN ESSAY ON THE EARLY HISTORY OF THE LAW MERCHANT 138-39 (1904); CIZAKCA, *supra* note 108, at 29-30.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

[129] *Id.*

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

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

## B. Bankruptcy and Partnership in England

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

[144] *Id.* at 664.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

## D. General Incorporation Acts in the United Kingdom

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

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

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

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

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

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

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

# VII. THE MODERN PERIOD IN THE UNITED STATES

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

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

## A. The Strengthening of the American Partnership

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

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

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

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

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

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

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

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

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

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

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

[171] *Id* at 4-5.

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

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

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

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

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

[174] UNIF. PARTNERSHIP ACT § 31(5).

[175] UNIF. PARTNERSHIP ACT § 37.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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[185] UNIF. PARTNERSHIP ACT § 38(2).

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

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

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

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

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

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

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

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

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

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

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

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

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

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

## B. The Company Form in the United States

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

[201] See Id. § 16.

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

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

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

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

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

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

[205] *Id.* at 34.

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

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

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

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

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

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

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

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

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

## VIII. CONCLUSION: THE UNRESOLVED PROBLEMS OF ENTITY SHIELDING

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

Notwithstanding the reasons underlying Rome's reticence to embrace entity shielding, it seems clear that lack of demand for merchant credit was not an impediment to the rise of strong entity shielding in the intensely commercial cultures of medieval Italy and early modern England. Rather, the strong demand for credit in medieval Italy and early modern England suggests that cost factors

were binding constraints on the supply of entity shielding in those societies. For example, weak entity shielding was "locational" rather than firm-based in medieval Italy because the jurisdiction of bankruptcy courts and the monitoring abilities of merchants were inevitably local. Similarly, strong entity shielding was facilitated during the Middle Ages by the single-voyage nature of merchant ventures and the clear boundaries on firm assets provided by the hulls of merchant ships. The relationship between strong entity shielding and monopoly also manifests itself in the special medieval Genoese companies and forms a bridge to the joint stock companies of the early modern period. This is a relationship that is persistent but whose specific, cost-side mechanics demand further historical inquiry.

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

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

These particular costs arise because entity shielding subordinates the claims to entity assets of an individual's personal creditors without obtaining their consent or even, indeed, giving them explicit notice. This is why entity shielding requires organizational law rather than just contract, and why it is so effective in solving the transaction cost and moral hazard problems that would otherwise attend the creation of the pattern of creditors' rights seen in contemporary business forms. But the ability to impair the interests of personal creditors without their consent is also why entity shielding presents a greater opportunism hazard than does owner shielding, including in particular limited liability. It is

relatively easy to ensure that creditors know in advance that they are dealing with a limited liability entity, thereby enabling them to adjust the interest rate they charge and to impose contractual limitations on the entity's structure and conduct. The experience of the past two centuries has established the effectiveness of legal rules that assist entity creditors in forming and protecting their expectations regarding firm assets. But the subordination of personal creditors without notice presents different and perhaps thornier problems. These problems have not been central to the evolution of organizational law in the past, since they are strongly constrained in firms with multiple owners and relatively rigid structures. However, the increasing freedom in entity creation has brought them to the fore.

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

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

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

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

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

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

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

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

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

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

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# Merchants and the Origins of Capitalism

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Merchants and the Origins of Capitalism

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ABSTRACT: *N.S.B. Gras, the father of Business History in the United States, argued that the era of mercantile capitalism was defined by the figure of the "sedentary merchant," who managed his business from home, using correspondence and intermediaries, in contrast to the earlier "traveling merchant," who accompanied his own goods to trade fairs. Taking this concept as its point of departure, this essay focuses on the predominantly Italian merchants who controlled the long-distance East-West trade of the Mediterranean during the Middle Ages and Renaissance. Until the opening of the Atlantic trade, the Mediterranean was Europe's most important commercial zone and its trade enriched European civilization and its merchants developed the most important premodern mercantile innovations, from maritime insurance contracts and partnership agreements to the bill of exchange and double-entry bookkeeping. Emerging from literate and numerate cultures, these merchants left behind an abundance of records that allows us to understand how their companies, especially the largest of them, were organized and managed. These techniques can also be put in the context of premodern attitudes toward commerce and the era's commercial-political relations. The Commercial Revolution anticipated the Industrial Revolution by over half a millennium and laid the groundwork for today's world of global business.*

The emergence of business history as a distinct discipline, first in the United States in the late 1920s, and the development of the history of commerce in late medieval and Renaissance Europe were, from the very beginning, inextricably linked. N.S.B. Gras, the "father" of business history and holder of the first chair in the discipline at Harvard Business School (Boothman 2001; Fredona and Reinert 2017), fruitfully encouraged business historical work on premodern merchants and mercantile firms both in the U.S. and in Europe (Ferguson 1960: 13-17). Gras believed he had discovered, in the rise of what he called the "sedentary merchant" (understood in contrast to the earlier "traveling merchant" who accompanied his own goods to market or trade fairs), the crucial moment in the development of "mercantile capitalism" in Europe, the stage of economic development in which Europe first rose to

undisputed economic prominence on the global stage (Gras 1939). The articles on medieval and Renaissance merchants published in the foundational *Cambridge Economic History of Europe*, written by Gras's MBA student Raymond De Roover (1963b) and by Robert S. Lopez (1952), whom Gras had helped bring to the United States from Italy, bore the clear marks of Gras's influence. Lopez's piece, for example, used the phrase "sedentary merchant" nine times. And the later impresario of economic history Frederic Lane's (1944) early study of the fifteenth-century Venetian merchant Andrea Barberigo was explicitly conceived of as a case study of one such "sedentary merchant". In Gras's view, the sedentary merchant, freed from the demands of travel to trade fairs because he conducted his business through agents and by means of commercial correspondence, was able to develop revolutionary managerial techniques for the administration of business. And these techniques ushered in, or, more properly, developed alongside a "commercial revolution" in the later Middle Ages, focused around a long thirteenth century, a fertile conceptual nexus first coined by De Roover (1942) in response to Gras and later associated with Lopez's (1976) widely-read and debated book of that name, which presented the case for such a revolution (more broadly understood) even earlier.

The medieval "commercial revolution"—not to be confused with Early Modern commercial or financial "revolutions" in the Low Countries and England (involving the long-term development of the bourse, exchange banks, joint stock companies, and so on) that built upon it (e.g. Roseveare 1991)—saw the invention, diffusion, or earliest perfection of holding companies, of cashless transactions using bills of exchange, of contracts for marine insurance, and of advanced bookkeeping techniques including so-called "double-entry" accounting, practices which together allowed for the radical facilitation and expansion of long-distance

trade, international banking, and commercial and industrial partnerships. Although Gras's schematic and stadial view, with the "sedentary merchant" as point of historical rupture, is doubtlessly an oversimplification of complex, contingent, and overlapping historical processes, there can be little doubt that the period of the “commercial revolution” saw a remarkable transformation of mercantile practices, practices by which merchants were able to create a global trade in both commodities and luxury goods and to thereby enrich and empower urban Europe. Gras, along with Italian pioneers like Gino Luzzatto and Armando Sapori (Varanini 2014; Franceschi 2014), understood that business records (chiefly account books and commercial correspondence), mercantile manuals, and the personal memoranda of merchants (called, in Italy, *ricordi* or *ricordanze*) could give a clearer picture of the development of commerce and of business practices than the normative sources (guild statutes, laws, and so on) that had largely informed earlier (especially nineteenth-century and German) work. This essay will briefly sketch the development of medieval and Renaissance mercantile practices, focusing especially on Italian merchants in the Mediterranean, for it was in large part Italian merchants who invented or developed the techniques of modern business, not least of accounting and banking, and thereby created the world of pre-Industrial global capitalism.

## THE COMMERCE OF THE MEDITERRANEAN

The fall of Rome in the West, concomitant with the "invasion" of by then already Romanized "barbarians", witnessed the collapse of the movement of surplus wealth from North Africa and Egypt to the imperial center and to its politico-cultural aristocracy, which had long been enriched in this way, thereby shattering the unity of the Roman Mediterranean as a

commercial space. Although it did not dissolve as a political unit or as a regional power (albeit a limited one) until the middle of the fifteenth century, Byzantium, the empire in the East centered at Constantinople, similarly survived as a major commercial power only until it lost its wealth-generating provinces in Egypt and the Levant to Islamic expansion, beginning in the seventh century (Lewit 1991; Wickham 2005). European Christians nonetheless maintained a presence, as pilgrims and traders, in North Africa and the Levant well beyond this period, and, although not necessarily predominant, commercial motivations inspired the Crusades, ca. 1095-1291, which saw the foundation and then loss of Christian states in the Levant, created new or larger European markets for Eastern goods, and allowed merchants from the Italian city-states to take advantage of new opportunities for West-East trade and seaborne transport (Abulafia 1993; Phillips 1988). Before Europe's epochal geographic expansion in the fifteenth century—beginning perhaps as early as 1415 with the Portuguese capture of Ceuta near Gibraltar, but punctuated and defined most powerfully by the discovery of the Americas and the navigation of the Indian Ocean in the 1490s (Chaunu 1995)—the mastery of global trade, from a European perspective, meant constructing anew a system of lucrative shipping lanes and proto-colonies in what had once been the Roman Mediterranean, a process fully underway already by the tenth century, when Lopez saw the first evidence of a "commercial revolution". And even up to and throughout the sixteenth century, as Europe began the process of creating maritime empires in the Indian Ocean and in the Americas, the Mediterranean remained an essential zone for European merchant activity.

No scholarly approach to the Mediterranean has been more influential than that of Fernard Braudel (1972), who viewed the Mediterranean as a single unit of analysis, where

interactions were defined more by long-term underlying ecological and geographic structures and by periodic cyclical changes in relation to these structures than by the profusion of "events" that preoccupied earlier political and economic historians. More recent approaches have stressed the Mediterranean's numerous tiny micro-regions and the connectivities, including economic ones, between them (Horden and Purcell 2000) or the resilience of the Mediterranean's environment in the face of millennia of human exploitation (Grove and Rackham 2003), but until the creation of the Atlantic economy, i.e., from antiquity to the sixteenth century, the Mediterranean was a (if not, indeed, the) chief locus of long-distance trade and dynamic wealth creation in the West. The industrial and mercantile cities of Northern Italy, enriched by the eastern trade, formed the bottom pole of an almost continuous geographic corridor of advanced, wealthy, and densely-populated urban communities stretching across the continent to the Low Countries and ultimately southern England (Brunet 2002). This corridor was the historical axis of capitalism, trade, and civilization in the West.

Even before the revival of global trade in earnest, the desire of European elites (in cities and in monasteries as at royal courts) for luxuries from the East was met by small merchant communities of Jews, Greeks, and Arabs or by traveling middlemen (Vercauteren 1964). But, not surprisingly, it was the Italian cities with the closest ties to Byzantium and its trade in the Eastern Mediterranean—places like Genoa and Venice, with commanding positions on the Tyrrhenian and Adriatic Seas, and cities along the Italian coast like Amalfi—that had the first major medieval breakthroughs in establishing effective and secure sea routes (McCormick 2001: 501-47). European merchants, chiefly Italian, without the control of territory within the Muslim and Byzantine polities of North Africa and the Eastern Mediterranean, regularly

established diasporic trading colonies there, following a pattern established by earlier commercial diasporas, of Jews, of Egyptians, of Greeks. By the twelfth century, merchants from Venice, Genoa, and Pisa had already established extensive networks of such colonies—often small and often centered around a *fondaco* (from the Greek *pandocheion* by way of the Arabic *funduk*), a combination warehouse and inn, where Christian merchants were permitted to trade and to pray, and where they were supervised and regularly subject to local taxes and duties; but sometimes large enough to house thousands of expatriate merchants, extending to entire neighborhoods or city districts, as at Constantinople—all along the Mediterranean basin. Similarly, foreign trading colonies existed within the mercantile cities of premodern Italy: the most famous is surely the Fondaco dei Tedeschi, or German traders' colony, at Venice, which was established in the early thirteenth century and which housed several hundred northern traders (Constable 2003). The communal nature of diasporas certainly mitigated the dangers of international trade before it was facilitated by more permanent institutions (Greif 2006), but they could also remain competitive even into the eighteenth century, as in Francesca Trivellato's (2009) important case of the Sephardim of the Tuscan free port of Livorno.

## THE COMMERCE OF EUROPE

Gras's sedentary merchant must naturally be understood in contrast to the so-called "traveling merchant" who defined an earlier but, to a significant extent, contemporary period of long-distance overland trade in Europe, a trade facilitated by the existence of regular circuits of commercial fairs across Northwestern Europe in the Middle Ages. Originally local or regional in character, linking town and countryside or economic center and periphery, these fairs soon

became hubs of inter-regional and international merchant activity, linking the premier commercial and industrial zones of Europe. The traveling merchant who attended these fairs accompanied his goods to market, bargained face-to-face with buyers and sellers there, and personally assumed the burdens, costs, and risks of overland travel, from bandits and wolves to unstable infrastructure and inclement weather. Commercial fairs are attested as early as the seventh century in France, but the ninth through thirteenth centuries witnessed an explosion of both long-distance overland trade and the establishment of fairs. The most important fairs were those of Flanders and of the Champagne-Brie region of Northeastern France. A cycle of fairs spread over the course of the calendar year (eventually there were six six-week events) and across the region, the Champagne fairs gained particular prominence because of their geographical position—there Flemish cloth dealers, bearing wool and linen cloth from the advanced industrial centers of the Low Countries, could meet with Italian merchants, bearing the goods of Italy and the Mediterranean trade—and because of the protection provided them by the Counts of Champagne. The protection of the Counts, out of which ultimately developed reliable systems of policing, debt enforcement, and dispute resolution, inspired confidence in the Champagne fairs. A sign of the importance and assurance of these fairs: by the late twelfth century, the coins of Provins (one of the Champagne fair towns) were regularly used in Southern Europe and the system of weights associated with Troyes (another) was commonly used in the North. In addition to the direct buying and selling of goods, the Champagne fairs, as those of Flanders had earlier, became centers for financial transactions, money markets and clearing centers facilitated by letters obligatory and by investment and association contracts, such that credit could reliably be extended at one fair and debt paid back at another (Bautier

1970; Epstein 1994; Cavaciocchi 2001). By the end of the thirteenth century, the largest European fairs were in decline. Although it is difficult to establish causation in one direction or the other, the foundation and increasing regularity and safety of direct sea routes connecting Italy (and thus the West-East trade) with Northwestern Europe was a parallel and related phenomenon. One possibility is that these direct routes, which passed by Gibraltar and linked the Mediterranean with other European sea spaces for trade, reduced the need for the fairs and for overland travel, for which increasingly endemic warfare and instability in Europe had radically increased transportation costs (Munro 2001).

Of course, the Mediterranean was not the only commercially important European sea space in the period. The Black Sea, fed by the Danube and directly open to Constantinople through the Bosporus (along with the connected Sea of Azov, fed by the Don), was an important source of foodstuffs and others goods for Byzantium, serving as a commercial crossroads that linked the Eastern Empire to Eastern Europe, Russia, and Central Asia. As early as the eleventh century, Byzantine concessions to Genoa allowed the Italian city-republic to trade and establish colonies there; and by the mid-thirteenth century, the Genoese controlled much of the direct seaborne trade of the Black Sea with the Mediterranean (Todorova 1987). More importantly, the East-West trade of Northern Europe, like that of the Mediterranean, was a lucrative source of both profit and power for premodern merchants. The German Hanse, a largely commercial but later loosely political organization of merchants in dozens of towns on and around the North and Baltic Seas—stretching from London and Bergen to Bruges and Lübeck and on to Novgorod in Russia—allowed merchants from Northern Germany to successfully mediate (though never to monopolize) the trade between the eastern Baltic and

Germany, Flanders, England, and Scandinavia. Although there were eastern markets for western goods, like woolen textiles, the Hanse largely satisfied the continental demand for grain, foodstuffs like salted fish, raw materials like wood and metal, and even luxury goods like fur and amber from Scandinavia and especially from the Baltic and regions east (Hammel-Kiesow 2000). But as lucrative as this trade was, it has nonetheless recently been estimated, on the basis of available records from Lübeck and Genoa in the second half of the fourteenth century, that the total value of the Hanseatic trade then represented as little as one fifteenth (ca. 6.6%) of that of the Mediterranean trade (Spufford 2002).

COMMERCIAL INNOVATIONS

The desire for merchant credit and decreased transaction costs in long-distance trade led to the use of moneys-of-account and the creation of the earliest instruments of international finance; the most fundamental of the latter was the "bill of exchange", the *lettera di cambio* or *di pagamento*, a multi-party payment order executable in a foreign currency in a distant location, which was invented in Northern Italy, widespread already in the fourteenth century, and in use—largely unchanged—until the eighteenth. Cashless exchanges had occurred at the fairs, on the basis of obligatory letters or so-called *lettres de foire*, but the bill of exchange was revolutionary because the issuer could thereby order a distant third party to pay the debt in another currency, which allowed the bills to circulate widely and function as instruments of both credit and transfer in international trade. The interest or profit from issuing such bills of exchange could be included (or perhaps better, given the usury prohibition, hidden) within the exchange rate, artificially raised in the lender's favor (De Roover 1953). By the 1320s,

Florentine merchants were importing the highest quality raw English wool for local manufacturing directly from Southampton rather than through continental middlemen. Florentine merchant-bankers were also simultaneously dominating both international finance and the incredibly lucrative collection of papal taxes; as a result, the largest Florentine companies were able to make extensive loans to the English crown, secured by income from English duties on the export of wool. In this environment, for example, bills of exchange could be employed to great advantage, allowing Florentines resident in England to buy English wool with English papal taxes and to have their partners resident in Italy give the Pope profits from other transactions in lieu of those English taxes (Lloyd 1977: 60-140). The extension of credit, indeed of trust, through formal mechanisms like the bill of exchange facilitated trade between merchants who no longer were meeting face-to-face, and brought together those with capital and those in need of it.

Primitive methods for spreading risk through indemnification, akin to so-called "bottomry" loans, high interest maritime loans nullified by the loss of the ship itself, may have been known to the ancient world (Andreau 1987), but insurance as we understand it today appears largely a development of the fourteenth century in the maritime cities of Northern Italy, where the risks and rewards of business were stark enough and big enough to create regular entrepreneurial opportunities to offer premium insurance for profit. Although there were certainly earlier and undocumented developments, the earliest known insurance contracts that can properly bear that name (even though they hid their interest-bearing nature for legal or ethical reasons) are Genoese and cover a 1343 voyage from Pisa to Sicily and a 1347 voyage from Genoa to Mallorca (Melis 1972: 7; Bensa 1884: 192). A wide range of insurance

contracts (Zeno 1936) rapidly developed side-by-side with advances in maritime transport, and the resulting parallel decrease in risk and in shipping rates fed an explosive growth of trade, such that by the late fourteenth century, according to Federigo Melis, a real insurance market had emerged and merchants, originally in Tuscany, had turned insurance into a matter of issuing private contracts (rather than public, notarized documents) and began to include insurance premiums as discrete debits in their bipartite (credit-debit) accounts (Melis 1975; 1984). The next great advance would have to await the mathematics of probability and the mathematization of risk (Daston 1987), and the related growth of large-scale insurance firms, but in the Renaissance the insurance market was highly fragmented and merchants had to rely on a large pool of small-time insurers, since these other merchants and merchant-bankers were willing to underwrite only relatively small policies to avoid catastrophic loss. Between 1390 and 1401, for example, the fabled Prato merchant Francesco Datini, whom we will discuss below, had to rely on some 490 insurers to underwrite 128 policies (Goldthwaite 2009: 99).

The initial and profound expansion of the Mediterranean trade in the tenth and eleventh centuries was also symbiotically accompanied by the creation of new, legally-recognized forms of commercial cooperation that appreciated the special characteristics of long-distance merchant ventures, which were high risk and required large initial capital investment. The best known of these is the so-called *commenda*, signified by numerous contemporary names, a contract for pooling capital and sharing the risks and rewards of overseas commerce, which likely evolved from earlier Islamic commercial agreements. A recent analysis of notarial records in medieval Genoa suggests that over 90 percent of all commercial partnerships there before the mid-fourteenth century were based on *commenda* contracts (van

Doosselaere 2009). *Commenda* contracts varied in details, but one (sometimes called a "bilateral *commenda*") might look like this: a passive investor, resident in Genoa, puts up 2/3rds of the necessary capital for the commercial sea voyage; an active investor—a traveling merchant who will accompany the goods in transit and provide commercial expertise—puts up 1/3; profits are shared equally; losses shared are shared in proportion to the initial investment (based on Lopez and Raymond 1967, doc. 84). Contracts of this sort, abundantly available in medieval notarial cartularies, allow us to trace the activities of merchants first hand, but these activities must always be placed in the context of Genoa's contemporary trade wars with its Mediterranean rivals, like Venice and Pisa; its development of colonies as far away as Kaffa on the Black Sea and maintenance of Pera, the Christian trading quarter of Constantinople; and its early creation of a public debt to finance costly naval construction and maritime expansion (Epstein 1996; Miner 2017). The line between Genoese government action and commerce was often exceptionally indistinct: the Genoese colony at Chios, on the Aegean, for example, was administered by a consortium (called the *maona*) of Genoese investors who had funded its capture in 1346 and who exploited its resources to pay dividends to its members (Argenti 1958). Unlike agreements based on a single sea voyage, other forms of partnership agreements were created for firms engaged in longer-term commerce; in Italy such a firm was commonly called a *compagnia*, related to our own word "company", and its members *compagni*. Partnership agreements specified the duration of the partnership (often three years), the initial capital investment (*corpo*) and ultimate shares of the profits, how later investment of capital (*sopraccorpo*) would be handled, which partner(s) would actively run the business either in person or through agents and which would remain passive "investors", and they often depicted

the partnership's *segno* or trademark and laid down guidelines for its portability to other firms. Firms could vary in size, but most had only a handful of partners, often blood relatives (even if only distantly related), and the size or scale of partnerships in Tuscany seems to have been under largely downward pressure after the mid-fourteenth century (Goldthwaite 2009: 64-79). Although the strength of the Renaissance family has become something of a popular trope, dynastic family businesses, with ownership descending through a single patriline, remained relatively rare (though see the example in Caferro 1996) and most firms were, for lack of a better term, *ad hoc*, with merchants seeking to expand their business creating new partnerships as needed. Partnership agreements, largely unchanged throughout the period, also created—unlike the modern corporation—unlimited personal liability in the partners, even though legislation could (as in Florence after 1408) grant external, passive investors limited liability (Melis 1991).

The sedentary merchant, seen by Gras as defining the first (mercantile) stage of capitalism, achieved what Alberto Tenenti in a suggestive profile of the Renaissance merchant (1988) has called the "gradual and organized control of time, space, and risk" by becoming a manager instead of a trader, and this management required him to transform the world around him into information, into words and numbers. In the jargon of the Tuscan merchant of the late Middle Ages and Renaissance, the word for a firm and the word for its set of account books was, not coincidentally, the same: *ragione*, from the Latin *ratio*, a count, an accounting, a calculation, a reckoning (Edler 1934: 236). In the firm's books, as in its articles of association, the theoretical body achieved something like a concrete existence. Although the limited-liability joint stock company was a much later innovation, business corporations of a significant size—

with a home office, distant branches (*filiali*), directors, partners, agents, and employees—emerged, "constructed out of sedentary merchants", in the second half of the thirteenth century in Tuscany (Padgett 2012, quotation at 121), where and when we also find the earliest references, as in an incomplete 1281 cash book of the Sienese Salimbene company, to complex accounting procedures involving interrelated accounts books (De Roover 1974b). Tuscan account books came to be routinely written in the bilateral or *contrapposto* format, showing debits verso and credits recto, a century later (Padgett and McLean 2006:1539-43), sometimes using the so-called "double entry" (*partita doppia*) technique, which is often associated with its first systematic exposition by Luca Pacioli near the end of the fifteenth century and which did not gain widespread European acceptance until the seventeenth century (De Roover 1974b; Yamey 2004). Jacob Soll (2014) has recently shown the clear relationship between these methods and the viability ever since of political communities, indeed of the modern state itself, which has historically flourished when accompanied by a culture of accountability.

MERCANTILE CULTURE AND ARTEFACTS

If the figures presented by the historian Giovanni Villani are to be believed, already in the 1330s Florence had a boyhood schooling rate as high as 83 percent (Grendler 1989: 72), and, nearly a century later, self-submitted property surveys confirm an overall urban male literacy rate of around 80 percent (a rate not reached in England, for example, until the late nineteenth century). In the Florentine context, before classicizing humanism transformed childhood education in the late fifteenth century, literacy meant the basics of reading and writing in the Tuscan vernacular followed by the abacus training necessary for a life in

commerce (Black 2004). Literacy and numeracy together were, not surprisingly, the twin foundations of a thriving commercial culture, one evidenced by the abundance of literature left behind by early Renaissance merchants—men like Villani himself, who was a *factor* (business agent) of the Peruzzi bank in Bruges as a young man in the first decade of the fourteenth century (Luzzati 1969)—and by the super-abundance of business records left behind by their compatriots: approximately 2,500 account books from the thirteenth through the fifteenth centuries are extant in the archives of Florence and nearby Prato, more than for the rest of Italy and Europe combined (Tognetti 2012). And these extant books are, of course, but a fraction of the number of books produced: in the 1343 bankruptcy proceedings of the large Acciaiuoli family company, some fifteen hundred of the firm's account books were referenced (Hoshino 2001).

Merchants, again especially in Tuscany, and not surprisingly given the culture out of which they arose, seem to have been afflicted with a *furor scribendi*, a compulsion to write. In an important early study of these merchant-writers, Christian Bec (1967) showed how generically capacious pre-humanist merchant writing could be, with "*marchands moralistes*", "*marchands conteurs*", "*marchands mémorialistes*", and "*marchands historiographes*" producing advice books, short story (*novella*) collections, family chronicles, and histories. All of these genres, though, orbited around a central and vaster phenomenon, the keeping by merchants of run-of-the-mill *libri di ricordi* or *ricordanze*, personal memoranda books, usually recorded chronologically; quintessential records of "economics" in the pure, premodern sense of household or estate management (from the Greek *oikos*, home), these books laconically recorded chiefly personal business accounts, family data (births, marriages, deaths, etc.), and

only occasionally events outside the family-household sphere (Ciappelli 2014). The proverbial or aphoristic wisdom of merchant advice books, like that of Paolo da Certaldo, provides us with a glimpse into the ethos (sometimes startling, often all too familiar) of the premodern merchant (Branca 1986: 1-99). More apropos of the long-distance trade, manuals (*pratiche*) of commercial practices were also produced and examples, largely Tuscan and Venetian, remain from the fourteenth and fifteenth centuries: books, covering the width and breadth of the geography of the long-distance merchant's world, in which information useful to merchants—trade routes; distances; local currencies, weights, and measures; lists of spices and other goods; duties and tariffs; carriage costs—was compiled directly or second-hand from correspondents (Dini 1980, especially 53). The most complete specimen, written between 1310 and 1340 by Francesco di Balducci Pegolotti, who worked for the Bardi company in London and Cyprus, is extraordinary in scope, covering thousands of exotic coins, commodities, and measures in hundreds of cities from Acre, as it were, to Zara (present-day Zadar in Croatia) . The first route described by Pegolotti, for example, takes a merchant (or, more likely, his agents and goods) from the Italian colony of Tana (today Azov, Russia) to Canbalecco (Beijing), around 6000 kilometers away (Evans 1936).

After five to seven hundred years, we possess, quite understandably, only a small sample of the business records produced in the late Middle Ages and Renaissance. And when we do possess such records they are often incomplete, even fragmentary. More complete collections are unique and uniquely valuable: as we will describe below, it is precisely and only because so many of the account books and other materials from the businesses of the famous Prato merchant Francesco Datini survive that scholars, from Enrico Bensa (b. 1848) to Federigo

Melis (b. 1914) to the current generation of Italian economic historians, have been able to reconstruct the organization and management of his businesses. Harvard Business School's Baker Library possesses another uniquely complete collection (as per De Roover 1974c: 74), which, unlike the extraordinary Datini fonds, has barely been examined in the last 75 years (roughly since the important work of Edler 1934; and De Roover 1974 [1941 original]). The so-called "Selfridge Collection" of Medici family business records, donated to Harvard Business School by the Anglo-American retail magnate Harry Gordon Selfridge, contains about 150 manuscripts through which it is possible to trace the businesses—predominantly wool manufacturing and export—of one branch of Florence's Medici family. The most important merchant covered in the Harvard Business School collection is Francesco de' Medici (1450-1528) whose books, along with those of his father Giuliano di Giovenco (d. 1499), his son Raffaello (d. 1555), and his grandson Giuliano (d. 1565), make up more than 80 percent of the collection. Francesco began his business career in local banking by making petty loans in and around Florence (Goldthwaite 1985) and by selling the wares of goldsmiths; in 1472 he personally journeyed to Pera (the Christian trading quarter of Constantinople) and to Bursa (at the end of the Silk Road); after 1500 he was one of Florence's more prestigious entrepreneurs, regularly holding positions of honor in the city, and overseeing a sizable importing and exporting operation between Spain, Lyons, Florence, Ragusa (on the Italian Dalmatian coast), and the Ottoman cities of Constantinople and Adrianople, exporting finished woolens and importing raw wool from Spain, and silk, spices, and other luxuries from the East. Throughout his career, Francesco's business interests remained varied (lending small sums, dying wool, buying and selling leather, scrap cloth, silk, and jewels, etc.) and most often he had no partners

(operating as "Francesco di Giuliano de' Medici and Company"); when he did have partners they were about half the time members of his close family (his father, brothers, and son) and half other Florentine merchants, especially one other local banker and several merchants with similar interests in the Levant trade.[1]

When Gras conceived of the sedentary merchant, he most certainly had in mind the even more exceptional figure of Francesco di Marco Datini (1335-1410), about whom he commissioned an article for publication in the early journal of business history that he co-edited with Harvard Business School's first dean Edwin F. Gay (Brun 1930). Datini, who achieved something like lasting fame in modernity with the publication of Iris Origo's lively account *The Merchant of Prato* (1957), left behind a superabundance of records—over 600 account books, and over 140,000 pieces of commercial correspondence including hundreds of bills of exchange—that is unparalleled for any other premodern merchant. An orphan, Datini first made his fortune with a warehousing and export-import business in Avignon, where the presence of the papal court had created a thriving commercial and financial center, one linked to Tuscany with regular overland mercantile and diplomatic traffic. In the 1380s he returned to Prato, which had been annexed to the Florentine regional state in 1351, and from there operated a massive international enterprise, which has been called a system of businesses or of firms (*sistema di aziende*; Melis 1962) and which foreshadowed, albeit imperfectly, the multinational trading companies of the nineteenth century (Jones 2002) and the hierarchically administered multiunit firm of the twentieth century (Chandler 1977). With major branches in Avignon, Prato, Pisa, Florence, Genoa, Barcelona, Valencia, and Mallorca, Datini's commercial empire involved banking, industrial production (chiefly of woolen textiles), and hundreds of

commercial partnerships with junior partners, agents, and employees. Of course Datini's system was far from representative of the usually much smaller and more abundant mercantile partnerships of the era, and these were equally far from the still more abundant shops of the petty merchants of Prato in the same period, who kept only rudimentary accounts, dealt with the long-distance trade through local small bankers (*tavolieri*), and occupied a circumscribed world dominated by personal trust and rampant consumption loans (Marshall 1999). Late in life, and strongly influenced by a friend, the notary Lapo Mazzei, Datini became increasingly devout and left his fortune to a charitable organization for the poor of Prato that he established called the Ceppo dei poveri (Guasti 1880; Nigro 2010).

Although Datini regularly opened his new accounts in the name of "God and profit", as many Italian merchants of the time did, he also, again like many of his contemporaries, increasingly grew anxious about his wealth and its possibly deleterious effect on his salvation. The relationship of religion to capitalism and its origins became a major question around the beginning of the twentieth century: Max Weber's (2010; original 1905) famous argument that the "spirit" of capitalism did not arise until Calvinist and Puritan doctrines gave work, as a secular vocation (*Beruf*), a dignified place within God's plan was formulated in reaction to Werner Sombart's (1902) that capitalism's origins were to be found in the Italian merchants of the late Middle Ages, among whom acquisitiveness and the rational calculation of profit first became widespread (Lehmann 1993).  Although the larger question of "spirit"—a cultural rather than empirical one—remains moot, capitalism as it developed in the medieval West did so alongside an often hostile religious or ethical mindset, most commonly associated in the most widely known scholarly literature with the usury prohibition and the just price doctrine.

Usury, understood as *any* interest rather than excessive interest, was forbidden by the Biblical and Koranic traditions, but was allowed in Byzantium, where legal rates were set by imperial legislation. The increased trade of the twelfth century created a demand for commercial credit and prompted increasing condemnations from church councils, like the Third Lateran Council of 1179, as well theologians and preachers. Pawnbrokers and moneylenders, often Jews because the Jewish usury prohibition was understood to extend only to loans to other Jews and not to gentiles, were understood to be preying on the Christian poor and were regularly subjected to rhetorical and physical violence (Le Goff 1988). Moneychangers and bankers provided their services and loans of capital at interest, but they often obscured the interest, as we have already noted, under the guise of otherwise licit transactions. And theologians and canon lawyers, already in the thirteenth century, had moreover created innovative doctrines to support commercial credit on the basis of risk, opportunity costs, and the legitimacy of remuneration for performing financial services. The Provençal theologian and Spiritual Franciscan Peter John Olivi even distinguished productive capital from money, a non-productive or "sterile" medium of exchange in the Aristotelian and Scholastic traditions (Spicciani 1990). Although there is some evidence that the usury prohibition retarded the growth of financial markets in medieval Italy, and although merchants were sometimes affected by moral anxiety that led them to undertake usury restitution (Galassi 1992), the impact upon merchants and upon the development of commercial instruments appears minimal. Similarly, the so-called "just price" was rarely understood by medieval theologians and canonists, in practice and under ordinary conditions, as anything other than the market price (De Roover 1958). That said, certain essential staple goods, like grain—subject to

unpredictable crop failures, and thus life or death matters for rulers and their subjects—were highly regulated (De la Roncière 1982) and continued to be for centuries (Kaplan 2015: xxii-xxiv); and neither the trades nor trade were "free" in premodern urban Europe: guilds and governments alike erected barriers to trade protecting local merchants and industries including quality, price, and exchange controls; tariffs and levies; subsidies and privileges; and franchises and legal monopolies (Munro 1977; Mackenney 1987; Mauro 1990).

## VENICE: MERCHANTS AND THE STATE

In approaching the trade of the Mediterranean, the case of Venice, the preeminent commercial power of the later Middle Ages and Renaissance, is exemplary; foreshadowing the mercantilist and national powers of the seventeenth century, in Venice more purely commercial activity went hand-in-hand with industrial-technological advancement and state intervention, creating for the Serenissima a set of partially overlapping commercio-political empires on the Italian mainland (the so-called *Terraferma*, ultimately extending to the plains of Lombardy and including cities like Brescia, Cremona, Padua, and Verona), in Istria and on the Dalmatian coast, and all across the eastern Mediterranean, controlling and fortifying possessions along the Strait of Otranto, the Gulf of Corinth, the Peloponnese (or *Morea*), and beyond, including Crete and Cyprus. Although undisputed Venetian mastery of the eastern Mediterranean was brief, lasting between the end of a series of commercial wars with Genoa and the start of Ottoman encroachment, its commercial and industrial power writ large was extraordinarily long lived (Chambers 1970; Lane 1973). A symptom of Venice's stable and expansive mercantile power: Although Florence and Genoa both minted gold coins before

Venice did, with the former's famed Florin quickly displacing North African gold coins and gold dust as the foremost medium of exchange for high payments in Europe, the Venetian Ducat—first minted in 1285—was rapidly used and copied throughout the Eastern Mediterranean and, in the fifteenth century, overtook the Florin as the premier gold coin of Europe (Lane and Mueller 1985; Stahl 2000). Venice had been a vassal state under the jurisdiction of Byzantium until the late ninth century, it established major trade routes in the eleventh century, and by the start of the thirteenth century—when, in 1204, Doge Enrico Dandolo diverted the Fourth Crusade to sack Constantinople—it conspicuously rivaled or equaled the Eastern Empire due to its maritime prowess (Nicol 1988; Laiou-Thomadakis 1980-1). Venice's slow loss of mercantile supremacy in (and colonial rents from) the Eastern Mediterranean, offset in part by increased expansion in the Terraferma, sped up only in the seventeenth century, when Northwestern European national powers, the Dutch and the English, began to capture significant parts of the Levantine trade as a result of their burgeoning naval and economic power. The English Levant Company, a politico-commercial entity, came to trade directly with the Ottomans, entirely sidestepping the Venetians and similarly, when necessary, small and mobile communities of English merchants would deal with Greek rather than Venetian traders in territories under Venetian domination (Fusaro 2015). Such reversals of fortune often follow successful politico-mercantile emulation (Reinert 2011).

In Venice, as elsewhere in Northern and Central Italy, industry and trade were intimately and harmoniously linked. To take one famous example: Although the Venetian glass industry, centered on the island of Murano, began as early as the tenth century, it was the astonishing wealth of Venice's merchants in the late Middle Ages and Renaissance that supplied the large

capital investment necessary for growth and technological development and it was these merchants' mastery of Mediterranean sea lanes that facilitated both the importation of raw materials and the export of luxury glasswork (McCray 1999). Similar arrangements also existed on a much larger scale. The massive industry of turning raw timber, culled locally or from Venetian forests in Istria and Dalmatia, and long one of Venice's chief commodities for sale, into ships for war and trade lay at the heart of the Venetian enterprise: the Arsenal, Venice's shipyard, built in stages from the thirteenth through the fifteenth centuries, employed as many as sixteenth thousand shipbuilders in the 1420s and achieved remarkable productivity (Appuhn 2009; Concina 2006). The production of the Arsenal fed the system of public galley convoys that had long been central to Venice's maritime trading and war-making capacity, a system that collapsed only in the sixteenth century when the private interests of the Venetian patriciate could no longer be reconciled with the city's public interest (Judde de Larivière 2008).

THE SCALE OF MERCANTILE ENTERPRISES

Throughout the Middle Ages and Renaissance, merchant partnerships and companies, even those with "global" reach, tended to remain both small in size and limited in duration, and are often best viewed as particularistic entities embedded in much larger and sometimes overwhelming mercantile networks, trade routes, and flows of goods and precious metals, but there were exceptions: late medieval Florence, for example, saw the creation of what Edwin S. Hunt (1994) has called "super-companies": the Bardi, Peruzzi, and Acciaiuoli family companies of the fourteenth century. The Peruzzi company, defined by a series of renewed short-term partnership agreements, lasted nearly 70 years and grew to a conspicuously large size: in

addition to a main branch in Florence and others in some of the political and economic centers of Europe (Avignon, London, Paris, Bruges), the company, in 1335, had subsidiary branches all over the Mediterranean world—Pisa, Venice, Naples, Barletta, Sicily, Sardinia, Mallorca, Tunis, Cyprus, and Rhodes—and employed 90 salaried agents. By comparison, the papacy in Avignon, by far Europe's largest administrative operation, employed about 250 there. The Bardi company was even larger and its assets, again in 1335, were an astonishing 4.5 times larger than the net receipts of the English crown nearly a century later. The scale of these companies allowed them to obtain trading privileges with kings and other political rulers in exchange for the large cash loans required to wage war. The three companies went bankrupt in the 1340s. It was long believed, due to the historic centrality of the wool trade in Florence, that the Peruzzi company's failure resulted from Edward III, the English king, defaulting on the enormous loans that secured for the company control of the supply of high-quality raw English wool, but Hunt has shown that the Peruzzi instead fell victim to decreasing profit margins in the grain trade, which formed the real core of their business. Even if the "super-companies" did not collapse due to sovereign defaults, lending to kings, city-states, and other large institutions could be a very dangerous business for premodern merchants and merchant bankers. The case of Jacques Coeur is exemplary: the Bourges merchant, who amassed a fortune by importing tapestries and silk through Damascus, financed French military campaigns in the 1440s before ultimately running afoul of the court, having his property confiscated, and fleeing arrest to Rome (Mollat 1988).

Some Renaissance family companies also grew to extraordinary size and attained equally large geopolitical influence, most famously the Medici bank of fifteenth-century

Florence and the Fugger bank of sixteenth-century Augsberg, both of which profited from the collection of papal taxes, from the sale of insurance, from the regular fluctuation of international exchange rates, and from loans to merchants and princes. And both the Medici and Fugger companies, with branches all over Europe, in addition to these more bank-like activities, acted as vast international holding companies (or perhaps multinational business groups), operating manufacturing and mining enterprises and export-import businesses. Using the abundant and meticulous extant records of the Medici bank, including some of its "secret books" (*libri segreti*) discovered by his wife Florence Edler, Raymond de Roover (1963a) showed that the bank's success relied not on innovative banking techniques but on managerial prowess—-insulating the central company from losses, incentivizing branch managers to increase profits, requiring the regular presentation of financial statements—and that its failure, between 1464 and the ultimate collapse of 1494, likewise was the product of mismanagement by the younger generation. Jakob Fugger, the richest man in Europe, personally helped finance the 1516 royal election of Charles I of Spain (later the Emperor Charles V), and his family bank, its fortunes tied to Spain, reaped enormous profits and gained incredible holdings in land and mines (by which unpaid loans to the crown were redeemed) but, in the second half of the sixteenth century, was battered by a series of Spanish state bankruptcies (Kellenbenz 1990).

## CONCLUSION

It has lately become fashionable to suggest that the West's clear economic advantage over the East is a relatively recent phenomenon, with Europe overtaking China only in the mid-eighteenth century (Pomeranz 2000), even though earlier periods, like the fourteenth century,

have been more persuasively presented on the basis of economic data (Maddison 2006). But the most commercially advanced regions of Europe, like the urban centers of Flanders and North-Central Italy, were extreme outliers much earlier, both globally and within Europe itself. Italy's was the leading world economy ca. 1300 and, even with a steady and long decline from then to the 1880s (Malanima 2011), England's did not overtake it (in terms of real wages) until the eighteenth century (Malanima 2013). Although the Industrial Revolution allowed for unprecedented prosperity and brought about modern economic growth (Hartwell 1971), Michael Mitterauer (2010) is right that Europe was set on its "special path (*Sonderweg*)" in the Middle Ages, but his search for causes—from the cultivation of rye to the centralization of the Papal church—largely overlooks the patent cause of Europe's distinct late medieval prosperity, which spurred revolutionary advancements in shipping, communications, and manufacturing: the long-distance trade of merchants. Indeed, to speak of the makers of global business must be, first of all, to speak of merchants.

In this chapter, with its focus on the Mediterranean trade of the Middle Ages and Renaissance, we have shown how the merchant—Gras's "sedentary merchant", freed from the harsh demands of travel by his mastery of information and by the seismic innovations of the medieval "commercial revolution"—emerged as a truly global figure. Then, as now, merchants pooled capital and shared risk to enrich themselves and their polities, utilizing the infrastructure and markets that they helped to make, and creating new legal and financial instruments to facilitate their ventures. Premodern merchants bequeathed to the businessmen of later centuries essential techniques of trade and bookkeeping, but also their commercial ethos, their institutions, and the very riches for which they competed and often risked their

lives. It is not by chance that the politico-economic system that followed is called the mercantile system, as in Adam Smith's (1976: 396-417) pejorative usage, or simply mercantilism, for, broadly understood, it held that the competition for trade lay at the essential core of state power (Reinert 2013). The violent Genoese-Venetian struggle for the Mediterranean trade, the aggressive emulation of Italian banking practices in the Low Countries, and so on, are forerunners of the mercantilist age and, indeed, of the perpetual competition, diversity of forms (political and economic), and innovation that has marked the development of the West.

Let us conclude with an example, from the Low Countries instead of Italy, which encapsulates much of what had already been said: Bruges, the quintessential merchants' city, spatially positioned to benefit from the decline of the Champagne fairs and from regional advances in textile manufacturing, was by 1350 a center a trade, finance, and industry: politically responsive to mercantile interests, densely urbanized, concentrating and exploiting the resources of the surrounding countryside, attracting skilled craftsmen as immigrants, hosting large merchant colonies (of Italians and German Hanse traders, of course, but of many others as well), and importing and exporting commodities and luxury goods in a trade covering the known world and extending beyond it, the Flemish seaport was also a center for deposit banking and credit creation, and a clearing house for commercial information (De Roover 1948; van Houtte 1982). To see one of the European merchant metropolises of the late Middle Ages or Renaissance—to see a city like Bruges or like Venice—was, we may say with crystalline hindsight, to glimpse the very future of the global business.

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[1] The collection (briefly described in de Ricci 1935) was acquired by Selfridge at auction in London (see Tyler 1919). HBS Medici Family Collection, Baker Library Special Collections, Harvard Business School, ms. 495, fascio C, pp. 89-146 for Francesco's sojourn in Turkey; ms. 519 [not physically with the collection, on which see Goldthwaite 2009b] for some of his earliest businesses; Francesco's activities from 1471 to 1525 are represented by at least 11 partnership agreements [in ms. 495] and 27 manuscript books [mss. 514, 516, 518-21, 523-4, 526, 528-34, 536 (2-6), 537-9, 543(1), 545-6, 568(1)], many of them ledgers (*libro debitori e*

*creditori*), with a sizable number of other types, including journal (*giornale*), memoranda (*ricordanze*), and letter copybook (*copialettere*), and a single *libro segreto*.

# Law and Finance "at the Origin"

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**Abstract**
What are the key determinants of financial development and growth? A large literature debates the relative importance of countries' legal and political environment. In this paper, I present evidence from ancient Rome, where an early form of shareholder company, the *societas publicanorum*, developed. I show that the *societas publicanorum* flourished in a legally underdeveloped but politically supportive environment (Roman Republic) and disappeared when Roman law reached its height of legal sophistication but the political environment grew less supportive (Roman Empire). In the Roman case, legal development appears to have mattered little as long as the law as practiced was flexible and adapted to economic needs. The 'law as practiced,' in turn, reflected prevalent political interests. After discussing parallels in more recent history, I provide a brief overview of the literature on law and finance and on politics and finance. The historical evidence suggests that legal systems may be less of a technological constraint for growth than previously thought—at least "at the origin."

## 1 Introduction

Understanding the causes of financial development and economic growth is central to research agendas in many fields of economics, ranging from macroeconomics and microeconomics to finance. The law and finance literature suggests a causal impact of countries' legal systems.[1] Another strand of the literature emphasizes the role of the political environment and argues that the effectiveness of institutions varies considerably with the political support they receive.[2]

* I would like to dedicate this article to the late John McMillan, without whose encouragement and interest, I would never have written it. I would also like to thank Daron Acemoglu, Thorsten Beck, Stijn Claessens, Stefano DellaVigna, Peter Howitt, Simon Johnson, Marco Pagano, Enrico Perotti, Paola Sapienza, Walter Scheidel, Andrei Shleifer, Mark Weinstein, Jeff Wurgler, Luigi Zingales as well as the participants at the 2006 Conference on the Formation and Evolution of Institutions at Brown University, UC Berkeley, UCLA, and Yale University for helpful comments and discussions. The article also benefited significantly from the detailed comments of four anonymous referees and Roger Gordon, the editor. Yelena Bakman, Aisling Cleary, Kimberly Fong, Xing Huang, Zhenyu Lai, William Leung, and especially Prasad Krishnamurthy provided excellent research assistance.

[1] La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1997) and (1998).

[2] Rajan and Zingales (2003); Acemoglu and Johnson (2005); Pagano and Volpin (2005).

Definitive empirical evidence for either of those approaches is hard to come by. Given the scarcity of perfect natural experiments, careful and detailed analyses of individual cases are a valuable part of the literature, even if they stop short of proving causality. In fact, much of the literature revolves around specific historical examples, mostly taken from the last two centuries.[3]

This paper expands the current body of evidence to a much earlier time period, two thousand years ago in ancient Rome. I focus on a specific cornerstone of financial and economic development: the emergence of the business corporation. I propose that, contrary to widespread belief, the earliest predecessor of the modern business corporation was not the English East India Company nor the medieval *commenda*,[4] but the Roman *societas publicanorum*, i.e. the "society of government leaseholders." While this claim alone may be of independent historical interest, I use the Roman case to shed light on the "law and finance" versus "politics and finance" debate. The Roman evidence illustrates the limitations of the existing law and finance theories. In the case discussed here, legal restrictions (or the lack of legal development) per se appear to matter little as long as the law *as practiced* is flexible and adapts to economic needs. In fact, one of the most important periods of legal development, "classical Roman law," appears to be negatively correlated with financial and economic development. I also show that 'the law as practiced' reflects prevalent political interests.

In addition, the historical evolution of the Roman *societas publicanorum* allows us to better understand the political and economic preconditions for the development of the business corporation in modern history, an organizational format that has been essential for economic development. The Roman case illustrates the balance of power between the political elites and the business elites that determines whether this organizational form can survive and expand.

I first provide a historical introduction to Rome's economy and legal system. This brief overview helps to explain how an ancient economy could arrive at a surprisingly sophisticated level of financial structure. I emphasize the flexibility in the creation and interpretation of legal rules, which allowed new business forms to be invented through modifying preexisting commercial and social institutions (Section 2.1). I then describe the role and business activities of the publicans, from the 5th century BC until their demise under the Roman emperors (Section 2.2). I argue that, at the height of its develop-

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[3] Examples are Engerman and Sokoloff, (1997) and (2002); Berkowitz, Pistor, and Richard (2003); Lamoreaux and Rosenthal (2005); and Haber, Razo and Maurer (2003).

[4] Ekelund and Tollison (1980) and Gower (1969), p. 22. Kindleberger (1984) characterizes, more generally, alterations of the "true" partnership as the earliest forms of business organization but views the medieval *commenda* as the starting point (p. 195). Baskin and Miranti (1997) explicitly assess the development of the business organization under Greco-Roman law as restricted to partnerships.

ment, the *societas publicanorum* resembled the modern shareholder company along several core dimensions: its existence was not affected by the departure of partners (differently from the regular *societas*, i.e. the Roman partnership), and it could issue traded, limited-liability shares (Section 2.3). I then discuss the causes of the corporation's demise under the Roman Empire (Section 2.4). In particular, I point out how a change in political interests triggered its demise at a time when the general legal framework had substantially evolved and was, if anything, better able to support the institutional format of the corporation. That is, I evaluate the demise of the *societas publicanorum* in the light of a drastically changing political environment, the shift from Republic to Empire. In Section 2.5, I summarize the insights from this historical evidence and point to parallels in the later development of the East India Company and other parallel cases from modern history.

I link the historical evidence to the modern debate on the causes of financial development and growth. In Section 3, I first provide a brief overview of the literature on law and finance and on politics and finance. While the law and finance literature emphasizes the importance of a growth-fostering legal environment, the politics and finance literature argues for the predominance of political interests in determining the growth path of an economy. The overview emphasizes research on the role of different business formats (such as the shareholder company) and their characteristics (such as limited liability, agency, and representation), which has found less attention in previous reviews. These historical papers highlight that smooth access to financing requires more than investor and creditor protection. Restrictive business formats impose transaction costs on managers and may impede the funding of promising enterprises.

I discuss the implications of the rise and fall of Roman corporations for the current debate on law versus politics, focusing on two aspects. First, the fundamental assumption underlying the law and finance approach is that the legal environment causally affects economic development. The literature attributes better financial development in common-law than in civil-law countries to the legal flexibility inherent to common-law systems and the lack thereof in civil-law systems, often using Roman legal origin as a proxy for a rigid and growth-hostile legal environment. The historical evidence (from the time period that spawned Roman law) suggests that legal systems may be less of a technological constraint for growth than previously thought—at least "at the origin." Roman law provided a flexible and nurturing legal environment for financial development during the Republic, accommodating fundamental advancements such as a corporate business format. In fact, the case-based evolution of Roman law closely resembles today's common-law systems.

In the same vein, the case of the *societas publicanorum* illustrates that the functioning of an organization may develop independently of formal laws regulating company

formats. Business formats affect firms' access to external financing, stability (or "longevity"), ease of representation by individual managers, and the rights and obligations they can assume. An advanced (corporate) format facilitates its operation. However, analyses focusing on the formal law rather than the 'law as practiced' risk misconstruing the actual state of organizational development and its implications for finance and growth.

Second, if it is the 'law as practiced' that matters, the next question is what affects the practice of law and its responsiveness to economic needs. Here, the historical evidence points to the role of political pressure. The law as practiced appears to serve economic needs if and only if aligned with the dominant political interests. Differently from the view put forward in some of the politics and finance literature (e.g., Perotti and van Thadden, 2006), the Roman case does not provide evidence that the influence of politics acts via its influence on law, i.e., the view that the law matters, but that the choice of the law is endogenous to political forces. What we see in the Roman case is that formal contract and business law develop orthogonally to political changes. Formal law has little influence on economic outcomes because it is trumped by political forces.

While this dominance of politics over law is only a historical observation, based on a specific, non-generalizable case , the Roman case presented here overcomes a basic identification problem faced in the empirical analysis of law, politics, and finance: As law and politics evolve over time, they often develop in the same direction—either fostering or limiting financial development. That makes it difficult to attribute financial development to either source. The *societas publicanorum* provides a rare case in which the evolution of law and politics diverged. During the Roman Republic, when Roman law was still far from a complete body of civil law ("pre-classical" period), political interests demanded stable business organizations that could raise large-scale financing. During the Roman Empire, when Roman legal science peaked ("classical" period) and the law-related transaction costs of economic interaction diminished, political interests reversed and grew less favorable toward the smooth operation of large-scale economic activities. Financial contracting regressed despite the progress in legal framework. My findings suggest that economic development that coincides with government interest requires little formal legal underpinning other than a willingness to sanction experimentation with existing legal forms on a case-by-case basis. Without government support however, it may wither despite an existing legal framework.

These insights do not rule out that law does affect financial development. The Romans might never have arrived at developing an early type of corporation without their advanced legal environment. Nor do we observe the counterfactual history where the formalization of Roman law in the classical period gives explicit sanction to legal forms such as the *societas publicanorum* and codifies their rights. Rather, the historical case il-

lustrates that a failure to account for the political economy and its effect on the legal environment leads to a misreading of the relationship between law, finance, and growth.

## 2 A Historical Case Study: the Roman Corporation

### 2.1 Roman Economics and Roman Law

Historical evidence about the publicans and their companies stretches from the beginnings of the Republic into the Empire. The height of their activities falls into the last two centuries BC. I provide a brief overview of the economic and legal development at the time. Table 1 provides a chronological overview.

#### *Economics*

A starting point for my analysis is the question of how an early economy could be sophisticated enough to generate a business form as advanced as the *societas publicanorum*. Peter Temin (2001, 2006) uses evidence from grain markets, employment contracts, the manumission of slaves, and loan contracts to argue that Rome's economic institutions during the Early Empire were more market-oriented than even in the medieval economy many centuries later. In this subsection, I provide examples that illustrate the same point and extend the discussion to the period of the Roman Republic.

From the third to the first century BC, Rome grew from a rural community to a power stretching all over Italy and then beyond the Mediterranean, including West and South Europe, Asia Minor, the Near East, Egypt, and North Africa. In the wake of this geographic expansion (see Table 1), large-scale commerce, industries and financial sectors developed, and the volume of trade exploded. This appears to be particularly true for seaborne trade. For example, Hopkins (1980) infers from data on 545 dated ancient shipwrecks, found near the coasts of France, Italy, and Spain, that interregional trade was higher in the period from 200 BC to AD 200 than either before or during any time in the following millennium. Analyses of the number of silver coins minted in Rome during the late Republic (157-50 BC) supports this hypothesis: the circulation of coins increased tenfold over that sample period.

The wide geographical expansion of Rome as a single political entity provided favorable conditions for the establishment of large product markets. Kessler and Temin (2005) argue that there was an integrated grain market stretching over all of the Mediterranean. Analyzing historical data on grain prices in Rome, Northern Italy, Sicily, Spain, Turkey, Palestine, and Egypt, they find a strong linear relationship between prices and distance from the production site, which appears to reflect transportation costs and suggests a functioning market and price mechanism. Similarly, Hopkins (1980) uses the spread of silver coins, minted in Rome, across the different regions of the growing Ro-

man state to illustrate its integration into a single monetary economy. He plots the number of catalogued Roman coins found in Southern Germany, Northern Italy, Britain, France, the Balkans, and Syria, over the years AD 50-200. The positive correlation of time trends across regions suggests a smooth flow of money across the Empire, consistent with the view that Rome had become the monetary center of the known Western world in the first century BC (Cunningham, 1898, p. 164). The coin-flow also corroborates the empire-wide operation of many other product markets (Temin, 2001).

Technical progress supported the growth of the Roman economy. For example, Wilson (2002) argues that the discovery and spread of water-powered devices had a causal impact on economic development in Rome. He shows that the use of water-powered mining technology is strongly correlated with the volume of metal extraction. The estimates of extraction volume are based on analyses of Greenland ice cores, which record the atmospheric pollution from silver, lead, and copper extraction in different periods throughout history. A time-series plot of the concentration of lead between 962 BC and AD 1532 shows a steep increase in the first century BC, a somewhat lower plateau in the first century AD, a further decrease in the second century, and an even lower level up to the fifth century. Similar data of copper pollution reveals peaks from the first century BC to the second century AD and subsequently lower levels – all the way until the Industrial Revolution. The data suggests that advancements in Roman mining technology led to enormous increases in metal extraction. As we will see, the decline in production mirrors the decline of Rome's *societas publicanorum*, though with some time lag.

A broad overview of the archeological evidence of technological innovation and the speed of technological transfer can be found in Greene (2000), especially for the late Republic and early Empire. Examples include the spread of grape- and olive-pressing equipment and water-powered grain-mills throughout the Mediterranean, bone dimensions of cattle that suggest selective breeding, and remains of pumps and water-wheels that allowed mining below the water table in the Northwestern provinces of Gaul and Spain.

The Roman financial system was also fairly developed. Temin (2004a) documents that sophisticated financial intermediaries – bankers (*argentarii*) and brokers (*proxenetae*) – pooled and distributed funds effectively across the Roman economy. Evidence from the early Roman Empire includes the so-called *Muziris* papyrus of a large maritime loan, which appears to be copied from a standardized maritime loan contract; catalogues of loans in Roman Egypt; and numerous literary sources such as Livy's account of the evasion of interest rate regulation via lending to foreigners in his History of Rome (*Ab urbe condita* 35.7). These sources report various lending practices, bank branching, loan transfers, and lending activities of temple endowment and local governments. Related to

the context of my analysis, Temin points out that the publicans functioned as de-facto deposit institutions for the Roman government and provided interest income on revenues they collected for the government.

These details about the ancient Roman economy illustrate the fast-paced economic development during the late Roman Republic and early Empire, in which we have to place the development of a company format as advanced as the *societas publicanorum*.

***Law***

Our knowledge of Roman law in the period prior to the Punic Wars (middle of the third century BC) is limited to the famous Twelve Tables from 450 BC. The Twelve Tables are generally perceived to be the foundation of Roman law. As far as we can judge from the surviving text fragments,[5] the Twelve Tables were not an exhaustive codification of all legal rules. Rather, they defined various private rights and legal procedures and ensured basic economic and political rights for the plebeians in their power struggle with the patricians.

The jurists of the last two pre-Christian centuries, the pre-classical period, developed a "legal science" with formal legal concepts and systematization. This development has often been attributed to the encounter with Greek philosophy (Kaser, 1980, p. 4). It is also the period in which the activities of the publicans and the formation of *societates publicanorum* achieved their greatest expansion and development.

The "classical" period during the first 250 years AD marks the height of Roman law. The law of this period exerted a large influence on legal development throughout the world and throughout history. The discussion about "Roman-law origin" in the modern law and finance literature is only one example. Among the different fields of law, however, only the private (or civil) law has had this influence, either directly, as the foundation of modern private law, or indirectly, through the modern Civil Codes.[6]

Roman private law did not undergo systematic codification until the beginning of the sixth century AD. During the pre-classical and classical periods, legislated statutes (acts *(leges),* plebeian resolutions *(plebiscita),* or senate resolutions *(senatus consulta)*) played a fairly small role. Rather, the law emanated from the advice of legal experts, the *responsa prudentium*, to the judicature, i.e., to the *praetor* (judge), to the *aediles curules* (senatorial superintendents), and to the governors in the provinces. These magistrates and their jurors, called *tribunales*, usually had no legal training, but appointed jurists into a committee of legal experts, the *consilium*. The appointment as an expert was honorable

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[5] See Schöll's *Legis XII tabularum reliquiae* (1866) for a widely cited reconstruction of the Twelve Tables.

[6] Civil-law codifications replaced the direct application of Roman law in many countries, starting at the end of the 18th century (Kaser, 1980, p, 2). Note that even civil code traditions that are not commonly characterized as having Roman legal origin typically borrow directly from Roman law.

and desired among lawyers, who usually belonged to the aristocratic class (patricians) and also advised plaintiffs and defendants. Based on the experts' opinion, the magistrates would grant actions (*actiones*), defenses (*exceptiones*) and other legal remedies. Those expert opinions shaped the legal system, even if they had no formal legal power. Hence, Roman law textbooks often characterize Roman law as "juristic law" (e.g. Schulz, 1951; Buckland and Stein, 1963). Since legal experts did not discuss abstract concepts but concrete cases of current interest, Roman law developed in step with the legal issues of the day. In fact, Roman-law scholars like Duff (1938) and Kaser (1980) liken Roman law to English law today: largely free of abstract concepts and essentially "case law." This gave the Roman law an enormous degree of flexibility, providing the ability to cope with the transformation of Rome from a rural community to a large empire.

Under the Principate, the emperors' decrees (*constitutiones*) started to be recognized as binding legislation. The emperors, however, imposed little constraint on the autonomous, case-driven legal development. The preexisting body of law continued to evolve in a similar fashion as before.

Systematic codification finally took place under the Byzantine emperor Justinian. Justinian aimed at documenting and codifying the full body of Roman law in the so-called *Corpus Iuris Civilis*. In AD 533 and 534, the main parts of the *Corpus* were issued: the *Institutes* (an introductory textbook), the *Digest*, or *Pandects*, (the core piece, which documents various legal debates), and the *Codex* (imperial constitutions from the Principate). Our knowledge of Roman law stems mostly from the *Corpus Iuris Civilis*.

The case-oriented evolution of Roman law helps us to understand how the creation of a quasi-corporation could occur without formal legislative changes and recognition of legal concepts often considered indispensable, such as limited liability, agency and representation.[7] For example, Roman law never recognized limited liability for private businesses – besides removing the right of a creditor to kill or sell into slavery a debtor if he failed to pay (*lex Poetelia Papiria de nexis*) in 326 BC. Instead, Rome accommodated the demand for limited liability by exploiting the *peculium* of slaves. Slaves were legally "things" and, as such, could not own other things. In practice, however, they were allowed to accumulate earnings and other property, denoted as their *peculium* (allowance). They became the legal owner after manumission, i.e., when granted freedom. To remedy the lack of a business format with limited liability, Romans employed "company slaves" (*exercitores servi communes non volentibus dominis* or *servi communes negotiatores*) as managers and funded them with a *peculium* for business transactions. That

[7] For more details see Malmendier (2002), pp. 212-213.

way, they avoided liability for business conducted by the slaves beyond the funds with which they provided them.[8]

Similarly, Rome never instituted the law of agency. Instead, to meet the increasing demand for binding representation in business matters in Rome's growing economy, the Romans employed the *patria potestas*, i.e., the power of a Roman father over his (adult) children, and the ownership of slaves as a form of agency.[9] The Roman *pater familias* and *dominus* could act through children and slaves, in which case he was liable for their offenses.[10] Slaves managed estates and arranged trading and banking transactions on the master's behalf. Even top managers were typically selected from among slaves, which helps to explain the astonishingly common phenomenon of Romans "placing themselves into slavery." Free men sold themselves into slavery in order to attain a high position in the enterprise of a senatorial house,[11] a striking example of how the Romans achieved modern organizational functions without formal legal reform by expanding the interpretation of existing legal institutions.

### 2.2 Who Were the Publicans?

The *societas publicanorum* owes its creation to Rome's Republican system of government. During its five centuries of existence, the Roman Republic never assembled any sizable bureaucracy. Similar to the ancient democracy in Athens, Rome distrusted the continuity of power embedded in a bureaucratic state machine. Instead, public services were contracted out and public income sources were leased to private entrepreneurs. These private contractors were called "government leaseholders" or publicans (*publicani*). As Ulpian writes in the Digest (*Digesta* 39.4.1.1):

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| *Publicani ... sunt qui publico fruuntur, nam inde nomen habent.* | Publicans … are those who deal with public property; that is where their name comes from. |

And shortly thereafter (*Digesta* 39.4.12.3 [38 ad ed.]):

| | |
|---|---|
| *Publicani autem dicuntur, qui publica vectigalia habent conducta.* | Those are called publicans who conduct the exaction of public taxes. |

[8] Brentano (1929), p. 143; Földi (1996), esp. the summary on p. 211. For a discussion of the exceptions, in which the liability went beyond the *peculium*, see Honsell, Mayer-Maly, and Selb (1987), pp. 378-381.
[9] On the law of agency and its substitutes see Garnsey and Saller (1982), p. 33, and Crook (1967), p. 60. On the same topic in the context of the Roman labor market see Temin (1994b), p. 536.
[10] Taubenschlag (1944), pp. 307 ff., 505 ff.
[11] Ulpian (*Digesta* 28.3.6.5) denotes such slavery as *ad actum gerendum*, i.e., to secure the post of an *actor*, who runs the senatorial household.

Since the Roman senators were not allowed to participate in the government leases, a separate class of entrepreneurs emerged, later often equated with the knights (*equites*).

The business activities of the publicans are described in Badian's classic work titled *Publicans and Sinners* (1983), and in Malmendier (2002).[12] The earliest reports refer to the 5th century BC. Ancient historians such as Dionysius of Halicarnassus and Livy provide accounts of religious and ceremonial services as well as construction jobs contracted out to private entrepreneurs. Another famous example is the feeding of the white geese on the Capitol. The geese received government-sponsored meals since, in 390 BC, their honking had warned the Romans of the attacking Gallic troops.[13] According to Pliny[14], the "geese feeding program" was leased out to the publicans.

Over the course of the Republic, an increasing volume of public works were outsourced, until the publicans were dealing in practically every state department's business (Cunningham, 1898, pp. 157 and 162). The three main areas were:

1. provision of goods and services for the public,
2. utilization of public property, and
3. collection of public revenues.

The key element in the first group of contracts was the provision of supplies to the Roman army.[15] This included the regular supply to fixed and stationary garrisons as well as the less predictable supply demands during wartime. We have evidence of the latter even for the imperial period when the publicans were otherwise in demise. The revenues from these contracts were astonishing; as Badian (1983, p. 29) shows, they were equivalent to the annual pay for 10,000 soldiers (about 1.2m *denarii*) in the case of a supply contract for togas, tunics, and horses in the second century BC (Livy, *Ab urbe condita* 44.16).

The construction, renovation, and maintenance of public facilities were likely the next-largest type of public provision contract. Public buildings included streets, city walls, temples, markets, *porticus*, basilicas, theatres, facilities for the circus games, aqueducts, and public sewers.[16] Private entrepreneurs were also contracted to erect statues.[17]

[12] The 1997 edition of Badian's work (in German) incorporates some newer sources and offers modified interpretations. Older literature includes Kniep (1896); Deloume (1889); and Üródgi (1968).

[13] Livy, *Ab urbe condita* 5.47.4.

[14] Pliny, *Naturalis historia* 10.26.51.

[15] See for example Livy, *Ab urbe condita* 23,48,5-49,4; 25,3,10; and 34,6,13 for the year AD 215; 27,10,13 for AD 209; 44,16,4 for AD 169; Valerius Maximus, *Factorum et dictorum memorabilium* 5,6,8. See on the topic Hill (1952), p. 88-89.

[16] Examples can be found in Cicero, *Secunda in Verrem* 1.49.128 (maintenance of temples); Dionysius of Halicarnassus, *Roman Antiquities* 3.67 (maintenance of public sewers); Livy, *Ab urbe condita* 4.22.7 (construction of the *villa publica*); 5.23.7 (construction of the temple for the Mater Matuta at the Forum Boarium for Iuno Regina on the Aventine hill); 6.32.1 (maintenance of city walls); 24.18.10 (maintenance of temples); 29.37.2 (street repairs; also in 41.27.5); 40.51.3-5 (renovation of markets and theatres).

[17] Cf. Milazzo, Realizzazione delle opere pubbliche, p. 147 ff.

Like the army supplies, building contracts required vast financial resources. Badian (1983, p. 67 f.) suggests that the building contract for the Marcian aqueduct in the middle of the second century BC amounted to 45m *denarii*, which was roughly the entire fortune of the (purportedly) richest millionaire in Rome in the first century, M. Crassus.

Another famous, though smaller task was coinage. The government entrusted private entrepreneurs even with the minting of Roman coins.

The second group of contracts, the utilization of public property, includes grazing on the public domain (*ager publicus*), mining, and fishing in public lakes.

The most (in-)famous contracts where those outsourcing tax collection, especially poll or land taxes from the provincials. Taxes and dues initially played a minor role in ancient Rome. Like the Greek *polis*, Rome had no concept of direct taxes. The peoples conquered outside of Italy paid tributes, but direct personal taxation such as an income tax was deemed unworthy of free men. The state's primary source of income was war booty. The only tax burden on the Roman citizen was the *tributum*, a tribute demanded irregularly to finance soldiers' pay.[18] It was levied only when military ventures had exhausted the state treasury. Even then it was perceived as a loan of the citizens to the state, to be repaid later out of war booty.[19] With the expansion of Rome, the tribute disappeared almost completely,[20] at the expense of the provinces. A steadier stream of tax revenues was imposed only during the Principate. At that time, however, an official fiscal administration took over and excluded the publicans from the collection of the taxes.

Instead, the collection of indirect taxes and tributes on goods and services became a core activity of the publicans. These dues were imposed primarily on non-Romans and non-Roman goods, namely traders arriving at ports, city gates, and market places. Cicero mentions the three most important taxes that were contracted out in *De Imperio Cn. Pompei* 6.15: the port tax (*portorium*), the "tenth" of the harvest of agricultural products including grain (*decuma*), and the grazing fee (*scriptura*). The inheritance tax (*vicesima hereditatium*) was also contracted out but played a subsidiary role.[21]

All three types of contracts were awarded via auctions (*sub hasta*), similar to licenses or spectrum rights today. Livy, *Ab urbe condita* 39.44.5-8, mentions public procurement auctions taking place as early as 200 years BC. The auctions appear to have

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[18] Originally, the *tributum* probably replaced the self-provisioning during military service; Laum (1926), p. 229.

[19] Even voluntary contributions were repaid whenever possible. A famous example is the voluntary contributions of Roman citizens during the Second Punic War (in 210 BC). Livy reports (starting in *Ab urbe condita* 23.48.5) that, after the financial situation improved in 204 BC, the contributions were ex post recognized as loans and repaid in three installments. See Briscoe (1989), p. 75.

[20] Cicero describes the *tributum* in *De officiis* 2.21.74 as an overcome means of public financing.

[21] Cicero complains in his *Epistulae ad Atticum* 2.16.2 that the *vicesima* alone generates too little tax income.

been conducted regularly, with a regular and large audience of entrepreneurs specializing in contracts with the state: Livy, *Ab urbe condita* 24.18.10-11, refers to businessmen in 214 BC who "frequently participated in such auctions" (*frequentes qui hastae huius generis adsueverant*). The Roman *censor* (the registrar and "finance minister") awarded utilization or tax-collection rights to the highest bidder, procurement contracts to the lowest bidder. A *societas publicanorum* was represented in the auction by a *manceps*, normally the most illustrious partner (*manceps princeps inter suos* as Cicero formulates in *Pro Plancio* 13.32 and Pseudo–Asconius*, Divinatio in Caecilium* 33). The auctions took place on the central Roman market place, the *Forum Romanum*, with the exception of a few auctions in the provinces. In *De Lege Agraria contra Rullum* 1.3.7, Cicero writes that the censors can grant tax-collection contracts only in front of the Roman people (*censoribus vectigalia locare nisi in conspectu populi Romani non licet* ), preventing non-competitive allocations to preferred entrepreneurs.

The customary contract term was five years, likely because the censors were originally in office for the period of five years (*lustrum*).[22] The individual contract terms and conditions were laid down in so-called *leges locationum* (or *lex censoria*), a reservoir of fixed contract clauses that, for the most part, could be used for each new contract grant.[23] The contract specified payment schemes, warranties, and legal rights.

The scale of these three types of business activities expanded vastly with the expansion of Rome. While the types of contracts did not change much throughout the Republic, the economic opportunities grew with the addition of new territories. The decline of the Roman Republic and the onset of the Principate, however, brought an end to the success story of the publicans. As discussed in more detail in Section 2.4, the knights (*equites*), and thus many of the publicans, were subject to proscriptions during the last century BC, resulting from power struggles with the senatorial aristocracy.[24] Legal reforms were passed that restricted the business activities of the publicans. First, they were limited to collecting taxes and dues.[25] Then, Augustus transferred the tax collection contracts in Gaul, Asia, and finally in all imperial provinces to a *procurator Augusti*, who was part of his bureaucracy.[26] The Julio-Claudian emperors (AD 14-68) continued to gradually reduce the contracting with private entrepreneurs and, in the 2nd century AD, Trajan (AD

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[22] Mommsen (1877), vol. 2, p. 342 f., speculates that, originally, the franchises were granted *quinto quoque anno*, i.e. every four years, and it was only later that this cycle was extended to five years.
[23] An example is the *Lex Portorii Asiae*, see fn. 29.
[24] According to Appian (*De bello civili* 4.5), 2000 *equestri* were killed; see also the detailed account of the brutality of the proscriptions in Cassius Dio (*Roman History* 47.14). More on this in Ürödgi (1968), col. 1201.
[25] Cimma (1981), p. 99 ff.; Hirschfeld (1963), p. 69 ff.; Rostovtzeff (1902), p. 379 ff.
[26] Marquardt (1884), pp. 301-318; Ürödgi (1968), col. 1200, 1202. A province was called imperial if the emperor appointed the governor, and senatorial if the senate appointed the governor.

98-117) finally limited it to a few specific taxes such as the inheritance tax. The large-scale operations of the publicans reverted to smaller-sized businesses of so-called *conductores* (contractors), similar to their origins in the early Republic.[27]

Concurrent with the demise of the *societas publicanorum,* economic growth slowed down in several industries. One example is the mining industry, which had formerly seen an explosion in output, likely due to technological improvement and its use by the companies of the publicans. As Wilson (2002) reports, the use of the new water-powered mining techniques and the output from various mines shrank significantly in the first century AD, which is after the emperors took over the mines.

The correlation between output and activities of the publicans in other industries is harder to measure. Tax collection by state officials, for example, might have been easier to enforce, even if less efficiently organized. It was also affected by the drastic changes in tax laws mentioned above. The construction industry remained very active, which is not surprising in light of the territorial expansions and the emperors' demand for villas, temples, and palaces. It would be interesting to know whether the cost of production, e.g. for street repairs or army provisions, increased after the demise of the *societas publicanorum*. Unfortunately, such data is hard to procure.

The demise of the *societas publicanorum* also explains why this business format is not discussed much by economic and legal historians. As mentioned above, most of today's knowledge about Roman law stems from the compilation of Roman law under Justinian, the *Corpus Iuris Civilis*, in AD 533-534. The codex contains legal opinions from the classical and post-classical periods (1st to 6th century AD), but not from the pre-classical period. Since it was compiled after the lease-holding companies had disappeared, the jurists cited in the *Corpus Iuris Civilis* refer to the publicans only in the sense of smaller tax collectors. The lack of easily accessible evidence is likely the reason the *societas publicanorum* is relatively unknown in the history of the corporation.[28]

### 2.3 The *Societas Publicanorum* as a Business Corporation

To what extent were the large associations of the publicans "corporations"? From the historical literature and inscriptions,[29] we know that Roman law recognized two types of associations, the *collegium* and the *societas*. The *collegium* was the only incorporated form

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[27] See Pliny, *Epistulae* 7.14; *Panegyricus Traiani* 3.7.7; 39.5.

[28] See Malmendier (2002). In addition, most of the scarce evidence about economic activities in ancient Rome comes from the period of the early Empire; see Temin (2006).

[29] I use classical Roman and Greek literature and inscriptions, in particular the *Monumentum Ephesenum,* an inscription discovered in Ephesus in 1976, which turned out to be the translation of a Latin tax law – the *Lex Portorii Asiae* – from AD 62 (Engelmann-Knibbe, 1989). The nucleus of this law, paragraphs 1-36, originates in the late Republic, 75 or 74 BC, and reveals numerous details about the functioning of the lease-holding companies.

of organization besides the public corporations (such as the *populus Romanus,* i.e. the state, or the *aerarium* and *fiscus*, i.e. the state and imperial treasuries). It was, however, available only to organizations with "public purpose" such as religious and political associations, not including government lease-holding.[30] As a result, government leaseholders had to set up their companies as *societates*, the Roman version of partnerships.

The Roman partnership differs from the modern corporation in many ways: Partners (*socii*) could not limit their liability; the partnership could not exist beyond the death or renunciation of a partner nor in case of legal disputes among the partners; and the firm could not assume rights or obligations separately from its members.[31] Hence, the legal format of the *societas* was evidently unsatisfactory for the large-scale and long-term operations of government leaseholders. The Romans resolved this deficiency by reinterpreting and allowing exceptions to the prevailing legal rules, applicable only to lease-holding companies. Four features differentiate the *societas publicanorum* from the simple *societas*:

1. *Representation*: A single person could contractually bind the firm and assume rights in the name of the firm.[32] The representative with whom the *censor* interacted and who bid for contracts in the public auction was called *manceps*, as described above.
2. *Continuity and Stability*: The firm did not cease to exist if a partner died or left the firm. Moreover, legal disputes among the partners did not necessarily affect the existence of the *societas publicanorum*.[33] Even the departure of the key executive, the *manceps*, did not affect the contractual relationship between the company and the Roman government.[34]
3. *External Financing*: Investors could provide capital and acquire shares (*partes*) without becoming a partner and without being liable for the company's obligations. Several ancient authors refer to the shareholders of the *societates publicanorum* as *participes* or *adfines*.[35] We also know that the shares were traded and had fluctuating prices. For instance, Cicero writes about 'shares that had a very high price at that time.'[36] The statement also implies that the shares could be bought either from another shareholder or directly from the company, suggesting secondary offerings. Traders met on the *Forum Romanum*, supposedly near the Temple of Castor.[37]

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[30] Duff (1938), pp. 95 ff.
[31] See, for example, Kaser (1980), pp. 225-227.
[32] *Digesta* 3.4.1.1.
[33] The special legal action was called *actio pro socio manente societate*, see *Digesta* 17.2.65.15.
[34] We can infer this from paragraphs 46 and 54 of the *Lex Portorii Asiae*.
[35] E. g. Cicero, *Pro lege Manila* 2.6, *Pro C. Rabiro Postumo* 2.4; Plautus, *Trinummus* 330-331; Livy, *Ab urbe condita* 43.16.2. The meaning of *adfines* is vaguer; they are never mentioned in Cicero's work.
[36] Cicero, *In P. Vatinium testem interrogatio* 12.29. Badian (1983), p. 102, points out that the high stock prices Cicero mentions are consistent with a price reduction for tax collection rights in the same year.
[37] See Plautus, *Curculio*, 78, and the references in Chancellor (1999), p. 4.

4. *Rights and Obligations*. According to *Digesta* 47.2.31.2 the company of tax collectors could file actions, e.g., against fraud or embezzlement. The company could also own property and inherit items.[38]

The *societas publicanorum* had thus assumed the most important features of the modern corporation. In addition, other sources describe it almost directly as a separate legal entity. For example, Cicero reports about a *societas publicanorum* that "consists of other *societates* [*publicanorum*]",[39] and thus assumes the role of a natural *persona*. Gaius counts the *societas publicanorum* among the organizations with a *corpus* (*Digesta* 3.4.1.1). And *Digesta* 46.1.22 states that the *societas publicanorum* can "act like a person," which is exactly the modern characterization of corporations as legal *personae*.

The modified features of the *societas publicanorum* had a far-reaching effect on its access to capital. Cicero mentions that stock ownership in the *societates publicanorum* was widespread in the Roman population. According to Polybius, "almost every citizen" invested in government leases by the 2nd century BC.[40] A famous statement by Cato indicates that investors aimed for diversified portfolios. Cato advises that, if people wished to obtain money for shipping business, they should form a large association and when the association had 50 members and as many ships, he would take one share in the company.[41] These quotes from Cicero, Polybius and Plutarch illustrate not only the flows and functioning of the Roman capital market, but also that such transactions were a matter of course. Plutarch, for example, quotes Cato with the expectation that his readers in the early Roman Empire would understand his boasting. In other words, educated Romans knew about the possibility of buying shares in the *societates publicanorum*.

In summary, the *societates publicanorum* functioned much like modern corporations in terms of their recognition as legal entities and their access to capital markets. This being said, the *societas publicanorum* does not display every feature of a corporation, at least in the sense of a modern definition of legal *persona*. The concept of the legal *persona* was formed slowly over the centuries. Its modern conceptualization started in the 16th century and was the subject of extensive theoretical debates in the 19th century, most prominently between the "Romanist" legal scholar Friedrich Carl von Savigny and the "Germanist" Otto von Gierke.[42] The modern concept imposes much more structure than existed at the time.[43] The Romans were not concerned with such conceptual debates.

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[38] *Digesta* 3.4.1 (*habere res communes*) and *Digesta* 37.1.3.4 (*bonorum possessio*).
[39] Cicero, *Epistulae ad familiares* 13.9.2 ("*constat ex ceteris societatibus*"). Whether this quote truly indicates corporate pyramiding is debated, see Balsdon (1962) for a discussion, esp. p. 136 (with fn. 22).
[40] Polybius, *Historiae* 6.17.3-4.
[41] Plutarch, *Cato Maior* 21.5-6. I thank an anonymous referee for suggesting this quote.
[42] Von Savigny (1840-49), vol. 2; von Gierke (1887).
[43] A more detailed discussion of appropriate classification criteria for the ancient corporation is in Malmendier (2002). See also Duff (1938), e.g. on p. 48. A similar problem in the modern law and finance lit-

Dealing with the rapid transformation of their small closed agricultural economy into an open system that spanned the entire known world, they managed to accommodate the practical needs of their growing economy without revolutionizing the laws that regulated company formats. From a practical, economic perspective, the historical sources paint a compelling picture of the *societas publicanorum* as the first business corporation.

### 2.4 Why Did the Publicans Disappear?

Why did the development of the Roman business corporation come to a halt, ultimately being reversed under the Roman emperors? Why did the *societas publicanorum* disappear instead of becoming the direct predecessor of the modern corporation? These questions take us to the debate on the political economy of legal, financial, and economic development. I showed above that the rise of the publicans is closely related to the development and functioning of the Roman Republic and that its demise was triggered by the disappearance of the Republic and the rise of the emperors. But, while it seems clear that the rise and fall of the *societas publicanorum* reflects Rome's changing political environment and that their rise was in the interest of political elite in an expanding Roman Republic, it is less clear what motivated the emperors to suppress the activities of the *publicani* and the related financial and economic developments.

Traditionally, historians have linked the demise of the publicans to their abuse of power. Already in the 16th century, the legal historian Cujaz described the publicans as "unsurpassed in fraud, avarice, immodesty and audacity."[44] Over the last four centuries, this verdict has changed little. Deloume and Ürödgi portray the publicans as revenue-hungry exploiters.[45] Mommsen relates the rise of a class of profit-oriented entrepreneurs, i.e., of the publicans, to the emerging social tensions in the Roman Republic and, later, the disintegration of the Roman Empire.[46] Cunningham lists "avarice," "extortions," and "greed" as their main business motivation.[47] These historians interpret the elimination of the government lease-holding system and its replacement by public administration as an attempt of the emperors to remedy the shortcomings of contracting and outsourcing that

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erature is implicit comparisons relative to the standards in one country. For example, some countries may (formally or informally) recognize firms as separate entities even if they are not registered – which is, instead, a legal prerequisite on most Western countries. As a result, data collected on firms and different types of firms in different countries may be biased. For instance, most Latin American countries have no concept of "partnerships" and only limited-liability companies are included in the "formal" sector (Klapper and Quesada Delgado, 2007).

[44] Cujaz (1595) characterizes the *publicani* in his commentary on *De publicanis et vectigalibus et commissis* (*Digesta* 39,4) as: *"Hi quam fraude, avaritia, immodestia, audacia superent ceteros homines nemo est qui nesciat…*" (p.54).

[45] Deloume (1889), p. 475-476; Ürödgi (1968), col. 1191-1192.

[46] Mommsen (1916), vol. 2, p. 379-380.

[47] Cunningham (1898), pp. 157 and 165.

relied on monetary incentives. Augustus is hailed for organizing an effective public administration that eliminated the abuses of the publicans.

There are, however, two problems with this traditional view. First, it is unclear how severe the abuses of the publicans were. As Badian (1983) points out, the negative image of the publicans is biased. At times when the system of public contracts was working well, there was little reason for ancient writers to report about it. The excesses and abuses of the publicans, instead, stirred the interest of the ancient historians and led then to a partial treatment of the publicans in the historical literature centuries later.

Second, however grave the abuses were, it is unclear whether the governing political class had any interest in protecting the inhabitants of the provinces from the excesses of the publicans. Attempts to restrain the publicans, such as the legislation of Q. Mucius Scaevola as governor of province Asia in the early first century BC, were rare. Politicians had to overcome resistance among their fellow magistrates in order to enact any such legislation, as Cicero reports in his letters to Atticus (*Epistulae ad Atticum* 6.1). Quite to the contrary, the proconsuls displayed similarly abusive behavior in the provinces they were governing.[48] Thus, the traditional explanation for the demise of the publicans, which invokes the "benevolent paternalism" of the imperial Roman government, lacks plausibility.

It is right, however, that the political change from Republic to Empire fundamentally changed the political-economy framework in which the publicans conducted their business. First, the government became less dependent on the publicans for purely organizational reasons. During the Republic, the short tenure of the consuls and other magisterial offices precluded a stable bureaucracy that could have been in charge of public works. In other words, it was a necessary condition for the change from private leaseholding to public ("re-nationalized") administration that the emperors established a permanent bureaucratic apparatus.[49] At the same time, creating a bureaucracy also allowed the emperors to divert public funds more easily. Under the Principate, as the emperors increasingly re-directed public revenues into their (private) pockets and Rome's public treasury, the *aerarium*, lost its importance.[50] Such diversion was likely easier when the emperors' own employees collected public revenues rather than when the task was publicly auctioned off and performed by private entrepreneurs. In fact, as Badian (1983) points out, earlier during the Republic, Gaius Gracchus started to outsource tax collection

[48] See for example, Cary and Scullard (1975), p. 174.
[49] Heuss, 1960, p. 363; Rostovtzeff, 1957, p. 382.
[50] During the Republic, all state finances went through the *aerarium*. It was the role of the two quaestors to manage the *aerarium*, following the decrees of the Senate. During the Principate, the emperors established an additional treasury, the *fiscus*, with whose usage they bypassed Senate. They also started to nominated the quaestors themselves or replaced them with dependent officials. See Cary and Scullard (1975), p. 379.

in the province of Asia to the publicans in order to *prevent* the governors from diverting public revenues. A reverse argument explains why the emperors wanted to discontinue outsourcing.

Second, the switch from private entrepreneurs to bureaucrats coincided with the gradual increase in taxes under the emperors. As discussed above, taxation was generally viewed as intruding on civil liberty and had caused violent resistance all over the empire.[51] Hence, it is conceivable that enforcement was easier for government employees, i.e., representatives of public sovereignty with public enforcement rights, than for private entrepreneurs. Thus, even if the auction-based outsourcing system had revenue-enhancing features, e.g., identified the lowest bidder for the provisions of services and the highest bidder for revenue rights, these advantages might have been outweighed by the better yield from public collection when taxation increased.

A third reason relates to the tensions between the political and business elites in ancient Rome. The emperors may have had concerns about powerful and large business organizations since the power of the publicans posed a threat to their own imperial position, consistent with arguments in the modern political-economy debate (e. g. Rajan and Zingales, 2003). During the Republic (particularly in times of war) the Roman government repeatedly came to realize its dependence on the services of the publicans. The emperors were in the position to avoid such dependence building up their own bureaucracy.

This latter argument is particularly compelling in light of the increasing political role of the publicans. Early during the Republic, the publicans had shown little interest in political involvement. Becoming a senator and running for political offices would have required them to give up their business, as senators were excluded from trade and commerce.[52] The political involvement of the publicans, however, increased significantly with the Gracchan reform movement. After the murder of his elder brother Tiberius Sempronius Gracchus in AD 133, Gaius Sempronius Gracchus continued to strengthen the position of the *equites*, i.e., the knights, who also ran the *societates publicanorum*. He passed a law (*Lex Iudicaria*) granting them control over the courts that dealt with the senatorial extortions in the provinces. These reforms helped to create an *ordo equester*, i.e., a 'class' of knights with a distinct identity. C. Gracchus also reinforced the economic power of the publicans by allowing them to collect the "tenth" (*decuma*) in Asia, Rome's richest province. (Previously the publicans had only collected small taxes in Asia.) The *equites* and, most prominently among them, the publicans started exerting increasing in-

[51] Laum (1926), p. 218; Meincke (1984), pp. 170-1.

[52] Partly, the apparent lack of political ambition might reflect hidden constraints. While *equites* were formally qualified to enter the Senate, being part of the land-owning aristocracy may have been an informal impediment embedded in social prejudice, as for example argued in Badian (1983).

fluence on state politics – an influence that senators (like Drusus and L. Sulla) and, later, the emperors aimed to undermine.

Finally, another possible reason for the demise of the publicans is lack of credible commitment on the side of the emperors. That is, it might have been impossible to sustain the *societas publicanorum* and the system of government leases even if the emperors had wanted the system to persist. How could the emperors convince entrepreneurs that they would respect property rights and honor obligations towards the publicans? The Roman Republic was a system of checks and balances. But the emperors centralized power and could, in principle, bend law and its enforcement in their favor. Eliminating the large companies was that much easier, given that their status was not enshrined in formal law. Similar accounts of kings and other powerful elites imprisoning or killing their bankers are common throughout history, especially if the elites were knee-deep in debt.

These factors point to the importance of politics, in addition to and sometimes in spite of legal development, for the establishment and longevity of corporations in Rome.

### 2.5 Finance and Growth of Large Firms—With and Without Law

I have shown that the Roman publicans were able to establish large-scale business operations when the governing class supported and, in fact, benefited from those businesses. Laws were reinterpreted to facilitate government lease-holding without fundamental legal reforms. With the transition from a Republican to an imperial government, however, the Roman economic system gradually switched from contracting with private entrepreneurs to large-scale nationalization. Since such financial and economic regression occurred at a time when the legal system reached its height of development, the Roman case allows us to distinguish the influence of political changes from that of legal changes.

The historical case provides one example of corporations functioning without the legal environment we usually presume they need (including legal concepts such as limited liability or private corporation), provided that the government is willing to grant their status and operation. The Roman experience highlights two institutional circumstances that were favorable to the development of the business corporation: First, the state needs to be strong (or rich) enough to generate demand for complex organizational tasks but weak (or frugal) enough that these tasks must be outsourced. Second, the legal system needs to be accommodative enough to extend existing, sanctioned legal forms to solve new organizational problems.

The historical evidence also illustrates that the growth of business organizations in scale and scope tends to generate tensions between the commercial elites who control them and the political elites who control the state. One aspect is that political (and military) needs to centralize may jeopardize the existence of independent business corporations. Another aspect is that the growth of business corporations can result in control over

portions of the economy, leading to significant political influence and control over institutional development – a feedback loop that might result in large and inefficient firms (Morck, Wolfenzon, and Yeung, 2005). One interpretation of the Roman evidence is that the former loop and fear of the latter one explain the demise of the business corporation under the Roman emperors.

Economic historians as well as legal scholars have elaborated on the emergence of financial and economic relationships "even without law" given the right set of institutions (Ellickson, 1991; Greif, 1989). Cull, Davis, Lamoreaux, and Rosenthal (2006), for example, discuss how a wide variety of financial institutions arose across Western Europe and North America to meet the financial needs of small- and medium-size enterprises at times when securities markets and banks focused on financing large enterprises. Temin (2006) points to the growth-promoting qualities of political institutions in Rome, such as granting security to private individuals during the long-lasting *Pax Romana* (27 BC - AD 180). However, the case of the *societas publicanorum* stresses the countervailing force: While it is true that the economic growth of Rome during the late Republic and the early Empire indicates the quality and importance of Roman institutions, it is also true that these institutions persisted only as long as they served the interests of the political elite. They were not stable or resistant enough to protect citizens when political interests reversed.

Interestingly, political and economic interests of the government played a similar role in the later development of the corporation. In the 17th and 18th century, the English East India Company developed from a loose association of merchants, who contributed capital and divided profits one voyage at a time, into a continuous organization.[53] Its incorporation was originally driven by the need to create a body of merchants to which the government could transfer monopolistic trading privileges and which the governmental authority needed to extract economic surplus.[54] As the Company gained in power, it threatened the interests of the British political elite. This conflict led to the centralization of imperial power and expansion of the imperial bureaucracy, the dissolution of the Company, and ultimately the official annexation of the Indian colonies under the crown in the 19th century. By this time, however, the practice of incorporation was established beyond the East India Company and remained in practice in the format of "special incorporation," whereby corporate bodies are created (and dissolved) by explicit acts of the state and provide monopolistic rents to elites in exchange for performing state-like functions. The subsequent rise of democracy in England and the United States led to debates over such elite privileges and the existence of corporations. The function of corporations was

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[53] For a detailed history see, for example, Davis (1973) and Scott (1910-12), vol 2.
[54] Gower (1969), p. 24.

again transformed as a result of political conflict, this time in line with the principles of free entry and competition that inspired the passage of "general incorporation" statutes.

Other examples throughout more recent history provide evidence of the broader point that the state can be critical in fostering economic development, even without systematic changes in legal environment. One example is Mexico's development in the nineteenth century. Historians have related the lack of economic growth in the first half of the nineteenth century to Mexico's political instability and inefficient institutions and the resumption of growth in the second half of the century to the political changes, including of political elite's evolving interest in developing a stable economy, as is evident from the government's active support of railroad construction (Cardenas, 1997) and banking system development in the 1880's (Marichal, 1997).

Even more recent parallels can be found in East Asia, where changes in political interest have affected economic performance without changes in legal framework. One example are the political and social reforms in China during the Great Leap Forward, Mao's attempt to modernize China's agriculture and industries (1958-1960), and the Cultural Revolution, Mao's political campaign to revolutionize Chinese society and eliminate his political rivals (1966-1976). These changes in political interest weakened many central institutions and shifted economic power to local governments.[55] With political support – but without legal reforms – China moved closer to a market economy by decollectivizing agriculture, encouraging private enterprise, and allowing profit sharing in state factories. Later, political elites even pushed for the creation of new forms of business that were exempt from the usual legal restrictions in order to attract foreign investment. On the legal side, however, there were few attempts to establish the type of legal environment that is typically considered central to economic progress, such as secure private-property rights, commercial law (including property and contract law), or an independent court system for adjudication (Montinola, Qian, and Weingast, 1996).

A similar example is Korea. Korea's transformation from depending heavily on foreign aid in 1960 to growing at a rate of over 9 percent between 1965 and 1979 is generally attributed to changes in political economy.[56] Starting in 1962, the Korean government pursued a sequence of aggressive five-year economic development plans, fostering the chemical, steel, and machine industries as well as export-oriented growth. Throughout the 1970s, the scope of governmental intervention expanded, evolving into a government-directed system of economic order.[57] Democratization and the establishment of a free market economy, however, occurred only in the 1980s. The 2008 World Bank business

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[55] Shirk (1993)
[56] Collins (1990)
[57] Cho (1989)

survey of countries' legal environments ranks Korea's investor protection 66th out of 181 countries (China is 84th).[58] This evidence is consistent with the view that political and economic relationships are able to develop despite a dearth in parallel legal developments.[59]

## 3 Determinants of Financial Development and Growth

The rise and fall of the *societas publicanorum* provides a unique setting in which legal and political influences on financial development and growth can be disentangled. In this section, I discuss how this case informs the current debate about finance, growth, law and politics.

### 3.1 The Link Between Financial Development and Growth

The underpinning of the debate about legal and political determinants of financial development and growth is the link between finance and growth. While there is little doubt about the positive correlation between finance and growth (see, e.g., Levine and Zervos, 1998), the question is: Does financial development *cause* economic growth? This question is particularly relevant to the "law versus politics" debate since the legal environment has been found to predict various measures of financial outcomes, but less consistently measures of economic growth. The literature uses several methodologies to establish a causal link: simple *post hoc ergo propter hoc* arguments (King and Levine, 1993), the analysis of regulatory changes that affect financial development but not growth (Jayaratne and Strahan, 1996), horse races between alternative explanations (Beck and Levine, 2002), and firm-level analyses (Demirgüç-Kunt and Maximovic, 1998). Each of these approaches is open to obvious endogeneity concerns and alternative explanations so that additional evidence remains valuable.

In the Roman case, financial development and the rise and fall of the Roman shareholder company coincide with the increasing and then decreasing production in some of the *publicani*'s industries. This correlation does not provide evidence of a causal link. We do observe, however, a practical need for advanced contracting and financial development in order to realize the growth opportunities in the expanding Republic: Without a quasi-corporate organizational form such as the *societas publicanorum* and its improved access to external financing (via traded shares) it would have been hard to undertake large-scale projects such as the construction of streets, public buildings, or tax collection. Financial development appears to have been a precondition for growth.

[58] World Bank Doing Business Survey; CIA World Factbook.
[59] Ginsburg (2000).

The Roman case study also contributes to the debate about the specific channels through which advances in financial contracting can foster productivity. The current literature suggests that financial development leads to growth by channeling financing to growing rather than declining industries (e.g., Wurgler, 2000), to small firms (e.g., Beck, Demirgüç-Kunt and Maksimovic, 2005), and to firms in high need of external financing (see, e.g., Rajan and Zingales, 1998).[60] Here, too, it has been difficult to address endogeneity concerns and to distinguish the proposed channels from correlated determinants.[61] Consider, for example, Rajan and Zingales' (1998) argument for the channel of external financing. They show that sectors in greater need of external finance develop faster in countries with more developed financial markets. "Need of external finance" is calculated as the fraction of capital expenditures not financed internally in the median firm in the corresponding U.S. industry. The analysis is open to the interpretation that sectors with large external financing (in the U.S.) are drivers of economic growth for other reasons; for example, they might be the sectors with the smallest inherent moral hazard problems.

The Roman case study provides an additional piece of evidence for the channel of external financing. The calculations in Section 2.2 indicate the extraordinary magnitude of financing required for the Roman public lease projects. The *societas publicanorum* could issue *partes* (shares) and thus have access to a much larger pool of external financing. Moreover, investors could move their money more easily between different companies, and such investments became wide-spread, as Polybius reports.[62]

### 3.2 The Determinants of Financial Development

The link between finance and growth raises the question of what, in turn, determines financial development. In my analysis of the *societas publicanorum*, the flexibility of Rome's legal system emerges as one important factor in the development of advanced financial contracting arrangements. A second major influence was the interests of the political elites during the Roman Republic and Empire. Much of the current literature revolves exactly around these two determinants: law and politics.

I briefly review the current debate in the literature, emphasizing questions which the historical Roman evidence speaks to. Excellent surveys of the broader literature are, for example, provided by Levine (2005) and Beck and Levine (2005).

[60] A relate literature in macroeconomics also identifies access to external finance as a determinant of long-term growth (e.g., Barro, 1997; Aghion, Howitt, and Mayer-Foulkes, 2005; Bencivenga and Smith, 1993).
[61] Koren and Tenreyro (2009) propose technological diversification as an alternative link.
[62] See fn. 40.

### 3.2.1 Law and Finance

Starting with the seminal papers by La Porta et al. (1997) and (1998), researchers have related financial and economic development to the legal environment of a country. The causal effect of the legal environment, however, is difficult to establish since legal institutions arise endogenously. For example, if a country makes a political choice in favor of banks and then adopts laws that strengthen banks' position as creditors, the resulting correlation between creditor protection and legal environment simply reflects a political choice. La Porta et al. argue that relating financial outcomes to "legal systems" rather than to current laws ameliorates the causality problem. "Legal system" serves as an instrument to isolate the independent effect of legal rules on investor protection since countries have not "chosen" a legal system or, to the extent they have, did not do so on the basis of modern-day investor protection.

La Porta et al. (1998) distinguish four legal systems: British common law, French civil law, German civil law, and Scandinavian civil law.[63] They relate these legal traditions to a core aspect of financial development: investor protection. If the rights of investors are not protected, managers can divert returns into their own pockets, and investors will be unwilling to finance investments in the first place. The authors find higher shareholder protection in common-law than in French civil-law countries. For example, in common-law countries, proxy voting by mail is more common, minority shareholders can more easily challenge major management decisions such as mergers, and lower share capital is required to call an extraordinary meeting. The difference in creditor protection is directionally similar, though not as pronounced.

La Porta et al. (1997) take this evidence one step further and argue that countries with better investor protections have more highly valued and broader capital markets and therefore easier access to external finance. They estimate a 30 percentage point decrease in the ratio of "external capital" (stock market capitalization held by outside shareholders) to GNP associated with a change from common law to any type of civil law, though the effect is insignificant and smaller with some of the control variables used for shareholder protection. The authors also estimate that French civil law is associated with a 12 percentage point lower Debt/GNP ratio than common law. Overall, civil-law systems and French civil law, in particular, emerge as most detrimental to financial development.[64]

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[63] The authors consider only countries with at least five domestic, non-financial, publicly traded firms with no government ownership (no socialist or transition countries): 21 countries with French civil-law tradition, 6 with German civil-law tradition, 4 with Scandinavian civil-law tradition, and 18 common-law countries.

[64] Follow-up research relates investor protection and private property rights to firm valuation (La Porta et al. 2002; Caprio, Laeven, and Levine, 2003), dividends (La Porta et al., 2000), and reinvestment of earnings (Johnson, McMillan, and Woodruff, 2002). Levine (1998, 1999, 2003) and Beck, Levine, and Loayza (2000a, b) link legal-origin induced investor protection to the development of stock markets and financial intermediation.

The Roman evidence presented in this paper cannot contribute to cross-country comparisons of legal systems. But it does speak to the specific channels through which a civil-law system may affect economic outcomes. Two prominent channels, discussed in Beck, Demirgüç-Kunt, and Levine (2003a) and Beck and Levine (2005), are "political structure" and "adaptability." The political-structure argument holds that civil-law countries accord excessive power to the state and constrain property rights. These countries are less likely than common-law countries to maintain politically independent judiciaries, to grant courts jurisdiction in cases involving executive or legislative power, and to extend to courts the power of constitutional review. The adaptability argument holds that the common-law reliance on judicial discretion and case law has allowed it to adapt more easily to changing commercial and financial needs. Judges are better at adapting to new circumstances because they are more objective than legislators and are shielded from political pressure. The adaptability view also points to the common law's eschewal of rigid guidelines for the presentation of evidence and communication between parties that can otherwise hamper the judicial process. By contrast, civil-law systems have evinced, at least from the time of Napoleon, a mistrust of judges and have tied their hands with formalistic statutes and procedures that cannot easily be adapted to changing needs.

On the surface, the Roman evidence may appear to be consistent with the political-structure argument. When the political elites of Republican Rome aimed to foster the entrepreneurship of the *publicani*, legal rules were interpreted in a flexible way so that the *publicani* could access broad financing. Conversely, when the political elites of the Roman Empire aimed to reverse this development, the *publicani* did not benefit from the legal environment any more. But it is not the case that the emperor interfered with judiciaries or the interpretation of law. To the contrary, Roman civil law, especially (and famously) contract law, evolved into a sophisticated and nuanced, yet practically more viable and less formalistic set of rules under the emperors, who did not interfere with the development of legal opinions (Kaser, 1980). Hence, the Roman evidence confirms the role of political influences on economic development, but not via legal development or the lack of politically independent judiciaries.

The Roman case also provides a counter-example to the common-law/adaptability link. It was precisely the adaptability of Roman civil law that allowed the *publicani* to flourish. Legal rules on the Roman partnership (*societas)* were adapted to meet the economic demands of the growing country and its need for larger companies with greater access to external financing. Hence, the adaptability mechanism to which the growth-friendliness of *common*-law systems is attributed was at work also "at the origin" of civil law.

Of course, civil law "at its (Roman) origin" is different from French or German legal origin in its later incarnations. French civil law assumed its more rigid nature with

the codification under Napoleon (Beck, Demirgüç-Kunt, and Levine, 2003a), and one may presume that the same is true for Roman law and the codification under Justinian. That is, one may suspect that, while the Roman law was flexible pre-Justinian, it changed its nature after being codified at the beginning of the sixth century AD. This is, however, not the case. The core piece of the *Corpus Iuris Civilis*, the *Digesta*, presents long discussions of the legal opinions of various jurists, who do not always agree. These discussions typically revolve around case variations that reflect changing commercial circumstances. The discussion of the Roman partnership (*societas*) in the 17th book illustrates precisely this nature of legal evolution. The jurist Pomponius points out that a partnership dissolves if one of the partners dies, with the exception of the *societas vectigalium*, i.e., the type of *societas publicanorum* occupied with tax collection that survived into the Principate.[65] Pomponius then discusses whether this exception applies if the deceased partner founded the business or otherwise played a "core role" in running it.[66] The fact that Pomponius questions the applicability of more relaxed partnership rules in this case illustrates that the adaptation of Roman law was driven by the practical demands of large-scale businesses that were distinct from the involvement of individual "partners." Where this characterization did not apply, as it became more common among the smaller *societates publicanorum* under the Principate, the adapted legal rules did not apply either. This discussion exemplifies how the *Corpus Iuris Civilis* preserved the case-based and adaptable nature of legal rules. Thus, the Roman evidence suggests caution in characterizing civil-law systems as less adaptable to changing circumstances, with or without codification.

This insight resonates with the findings in other historical cases. Comparative historical studies have highlighted that civil-law institutions have better served the organizational needs of an evolving commercial society than common-law institutions at various points in history. Lamoreaux and Rosenthal (2005), for example, argue that French law has historically allowed more flexible forms of liability and ownership than the U.S. common law. Before 1867, businesses in France could not form limited-liability corporations. However, they could form a *société en commandite*, which consisted of general partners, who managed the firm and had unlimited liability for its obligations, and special partners, whose liability was limited to their investments and who had no managerial role. These organizations issued shares as well. The authors argue that the *commandite* provided a sufficient substitute for the corporation. In the mid-19th century, when stock quotations were only available for a few firms in New York and around fifty in Boston, over 200 firms were traded in Paris. No such flexible partnership arrangements were

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[65] *Digesta* 17.2.59 *pr*.: *Adeo morte socii solvitur societas … in societate vectigalium nihilo minus manet societas et post mortem alicuius, …*

[66] Later in *Digesta* 17.2.59 pr.: *quid enim, si is mortuus sit, propter cuius operam maxime societas coita sit aut sine quo societas administrari non possit?*

available in the United States. New York's 1822 enable statute for the *commandite* required partners to declare the amount of their individual investments, precluding the trade of shares, and courts often interpreted these arrangements as exposing limited partners to unlimited liability. Unlike American law, French law also allowed ordinary partnerships to alter the terms of partners' liability and managerial authority through contract. The lack of flexibility in American corporate law was particularly onerous to minority shareholders, who could neither force dissolution of the company nor exit easily by selling their shares. Reliable protection for outside investors arrived only with the creation of the Securities and Exchange Commission in the 1930s. The authors conclude that the opposition of a flexible, judge-led common law tradition to an ossified, code-besotted civil law does not stand up to historical scrutiny. While it may characterize the legal environments today, it did not do so at previous points in history, which casts doubt on the perceived fundamental differences between the two legal systems.

The work by Lamoreaux and Rosenthal also emphasizes an aspect of the legal environment that has received less attention in the law and finance literature but is central to our Roman-law analysis: company law and, in particular, the role of "company formats". Does it matter whether firms can incorporate? Does the company format affect access to external finance? External financing is likely to be easier if the liability of investors for company debt can be limited and if the company's existence does not depend on the presence of its members (partners).

To date there is little empirical evidence analyzing the role of legal and organizational formats. Ayyagari, DemirgüçKunt, and Maksimovic (*forthcoming*) provide suggestive evidence from the 1999 World Business Environment Survey that firm-level characteristics, such as legal organization and ownership structure, affect property rights protection as much as institutional factors, such as the legal system. More attention has been paid to the role of limited liability in a number of historical studies. Analyzing the introduction of limited liability in California in 1931, Weinstein (2003) finds little impact on corporations or shareholders. There is no evidence of any surge in the number of firms changing their names to take advantage of limited liability status (as required under the statute) and no dramatic increase in the number of corporations filing income tax returns or in the share values of California's seven NYSE-listed firms after the change.[67]

In contrast, Forbes (1986) argues that the introduction of limited liability in Massachusetts in 1830 had economic benefits. He plots the ratio of incorporations in Massachusetts to those in New York against time (1811-42), where the incorporations in New

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[67] In a related paper (Weinstein, 2005), the author also analyzes the position of interest groups (California Bankers Association, California State Bar Committee, San Francisco Association of Credit Men) and is unable to find strong support for or opposition against the change.

York are meant to capture time-variant influences on incorporations in Massachusetts other than the introduction of limited liability. The ratio increases after 1829 (though it plunges after 1839 and shows wide fluctuations before and after). The author estimates a modest $8,290-a-year increase in investment as a result of limited liability. Naturally, the mere time-series identification, based on a single event, leaves ample room for alternative explanations, including other simultaneous legal changes and economic development. Forbes interprets these results as indicating the value of limited liability as a legal innovation. In his conclusions, he speculates why limited liability might have arisen late in England (in 1855), though it was the earliest country to industrialize. The author suggests that large incumbent firms opposed the introduction of limited liability as a means of deterring future entrants, especially in the shipping, cotton, woolens, iron, and steel industries, which were all key sectors in the early part of the Industrial Revolution.[68]

In comparison, the example of the Roman corporation draws a more nuanced picture of the role of limited liability and other legal features. On the one hand, it supports the view that it does not matter whether company laws formally allow for private corporations. Roman businessmen achieved a corporation-type organization in practice, even without the formal legal implementation. On the other hand, it *does* matter whether quasi-corporations were enforced in practice. In the Roman case, large businesses withered when government interests opposed them and prevented their corporate organization.[69]

The Roman evidence also suggests that company features other than limited liability are equally important, such as the ability of the firm to exist independently of specific "partners" or its ability to carry legal right and obligations. Without those it would be hard to issue and trade shares and to involve larger fractions of the population in the financing of these companies. Hansmann, Kraakman, and Squire (2006) emphasize precisely this point. The authors argue that, rather than limited liability, which protects an investor against claims of the company's creditors, protection of the *company* against creditors of the *owners* have been the crucial step in the legal development of the firm.

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[68] An alternative interpretation (e.g. Harris, 2000) is that the delayed arrival of limited liability reflects political tensions between the landed gentry and the rising merchant and manufacturing classes. The aristocratic judges showed little interest in fostering the economic development of the nouveau riche. Thus, the Lord Chancellor in the 1830's held that it was the Crown's prerogative to grant limited liability. Both interpretations agree in their emphasis on the instrumentalization of and opposition against limited liability.

[69] The importance of enforcement is more general. As Easterbrook and Fischel (1991) argue, the explanatory power of legal rules is limited if firms can opt out of the default regulation. From this point of view, it is puzzling that legal rules have *any* significant impact on economic outcomes. Gennaioli (2006), however, points out that "opting out" is a true option only if the alternative private contracts are permitted and enforced by courts. He develops a model illustrating the role of the "contractual channel" via which law can affect economic development.

The above concerns about the adaptability of legal systems and role of legal institutions such as limited liability relates to a broader debate about the classification of legal systems in the law and finance literature. For example, are South Africa and Israel really common-law countries despite the significant civil-law elements in their laws? More broadly, do the four legal systems distinguish significantly different legal environments?

In using this four-part classification scheme, La Porta et al. refer to the classification of commercial legal systems in David and Brierley (1985), a division also utilized by Merryman (1985). However, David and Brierley propose a tripartite division of Western law into Romano-Germanic, common-law, and socialist families, with Romano-Germanic including Latin, Germanic, Scandinavian, Latin American, etc. Merryman classifies French and German law as two of many subclasses of civil law.[70] Similarly, Dawson (1960)'s often cited history of the transformation from lay to professional judges in England, France, and Germany treats these countries as regions with distinct histories and institutions but does not suggest that they are exhaustive typologies of legal systems. Thus, the fourfold typology in the law and finance literature does exist in prior legal literature, but is by no means universally accepted.

The Roman case illustrates one reason why it is hard to identify groups of legal systems with distinct features. Legal systems are in flux and their character changes over time. How can the "origin" cement the character of a modern legal system if the character of the origin itself changed over time from adaptable and case-based to non-adaptable? The case-based evolution of Roman law, in particular, casts doubts on a sharp distinction between Roman and other legal origins. The more rigid character of codified legal systems seems to be the result of later developments, not present at "its origin."

Another, deeper classification concern is that legal origin is not causally relevant for financial development. Omitted variable candidates abound. For example, common law is perfectly correlated with England as the colonizing power and with the Anglican Communion as the dominant Protestant denomination. Beck and Levine (2005) show that the relationship of legal origins to financial development is robust to controlling for many candidate explanations, such as religion, competitiveness of the election process, national openness, and resource endowments. Berkowitz et al. (2003) argue, however, that legal origin matters little in comparison to a country's receptiveness to the legal system at the time it was introduced. They distinguish between "origin countries" like England and France, in which legal systems developed organically over time, "receptive transplants" such as Japan, which selectively borrowed from foreign systems while preserving the

[70] According to Merryman, French law and German law are rather unrepresentative of the civil-law tradition – in the case of France because of its revolutionary roots, and in the case of Germany because of the large influence German scholars exerted on their jurisprudence.

characteristics of their own systems, and “unreceptive transplants,” in which foreign legal codes were adopted wholesale and without the support of domestic constituencies.[71]

The Roman evidence points to one other alternative explanation, political influences, to which I devote the next Subsection.

### 3.2.2 Politics and Finance

A more recent strand of literature on politics and finance re-evaluates the role of legal relative to political institutions. One part of this literature argues that legal and economic institutions are endogenous to the political environment. According to this view, political elites produce institutional outcomes, including the legal system, which then affect economic outcomes. Another part of the literature takes the role of politics one step further and proposes that politics directly determines long-term growth – with or without law.

The first type of politics and finance literature does not necessarily refute that the legal environment has a causal impact on finance and growth. It merely points out that the finance- and growth-friendliness of a legal system depends on the interest of the political elites. For example, Rajan and Zingales (2003) argue, in the spirit of North (1981), that, if the interests of the elites coincide with financial and economic development, they will implement legal and other institutions that foster development. If their interests and desire to cement their political power demand institutions that are unfavorable to growth, they will implement those. The authors observe that civil-law countries such as Belgium, France, Germany and Sweden had more developed financial systems than common-law countries such as the United States prior to 1913, but when financial development slowed after 1913, the decline was stronger in the civil-law countries. The authors argue that these empirical patterns correlate with the industrial and financial elites opposing open access to financing and, hence, financial liberalization.[72]

Related papers investigate the role of relevant stakeholders and their political weight in the context of investor protection. Roe (1994) details how competing political groups have, through history, cumulatively determined the present form of American corporate governance. Pagano and Volpin (2006), point out that good shareholder protection triggers stock market participation of a broader portion of voters, who then favor even more shareholder protection. Perotti and van Thadden (2006) focus on the identity

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[71] The distinction between origin countries and transplants also helps to address the concern that a time-invariant instrument like legal origin cannot explain the historical evolution of financial systems, i.e., the concern that if legal institutions and legal origin are to be reliable predictors of financial development then they ought to be such a predictor not only today but throughout history. Distinguishing between “origin” and “transplant” and by receptiveness, all of which can vary over time, legal systems are better able to explain economic outcomes (Glaeser and Shleifer, 2002).

[72] Sylla (2006) questions the empirical methodology in Rajan and Zingales (2003). For example, the claim of a “great reversal” of financial development in the US relative to other countries from pre-1913 to post-1913 is based on calculations that do not account for bond markets in the US but do so for other countries.

of the majority shareholder. For example, if the financial participation of the middle class is low, the median voter will choose low investor protection and favor bank or family control. If, instead, middle-class participation is high, the median voter will choose equity control and investor protection. According to Pagano and Volpin (2001), similar dynamics are at play in a variety of policy arenas, including corporate control, public ownership of enterprise, bankruptcy, and securities market regulation. Haber et al. (2003) use the case of Mexico from 1876-1929 to explain how economic systems can remain stable in spite of considerable political instability when governments selectively enforce property rights for those property holders who are integrated into the political system.

The second strand of this literature takes the role of politics one step further. Rather than analyzing the interaction of politics and law, this research asks whether politics determines financial development and long-term growth directly – with or without law. A starting point is the research by Engerman and Sokoloff (1997, 2002). The authors identify the tendency to maintain initial conditions of wealth and political power as a key determinant of cross-country differences in economic growth between North America and other New World economies. They argue that colonies in which initial endowments, climate, and soil conditions favored the farming of crops that were most efficiently produced on large farms (such as sugar, coffee, or tobacco) evolved into an unequal distribution of endowments between a small elite that was rich and politically powerful and a large population of poor workers and slaves without political say. Colonies in which climate and soil favored, instead, mixed farming and provided for little economies of scale evolved into societies with more equality. Acemoglu, Johnson, Robinson (2001) further this argument by using an empirical link between European settler mortality, employed as an instrument for current political inequality in institutions, and economic growth. An even starker example of the direct role of politics is Roe's (2006) analysis of military invasions in the twentieth century. Roe points out that the winners in military conflicts during the past century overwhelmingly had common-law legal systems, but that their financial development may reflect their military success (or lack of war devastation) rather than their legal origin.

Even more directly, Acemoglu and Johnson (2005) question how central legal institutions are to the economic and financial development of a country compared to political institutions. They argue that a weak legal environment (weak protection of contractual rights) can be remedied in private agreements and via reputation, but weak political institutions (weak property protections) cannot. Empirically, they relate various measures of financial and economic development to indices of political and legal institutions. They instrument for political institutions using settler mortality and population density. The basic argument for the first instrument is that, in areas with high initial mortality, colonial

powers established extractive political institutions to expropriate wealth from their colonies, while in areas with low mortality they created settlements with greater property protection.[73] The logic of the second instrument, population density at the time of colonization, is that, in more densely settled societies, colonizers set up institutions to extract resources through slave or bonded labor.[74] The instrument for legal institutions is legal origin, based on the argument in La Porta et al. (1997, 1998) that common-law systems provide more robust contract protections than civil-law systems. The authors argue that this classification is particularly appropriate in the context of colonies since colonized countries neither chose their colonizer nor chose to retain their colonizer's legal system because of its contract law. (A caveat is the potential lack of receptiveness in colonies, as discussed above.) The authors find that, after controlling for political institutions (constraints on the executive, protection against government expropriation, private property protection), none of the proxies for legal institutions (legal formalism, procedural complexity, and the number of procedures necessary to resolve a court case of unpaid commercial debt) predict growth. The coefficient estimate on the political-institutions variable "executive constraint," instead, is significant and large: a one-standard deviation increase in executive constraint doubles GDP. The authors conclude that legal institutions do not have a big impact when they are not backed by political power. And, vice versa, even dysfunctional legal institutions suffice to support economic and financial growth as long as political institutions provide security against expropriation by elites and government.

Beck, Demirgüç-Kunt, and Levine (2003b) undertake a similar horse race between legal and political institutions. They relate cross-country differences in financial systems to law and politics, using French Legal Origin of the colonizer and Setter Mortality as the main independent variables and various measures of financial development as outcome variables, controlling for a wide range of other possible determinants such as

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[73] In Acemoglu, Johnson, Robinson (2001), the authors check the validity of settler mortality as an instrument for contemporary institutions. They show the robustness of their results to the inclusion of a large range of proxies for other determinants of contemporary per-capita income that might be correlated with settler mortality in particular geographic and climatic factors (as traditionally suggested, e.g., by Diamond, Sachs, Montesquieu).

[74] Here, some further investigation whether or not the instrument is uncorrelated with determinants of per capita income like disease would be valuable, especially in light of Jared Diamond's (1997) thesis on the link between the early development of populations and the transmission of human disease: hunter-gatherer populations were typically less dense and had less proximity to animals than settled agricultural societies. As a result, they did not develop immunities to human diseases transmitted from domesticated animals—like measles and smallpox—and were virtually exterminated by such diseases after encountering Europeans. Diamond's argument suggests that the transmission of diseases strongly affected the development of different societies. Some of the robustness checks in the related Acemoglu et al. (2002) paper indirectly address this concern (e.g. dropping the Americas, where the arrival of Europeans after prompted a dramatic demographic collapse or excluding populations with extremely low population in 1500).

continent (Latin America and Africa), main religion (Catholicism, Islam, or Other), the percentage of years since 1776 that a country has been independent, and ethnic fractionalization (the probability that two randomly selected individuals in a country will not speak the same language). Similarly to the findings in Acemoglu et al., legal origin typically does not predict private credit or stock market development after including the controls.

Overall, our example of the Roman corporation illustrates precisely the view put forward in this second strand of literature: politics can determine financial and economic outcomes, regardless of the state of the legal development. We observe advanced financial contracting at a time when Roman private law was little developed. And we observe regress at a time when the legal development reaches its height but political interest reverses. Moreover, the Roman case shows that the effect of the political environment does not need to work through changes in the law, i.e., the mechanism suggested in the first strand of the literature. Roman Private Law appears to have followed an independent path of increasing legal sophistication and reduction in transaction costs of legal dealings. A precondition for politics to have a direct impact, irrespective of the formal changes in law, was the flexibility of Roman law discussed above: Roman law as practiced adapted to a changing economic environment without the need for formal legal reform.

## 4 Conclusions

The ongoing debate about the determinants of finance and growth focuses on two main candidates: law and politics. The evidence about the rise and fall of the Roman shareholder company provides historical support for the view that political institutions can dominate the role of other institutions. The right set of political interests allowed a type of shareholder company, the *societas publicanorum*, to flourish under the Republic, even though the legal environment was not (yet) sophisticated enough to allow for the concept of a private corporation. And, conversely, when the Roman legal system reached its height in the classical period, but government interests changed, the *societas publicanorum* vanished.

At the same time, the evolution of such a sophisticated business format in an ancient economy may never have been possible without Rome's advanced legal environment. And, vice versa, it is possible that the decline in financial contracting and economic scope of markets during the Roman Empire would not have been observed in a different legal environment. A legal environment similar to a modern common-law system might have provided better protection against the State, consistent with the view that civil-law systems are weaker in their protection of property rights. In other words, a horse race between the two determinants is unlikely to be a useful exercise. Today as in ancient Rome, legal determinants cannot be separated from the political environment and the political

developments are preconditioned by the legal framework. The Roman case as well as the recent politics and finance literature *do* clarify, however, that politics cannot be left out of the analysis.

A second insight regards the modern-day empirical proxies for the legal environment. The Roman-law analysis implies that relevant legal determinants are not captured in formally coded law or even the non-codified law that is enforced in the courts. In practice, economic agents may find ways to accommodate their practical needs, such as better access to external financing or limited liability, even if the recognized law appears to stand in the way. Thus, when trying to measure the transaction costs that an institutional environment (including its laws) imposes on economic transactions, it is most sensible to investigate how a specific demand (e.g. for equity financing) is solved in practice – akin in spirit to the law and finance approach of asking lawyers how a legal problem is solved in practice. A number of historical papers on limited liability and corporations point in this direction. It would be desirable to see attempts to quantify such effects today.

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# Table 1. Choronology of Rome

| Period | | *BC* | Political Events | Economic/Cultural Developments |
|---|---|---|---|---|
| MONARCHY | | 700 – 500 | | Expansion in the western Mediterranean. Growing urban settlements with temples, fortifications, and other communal facilities |
| | | c.625 | Foundation of the city of Rome (fictional date: 753) | |
| | | 600 – 575 | | Usage of Greek coinage |
| EARLY REPUBLIC | | 500 – 470 | Foundation of the Republic: monarchy replaced with time-limited magistracy | |
| | | 486 | | Earliest recorded agrarian laws, regulating the disposition of public land |
| | | c.450 | Codificiation of law in the Twelve Tables | |
| | | 393 | | All Roman citizens are alloted 7 iugera (4.38 acres) of land north of the city, leading to the creation of a class of working landowners. |
| | | 367 / 366 | *Lex Licinia Sextia* restores consulship and appointment of plebeians to consular positions. | *Lex Licinia Sextia* limits the amount of land a citizen can own. Not enforced in practice. |
| | | 367 – 287 | Class struggle between the two orders, plebeians and patricians; shapes the constitution of the classical Republic and forms a ruling class (*nobilitas*) consisting of both plebeians and patricians. | |
| | | 366 | | First Roman coinage |
| | | 347 | | Century-long legal interest rate of 8 1/3 percent falls by half |
| | | 342 | | Prohibition of interest (*lex Genucia*) |
| | | 340 – 290 | | Earliest centuriations (formal divisions of colonies into square blocks), indicating the appropriation and exploitation of conquered territories. |
| | | 300 – 200 | | Earliest *villas*, indicating large scale slave plantation agriculture. |
| | | 287 | Resolutions of the plebeian assembly (*plebiscites*) are made binding by the *lex Hortensia*; end of the conflict of the orders. | |
| | | 269 | | Discontiunation of old coinage and implementation of denarial system. Opening of first mint. |
| | | 264/3 – 241 | First Punic War against Carthage | Beginning of tribute system. Annual tribute to Rome amounts to about one million bushels of wheat. |
| | | 264 – 227 | Rome expands in the western Mediterranean; establishes first overseas provinces (Sicily and Sardinia) under military governors (praetors). | |
| | | 218 – 201 | Second Punic War | |
| | | 202 | Defeat of Hannibal at Zama in North Africa | |
| | | 200 – 150 | | Slaves constitute a significant proportion of the population and an important input to production, especially in *villas*. Wine production and exports begin to flourish |
| | | 200 | | Development of Roman roads and increasing use of mules as packsaddle animals and to pull carts. |
| | | 197 | Creation of two Roman provinces on the Iberian peninsula | |
| | | 194 | | Revitalization of the harbor of Puteoli; becomes Rome's main sea harbor |
| | | 193 – 174 | | Construction of giant warehouse *Porticus Aemilia* and new marketplaces in Rome. |
| | | 167 | | Direct taxation of Roman citizens abolished. Polybius (historian) arrives in Rome. |
| | | 154 – 133 | Crisis of Roman control: wars in Spain | Rome's domination in the central and western Mediterranean stimulates exchange and encourages mass production for export. |
| LATE REPUBLIC | | 146 | Destruction of Carthage and Corinth. Carthaginian North Africa, Macedonia, and parts of Greece become Roman provinces | |
| | | 143 – 71 | Era of slave rebellions | |
| | *BC 133. Tribunate of Tiberius Gracchus* | 133 – 129 | Creation of the Roman province of Asia | |
| | | 131 | | Census records 318,823 adult males as Roman citizens. |
| | *BC 123. Tribunate of Gaius Gracchus* | 122 | | Introduction of subsidized monthly sales of grain in Rome |
| | | 91 – 88 | Social War. All Italians are granted Roman citizenship | |
| | | 88 | Sulla's first march on Rome. Militarization of internal conflicts | |
| | | 86 | | Legislation imposes debt forgiveness of 75 percent |
| | | 82 / 81 | Sulla's dictatorship leads to the reorganization of the state. | |
| | *BC 70. Consulship of Pompey and Crassus* | 70 | Repeal of the main points of the Sullan system. | |
| | *BC 63. Consulship of Cicero* | 63 | Suppression of the Catilinarian conspiracy | Wars cause civil and economic disturbances. Export ban of silver and gold from Italy. |
| | *BC 59. Consulship of Caesar* | 60 | First Triumvirate between Caesar, Crassus, and Pompey | Abolishment of harbor custom dues in all the ports of Italy (but not the provicences) to support Italian industries and resolve dissatisfaction with collection practices. Later reintroduced by Caesar. |

| Period | Era | Date | Event | Other |
|---|---|---|---|---|
| | | 49 | Caesar crosses the river Rubicon, against Roman law, marking the start of civil war (*alea iacta est* : "the die is cast" [acc. to Sueton]). | Legislation imposes debt forgiveness of 25 percent. |
| | | 46 – 44 | Caesar's dictatorship; reforms and monarchical reorganization | |
| | | 15 Mar 44 | Murder of Caesar | |
| | | 43 | Second Triumvirate between Antony, Lepidus and Octaviar | |
| | | Oct / Nov 42 | Victory of the triumvirs over the Caesar's murderers Cassius and Brutus at Philippi | |
| | | 33 / 32 | Break between Antony and Octavian | |
| | | 28 | | Census records 4,063,000 adult males as Roman citizens. |
| | | 27 BC – AD 6 | Creation of a professional army and provision for veterans | |
| | | 27 BC – AD 9 | Consolidation of the boundaries of the Roman Empire | Beginning of period of Roman peace, *Pax Romana* |
| *BC 19. Reign of Augustus* | PRINCIPATE | 19 / 18 | Reform legislation of Augustus | |
| | | 12 | Augustus assumes highest religious position (*pontifex maximus* ) | |
| | | ***AD*** | | |
| *AD 14 - 68. Julio-Claudian Dynasty* | | 43 | Claudius conquers Britain. | |
| | | 64 | Fire in Rome for nine days. Persecution of Christians | |
| *AD 69 - 96. Flavian Dynasty* | | 79 | Eruption of Vesuvius. Destruction of Pompeii and Herculaneum | |
| *AD 96 - 192. Age of the Antonines* | | 100 – 110 | | Tacitus writes *Histories* and *Annals* . |
| | | 165 | | Estimated Population of Roman Empire between 60 and 70 millior |
| | | 180 | | End of period of Roman peace, *Pax Romana* |
| *AD 192 - 235. Severan Dynasty* | | 192 – 235 | Militarization of the Empire, increasing barbarian pressure at the frontiers, decline of the Roman world. | |
| | | 235 – 284 | Military anarchy, sequence of nearly twenty Emperors | |
| | | 250 | | Epidemic of plague |
| | | 284 – 306 | Diocletian re-establishes central power and founds the Tetrarchy (Roman Empire ruled as four separate parts) | |
| *AD 306 - 337. Reign of Constantine the Great* | COLLAPSE | 312 | Constantine wins battle of Milvian Bridge under the sign of the Cross: Christianity declared official state religion | |
| | | 395 | Division of the Empire between the sons of Theodosius | |
| *AD 378 - 395. Reign of Theodosius the Great* | | 407 – 410 | Increasing uprisings and external raids in Britain leads to gradual Roamn withdrawal during Empire's decline. | |
| | | 476 | End of Roman Empire in the West | |
| *AD 572 - 565. Reign of Justinian, Eastern Emperor* | LATE ROME | 533 | | *Digest* of Roman Law is compiled. |
| | | 1453 | Conquest of Constantinople by the Turks; end of the Eastern Roman Empire | |


Sources:
[1] Bringmann, Klaus. A History of the Roman Republic. 2007. p. 322-325. ISBN 0-7456-3371-4
[2] Boardman, John; Jasper Griffin and Oswyn Murray. The Oxford Illustrated History of the Roman World. 1986. p. 424-443. ISBN 0-19-285426-4
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# GENERAL CORPORATION LAWS: HISTORY AND ECONOMICS

DAVID MCBRIDE*

"Where there is no bread, there is no Law; where there is no Law, there is no bread."[1]

"[T]wo intellectual inventions of the Renaissance, double-entry bookkeeping and the corporation, proved vital to the development of European civilization in the New World . . . ."[2]

## I

## INTRODUCTION

The symbiosis of law and business is often noted, less often truly appreciated—until either law or economic growth is absent—and much debated. The relationship of corporate law to national economics is real, appreciated, and being hotly debated on this sixtieth anniversary of the Model Business Corporation Act (MBCA). The financial crises, scandals, and economic losses of the first decade of the twenty-first century have caused many to question the efficacy of state corporate laws—like the MBCA and the Delaware General Corporation Law—and advocate fundamental change, deemed to be "reform" of those laws.[3]

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1. BENJAMIN M. FRIEDMAN, THE MORAL CONSEQUENCES OF ECONOMIC GROWTH 325 (2006) (citing RABBI ELEAZAR BEN AZARIAH, CHAPTERS OF THE FATHERS).

2. JOHN STEELE GORDON, AN EMPIRE OF WEALTH: THE EPIC HISTORY OF AMERICAN ECONOMIC POWER 9 (2004).

3. The recently enacted Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) [hereinafter Dodd-Frank Act] contains several provisions that treat corporate governance, including most prominently authorization for the SEC to adopt a "proxy access" system, Dodd-Frank Act § 971, and "say on pay" and other executive compensation provisions. Dodd-Frank Act §§ 951–957. For differing views on proxy access, compare Lucian A. Bebchuk & Scott Hirst, *Private Ordering and the Proxy Access Debate*, 65 BUS. LAW. 329 (2010), with Joseph A. Grundfest, *The SEC's Proposed Proxy Access Rules: Politics, Economics, and the Law*, 65 BUS. LAW. 361 (2010).

There are important and legitimate questions being raised about corporate law and governance.[4] But much of the debate has centered on the appropriate level of government to address the subject—whether the law should be the domain of the states, the federal government, international bodies, or some combination of all of these. This article will leave those arguments aside, for they have been better addressed by others.[5] Rather, this article will briefly address three questions: (1) what are the purposes of the corporate law (or other entity law), as reflected by the history of such organizations and how well have those laws fulfilled those purposes; (2) what economic phenomena have contributed to the success or failure of those laws; and (3) what are the implications of these economic observations for corporate and entity law?

## II

## THE HISTORY, PURPOSE, AND SUCCESS OF THE CORPORATE FORM

Within the past 150 years, non-governmental corporations have become the principal social institution by which business and economic activity has been conducted—whether for-profit, not-for-profit, or for charitable purposes. It was not always so:

> The word [corporation] refers to any association of individuals bound together into a *corpus*, a body sharing a common purpose in a common name. In the past, that purpose had usually been communal or religious; boroughs, guilds, monasteries, and bishoprics were the earliest European manifestations of the corporate form. They all owed their existence, and the privileges stemming from a corporate charter, to an act of a sovereign authority. It was assumed, as it is still in nonprofit corporations, that the corporate body earned its charter by serving the public good. The same thinking applied in the chartering of joint-stock companies in the age of exploration and colonization.[6]

Before the Civil War in the United States, the corporate charter generally was perceived as a privilege granted only by a special act of the legislature for

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4. *See generally* Brian R. Cheffins, *Did Corporate Governance "Fail" During the 2008 Stock Market Meltdown? The Case of the S&P 500*, 65 BUS. LAW. 1 (2009); Frank H. Easterbrook, *The Race for the Bottom in Corporate Governance*, 95 VA. L. REV. 685 (2009); JOSEPH E. STIGLITZ, FREEFALL: AMERICA, FREE MARKETS, AND THE SINKING OF THE WORLD ECONOMY 151–55 (2010); RICHARD A. POSNER, A FAILURE OF CAPITALISM: THE CRISIS OF '08 AND THE DESCENT INTO DEPRESSION 97–99 (2009).

5. *See generally* Leo E. Strine, Jr., *Breaking the Corporate Governance Logjam in Washington: Some Constructive Thoughts on a Responsible Path Forward,* 63 BUS. LAW. 1079 (2008); Sean J. Griffith & Myron T. Steele, *On Corporate Law Federalism: Threatening the Thaumatrope*, 61 BUS. LAW. 1 (2005); William B. Chandler III & Leo E. Strine, Jr., *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, 152 U. PA. L. REV. 953 (2003); Renee M. Jones, *Rethinking Corporate Federalism in the Era of Corporate Reform,* 29 J. CORP. L. 625 (2004); Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588 (2003); David A. Skeel, Jr., *Icarus and American Corporate Regulation*, 61 BUS. LAW. 155 (2005); Lawrence A. Hamermesh, *The Policy Foundations of Delaware Corporate Law*, 106 COLUM. L. REV. 1749 (2006); Marcel Kahan & Edward Rock, *Symbiotic Federalism and the Structure of Corporate Law*, 58 VAND. L. REV. 1573 (2005).

6. ALAN TRACHTENBERG, THE INCORPORATION OF AMERICA: CULTURE AND SOCIETY IN THE GILDED AGE 5–6 (1982).

purposes deemed to be in the public interest.[7] Incorporation was not yet deemed a right available on application by any private enterprise: "The earliest charters were thus bestowed on insurance companies, commercial banks, canal, dock, and highway companies . . . ."[8] These corporations were not exclusively profit-seeking associations, but were quasi-public agencies of the state, oftentimes "mixed enterprises" in which public funds were invested with private funds for needed internal improvements to transportation facilities, such as highways and canals.[9]

The situation began to change with the economic growth, both in Europe and in the United States, during the nineteenth century, and, in the case of the United States, particularly during the period from the Civil War to the First World War (1860 through 1914). In the eighteenth and early nineteenth centuries, the American economy was characterized by individually and family-owned enterprises.[10] In the entire colonial period, only seven companies were incorporated in the British North American colonies.[11] In just the last four years of the eighteenth century, however, 335 businesses incorporated in the new United States.[12] "Organizations with more than a hundred employees were a rarity. By the time of the Civil War, however, several railroads were employing thousands, and industrial companies were growing as well."[13] In 1811, New York became the first state with a general incorporation statute, but it was available only to corporations manufacturing textiles, glass, metals, and paint. The earliest legislations permitting formation of corporations for any lawful, specified purpose were adopted by Connecticut in 1837 and Iowa in 1846.[14]

The corporate form had numerous advantages over non-corporate forms. The most critical was the doctrine of limited liability. Beginning with the railroads in the mid-1800s and accelerating after the Civil War, it became necessary to raise large sums of capital for growing enterprises. The pooling of small investments by numerous investors became an important means of raising those funds, but investors would not be willing to make small investments in enterprises they would not control, if doing so exposed them to unlimited liability for the debts of the enterprise. The limited liability of stockholders was critical, not only to the development of the corporation, but also to the economic development of Europe and the United States.[15] Other advantages of the corporate form included the ability to utilize "modern" management techniques, which were being developed during the late nineteenth and early

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7. *Id.* at 6.
8. *Id.*
9. *Id.*
10. GORDON, *supra* note 2, at 228.
11. *Id.*
12. *Id.* at 228–29.
13. *Id.* at 228.
14. MODEL BUS. CORP. ACT § 3.01 (2008).
15. *See* GORDON, *supra* note 2, at 9–11, 228–29.

twentieth centuries by professional managers who were not owners of the businesses,[16] perpetual existence, and the ability to merge.[17] The corporate form also was utilized as a means to restrain competition and coordinate vertical and horizontal integration in many industries.[18]

The most significant disadvantage of the corporate form is the well-known separation of ownership from operating control of the business.[19] This created the classic problem of management operating the entity for its personal benefit and gave rise to the imposition of fiduciary duties. This problem would pose the most significant threat to the efficacy of the corporate form because trust is so essential to the maintenance of all forms of cooperative human activity. The separation of management from ownership also gave rise to a need for better accounting, as stockholders wanted timely information with which to evaluate management, and management was tempted to use accounting to make its performance appear better.[20] Beginning in the 1880s, "[t]he big Wall Street banks, which were becoming ever more powerful, and the New York Stock Exchange increasingly required companies that . . . wanted to be listed on the exchange to conform to what would come to be called 'generally accepted accounting principles' and to have their books certified by" a newly-created profession—the certified public accountant, first legislatively recognized in New York in 1896.[21]

By the end of the nineteenth century, the laws governing incorporation had evolved to respond to the needs of the economy and the objectives of the business and financial worlds. No longer a privilege, incorporation became a right available to the exuberant businesspersons and financiers of the era. In essence, the corporation had evolved from a specialized entity, created for the particular ends of the "sovereign," to an entity created to facilitate new and ever evolving forms of organization needed by the economy.[22] However, under either structure, the corporation was designed for the purpose of facilitating common action, not restraining or prohibiting it. Not surprisingly, the laws that evolved to facilitate this form increasingly evidenced the characteristic of being "empowering" statutes, not regulatory statutes.[23] The essential caveats to this empowerment were the maintenance of trust, reflected in the fiduciary duties

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16. *See* TRACHTENBERG, *supra* note 6, at 83–86.

17. GORDON, *supra* note 2, at 229.

18. TRACHTENBERG, *supra* note 6, at 83–86.

19. *See* GORDON, *supra* note 2, at 229–30.

20. *Id.* at 230.

21. *Id.* at 231–32.

22. By the end of the nineteenth century, the laws treating the corporate form had "converged" in providing five basic features that characterized the corporate form: (1) full legal personality, including the ability to contract; (2) limited liability for owners and managers; (3) shared ownership by investors of capital; (4) delegated management; and (5) transferable shares. Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 439–40 (2001).

23. *See* MODEL BUS. CORP. ACT § 3.01 (2008).

imposed by the law, and the need for stockholders to be informed about the financial affairs of the corporation.

From this history, it is evident that the legal entity known as the corporation had become the favored form of organization for larger businesses, and that larger businesses were becoming a greater percentage of the economy.[24] This phenomenon leads to several conclusions. First, the essential purpose of a corporation—or any other form of legal entity—is to facilitate collective action by individuals. It allows various persons to make varying contributions to the collective effort. Second, the expansion of the corporate form, from governmental to quasi-governmental to private enterprise, evidences the success of this form of organization and its consequent proliferation. The creation of new types of legal entities has continued this proliferation.[25] Third, while some may question the benefits of growth or the allocation of its benefits among groups within society, it would seem no one could reasonably question the success of the corporate form in promoting growth and economic innovation.[26]

## III

## FACTORS FOR SUCCESS AND FAILURE

There are a host of reasons for the economic success of corporations, most of which are not directly tied to the law by which corporations are formed, but

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24. By 1904, "about three hundred industrial corporations had won control over more than two fifths of all manufacturing in the country, affecting the operations of about four fifths of the nation's industries." TRACHTENBERG, *supra* note 6, at 4.

25. During the past decade, the limited liability company (LLC) has become the favored form of business organization, except with respect to publicly-traded entities, where the corporation remains the favored legal entity. *See generally* Rodney D. Chrisman, *LLCs Are the New King of the Hill: An Empirical Study of the Number of New LLCs, Corporations, and LPs Formed in the United States Between 2004-2007 and How LLCs Were Taxed for Tax Years 2002-2006*, 15 FORDHAM J. CORP. & FIN. L. 459 (2010).

26. *See generally* GORDON, *supra* note 2; FRIEDMAN, *supra* note 1; DANIEL YERGIN & JOSEPH STANISLAW, THE COMMANDING HEIGHTS: THE BATTLE FOR THE WORLD ECONOMY (2002). The rate at which human economic production has grown has skyrocketed in the past 250 years. According to Berkeley economist, J. Bradford Long, per person gross domestic product (GDP) in a hunter-gatherer society of 15,000 years ago was approximately ninety dollars, increasing to $150 in the economy of the ancient Greeks in 1000 B.C. and to $180 in 1750. However, subsequent to 1750, there has been a thirty-seven-fold increase in GDP per person to $6,600, with the wealthiest societies producing well above that level. It took 99.4% of economic history to reach the wealth levels of hunter-gatherers, 0.59% of that history to double that level by 1750, and then just 0.01% of that history for global wealth levels to reach present levels. Over ninety-seven percent of humanity's wealth was created in just the last 0.1% of our history. ERIC BEINHOCKER, THE ORIGIN OF WEALTH: EVOLUTION, COMPLEXITY AND THE RADICAL REMAKING OF ECONOMICS 9–11 (2006). As described by economic historian, David Landes, "the Englishman of 1750 was closer in material things to Caeser's legionnaires than to his own great-grand-children." DAVID S. LANDES, THE UNBOUND PROMETHEUS: TECHNOLOGICAL CHANGE AND INDUSTRIAL DEVELOPMENT IN WESTERN EUROPE FROM 1750 TO THE PRESENT 5 (1969). This period of incredible growth obviously was driven by the industrial revolution and technological advances, but many of those developments were facilitated by and utilized by corporations.

rather, are a product of the strengths and weaknesses of the individuals who participate in or contribute to the enterprise and the social, market, and governmental environment in which they operate. But this article will focus upon several aspects of economic theory that seem important to the success of the corporate form or any form of organization.

To understand how and why the corporate laws may have contributed to the incredible growth of the past 250 years—and to understand how they may continue to do so in the future—an understanding of how and why that growth occurred is helpful. In *The Origin of Wealth: Evolution, Complexity and the Radical Remaking of Economics*, Eric Beinhocker[27] offers a survey and synthesis for the layperson of recent developments in economic theory that provides some explanation for this economic history.[28] He argues that:

> [W]ealth creation is the product of a simple, but profoundly powerful, three-step formula—differentiate, select and amplify—the formula of evolution . . . . Evolution is an *algorithm*; it is an all-purpose formula for innovation, a formula that, through its special brand of trial and error, creates new designs and solves difficult problems.[29]

The biological evolution described by Darwin—which involves differentiation by genetic mutation, natural selection, and amplification by genetic inheritance—is a type of evolution, but DNA is not the only arena in which evolution operates.[30] Biological and economic systems are subclasses of a more general and universal class of evolutionary systems, and researchers

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27. Eric Beinhocker's bio reads as follows:

> Eric Beinhocker is a senior fellow at the McKinsey Global Institute (MGI), McKinsey & Company's economics research arm, where he leads research on economic, management, and public policy issues. He was previously a partner at McKinsey and a leader in its Strategy Practice. His career has bridged both the business and academic worlds. He has been a software CEO, a venture capitalist, and an executive director of the Corporate Executive Board; at McKinsey he has served clients in a broad range of industries, including telecoms, computing, pharmaceuticals, and aerospace. He has also held research appointments at the Harvard Business School and the MIT Sloan School and has been a visiting scholar at the Santa Fe Institute. He is a graduate of Dartmouth College and the MIT Sloan School where he was the Henry Ford II Scholar.

MCKINSEY GLOBAL INST., http://www.mckinsey.com/mgi/perspective/biography/eric.asp (last visited Nov. 8, 2010).

28. BEINHOCKER, *supra* note 26.

29. *Id.* at 11–12. Others have argued that "unguided evolutionary process may, or may not, lead to economic efficiency. Unfortunately, natural selection does not necessarily choose the firms (or institutions) that are the best for the long run. One of the main criticisms of financial markets is that they have become *increasingly* shortsighted." STIGLITZ, *supra* note 4, at 273. Beinhocker, however, does not advocate for an *unguided* evolutionary process. As noted below, Beinhocker believes that the government may play an important role in establishing the environment in which evolutionary processes operate—either by setting goals or by setting constraints.

30. *See* BEINHOCKER, *supra* note 26, at 192. Beinhocker describes an algorithm as "a recipe that takes some set of inputs (for example, flour, eggs, sugar, butter), mechanically works them through some process (for example, stir together well, bake at 350°F or 175°C for fifteen minutes), and, if the instructions are followed, reliably produces some set of outputs (for example, cookies)." Beinhocker defines substrates as "the material or information on which the algorithm acts," and argues that "evolution is an algorithm that is substrate neutral. It takes information about the designs of things and mindlessly grinds that information through a process." *Id.*

believe that there are general laws of evolutionary systems.[31] Beinhocker notes Daniel Dennett's assertion that "evolution [is] a general-purpose algorithm for creating 'design without a designer.'"[32]

Evolution creates or discovers designs through a process of trial and error—a variety of candidate designs are created and tried out in the environment; the successful designs are retained and replicated.[33] An evolutionary process results in the emergence of greater structure and complexity over time, as evolution builds on the successes of the past to create novel designs for the future.[34] As the world changes, so too do the designs change and adapt.[35]

As Beinhocker explains, "[t]he notion that the economy is an evolutionary system is a radical idea, especially because it directly contradicts much of the standard theory in economics developed over the past one hundred years."[36] Since the late nineteenth century, the organizing paradigm of economics has been that the economy is an *equilibrium system*, essentially a system at rest.[37] That economic paradigm was borrowed from another field of science: Newtonian physics.[38] But while physics has moved far beyond the Newtonian universe, economics has not.[39] The new paradigm in physics—as well as other areas of science—is complex systems.[40] Those are systems of many dynamically interacting parts, in which the micro-level interactions of the parts or particles lead to the emergence of macro-level patterns of behavior or emergent characteristics not observed at the micro level.[41] When the parts or particles of the system have the ability to process information and adapt to their environment—Beinhocker refers to such parts or particles as agents—the resulting system is known as a "complex adaptive system."[42] Evolutionary

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31. *Id.* at 12 (citing JOHN H. HOLLAND, ADAPTION IN NATURAL AND ARTIFICIAL SYSTEMS (1992); L.D. WHITLEY, FOUNDATIONS OF GENETIC ALGORITHMS (1993); MELANIE MITCHELL, AN INTRODUCTION TO GENETIC ALGORITHMS (1996); L.F. LANDWEBER & E. WINFREE, EVOLUTION AS COMPUTATION (2002); J.P. CRUTCHFIELD & P. SCHUSTER, EVOLUTIONARY DYNAMICS: EXPLORING THE INTERPLAY OF SELECTION, ACCIDENT, NEUTRALITY, AND FUNCTION (2003)).

32. *Id.* at 13 (citing DANIEL C. DENNETT, DARWIN'S DANGEROUS IDEA 28–34, 48–60 (1995); RICHARD DAWKINS, THE BLIND WATCHMAKER (1986)). Beinhocker's description of evolution borrows heavily from the work of Daniel Dennett, an evolutionary theorist and director of the Center for Cognitive Studies at Tufts University, and from Richard Dawkins, the Oxford evolutionary theorist.

33. *Id.* at 14.

34. *Id.*

35. *Id.*

36. *Id.* at 16. Beinhocker notes that viewing the economy as an evolutionary system is "radical" when compared to traditional economic theory, but it is not new. In fact, Darwin's concept of evolution was sparked by Robert Malthus's economic writings, and, during the late nineteenth and early twentieth centuries, economists Thorstein Veblen, Alfred Marshall, Joseph Schumpter, and Friedrich Hayek examined the relationship between economics and evolutionary theory. *Id.* at 16–17.

37. *Id.* at 17.

38. *See id.*

39. *See id.* at 18.

40. *Id.*

41. *Id.*

42. *Id.*

systems are merely one type of complex adaptive system, and some social scientists have wondered whether economies might be another such system.[43] The study of economic systems as complex adaptive systems or evolutionary systems has created new schools of economic thought, known as "complexity economics" or "evolutionary economics."[44]

The economic evolution described by Beinhocker "is not a single process, but rather the result of three interlinked processes."[45] The first of these linked processes is the evolution of physical technology, such as bronze-making techniques, steam engines, and microchips.[46] The second process is the evolution of social technologies, or "ways of organizing people to do things," such as the rule of law, money, joint-stock companies, and venture capital.[47] The two are equally important, and "coevolve with each other."[48] An example is that the invention of the spinning frame (physical) made it economical to organize cloth-making in large factories (social), which, in turn, promoted development of water power, steam, and electricity (physical).[49] Finally, before the innovations of physical technologies and social technologies have an impact on the world, businesses must be formed to provide the goods and services created by these technologies to a marketplace. "Businesses are themselves a form of design," integrating "strategy, organizational structure, management processes, culture, and a host of other factors."[50]

These three evolutionary processes: physical technology, social technology, and business organization interact and coevolve. What emerges is a complex adaptive system that has three key characteristics: (1) many dynamically interacting parts, (2) the parts have the ability to adapt to changes around them, and (3) micro-level interactions of parts or particles lead to the emergence of macro-level patterns of behavior different from the micro patterns that underlie the system.[51] Perhaps most significantly, this complex adaptive system is not a system designed from the "top-down," but rather emerges from the "bottom-up."[52] The existing global economy is just such a complex adaptive system, "orders of magnitude more complex than any other physical or social structure ever built by humankind."[53]

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43. *Id.* at 18–19.

44. *Id.* at 19. *See also* Ulrich Witt, *Evolutionary Economics*, *in* THE NEW PALGRAVE DICTIONARY OF ECONOMICS (Steven N. Durlauf & Lawrence E. Blume eds., 2008).

45. BEINHOCKER, *supra* note 26, at 15.

46. *Id.*

47. *Id.*

48. *Id.* at 15–16. Beinhocker borrows these concepts from the evolutionary economist Richard Nelson of Columbia University. *See* RICHARD R. NELSON & SIDNEY G. WINTER, AN EVOLUTIONARY THEORY OF ECONOMIC CHANGE (1982); RICHARD R. NELSON, THE SOURCES OF ECONOMIC GROWTH (1996).

49. BEINHOCKER, *supra* note 26, at 16.

50. *Id.*

51. *Id.* at 18.

52. *Id.* at 18–19.

53. *Id.* at 6.

But lest this all sound entirely too mechanistic, there is another aspect of the process, and it involves that greatest of mysteries—human nature. Human nature is an inevitable ingredient in the evolution of these designs; it is a critical factor in their success or failure.[54] These evolutionary processes are all driven—at least in part—by human efforts to seek new and better ways of meeting our needs or desires. Beinhocker asks what spurs these efforts, and here is his answer:

> The answer lies in the magic of non-zero-sum games . . . . [In] zero-sum games . . . one person's gain is another person's loss . . . . [In] non-zero-sum games . . . both people can be made better off by cooperating. Cooperation in non-zero-sum games has a 1+1=3 logic, whereby if you scratch my back, I'll scratch yours, and together we can do something neither can do as well on our own and we both benefit. Non-zero-sum cooperation is one of those Good Tricks of survival that has been widely employed by biological evolution. Dogs hunt in packs, termites collectively build mounds, fish swim in schools, and, like most primates, members of *Homo sapiens* live in groups.[55]

The search for better ways of organizing ourselves—better social technologies—is the search for forms of organization "that enable people to play and capture the benefits of non-zero-sum games."[56] The success of social organizations in accomplishing this result turns on three critical factors. First, the organization must provide the potential for non-zero-sum payoffs or gains.[57] These gains can be produced by a plethora of means including technological improvements, division of labor, exchanging different contributions (labor from some, capital from others), increasing returns to scale, and risk-sharing.[58]

Second, people must share the benefits to be gained from the organization.[59] For people to have an incentive to cooperate, they must receive some share of the spoils, otherwise, cooperation collapses and the non-zero-sum gains evaporate.[60] It is here that the tension between selfish interest and collective interest is most intense, and this is the sphere in which gains that physical

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54. Subsequent to the financial crisis that began in 2007, classical economic theory and "free-market" theories have come under substantial attack. One of the criticisms is that classical economic theory is based upon unrealistic assumptions about human behavior. In particular, classical economics assumes human agents that use complex deductive calculations to assess self-interest, make no cognitive errors and have no cognitive bias, have complete information, and have no need to learn or adapt. *See generally id.* at 115–19. *See also* STIGLITZ, *supra* note 4, at 249–53; POSNER, *supra* note 4, at 79–116.

55. BEINHOCKER, *supra* note 26, at 265–66. (citing SAMUEL BOWLES, MICROECONOMICS: BEHAVIOR, INSTITUTIONS AND EVOLUTION (2004); HERBERT GINTIS, GAME THEORY EVOLVING: A PROBLEM-CENTERED INTRODUCTION TO MODELING STRATEGIC INTERACTION (2000); H. PEYTON YOUNG, INDIVIDUAL STRATEGY AND SOCIAL STRUCTURE: THE EVOLUTIONARY THEORY OF INSTITUTIONS (1998); ROBERT ALEXROD, THE COMPLEXITY OF COOPERATION (1997); BRIAN SKYRMS, EVOLUTION OF THE SOCIAL CONTRACT (1996); ROBERT AXELROD, THE EVOLUTION OF COOPERATION (1984) for the centrality of "game theory" to an understanding of the evolution of social norms and institutions). *See also* R. WRIGHT, NON-ZERO: THE LOGIC OF HUMAN DESTINY (2000).

56. BEINHOCKER, *supra* note 26, at 266.

57. *Id.*

58. *Id.* at 266–67.

59. *Id.* at 267.

60. *Id.*

technologies make possible might be lost. There are two characteristics that promote a sharing of gains in a manner that promotes continuing cooperation: trust and communication.[61] Both are critical because the sharing of gains requires trust in the reciprocal nature of the cooperation and communication about how the gains can be maximized and shared.[62] Trust, especially among strangers, is facilitated by the rule of law. But law cannot replace a lack of trust.[63]

Third, the social organization must have a means of dealing with those who "cheat" by seeking to capture the benefits of cooperation without contributing themselves (the "free rider") or by seeking to capture the benefits without sharing those benefits with others who have contributed.[64] Beinhocker notes that "[t]he incentive to cheat means that cooperation is inherently difficult to achieve and potentially unstable even once attained."[65] Psychological research demonstrates that

> the consistent and deep-rooted nature of human cooperative-reciprocity behavior. Evolution has steered us in a direction whereby we are naturally inclined to be cooperative to capture the riches of non-zero-sum games. Nevertheless, it has also equipped us with a sensitivity to cheating, expectations of fairness, and a willingness to mete out punishment to those we believe have crossed the line.[66]

Human history has evidenced the evolution of increasingly complex and sophisticated social structures for addressing these three prerequisites of non-zero-sum interaction.[67] From the family, to tribes, to agricultural settlements, and to nation-states and modern corporations, the trend has been to ever-larger organizations for cooperative activity encompassing greater numbers and wider geography.[68] Prevailing social technology can be decisive of whether a social organization can realize and perpetuate non-zero-sum gains.[69] One study has demonstrated that the most significant factors in the creation of wealth are *not* natural resources, sophisticated physical technology, or competent government.[70] The most important factors are the rule of law, the existence of property rights, a well-organized banking system, economic transparency, a lack of corruption, and other social factors that promote non-zero-sum gains.[71]

The modern corporation is the largest and most complex non-state institution in the world. It was made possible by technologies that allow for communication across vast space and the ability to process substantial amounts

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61. *Id.* at 274.
62. *See id.* at 267–68.
63. *Id.* at 274.
64. *Id.* at 268–70.
65. *Id.* at 268.
66. *Id.* at 269.
67. *See id.* at 270–75.
68. *Id.*
69. *Id.* at 261.
70. *Id.*
71. *Id.*

of information. It integrates a host of social technologies including money, accounting, and limited liability. Some cognitive scientists even believe that such organizations are capable of having emergent, cognitive capabilities that no individual in the organization has and that are greater than the sum of all the people within the organization.[72] Ironically, Beinhocker states that

> [British Petroleum (BP)], with its 103,000 employees in over a hundred countries around the world, is a marvel of human cooperation. The vast majority of its people have never met and never will meet, but are bound together in a web of social structures, norms, protocols, legal structures, and incentives that enable them to work together for a common purpose. If one extends that web of cooperation beyond BP's immediate employees to include its 1.3 million shareholders and thousands of supplier and other partner companies, then the scale of a social structure such as BP becomes even more remarkable.[73]

Yet, BP's oil spill in the Gulf of Mexico during the Spring and Summer of 2010 evidences the ability of such organizations to create massive harm as well as good.

The foregoing analysis is, of necessity, very generalized and surveys developing areas of study and analysis. Nonetheless, this focus upon evolutionary or complexity economic analysis and upon game theory may contribute to a better understanding of the attributes of corporate and entity law that will facilitate reaching societal or collective goals.

## IV

## THE IMPLICATIONS FOR CORPORATE LAW

There are three main conclusions from Beinhocker's survey that may have potential implications for corporate and entity law:

> 1. The creation of wealth—and the accomplishment of any human goals—are a function of evolutionary processes that create differing designs or structures, select for the design that is most fit for the environment in which it operates, and allow for the amplification or replication of that design. Organizational structures are one such design.
>
> 2. Economic systems are complex adaptive systems that were not and cannot be created from the top-down, but evolved from the bottom-up. The systems are far too complex to be managed by any singular source or authority because no one can know how all the parts work together. The parts of the system also are capable of evolving and adapting to meet its defined goals or humans needs.
>
> 3. Social organizations that evolve successfully will be those that promote the realization of non-zero-sum gains. This requires the

72. *Id.* at 275–76. (citing JOHN MICKLETHWAIT & ADRIAN WOOLDRIDGE, THE COMPANY: A SHORT HISTORY OF A REVOLUTIONARY IDEA (2003)).

73. BEINHOCKER, *supra* note 26, at 276.

> intelligence and ingenuity to develop technologies and organizations that create such gains, it requires an allocation of gains in a manner satisfactory to promoting and preserving the cooperation of those needed to realize the gains, and it requires a system to reliably punish those who cheat.

Each of these observations has some significant, if not surprising, implications for the corporate law.

## A. Allowing for Evolution

Legal structures that allow for evolutionary processes are important to the success and survival of any social structure. Freedom to experiment is important to fostering this process. The corporate law should allow the flexibility to develop new social technologies and adapt to change, so long as that flexibility does not sacrifice some equally important value. This characteristic has been part of the empowering philosophy of both the MBCA and the Delaware General Corporation Law.[74] With respect to many of the ongoing debates about what form of corporate governance is most advantageous, evolutionary theory suggests that the participants in corporate organizations ought to have the flexibility to experiment with different structures and resolve those issues for themselves. While the general corporation law contains default structures that operate in the absence of a conscious decision to vary them, the ability to vary those provisions is valuable.[75]

For example, stockholders ought to have the ability to experiment with structures that enhance their ability to exercise some control over the organization. The board-centered structure that is part of both the MBCA and the Delaware General Corporate Law ought to be subject to change and experimentation.[76] The empowering philosophy of these statutes ought to not be

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74. Various theorists have argued that free contracting in a competitive system will promote the general welfare. *See generally* FRANK EASTERBROOK & DANIEL FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1991). This proposition has been applied to competition among states for incorporations. *See generally* ROBERT ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW (1993). *But see* Lucian Bebchuk, Alma Cohen & Allen Ferrell, *Does the Evidence Favor State Competition in Corporate Law?*, 90 CAL. L. REV. 1775, 1778–81 (2002). The financial crisis of the past three years has generated substantial criticism of "efficient market" theory as the method for achieving or measuring the common good. Evolutionary or complexity economics may lead to certain conclusions also supported by efficient market theory, but based upon a different economic analysis. Beinhocker questions efficient market theories based upon traditional economic analysis. BEINHOCKER, *supra* note 26, at 21–75. *See also* STIGLITZ, *supra* note 4, at 239–48, 265–71.

75. For example, there are different models for the structure of corporate boards. The same model may not be the best model at all times for all corporations. Easterbrook, *supra* note 4, at 694–95. The point of evolutionary theory is that no one can determine a priori what is the best model, even for most firms, most of the time. Rather, boards operate as part of a complex adaptive system in which the fitness of the model will be determined by an evolutionary process operating from the ground up.

76. There is a considerable debate over the roles of stockholders and directors. For example, there is a plethora of criticism of stockholder activism, contending that stockholders are conflicted in their goals, short-term oriented, and uninformed. *See, e.g.*, Stephen M. Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L. REV. 601 (2006); Lynn A. Stout, *The Mythical Benefits of*

limited to empowering boards of directors. It also ought to extend to empowering stockholders, so long as other important values are not sacrificed. Similarly, in the longstanding debate between *stockholder* interest and *stakeholder* interest, the corporate law should be flexible enough to allow for experimentation, allowing other interests to be considered, if desired by the participants. In addition, the law ought to allow flexibility when selecting the purposes for which the corporation is created, recognizing that for-profit activities are not the only ends to be served by the corporate form of organization.[77] In essence, evolution will test the fitness of the various and competing theories advanced with respect to corporate governance.

There are limitations on the principle of flexibility and two are worth noting here. As explained below, the fiduciary duty of loyalty applicable to those who manage the assets and property of others is important to maintaining the type of organization that can create non-zero-sum gains. Experimentation that would jeopardize the existence and enforcement of those duties should be carefully examined. If game theory is correct, forms of social organizations that undermine trust are inherently dysfunctional in the long run. In addition, forms of organization that limit communication between corporate constituencies—especially between stockholders, managers, and directors—operate to hinder the realization of non-zero-sum gains. Experimentation that would jeopardize the ability of stockholders and directors to obtain information about the

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*Shareholder Control*, 93 VA. L. REV. 789 (2007); Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561 (2006); Jill E. Fisch, *Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy*, 31 J. CORP. L. 637 (2006). Others argue that stockholder activism is associated with better long-term performance of the corporation. *See, e.g.*, George W. Dent, Jr., *The Essential Unity of Shareholders and the Myth of Investor Short-Termism*, 35 DEL. J. CORP. L. 97 (2010) (exhaustively reviewing the literature critical of stockholder activism and the literature demonstrating the benefits of stockholder activism); Easterbrook, *supra* note 4, at 695 (citing Harold Demsetz & Kenneth Lehm, *The Structure of Corporate Ownership: Causes and Consequences*, 93 J. POL. ECON. 1155, 1161 (1985) (arguing that corporations in which individual investors or small groups of investors own large blocks of stock perform better because the owners are good monitors)).

77. The financial crisis of the past three years—and especially the government assistance provided to publicly-held corporations—has posed a fundamental challenge to the prevailing theories of corporate structure and purpose. Those events have challenged the assumption that the costs of the failure of corporate governance are only borne by the participants in creating, managing, and owning those entities. If corporate governance was a causative factor in the financial crisis—a point that is hotly debated—then that failure imposed tremendous "external costs" on persons other than directors, managers, and stockholders. STIGLITZ, *supra* note 4, at 15–19; POSNER, *supra* note 4, at 106–08, 114–15. In light of those costs and the resulting rescue efforts, it is not surprising that profound questions are being raised about the ultimate purposes to be served by the creation and operation of business entities. Of the six dominant theories of corporate governance, four are premised on long-term profit maximization for stockholders as the primary, if not exclusive, objective of the corporate enterprise, while two of the theories allow for the consideration of the interest of other constituencies or broader societal interests. J.W. Verret, *Treasury Inc.: How the Bailout Reshapes Corporate Theory and Practice*, 27 YALE J. ON REG. 283, 315–26 (2010). One commentator has proposed that "shareholder primacy"—profit maximization for the enterprise and stockholders—be a default setting that would give way in the case of an emergency, such as the financial crisis of 2008. *See generally* Robert J. Rhee, *Fiduciary Exemption for Public Necessity: Shareholder Profit, Public Good, and the Hobson's Choice During a National Crisis*, 17 GEO. MASON L. REV. 661 (2010).

corporation—subject to important confidentiality and trade-secret concerns—should be carefully examined.

Another important caveat about flexibility relates to the phenomenon of "too big to fail." Evolutionary processes necessarily involve change that is adaptive and change that is dysfunctional. The theory is that the process will "select" the successes from the failures. But what if the universe of organizations is so limited that the failure of one organization will result in the failure of that entire segment of the economy—or even of the entire economy? Biological evolution produces species that become extinct as well as those that proliferate. The answer to this paradox is not simple, and this issue poses a significant challenge to the utility of evolutionary economics, which presupposes a diversity of business forms on which selection for fitness operates. Nonetheless, freezing innovation and change by selecting a single form of organization deemed to be the "best" seems both hopeless and ill-advised. Changes in the environment in which corporations operate, including the demands and needs they are attempting to meet to be successful, will never end. Corporations must be able to adapt to those changes, and that adaption will involve experimentation. Nonetheless, experimentation that would produce catastrophic failure is not a prescription for accomplishing any societal goals. The options would seem to be limited to: (1) minimize the size of the institutions so that failure would not be systemic, (2) manage the failure so that the resources of the corporation are re-deployed in new organizations without too great a systemic cost to the economy and without engendering "moral hazard," or (3) allow failure with whatever consequences result. As of yet, it does not appear any satisfactory solution has been found.[78] But a respect for innovation and experimentation cannot ignore the size and concentration of economic—as well as governmental—power and resources. That very concentration may stifle the evolutionary process.

## B. The Illusion of Managing a Complex Adaptive System

The global economy undoubtedly is a complex adaptive system. The ability of any lawmakers to control or manage that system is not simply limited by the confines of territorial jurisdiction; it also is limited by the ability to understand the interactions of the multitude of factors affecting its operation. Nonetheless, this conclusion does not mean the system ought to be left to operate in whatever fashion it does. Beinhocker suggests a distinction that may be helpful in this regard:

> Policies that get the government involved in differentiating, selecting, and amplifying [physical or social technologies and business organizations] would be seen as

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78. Title II of the Dodd-Frank Act creates a new insolvency process for large, interconnected companies whose failure creates a significant risk to the financial stability of the United States. However, there is serious question whether the process created by Title II is sufficient to avoid the adverse and systemic damage that supposedly was prevented by the Troubled Asset Relief Program (TARP).

> interfering in economic evolution and have all the problems discussed in the critique of socialist economies . . . . In contrast, policies that *shape the fitness environment*, while leaving . . . selection and amplification [of technologies and business organizations] to market mechanisms, are a different matter.[79]

This prescription would leave the structure and form of business organizations to the evolutionary processes allowed by flexible business organization laws, while allowing government regulation to set the parameters within which such evolutionary and market processes would operate. Any evolutionary process operates within an environment that sets the parameters by which fitness is tested. Cold environments produce certain physical traits that promote survival, and hot environments produce other physical traits that will promote survival. What will succeed depends upon the external environment in which the evolutionary process operates and to which that process must adapt. The law may establish the "environment" in which social organizations, including corporations, operate by defining the outcomes being sought and the constraints in which the evolutionary process will operate. Setting such parameters does not necessarily result in losing the benefits of an evolutionary process. The law may define some of the ends, and the means to reach those ends will be created by an evolutionary process. This paradigm also may reconcile the competing, and sometimes conflicting, roles of federal law (or multinational law) and state entity law. The state law allows for the evolutionary process of design creation and selection; federal or multinational law sets the environment in which that process operates, thereby setting the parameters by which "fitness" will be measured.

### C. Non-zero-sum Games and Fiduciary Duties

Game theory postulates that social organizations that promote trust and communication between cooperating individuals will better realize the gains possible from non-zero-sum interactions and better sustain such interactions. There are a number of differing groups that must cooperate to produce an effective corporation, but the relationships of most concern to the corporate law are those between (1) officers and directors, (2) stockholders and officers and directors, and (3) among stockholders. A lack of trust and communication between these groups will presumably undermine the ability of the corporation to produce gain.

Game theory also postulates that social organizations must have the ability to identify and discipline cheaters—those who do not reciprocate in sharing benefits or those who "free ride" on the work of others. The precise "bargain" that cooperating parties may strike—and consequently the definition of cheating—may vary from organization to organization. According to John Nash (profiled in the popular book and movie, *A Beautiful Mind*), the bargain struck for dividing the gains from non-zero-sum interactions depends upon how much each of the parties values the benefits of the deal, and what alternatives are

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79. BEINHOCKER, *supra* note 26, at 426 (emphasis in original).

available to each of the parties.[80] The trade is made "at the point at which no one has any incentive to change position, given the actions of the other. This point became known as the Nash equilibrium."[81]

The most critical component of the corporate law for establishing and enforcing trust between directors and officers, on the one hand, and stockholders, on the other, is the fiduciary duty of loyalty. The MBCA codifies that duty in sections 8.31 and 8.42—which obligate directors and officers, respectively, to act "in the manner the director reasonably believes to be in the best interests of the corporation"[82]—and in subchapter F, which deals with directors' conflict-of-interest transactions. The Delaware law imposes similar fiduciary duties on directors and officers, although those duties are developed in the case law and not by statutory codification. In both cases, the corporate law does not allow those fiduciary duties to be modified or eliminated, and in the case of the Delaware General Corporation Law, a director's liability for money damages for breaches of such a duty may not be eliminated.[83] The MBCA is somewhat more permissive in allowing directors to be exculpated from monetary liability for breaches of the duty of loyalty.[84]

Game theory suggests that laws that undermine the obligations of the duty of loyalty could undermine trust and, ultimately, the cooperation necessary to any successful social organization. To a certain extent, the parties may be able to contract as to their expectations of each other, thereby establishing trust through the mechanism of compliance with contractual undertakings.[85] However, such contractual arrangements are more effective if they are the result of real bargaining and are truly reciprocal. Contracts of adhesion that are so one-sided as to destroy any sense of reciprocity are more likely to undermine trust rather than promote it.[86]

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80. *Id.* at 267.

81. *Id.* at 267–68 (emphases omitted).

82. MODEL BUS. CORP. ACT §§ 8.31, 8.42 (2008).

83. DEL. CODE ANN. tit. 8, § 102(b)(7) (2001).

84. MODEL BUS. CORP. ACT § 2.02(b)(4) (2008).

85. *See generally* Myron T. Steele, *Freedom of Contract and Default Contractual Duties in Delaware Limited Partnerships and Limited Liability Companies*, 46 AM. BUS. L.J. 221 (2009).

86. The proposition that contractual agreements—either real or hypothetical—may be either the best utilitarian outcome or the fairest outcome is hotly debated. *See, e.g.*, J. William Callison & Allan W. Vestal, *Contractarianism and Its Discontents: Reflections on Unincorporated Business Organization Law Reform*, 42 SUFFOLK U. L. REV. 493 (2009). In order to preserve the long-term cooperation essential to creating non-zero-sum gains, the contract should produce a division of gains deemed by the participants in the exchange as minimally fair. As one commentator has noted, "actual contracts carry moral weight insofar as they realize two ideals—autonomy and reciprocity." MICHAEL J. SANDEL, JUSTICE: WHAT'S THE RIGHT THING TO DO? 144 (2009). The autonomy of the contracting parties may be undermined by their unequal bargaining positions, and the reciprocity of the contract may be undermined by a host of factors including the relative knowledge and judgment of the parties. *See id.* at 144–51. The long-term "fitness" of a purely contractual model for legal entities may depend upon how close or far the contract is from the ideals of autonomy and reciprocity. Two factors in evaluating such matters are the size of the enterprise and the role of the parties in setting the terms of the contract.

The need for trust also is critical in the relationship between officers and directors. Directors are largely dependent upon officers to provide the information necessary for decisions, to present the risks and benefits of various options in an even-handed and candid manner, and to alert the directors as to issues that need to be addressed. Officers determined to control the decisions made by the board can attempt to do so by limiting information, biasing the analysis of options, or failing to alert the board to relevant issues. In such an environment, it is difficult for the board process to be meaningful, and, if the board perceives it is operating in such an environment, the board's relationship either with the officers or the stockholders will be undermined. The relationship with officers will be undermined because the board will no longer trust the information or analysis being provided. The relationship with the stockholders will be undermined because the stockholders may perceive the board as not protecting their interest, but merely "rubber-stamping" the proposals made by management.

Finally, the need for trust among stockholders is an increasing issue. The default—and largely mandated—structure of the corporation is built upon the model of stockholder democracy. Each stockholder largely is dependent upon the judgment of a majority of stockholders as to who should be the directors of the corporation, what fundamental transactions (such as a merger) should be undertaken, and what contractual terms should be specified among interested parties with respect to the corporate arrangement (such as what provisions should be in the certificate of incorporation or the bylaws). This model is premised on the idea that all stockholders—either in the long or short run—seek to maximize the value of the corporation. The use of classes of stock with differing terms and powers can create conflicts among stockholders and render stockholders distrustful of each other and corporate governance. Institutional stockholders may have financial interests that may conflict with the interest of others in maximizing the value of the corporation (such as relationships with the corporation in addition to being a mere stockholder, or competing investments). Finally, new derivative instruments may provide opportunities for stockholders to benefit from the failure or lack of success of the corporation, and those interests may be larger and more significant than the stockholders' interest in the stock.

Game theory also postulates that communication is critical to the ability of a social organization to realize the gains of non-zero-sum interactions. The corporate laws and the federal securities law operate to promote communications in certain respects. The corporate law allows stockholders to obtain corporate books and records for certain purposes relevant to their investment, and the securities laws mandate certain disclosures. Laws that restrict a stockholders' ability to obtain information may undermine communication and, in turn, undermine the effectiveness of corporations. On the other hand, more information is not necessarily better information. The volume of information may be so burdensome that it becomes useless. In the final analysis, the information that officers provide to boards and that boards

provide to stockholders may be more effective by focusing boards and stockholders, respectively, on the important issues and decisions, the salient pros and cons, and the value judgments made in collecting and presenting the information. In addition, volumes of information may render the situation more opaque, not more transparent. Once the information is not trusted, the relationship between the parties may become dysfunctional.

## V

## CONCLUSION

The corporate form was created and succeeded in a much simpler world than the world of today. The increasing size and complexity of corporations and the financial markets has created an increasing number of problems with respect to the most efficient and fair form of organization, maintaining the trust necessary for successfully functioning social organizations and markets, and facilitating the flow of information and communication between interested parties. These challenges may require experimentation with new forms of organization to ascertain by trial and error what forms may best address these issues. If evolutionary economics and game theory are correct, those new forms that best address these issues ought to succeed in the long run. In addition, if evolutionary economics is correct, the law would operate best by allowing experimentation with respect to means, even if the law sets the ends desired and imposes certain constraints. But the law also requires a modesty to acknowledge its own limitations and a realization that the law is an imperfect expression that requires careful and constant reconsideration. The sixtieth anniversary of the MBCA is a perfect occasion for such reconsideration.

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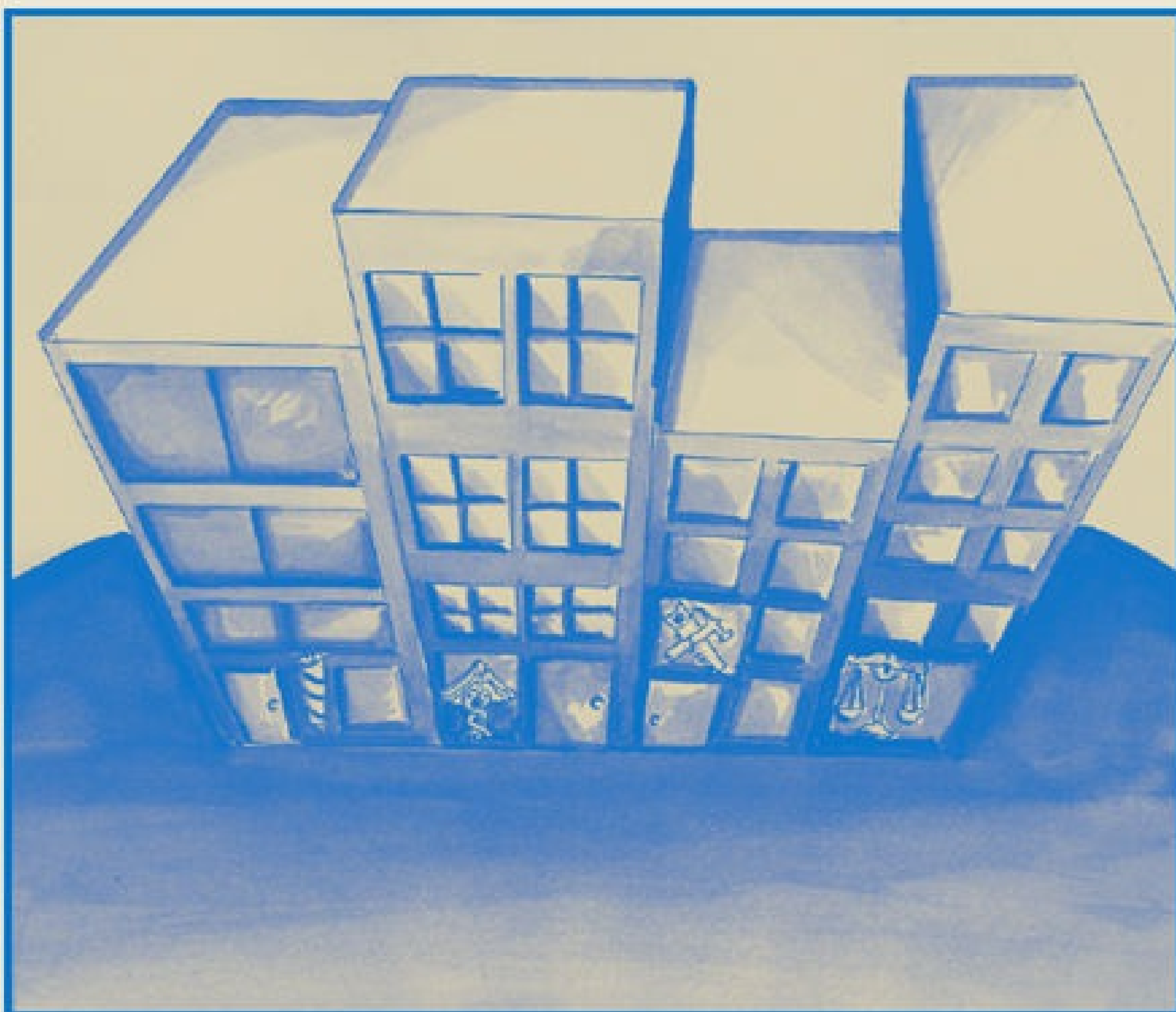
# Agency, Partnerships, and LLCs

Fifth Edition

Daniel S. Kleinberger



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# Agency, Partnerships, and LLCs

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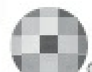
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*To my daughter, Rachael, and her beschert, Andy.*
*To my son, Sam, and his beschert, Zach.*
*And, always, to Carrie, my beschert.*

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# Abbreviations

The following abbreviations are used throughout this book.

## ORGANIZATIONS

ALI = American Law Institute

ULC = the Uniform Law Commission (also known as the National Conference of Commissioners on Uniform State Laws)

## RESTATEMENTS

R.2d = Restatement (Second) of Agency

R.3d = Restatement (Third) of Agency

R.EL = Restatement of the Law of Employment

## UNIFORM ACTS (BY ENTITY TYPE)

### *General Partnership Acts*

UPA (1914) = the first uniform general partnership act, approved in 1914

UPA (1997) = Revised Uniform Partnership Act, the revised general partnership act approved in 1997 (following a series of earlier- approved revisions that began in 1992)

UPA (2013) = the most recent uniform general partnership act (formally named UPA (1997) (Last Amended 2013)), a product of the ULC Harmonization Project[1]

## *Limited Partnership Acts*

ULPA (1916) = the first uniform limited partnership act, approved in 1916

RULPA = the Revised Uniform Limited Partnership Act, first approved in 1976 and substantially revised in 1985

ULPA (2001) = the first stand-alone uniform limited partnership act, approved in 2001, replacing RULPA entirely

ULPA (2013) = the current uniform limited partnership act (formally named ULPA (2001) (Last Amended 2013)), a product of the ULC Harmonization Project

## *Limited Liability Company Acts*

ULLCA (1996) = the first uniform limited liability company act, approved in 1996

ULLCA (2006) = the Revised Uniform Limited Liability Company Act (often abbreviated as Re-ULLCA), approved in 2006

ULLCA (2013) = the current uniform limited liability company act (formally named ULLCA (2006) (Last Amended 2013)), a product of the ULC Harmonization Project

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1. For an explanation of this project, see Note on the ULC Harmonization Project.

# Preface to Fifth Edition

In the seven years between the publication of the first and second editions of this book, the law of unincorporated business associations underwent a revolution. The limited liability company (LLC) became the entity of choice for a myriad of enterprises, and the Revised Uniform Partnership Act (RUPA) revitalized the law of general partnerships. In some states, the annual number of newly formed LLCs grew to exceed the number of newly formed corporations, and RUPA — with its tilt toward entity continuity and its provisions on limited liability partnerships (LLPs) — made the "shielded" general partnership as usable and interesting as an LLC.

In 2002, when the second edition was published, the National Conference of Commissioners on Uniform State Laws (NCCUSL) had just promulgated a new uniform limited partnership act — ULPA (2001) — and the American Law Institute (ALI) was hard at work on the Restatement (Third) of Agency.

In 2008, when the third edition was published, the ALI had just given final approval to the Restatement (Third) of Agency (giving particular attention to agency issues within business entities and other modern organizations), ULPA (2001) was gaining enactments across the country, and NCCUSL had just promulgated a Revised Uniform Limited Liability Company Act.

By 2011, when the fourth edition was published, the prominence of LLCs had become indisputable, and case law — once scant — was legion. For almost all newly formed, closely held businesses, the LLC was the vehicle of choice. The law of partnerships had come to include an alphabet soup of varieties, and the common law of agency continued to significantly influence the analysis of matters ranging from the prosaic to the profound.

In 2017, as this edition is published, business lawyers understand that the LLC is increasingly dominant for business entities whose ownership interests are not publicly traded. Partnerships continue to be important — especially to house law firms — and agency issues and agency law are as ubiquitous as ever.

The matters covered by this book thus continue to have great current importance. However, this "relevance" accounts for only half the benefits of studying these topics. Regardless of how you plan to use your legal training, studying agency law and the law of unincorporated business organizations will help you "think like a lawyer."

That phrase is a cliche and vague, but it is still useful to indicate (i) intellectual discipline and (ii) a specific approach to posing and answering questions. That approach includes a process that I have labeled "categories and consequences"—analyzing situations by defining categories of behavior and then attaching consequences to those categories. This is not the only way in which lawyers understand the world, but it is certainly a fundamental one.

Agency law is an excellent way to learn about categories and consequences. Indeed, the analytic training that comes with understanding agency law's approach to issues rivals the analytic training available in confronting the Rule Against Perpetuities. Fortunately, mastering agency law is less traumatic.

The analytic benefits of studying partnership law come from several sources: applying the categories and consequences approach in more complex settings; seeing how themes from one area of law (i.e., agency) manifest themselves in a related but distinct area of law; developing familiarity with the concept and function of "default rules"; and learning to distinguish between issues within an organization (inter se issues) and issues between an organization and third parties.

To this mix of skills and concepts, studying the law of LLCs, LLPs, and limited liability limited partnerships adds further experience in recognizing old themes in new settings (e.g., power to bind the organization, fiduciary duties within an organization), and further refinement of the distinction between inter se issues and third-party issues (e.g., direct versus derivative claims, conflicts between an LLC's articles of organization and operating agreement).

I hope you will find this book useful, whether you are taking a course that considers this book's topics in depth or in passing. If you have questions or

comments about the book or the doctrines that it discusses, you can reach me through www.danielkleinberger.com, danielkleinberger@ mitchellhamline.edu, or 651-341-7246.

Daniel S. Kleinberger
*August* 2017

# Note on the ULC Harmonization Project

In 2009, the ULC began "an intensive effort to harmonize, to the extent possible, all uniform acts pertaining to unincorporated organizations."[1] The Harmonization Project lasted four years, and the then-current uniform general partnership, limited partnership, and limited liability company acts were central to the effort. The official names of the three harmonized acts are UPA (1997) (Last Amended 2013), ULPA (2001) (Last Amended 2013), and ULLCA (2006) (Last Amended 2013). This book uses abbreviated names: UPA (2013), ULPA (2013), and ULLCA (2013).

1. Uniform Partnership Act (1997) (last amended 2013), Prefatory Note to 2011 and 2013 Harmonization Amendments.

CHAPTER 7

# Introductory Concepts in the Law of General Partnerships

## §7.1 THE ROLE, STRUCTURE, AND RELATIONSHIP OF UNIFORM PARTNERSHIP ACT (1914), UNIFORM PARTNERSHIP ACT (1997), AND UNIFORM PARTNERSHIP ACT (2013)

### §7.1.1 General Partnership: Creature of Contract and of Statute

A general partnership is a creature both of contract and of statute,[1] but, unlike other business organizations, a general partnership is not created by filing a public document pursuant to an "organic" statute.[2] Instead, a general partnership arises when two or more persons manifest an intention to associate as co-owners in a business for profit. Their manifestations — whether by word or conduct or both—create what is essentially a contract between or among them.[3]

Some general partnerships have detailed written partnership agreements,

while many other general partnerships have no written agreement at all. Regardless, one fundamental aspect of a general partnership is the contract-based relationship among the partners.

Another, equally fundamental aspect is the statutory context in which such contracts arise and exist. In every state, a partnership statute provides that context by:

- determining whether a partnership exists;
- governing the relationship of the partnership and its partners with outsiders;
- governing—largely subject to the partnership agreement—the relationship among the partners and between the partners and the partnership; and
- determining when a partnership ceases to exist and what then happens to the partners' interests, the partnership's assets, and the partnership's liabilities.

## §7.1.2 History and Prevalence of UPA (1914); Advent of RUPA (uPa (1997)); Creation of UPA (2013)

For almost all the twentieth century, UPA (1914) was the backbone of partnership law in the United States. Promulgated in 1914 by the ULC, UPA (1914) was adopted in 49 states.[4]

In 1992 the ULC adopted a new uniform partnership act, which had some initial difficulties. The ULC made changes to the act in 1993, approved the revised version in 1994, and made further revisions in 1996 and 1997. The earlier versions have mostly historical interest, and this book refers to the 1997 version—i.e., UPA (1997).[5] UPA (1997) is in many ways a major improvement over UPA (1914), although some the 1997 act's provisions have been controversial, especially those relating to fiduciary duty.[6] In any event, UPA (1997) is far more detailed and longer than UPA (1914),[7] and any UPA (1997) neophyte must invest time to assimilate the act's architecture and understand how its many sections interrelate.

Despite its complexity, UPA (1997) gradually became the dominant general partnership statute in the United States, with only a handful of holdouts. For currency's sake, this book refers principally to UPA (2013), invoking the UPA (1997) version in addition where the Harmonization Project made an important substantive change or where discussing the 1997 version helps explicate the 2013 version. The phrases "the modern acts" or "the two modern acts" each refers to the 1997 and 2013 versions. The phrase "all three acts" refers to all three versions.

Although this book describes many statutory provisions in detail and analyzes many in depth, *no secondary source can ever replace your own careful reading of each statute.* Each time you consider a section of this book that deals with a statutory section, you should compare this book's analysis with the statute's actual language.

## §7.1.3 The Role of Case Law

Case law is also extremely important in the law of partnerships, perhaps more than one might expect in a field covered by apparently comprehensive statutes. This phenomenon has several interrelated causes:

- All three acts rely on judge-made law to fill statutory gaps. For example, UPA (2013), section 119 states: "Unless displaced by particular provisions of this [act], the principles of law and equity supplement this [act]."
- UPA (1914) has some substantial gaps, especially concerning fiduciary duty,[8] and judge-made law has filled those gaps, and a few UPA (1914) provisions are so vague or recondite as to have necessitated judicial clarification. Both modern acts are also subject to judicial interpretation.
- UPA (1997) was drafted against the backdrop of UPA (1914)-related case law, which is therefore important to understanding many provisions of both modern acts.

In all three acts, most of the provisions are "default" rules, which can be displaced by agreement.[9] Numerous cases consider the existence and effect of such agreements.

## §7.1.4 Flexibility: Default Rules and Agreements Among Partners

### a. *Inter Se* and Third-Party Rules

The rules of all three acts can be divided into two categories:

- those that govern the relationship among the partners (*inter se* rules)
- those that govern the relationship between the partnership (and its partners) with outsiders (third-party rules)

These categories carry an important practical distinction. *inter se* rules are almost entirely "default" rules, applicable only in the absence of a contrary agreement among the partners. Such an agreement may be express or

implied, written or oral.[10]

As a matter both of partnership and contract law, *adopting* a partnership agreement always requires unanimity. Therefore, to the extent the default rules are to be changed by the initial partnership agreement, unanimous consent is required. However, a partnership agreement can provide for its own amendment on a less-than-unanimous basis (e.g., majority vote of the partners). With such a provision in place, subsequent changes to the default rules can be accomplished with less-than-unanimous consent.

In contrast, third-party rules are mandatory rules. An agreement among the partners cannot change them.[11]

**Figure 7.1. Default and Mandatory Rules**

| **Most Rules Governing *Inter Se* Relationships** | **Rules Governing Relationships with Third Parties** |
|---|---|
| "Default rules" can be changed by agreements among partners | "Mandatory rules" cannot be changed by agreements among partners (third-party consent is necessary) |
| **Examples:** | **Examples:** |
| UPA (2013) §401(b); UPA (1914) §18(a) *partners share profits equally* | UPA (2013) §301; UPA (1914) §9(1) *partner has power to bind partnership through apparently usual acts* |
| UPA (2013) §401(f); UPA (1914) §18(e) *partners have equal rights to manage partnership and its business* | UPA (2013) §305; UPA (1914) §13 *partner's wrongful act in the ordinary course binds the partnership* |

Under all three acts, the default rules comprise a basic operating system for partners who do not want to spend the time and money to develop their own "rules of the game."[12] But partners who wish to deviate from the default structure may tailor their relationship almost entirely as they see fit. This great flexibility reflects partnership law's respect for, and dependence on, the agreement among the partners.

## b. *Inter Se* Rules That Are Mandatory (Non-Variable)

The special tailoring does have some limits. Deviating too far from the default rules may negate the existence of a partnership. For example, if an agreement labels a person a partner but denies that person any share in the profits, that person would not be a partner.[13] In addition, rules dealing with

partner-to-partner fiduciary duties can be shaped by agreement, but not abrogated.[14]

Under UPA (1914), limitations on the power of the partnership agreement are mostly a matter of case law.[15] The modern acts, in contrast, devote major attention to the question. For example, UPA (2013) section 105 states that, as a general rule, "the partnership agreement governs: (1) relations among the partners as partners and between the partners and the partnership; (2) the business of the partnership and the conduct of that business; and (3) the means and conditions for amending the partnership agreement." This general rule is subject to a list of specific exceptions—most notably constraints on the partnership agreement's power to (i) reshape the fiduciary duties that partners owe each other and the partnership and (ii) limit the power of partners to "dissociate" themselves from the partnership. [16] Section 105 also states that, as to relations among the partners and the partnership, "[t]o the extent the partnership agreement does not provide for a matter described in subsection (a), this [act] governs the matter."[17]

In any event, under all three acts, partnership agreements have broad latitude. Flexibility in structuring *inter se* relationships is a prime attraction of the partnership form.

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# §7.2 PARTNERSHIP DESCRIBED

## §7.2.1 Key Characteristics

*Partnership* is the label that the law applies to a particular kind of business relationship. In the words of UPA (1914), "A partnership is an association of two or more persons to carry on as co-owners a business for profit."[18] UPA (2013) provides, "the association of two or more persons to carry on as co-owners a business for profit forms a partnership, whether or not the persons intend to form a partnership."[19]

The paradigmatic partnership is:

- an unincorporated[20] business, intended to make a profit,
- that has two or more participants, who may be either individuals or entities,
- each of whom "brings something to the party," such as efforts, ideas, money, property, or some combination,

- each of whom co-owns the business (not the assets of the business),[21]
- each of whom has a right (subject to the partnership agreement) to co-manage the business, and
- each of whom has a right to share in the profits of the business (if any).

Partnerships appear in a wide variety of forms and engage in a wide variety of businesses. Some partnerships have only two partners; others have hundreds.[22] Some partnerships are based on complicated partnership agreements. Others arise from a handshake or a course of conduct. Many small retail establishments are partnerships, as are many businesses that own real estate. At one time, lawyers wishing to combine their efforts and share profits had no choice but to form partnerships.[23]

Creating a general partnership involves no special formalities. There are no magic words that must be said or documents that need be signed or filed. If a business structure has the essential characteristics of a partnership and has not followed the formalities necessary to be a limited partnership, corporation, or limited liability company (LLC), then the business is a general partnership.

# §7.2.2 The Consent Characteristic

All versions of the general partnership acts refer to a partnership as "an association."[24] That term connotes voluntariness, and the law has always considered a partnership to be a consensual relationship. For a partnership to exist, there must be a business relationship whose participants manifest an intention to have the kind of arrangement that the law calls a partnership.[25] The participants must agree to that arrangement, either expressly or by their conduct.

It is not necessary, however, that the participants intend or agree to the *legal label* of partnership. A partnership can exist even though the participants have no idea that the legal label applies to them. Indeed, a partnership can exist among participants who have expressly disclaimed the partnership label.[26]

**Example**

> Sid has fallen on hard times. He receives the following letter from his brother, Jules:

Dear Sid,

I am sorry to hear that you've lost your job. Things are very tight here, otherwise I'd be happy to send you some money to tide you over.

I do have another idea, though. You know that land I own up by the lake? I think it would make a good resort, if I could just get some cabins built on it. If you'd be willing to move up there with your family and build the cabins, I would pay for all the materials, and for food and necessities for you and your family. I couldn't afford to pay you any wages, but once we got the resort up and running I'd give you half of the profits for the first five years.

Let me know how you feel about this.

/s/Jules ◂◂◂

Sid's letter may be the blueprint of a partnership.

**Example**

> Caesar lends money to Julio, who personally owns a company that produces and markets cheese. The loan agreement provides that, until the money is repaid, Caesar (i) will receive a share of the company's profits in lieu of interest, (ii) may have the marketing rights for 50 percent of the company's output, and (iii) may have his own accountant check the company's finances weekly and approve any payments to be made by the company in excess of $100. The loan agreement also expressly states that Caesar and Julio are not partners in the cheese company but rather are creditor and debtor. Nonetheless, a court may find that a partnership exists.[27] ◂◂◂

When making such a finding, courts sometimes use the label "de facto partnership"; but however labeled, partnerships that arise inadvertently are likely to be problematic. The parties will have created a legal relationship without having thought about, much less worked through, key business issues. At least initially, statutory default rules will govern their relationship,[28] but those rules may fail to match the deal the parties would have made for themselves. In any event, the applicability of those rules will come as quite a surprise.

When a partnership arises despite an express disclaimer, there is another unpleasant consequence. Disputing the disclaimer is worthwhile only when money is at stake, so in these situations the label "partner" is invariably

costly. For instance, in the Example above concerning the cheese company, if Caesar is determined a partner of Julio, then Caesar will be personally liable for the cheese company's debts.[29]

## §7.2.3 The Profit-Sharing Prerequisite

For participants in a business to be partners they must have the right to share in the business's profits. It is not necessary that the business actually makes a profit, and profit sharing is not irrefutable evidence of partner status.[30] However, the right to share whatever profits exist is a necessary precondition to being a partner. In logical terms, a right to share profits is necessary but not sufficient to establish partner status.

**Example**

> Carolyn opens an art supply store in a building she rents from Sylvia. As part of her rent, Carolyn pays Sylvia 30 percent of Carolyn's monthly revenues. No matter what other indicia of partnership are present, Carolyn and Sylvia cannot be partners. They do not share profits. ◂◂◂

Since sharing in revenues does not satisfy the profit-sharing prerequisite, it is important to understand the difference between profit sharing and revenue sharing. Roughly speaking:

- A business's revenue (or proceeds, or receipts, or gross income) consists of all the money the business takes in.
- A business's profit equals the amount of its revenue, less the amount of expenses the business has incurred in generating that revenue.

**Example**

> The Acme Widget Company manufactures and sells widgets. In 2015, the Company

— sold 50,000 widgets, for which it received $500,000;
— spent, in order to make and sell the widgets:
— $100,000 on materials;
— $150,000 on salaries, wages, and sales commissions;

Co-ownership is a key characteristic of a partnership, but the concept can be quite confusing. The

confusion exists because:160; — $20,000 in energy costs;
— $30,000 in legal fees;
— for total expenses of $300,000.

Thus, in 2015, the Company had $500,000 of revenue (or gross receipts), but only $200,000 of profits ($500,000 minus $300,000 of expenses equals $200,000).[31]◂◂◂

Sharing in revenues tends to produce a different, narrower approach toward a business than having a share of profits. A person with a revenue share naturally focuses on the business generating as much revenue possible. Such a person may have little direct concern for the costs of providing goods or services. In contrast, for someone who shares profits, sales (and revenues) are only part of the equation; a profit will exist only if the whole business is functioning well and costs are controlled.

**Example**

> Sylvia is a partner in the Acme Widget Company with a right to 10 percent of the profits. Phil is a salesperson for the Company, with a 5 percent commission on all revenue collected from the sales he makes. Phil has a customer who is willing to buy 5,000 widgets if Acme can ship within two weeks. Acme can make that deadline only by paying its workers substantial amounts of overtime pay. For Phil the main concern is booking the order and seeing that Acme meets the shipping deadline. Sylvia, in contrast, wants to know how much the extra overtime costs will add to the cost of manufacturing. ◂◂◂

The profit-share prerequisite thus fits well with two other key partnership characteristics: co-management and co-ownership. Those who share profits tend to view their economic fate as linked with the fate of the enterprise as a whole. As a consequence, they will wish to involve themselves in controlling the enterprise and will tend to see the enterprise as belonging in part to them.

# §7.2.4 The Role of Loss Sharing

Express agreements to share losses certainly intensify the co-management and co-ownership inclinations just discussed,[32] and in all jurisdictions such

agreements are very strong evidence of a partnership. In some jurisdictions, an express agreement to share losses is actually a prerequisite to a finding of partnership.

The majority rule, however, is to the contrary. None of the three acts mentions loss sharing as a prerequisite. Instead, the acts treat loss sharing as a consequence of partnership status.[33]

**Case in Point — Kopka v. Yockey**

“This [was] an action by appellee against appellant and one Frederick Lau to recover damages for personal injuries. It is averred in the complaint that, at the time appellee received the injuries complained of, defendants were jointly engaged in cleaning a certain public ditch; that appellee was in the employ of defendants, and was assisting them in the work of cleaning the said ditch; and that his said injuries were caused by the negligent acts of [Lau], who at the time was directing the work.” The claim against the appellant rested on a claim that Lau and appellant were partners. The appellant contended that no partnership could exist, because the appellant and Lau never agreed to share losses. The court rejected that assertion: “It is not the law, as contended by appellant, that a contract creating a partnership must specifically provide that the parties thereto shall share the losses. Where, as in the case at bar, it is stipulated in the agreement that the parties are to share the profits, and nothing is said as to losses, it follows as a legal consequence that they must share the losses.”[34]◂◂◂

# §7.2.5 A Meaning for “Co-Ownership”

*Co-ownership* is a key characteristic of a partnership, but the concept can be quite confusing. The confusion exists because:

- none of the three acts define the term;
- the concept has a different meaning depending on whether it is used to:
  - — help determine whether a partnership exists (i.e., as an entrance criterion to partner status); or
  - — describe certain legal rights that follow from partner status; and
- a colloquial sense of the term reflects the now-outmoded notion that a partnership is an aggregate of its partners and not a legal entity separate from them.[35]

To understand co-ownership as an entrance criterion to partnership

status,[36] consider two entrepreneurs who go into business together. They agree (as partners do) that they will jointly control whatever property the business uses ("the assets"). That is, they will decide together which assets to select; what use to make of those assets; and whether, when, and for what price to dispose of the use and control of those assets. They also agree that they will share the economic benefit (or detriment) that eventuates from their control, use, and disposition of those assets (i.e., they will share profits and losses).

In a lay sense, the two entrepreneurs co-own the assets of the business.[37] By their agreement they have arranged to share the two predominant characteristics of property ownership: the right to control use and disposition, and the right to benefit (or suffer) economically from the exercise of that right of control. Such functional co-ownership is characteristic of a partnership.[38] (Legal ownership of a partnership's assets is quite another matter, especially under UPA [1997] and UPA [2013].)

# §7.2.6 Partnership Types and Joint Ventures

## a. Partnership Types: The Default Paradigms

Each of the three acts contemplate three basic types of partnership, categorized according to when the partnership rightfully comes to an end.[39]

- *Partnership* at will. Each partner has the right to cause the partnership to come to an end, at any time and without having to state or have "cause."[40]
- *Partnership for a term*. The partnership comes to an end at the end of the time period specified in the partners' agreement.
- *Partnership for a particular undertaking*. The partnership comes to an end when the particular task or goal specified in the partners' agreement has been accomplished.

### Case in Point — Mack v. Mack

> *Facts*: Two brothers orally agreed to form a partnership, and through a series of oral agreements carried on the business, the goal of which was to continue operating their parents' farm after the parents were too old to do so. After the partnership successfully leased the property and later executed a contract for deed (at a very favorable price), one

> brother chose to withdraw from and end the partnership, asserting that the partnership was at will. The other brother contended that the partnership was for a particular undertaking—that of taking care of their aging parents (who were still living), which meant that neither brother had the *right* to terminate the partnership while the parents remained alive.[41] ◂◂◂

As explained in section 11.2.1(c), these paradigms are default rules. A partnership agreement may establish rules delineating the circumstances for rightful dissolution without having to specify a definite term or undertaking.

### b. Joint Ventures

The term *joint venture* provides more confusion than enlightenment. Under the law of most states, a joint venture is distinguished from a partnership by having a narrower scope than a partnership formed to conduct an ongoing business. But that distinction makes little sense; all three acts recognize limited-scope partnerships as partnerships for a particular undertaking. Moreover, under the law of most states, joint ventures are analogized to partnerships and therefore governed by partnership law.

## §7.2.7 Entity or Aggregate? (And Why Care?)

The question of "entity versus aggregate" has long vexed the law of partnerships. Is a partnership a separate legal person, with a legal identity distinct from its partners? Or is a partnership merely an aggregation of its partners, with no separate legal identity of its own?

### a. The Schizoid Approach of UPA (1914)

The problem inheres in UPA (1914). When the act was being drafted, reasonable minds differed on the issue. As the drafting project began, the principal drafter favored the entity approach. He died, however, in the middle of the project, and his replacement favored the aggregate view.

UPA (1914) as promulgated includes both approaches. Some provisions reflect an entity concept. UPA (1914) §9(1), for example, begins: "Every

partner is an agent of the partnership.” Other provisions reflect the aggregate notion. For instance, UPA (1914) §29 characterizes partnership dissolution as “the change in the relation of the partners caused by any partner ceasing to be associated in the carrying on ... of the business.” Still other provisions combine the two approaches, such as UPA (1914) §25, which uses a construct that sounds in property law (“tenancy in partnership”) to express partner management rights and to provide that partners have no right to use partnership assets for personal purposes.[42]

Understanding that UPA (1914) embodies two discordant themes helps make sense of some of that statute’s provisions. The themes can also have an impact in determining how nonpartnership law treats partners and partnerships.

**Case in Point—State v. Pielsticker**

> A state statute prohibited banks from making loans to their own directors. A bank made a loan to a partnership in which one of the bank’s directors was a partner. A court held that the bank had not violated the statute, since the partnership was an entity separate from its partners.[43] ◂◂◂

### b. The Simple Answer in the Modern Acts

For the most part, matters are far simpler under the modern acts. UPA (1997) cut the Gordian knot: “A partnership is an entity distinct from its partners.”[44] The dissociation of a partner from the partnership does not necessarily cause dissolution of the partnership, and UPA (1997) eliminated entirely the notion of “tenancy in partnership.”[45] The Harmonization Project made no substantive change in this area.[46]

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## §7.3 THE HALLMARK CONSEQUENCE OF AN ORDINARY GENERAL PARTNERSHIP: PARTNERS’ PERSONAL LIABILITY FOR THE PARTNERSHIP’S DEBTS

Until the very end of the twentieth century, the most important consequence of general partner status had been simply this: *All partners are personally liable for all debts and other obligations of the partnership*. The liability is automatic, strict, and arises solely due to a person's status as a partner. As a result, the liability applies to each partner regardless of whether the partner participates in, approves, or even knows of the conduct that gives rise to the partnership obligation.

In the modern commercial world, this situation is remarkable and—for partners and potential partners—harrowing. Being a partner is tantamount to giving a personal guarantee to everyone with a claim or potential claim against the business.

Today, partners can avoid this risk by causing their general partnership to be a limited liability partnership (LLP). LLP status severs the automatic connection between partner status and liability for the partnership's debts, and partners in a "full shield" LLP are no more liable for the partnership's debt than shareholders in a corporation are liable for the corporation's debts.[47]

However, it is still necessary to understand the liability rules for ordinary general partnerships. For one thing, even under the two modern acts many of the statutory default rules reflect the assumption that the partners are liable for the partnership's debts. For another, many, many general partnerships are not LLPs. (Regulatory barriers may exist, or the partners may simply not know that LLP status is available, or not understand the dangers of eschewing that status or the business owners may not realize that they have formed a partnership.)[48]

## §7.3.1 Exhaustion, Joint and Several Liability, *Inter Se* Loss Sharing

The rule of personal liability has three separate areas of complexity: an exhaustion rule, the question of joint and several liability, and the issue of how partners' liability to third parties relates to partners' obligations to share losses among themselves.

### a. Exhaustion Rule

In some UPA (1914) jurisdictions, as a matter of case law a creditor of the

partnership may not pursue individual partners without first exhausting the assets of the partnership. In jurisdictions with either of the modern acts, the exhaustion rule applies per the statute.[49]

## b. Joint Liability and Joint and Several Liability

In most UPA (1914) jurisdictions, partners are jointly and severally liable for certain kinds of partnership obligations and jointly liable for others. Under UPA (1914) §15, partners are jointly and severally liable for partnership debts arising from partner misconduct, and merely jointly liable for all other partnership debts.[50]

The distinctions between the two types of liability relate not to the extent of each partner's personal responsibility, but rather to the steps a creditor must take to pursue the partners. Under both forms of liability, each partner may be held individually responsible for the full amount of the partnership's debt.[51] When the liability is joint *and* several, the creditor may pursue any one of the partners individually. That is, the creditor does not need to include all the partners as defendants in the same lawsuit. Moreover, the creditor may release its claim against one of the partners without undermining its claim against the others. In contrast, when the liability is joint *but not* several, the creditor must sue all of the partners in order to sue any of them. Likewise, if the liability is merely joint, the creditor's release of any partner releases all of them.

Under the modern acts, the rule is simpler. In an ordinary general partnership, "all partners are liable jointly and severally for all obligations of the partnership."[52]

## c. Relationship of Partners' Liability to Third Parties and Partners' *Inter Se* Loss Sharing

As discussed in Chapter 8, partners characteristically share losses among themselves. Their *inter se* loss sharing has, however, absolutely no effect on a third party's claim against any particular partner.

**Example**

Under their partnership agreement, Larry, Moe, and Curley agree to

share losses 60/20/20. Shemp has a $100,000 claim against the partnership on which each partner is jointly and severally liable. Shemp sues only Larry, seeking to recover the entire amount. Larry cannot defend by saying, “At most, my liability is $60,000 (i.e., 60 percent).”[53] ◂◂◂

## §7.3.2 Why Risk It?

Why would anyone form a general partnership instead of a corporation or a LLC? Forming a corporation or LLC is a simple matter, and the resulting entity shields its owners from the debts of the business.[54] Why would anyone take the risk of partnership?

That question has had a five-part answer: (i) tax advantages, (ii) greater flexibility in structuring the “deal” among the participants, (iii) legal restrictions on the business forms available to professionals,
(iv) inadvertence, (v) poor or no legal advice. The first answer was once of great importance, but its day has passed. The second and third are for the most part mere vestiges of past practices. The fourth and fifth have the greatest lasting significance.

### a. Tax Advantages

For decades, tax advantages were a substantial reason for organizing a business as a partnership rather than a corporation. Most corporations are taxable entities and therefore face double taxation when distributing profits. The standard corporation can pay dividends to its shareholders (i.e., distribute profits to its owners) only in after-tax dollars. In essence, the corporation must first pay corporate income tax on its corporate profits before distributing any of those profits as dividends. The shareholders must in turn pay income tax on the dividends.[55]

A partnership, in contrast, is a “pass through” entity. Tax law treats the partnership’s profits as allocated among (i.e., passed through to) the partners. The partnership pays no tax; only the partners do. Partners thus face only a single level of taxation. Losses also pass through. When a partnership loses money, the partners obtain tax deductions for use on their own income taxes.

For some businesses, the tax advantages of a partnership were substantial enough to warrant the risks of personal liability—especially so when the risks were either small or insurable.[56] The advent of limited liability companies and LLPs eliminated this reason for forming an ordinary general partnership.[57]

## b. Greater Flexibility in Structuring the Deal

As discussed previously,[58] partners have almost unlimited flexibility in structuring their relationship with each other. With this flexibility, they may predetermine the various aspects of their deal. For example, they may agree in advance which partners will work in the business and how much, if any, extra remuneration those partners will receive for doing so. Or, in contrast, they may agree on a flexible mechanism for allocating profits. They may subject specified business decisions to the veto of each
partner or give complete management authority to one or more managing partners.

At one time, the corporate form did not allow comparable flexibility (and limited liability companies did not yet exist). Some courts invalidated predetermined corporate deals as attempts to "sterilize" the corporation's directors, who under traditional corporate norms are supposed to exercise independent judgment in managing corporate affairs.

Modern court decisions and modern corporate statutes have changed matters, however. In almost all jurisdictions, shareholders in a closely held corporation (i.e., a corporation with few owners) can do just as much predetermination as the partners in a partnership. Even in jurisdictions whose corporate statutes are antiquated, the limited liability company exists. Thus, it is no longer necessary to risk personal liability in order to fit the legal form to the business deal.

## c. Restrictions on Business Forms Available to Professionals

At one time, states prohibited professionals from practicing in corporate form. Professional status was seen as carrying a special responsibility, so the corporate liability shield was inappropriate for a professional practice. According to this view, professionals were properly saddled with the allencompassing, vicarious liability of a partner. Professionals who wished to practice together and co-own their practice had only one organizational

choice—a partnership.

Today, in contrast, almost every state permits professionals to practice in entities that shield their owners from partner-like vicarious liability. These entities include professional corporations, professional associations, professional limited liability companies, and professional limited liability partnerships. Consequently, most professionals who today choose the partnership form do so for reasons other than necessity.

## d. Inadvertence

Since creating a partnership requires no special formalities, partnerships can arise inadvertently.[59] Indeed, partnership is the "default" organizational status. If:

- a court determines that two or more persons in fact co-own a business and have agreed to share profits, and
- those persons have not formally chosen to form some other type of business entity, then

the law classifies the business as a partnership and treats the owners of the business as partners.

### Case in Point—In re KeyTronics

> Three individuals decided to begin a venture (an innovative payment system for car washes) together, in which a single person was the ostensible "lead" manager. They (subjectively) intended to form a corporation but never did. They carried on their venture until one of the individuals sued to dissolve what the individual alleged to be a partnership. The court agreed and ordered the winding up of the partnership and an accounting.[60]◂◂◂

Thus, many partners assume the harrowing risk of personal liability without understanding that they are doing so.

## e. Bad or No Legal Advice

Some persons knowingly become partners without appreciating the liability risk that accompanies partner status. These persons have either not sought legal advice or have received bad advice.

### §7.3.3 Why Study It?

Twenty years ago, most “business associations” courses allocated little time to general partnerships, which for the reasons just described were seen as a minor and dangerous form of business organization. The advent of limited liability partnerships (LLPs) and limited liability companies (LLCs) has changed matters substantially. An LLP can be a very useful way to organize a business, and an LLP is a general partnership plus a liability shield. Also, as discussed in Chapter 13, partnership concepts have substantially shaped LLC law, and most LLC statutes include key provisions modeled on the law of general partnerships.

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## §7.4 CONTESTING AND ESTABLISHING THE EXISTENCE OF A PARTNERSHIP

### §7.4.1 Why a Contest?

Some of the most important partnership cases involve disputes over whether a particular business relationship constitutes a partnership. These disputes usually relate to one of two major attributes of partnership status: the fact that partners are personally liable for the debts of the partnership or the fact that partners share profits with each other.

The liability attribute interests creditors seeking a “deep pocket.” If the party who owes a debt cannot pay, the creditor may seek a more solvent business associate of the debtor and try to characterize that business association as a partnership.

**Example**

> A manufacturing plant defaults on its obligation to buy power from a power company. Another creditor of the plant has exerted some control over the plant’s business and has received a share of the plant’s profits. The power company claims that the other creditor is in

fact a partner in the plant's operations and as such is personally liable for the plant's debt. Note that, because the participants do not consider themselves partners, they will not think to obtain the liability protection of an LLP. LLP status is not available retroactively.[61] ◄◄◄

The profit-sharing attribute interests those seeking a bigger piece of a business's pie. If a person who participates in a business can establish partner status, that person stakes a potentially valuable claim. As a partner, the person is entitled to a share not only of profits made in the future but also of any profits distributed in the past (i.e., while the individual was in fact a partner although not recognized as such).

**Example**

Bob owns and operates a tree farm. He induces Ted to work on the farm as manager, and Ted holds that position for six years. Ted then claims that Bob had promised him a 50/50 partnership after three years. During years four through six, Bob took $200,000 in profit out of the business. A court sides with Ted and orders Bob to pay Ted $100,000 in back profits. (After that payment, Bob's profit from years four through six will be reduced to $100,000, so the two partners will have profited equally.)[62] ◄◄◄

Occasionally it is the *inter se* loss-sharing attribute that is attractive.

**Case in Point—Stanford Carr Dev. Corp. v. Unity House Inc.**

A real estate developer sued one of its lenders, alleging that a partnership existed between the parties and the lender was liable as a partner for a share of the project's losses. The first proposal for an agreement between the developer and the lender provided the lender with an "equity participation" which would have resulted in "50 percent participation of project profits" for the lender. The final version entitled the lender instead to a $1.5 million "release fee" on the loan (arguably in lieu of the earlier "equity participa-tion"). The court determined that no partnership could have existed because the relationship lacked the prerequisite attribute of profit sharing.[63] ◄◄◄

## §7.4.2 The Pivotal Question: The Character of the Profit Sharing

Since no one can be a partner without a right to share in profits, disputes about the existence of a partnership inevitably focus on the characterization issue. All three acts treat profit sharing as strongly indicative of a partnership, while recognizing that profit sharing sometimes means something else. For example, UPA (2013) §202(c)(3) provides:

> (3)A person who receives a share of the profits of a business is presumed to be a partner in the business, unless the profits were received in payment:
>
> (A) of a debt by installments or otherwise;
> (B) for services as an independent contractor or of wages or other compensation to an employee;
> (C) of rent;
> (D) of an annuity or other retirement or health benefit to a beneficiary, representative, or designee of a deceased or retired partner;
> (E) of interest or other charge on a loan, even if the amount of payment varies with the profits of the business, including a direct or indirect present or future ownership of the collateral, or rights to income, proceeds, or increase in value derived from the collateral; or
> (F) for the sale of the goodwill of a business or other property by installments or otherwise.[64]

UPA (1997) §203(3) is essentially identical, and UPA (1914) contains a very similar list of protected categories.[65]

Thus, all three statutes conduce toward one basic structure of analysis:

- The party asserting the existence of a partnership must establish that each participant in the alleged partnership had a right to share in profits.
- The parties will joust over how to characterize the profit sharing. For example, did the profit share reflect the remuneration of a coowner (a partner) or the payment on a debt, or rent, etc.?
- If the profit share does not fit into one of the "protected categories,"[66] under both modern acts the arrangement is presumed to be a partnership. UPA (1914) refers to "prima facie evidence."[67]

The partnership *vel non* determination is a question of fact, unless of course the evidence is so one-sided that a reasonable fact finder could reach only one conclusion.

## §7.4.3 Factors in the Contest of Characterization

There is, unfortunately, no bright-line test for resolving disputes over the

characterization of profit sharing. It is, however, possible to identify five factors that tend to influence courts.

## a. Control

Co-management is a key characteristic of a partnership. The more an alleged partner participates in management decisions or exercises control over the business, the more likely is a finding of partnership.

The control factor can be especially problematic for creditors who receive profits "[a]s interest on a loan."[68] Many loan agreements permit the creditor a voice in or even control over management decisions if the debtor has trouble making payments. A creditor who takes a profit share and then exercises such rights faces substantial risks if the debtor's business fails. Other creditors will use the exercise of control to characterize the profit sharing as a partner's remuneration. Since in an ordinary general partnership all partners are liable for the partnership's debts, this characterization will make the profit-sharing creditor liable *on the other creditor's claims* against the debtor.

Control is a less useful factor when the alleged partner provides the business full-time services, rather than money or credit. Many key employees exercise substantial discretion in the conduct of their employer's business. Some key employees even have contract rights that oblige the employer to respect that discretion. Control can therefore be equivocal when trying to distinguish between profits received as a partner and payments received "for services as an independent contractor or of wages or other compensation to an employee."[69]

## b. Agreements to Share Losses

As previously explained,[70] an express agreement to share losses is strong evidence of a partnership. Such agreements rarely, if ever, exist in the arrangements between creditor and debtor, employer and employee, or in any of the other relationships that, according to UPA (2013) §202(c) and UPA §7(4), involve profit sharing but not partnership.

Business participants can and sometimes do share losses without having an express agreement to do so. That course of conduct usually implies a loss-sharing agreement and is by itself strong evidence of a partnership.

## c. Contributions of Property to the Business

If a party has contributed property to the business, that contribution favors the partnership characterization. As discussed more fully in Chapter 8,
partners often "buy into" a partnership by transferring to the partnership assets such as land, goods, intellectual property, or money.[71] The transfer is in return for a share of profits, plus management rights and the right, upon dissolution of the partnership, to a return of the value of the asset (but not the asset itself) measured as of the date of contribution.

A contribution of property is not a prerequisite to a finding of partnership, and many partners bring only their talents, skills, and labor.[72] However, a genuine contribution of property does "cut against" each of the nonpartnership "protected categories" under UPA (2013) §202(c) and UPA §7(4).

Property transfers do occur in some of those relationships, but the transfers are of a different nature. For example, a landlord transfers to a tenant the property right to occupy and use the leased premises, but (i) the transfer is only temporary, (ii) the landlord has a right to regain the same property and not just its value, and (iii) the return of the property ordinarily occurs at a time certain or upon specified notice, not merely when the partnership happens to come to an end. Similarly, a lender transfers to a borrower the right to use and dispose of the loaned funds, but the timing of the repayment ordinarily does not depend solely on the ending of the partnership. Even if a loan is due when the partnership ends, as explained in Chapter 11 the lender's rights are superior to the partners' rights to a return of capital.

## d. The Extent to Which the Profit Share Constitutes the Recipient's Only Payout from the Business

If a profit recipient receives no other payout from the business, that fact favors the partnership characterization. If, in contrast, the profit share is just a bit of "icing" on top of some other payments, courts are more inclined toward one of the protected categories.

**Example**

> Sylvia manages the widget factory of the Acme Widget Company. She receives no salary. Her only compensation is a 20 percent share of profits. She can "draw" a certain amount each month against her profit share, but if at the end of the year her draws have exceeded her share she must repay the excess. Phil, the national sales manager of the company, receives a salary of $50,000 per year, plus 1 percent of the Company's profit as an incentive. A court is far more likely to find Sylvia to be a partner than Phil. All her remuneration comes in the form of profits. For Phil, the profit share is small, and is a mere add-on to his salary.◂◂◂

### e. The Parties' Own Characterization of Their Relationship

Although the parties' own labels are never dispositive, in close situations some courts look to how the participants in a business relationship have characterized their relationship. This factor is probably more influential when the characterization dispute involves only the participants and especially when the business associates have held themselves out to others as partners. When someone outside the relationship (e.g., a creditor seeking to find a deep pocket) challenges the participants' self-labeling, courts are more likely to see the label as self-serving.

**Case in Point —VIDIVIXI, LLC v. Grattan**

> This case turned in part on the nature of the business relationship between two individuals. The plaintiff asserted that the individuals had been partners, and the defendant vigorously disagreed. Even though the plaintiff had originally alleged an independent contractor relationship, the court found that a partnership had been formed:

> Regardless of the specific division of labor, the VIDIVIXI furniture was the result of a collaboration between Bradley and Grattan, and they held themselves out as a de facto partnership. For example, in April 2014, Bradley and Grattan signed a contract to display five of their VIDIVIXI pieces in the "Good Colony" showroom. The contract identified Bradley and Grattan as "Co—Owner[s]" of VIDIVIXI . . . [other examples omitted]. In retrospect, both Bradley and Grattan have described their relationship as a "collaboration" and a "partnership."[73]

## §7.4.4 Handling the Factors (a Mode of Analysis)

Legal analysis involving factors is always difficult. Which factor is the most important? What if one factor points strongly in one direction while two other factors point weakly in the other? Unfortunately, no simple, mechanical paradigm exists for ordering the characterization factors. However, you may find the following perspective helpful.

All disputes about the character of profit sharing are either/or disputes. The parties do not contest the general paradigm of a partnership, but instead struggle over whether a particular person is a partner or merely a participant in one of the protected categories of UPA (2013) §202(c)(3) or UPA §7(4).
In one case, for example, the alleged partner will be either a partner or a wage earner receiving profits as wages. In another case, the alleged partner will be either a partner, or a lender receiving profits as interest.

To decide these either/or questions, courts can look to the factors discussed in section 7.4.3. If all the factors point in the same direction, the analysis is simple and the answer is clear. The analysis gets complicated only when the factors point in opposite directions.

You can handle that complexity by thinking of each either/or choice as involving a multilayered continuum. Each layer reflects one of the five characterization factors. At one end of the continuum sits the "ideal type"[74] of a partner. At that end, at each layer of the continuum, the facts indicate "partner." At the other end of the continuum sits the "ideal type" of the arguably applicable protected category. At that end, at each layer of the continuum, the facts indicate "wage earner," or "lender," or whatever the category may be. For example, when the characterization choice is either "partner" or "wage earner," the continuum might look like Figure 7.2.

Figure 7.2. Partner versus Wage Earner (assumes some right to share profits)

| "Partner" | | "Wage Earner" |
|---|---|---|
| participates in all important decisions | *Control* | obeys instructions; has no important discretion |
| has expressly agreed to share losses | *Express Loss Sharing Agreement* | has never agreed to share losses; when losses occur, payout does not change |
| contributed property to the business | *Contribution* | merely works in the business |
| all payout via profit share | *Importance of Profit Share* | profit share is only icing on the cake |
| called a partner | *Self-labeling* | called an employee |

Although in any particular case one factor (or layer) or another may predominate, courts rarely decide on the basis of one factor alone. Instead, they look at the overall picture: The more each layer of the disputed situation leans toward one end of the applicable continuum, the more likely the court is to come down on that side of the either/or fence.

The analysis is inevitably imprecise. Since the law declines to make one factor (or combination of factors) dispositive, courts are left essentially to decide whether the disputed situation "looks" more like one end of the continuum or the other.

## §7.5 PARTNERSHIP BY ESTOPPEL; LIABILITY OF A PURPORTED PARTNER

It is possible for a person to have partner-like liability for an enterprise's obligations without truly being a partner. UPA (1914) labels the applicable rule "partnership by estoppel";[75] UPA (2013) uses the caption: "Liability of Purported Partner."[76]

Unfortunately, the UPA (1914) rule is byzantine, and the modern acts have made only a few changes. Under all three statutes, however, the basic concept is fairly simple and consistent with ordinary estoppel principles:

***If***

- a person represents itself as being a partner in an enterprise (or allows others to make the representation);

***and***

- a third party reasonably relies on the representation and as a result does business with the enterprise;

***then***

- the person who was represented as a partner is liable on the transaction as if the person were a partner, even though the person is not in fact a partner; and
- others who have either made or consented to the representation are bound by the person's acts as if they were partners with the person represented as their partner.

The liability aspect of this rule rests on common beliefs about a partner's responsibilities and powers. Before the advent of limited liability partnerships, partner personal liability was a well-known fact of business life. To represent oneself as a general partner (or to allow someone else to make the representation) was therefore to impliedly promise to be "good for" any debts of the enterprise just like any other partner.[77]

The "power to bind" aspect of the rule rests on a similar rationale. It is well known that partners have certain powers to bind the partnership.[78] When a person is represented to be a partner with others, third parties will naturally believe that the person can bind the partnership and, on account of each partner's personal liability, can bind those others as well. To the extent that those others consent to the representation, a partner-like power to bind should apply.

***problem 55***

> Ralph wants to open a riding stable but does not have enough money. He approaches Sally, who has both experience managing start-up businesses and some money to invest. They agree that (i) each will own a half-interest in the business, (ii) Ralph will run the day-to-day operations while Sally will "handle the books," (iii) all major decisions will be made jointly, (iv) Sally will invest $50,000, and (v) Ralph will get 40 percent of the profits and Sally 60 percent. Sally is concerned with the liability that comes with being a partner, so the agreement between Ralph and Sally states clearly: "This relationship shall not be deemed to be a partnership." What legal effect will that disclaimer have on claims by creditors? ◂◂◂

**Explanation**

The disclaimer will be useless. Sally and Ralph have created precisely the type of business relationship that the law considers to be a partnership. They co-own, they co-manage, and they share profits. In the face of a claim by a creditor, the disclaimer will be disregarded as inaccurate and self-serving.◂◂◂

***Problem 56***

Mark is the treasurer of the Zenith Vending Machine Company. In that capacity he prepares all the Company's tax returns. The Company is a partnership, and each year its partnership tax returns list the partners as Allen,

Betty, Charlotte, and Ralph.[79] As part of his remuneration, Mark receives a share of Zenith's profits. If he later claims that he is a partner in the company, what role will the partnership tax returns play in the dispute? ◂◂◂

**Explanation**

The returns will argue strongly against him, because they list the partners and do not include Mark. As the preparer of the returns, Mark evidently assented to the exclusion. This situation therefore differs from efforts to use disclaimers against third parties.◂◂◂

***Problem 57***

For 10 years Paul has operated PAUL'S, an automobile salvage business. The business buys wrecked automobiles from insurance companies or at auction, and then either rebuilds them or cannibalizes them for parts. PAUL'S sells rebuilt and used parts to car dealers, service stations, and the public.

For the past three years, Eli has been working in the business with Paul. Eli has only a third-grade education but is an excellent, street-smart auto mechanic. He is active in almost all aspects of the business: bidding at auctions, buying cars from insurance companies, and fixing cars and parts.

However, only Paul determines the selling price for the cars and parts which the business sells. Paul also maintains all the business's records and takes care of the business's various tax returns.

Paul first approached Eli to come to work with him when Paul learned that Eli had won $9,000 at the racetrack. Eli gave the money to Paul, who used it to buy cars at an auction. Those cars were then used in the salvage business. Paul promised Eli 50 percent of the business's profit for as long as Eli would "work as hard, sweat as much, and do as much as I do."

Ever since Eli began work at PAUL'S, the company's records have shown him as an employee. His salary has been calculated based on 50 percent of the profits, and Social Security has been withheld from his checks. The company has paid Social Security and unemployment compensation taxes on account of Eli and has maintained workers' compensation coverage for him. Both the company's various tax returns and its insurance policies list Eli as an employee.

Is Eli an employee of or a partner in PAUL'S?[80] ◂◂◂

**Explanation**

> Eli is a partner. He shares in the profits and has made a capital contribution. Although Paul has exclusive responsibility in two areas, Eli shares management authority over other areas that are crucial to the business.

The company's books and tax returns do describe Eli as an employee, but that fact does not undermine Eli's partner status. The parties' selfdescriptions can give insight into their intents, but only when the parties genuinely assent to the description. There is no evidence that Eli was aware of the way he was described in the company's records, other than the withholding of Social Security from his checks. With his lack of formal education, Eli was probably unaware of what that withholding implied about his status. ◂◂◂

***Problem 58***

> As a sole proprietor, Bill runs a dry-cleaning store called Bill's Dry-Cleaning. He is in deep financial trouble. His bank will no longer give him any credit, and is threatening to call his loans (i.e., demand immediate payment of all money owed). Bill also owes money to various trade creditors (i.e., businesses that have supplied him goods

and services). Bill approaches Chris, a well-known venture capitalist, and asks her to refinance his business. Chris reviews his books and his operations and says, “Listen, you’re a great dry cleaner but a lousy businessman. I’ll bail you out, but we have to divide up the responsibilities a bit. If we’re going to make this business work, we have to be more hardnosed about it. First, no more credit to law professors. They’re lousy risks. Second, I want to determine who gets paid when. One of the arts of staying in business is stretching out your accounts payable. So, before you pay anyone, you check with me. Also, I want some upside potential. So long as you owe me money, I want 12 percent interest on what you owe or 10 percent of the profits, whichever is higher. You pay me the

12 percent monthly, and quarterly I’ll decide whether to keep the past three month’s interest or take my share of the past three month’s profits.”

Bill accepts Chris’s terms, with one condition: “We have to pay our people (i.e., the employees) on time. If we have the money, we pay them.” Chris accepts Bill’s condition, pays off the bank, and provides additional working capital to the business.

The business continues to operate under the same name, and no one except Bill knows of Chris’s role in the business. Bill stops extending credit to law professors. Each month, Chris reviews Bill’s accounts payable and sets the priorities for payment as follows: (i) pay Chris the interest owed her, (ii) pay overdue bills from people Bill intends to buy from again, (iii) pay overdue bills from other people who are threatening suit, (iv) pay others. Chris never does take a percentage of the profit, because the 12 percent interest figure is always higher.

Bill makes all decisions about which vendors to use. He also makes all personnel decisions (e.g., hiring, firing, salaries). After a year, the business fails. Bill owes Chris $350,000; he owes creditors a total of $175,000 ($150,000 to trade creditors and $25,000 in back wages to three employees). Bill has no money.

Can these other creditors collect from Chris? Consider Chapter 6 as well as UPA (2013) in analyzing this Problem. ◂◂◂

**Explanation**

> Two different theories hold promise for the creditors: partnership law and constructive agency under R.2d, §14 O. If the creditors can establish that Chris is Bill's partner, UPA (2013) §306(a) will make Chris liable with Bill for the partnership's debts. If the creditors successfully invoke §14 O, Chris will be liable to the creditors as Bill's principal.

Although it is unlikely that Bill and Chris thought of their relationship as a partnership, they may nonetheless have formed one. Their thoughts about the legal label are largely immaterial. What matters is the nature of the business relationship they have intentionally created.

The other creditors will contend that the business relationship fits most of the paradigmatic characteristics of a partnership. Most importantly, Chris has a right to share profits. That right, rather than the actual receipt of profits, is the fundamental prerequisite to partner status. Chris has also "brought something to the party": not only essential working capital, but also key management services. Moreover, like a paradigmatic partner, Chris has helped run the business, exercising management control over key financial issues.

She has not "contributed" any property in the partnership law sense, because she has a contractual right to be repaid her loan. But not all partners contribute property. There is no express agreement to share losses, but most jurisdictions do not require one.

In short, Bill and Chris have shared control over the business and its assets. They have linked their economic fate to each other and to the business by agreeing to share profits. They have thus arranged to "carry on as coowners a business for profit."[81]

Chris's response will be to characterize her right to share profits as mere "interest or other charge on a loan" and therefore not probative of partner status.[82] Both the profit-sharing agreement and the circumstances leading up to that agreement support this characterization. Chris's agreement with Bill gave her the right to take either interest at a fixed rate or a profit share. This arrangement demonstrates that profits, if chosen, were to take the place of conventional interest. Chris did not seek an interest in Bill's business, but rather demanded an option on profits as a condition to making a loan.

The biggest problem with Chris's argument is the type of control she exercised. While many loan agreements give the lender extraordinary power over the debtor's affairs in the event of a default, Chris asked for, obtained,

and began exercising *mundane* control *as a condition of granting the loan.* This deviation from standard lending practice may well tip the balance against Chris.

In any event, Chris has troubles under agency law. If a creditor asserts enough control over a debtor to take over the management of the debtor's business, R.2d, §14 O makes the creditor liable for the debts of the business. Mere veto power is not enough; extensive involvement is necessary.

Chris may well have asserted the necessary control and undertaken the necessary involvement. She was certainly involved in the business; she spoke specifically of"divid[ing] up the responsibilities." Moreover, she controlled some very important aspects of the business: namely, when and which accounts would be paid and what customers would be allowed to buy services on credit. Chris can, however, point to large areas of the business that she did not control: namely, all personnel matters and the selection of vendors.

With the question of control a close one, a court may be influenced by the striking similarity between Chris's situation and the situation in *Cargill.* The creditor in *Cargill* kept the Warren grain elevator in business, obtaining grain while the elevator's debts to farmers mounted. Chris kept the dry- cleaning enterprise in business and then used her control to make sure that she was paid before all creditors other than employees. In both situations, the creditor used its control to obtain a benefit at the expense of other creditors. Such an abuse of power simultaneously (i) demonstrates that the creditor did substantially interfere with the management of the debtor's business, and (ii) provides a policy reason for making the controlling creditor liable to the other creditors.

If Chris is liable under Restatement §14 O, the extent of that liability depends on whether the court follows *Cargill or Nash-Finch.*[83] *Cargill* follows §14 O faithfully and makes the creditor-principal liable for all debts incurred in the business after the creditor took control. Under *Cargill,* therefore, Chris would be liable to all creditors for all amounts arising after she refinanced and took control of the business.

Under *Nash-Finch,* in contrast, the principal's liability extends only to debts arising within areas of the business controlled by the creditor. Under that approach, Chris would not be liable to the three employees. She did not control their selection, training, supervision, or payment. She did control payment to trade creditors and would be liable to them.◂◂◂

1. U.S. law encompasses two forms of partnership: general partnerships and limited partnerships. Each of these forms has a version with a corporate-like liability shield for the owners: in the case of a general partnership, a limited liability partnership (LLP); in the case of a limited partnership, a limited liability limited partnership (LLLP). Whenever this book uses the term "partnership" by itself, the term refers to a general partnership without a liability shield. For a discussion of limited partnerships, see Chapter 12. For a discussion of LLPs and LLLPs, see Chapter 17.

2. In the modern parlance of business entity law, an "organic" statute is a statute under which a business entity is created and whose provisions govern the internal relationships ("internal affairs") of those who own and operate the business entity.

3. It is not necessary that the participants intend to be partners. See section 7.2.1.

4. Louisiana was the lone holdout. The District of Columbia, Guam, and the Virgin Islands also adopted UPA (1914). Some states adopted nonuniform provisions.

5. Almost all practitioners and commentators have thought of the act—whether in version 1992, 1994, 1996, or 1997 —as the Revised Uniform Partnership Act and have referred to the act by its acronym "RUPA." The promulgation of UPA (2013) makes the adjective "revised" ambiguous, so this book refers to UPA (1997) or UPA (2013), as appropriate.

6. See section 9.7.2.

7. The text of UPA (1997) was approximately 25 percent longer than the text of UPA (1914), but that comparison is only half of the story. Both UPA (1914) and UPA (1997) contain official Comments, but the Comments to UPA (1914) are scant while the Comments to UPA (1997) are copious. The comments to UPA (2013) are also copious.

8. See section 9.7.2.

9. For a more detailed discussion of this point, see section 7.1.4.

10. See UPA (2013) §102(12) (defining "partnership agreement" to mean "the agreement, whether or not referred to as a partnership agreement and whether oral, implied, in a record, or in any combination there of, of all the partners of a partnership"). For a discussion of *inter se* rules that are not default rules, see section 7.14(b). Courts are divided as to whether the statute of frauds applies to an undertaking within a partnership agreement that would be subject to the statute if the agreement were outside the partnership context. Most of the controversy involves undertakings that concern a person becoming a partner; for example, an oral agreement to contribute land to the partnership in return for becoming a partner, or an oral promise that a person will become a partner after performing specified services that cannot be accomplished within one year of the making of the promise. For a more detailed analysis, see UPA (2013) §102(12), cmt.

11. As a matter of contract law, a third party may agree with a partnership or a partner to waive rights created under one of the mandatory, third-party rules.

12. Indeed, those who become partners by inadvertence are stuck with those rules wholesale, at least initially. (Formation of a partnership requires no special formalities, and may occur even though the participants in a business relationship are unaware that the law labels their arrangement a partnership. See section 7.2.2.)

13. See section 7.2.3. However, if a third party knew of the label, the person might be liable to that third party as if a partner. See section 7.5 (Partnership by Estoppel).

14. See section 9.8.1.

15. UPA (1914) does contain a few statutory limitations. For example, under UPA §31(2) the partnership simply cannot prevent a partner from wrongfully causing the dissolution of the partnership by "express will." See sections 11.2.1 and 11.6.

16. UPA (2013) §§105(c) and (d); 106. For a more specific discussion of these constraints, see sections 9.8.1 (limits on agreements) and 11.8.2 (Dissociation Described).

17. UPA (2013) §105(b).

18. UPA §6(1).

19. UPA (2013) §202(a). As discussed in Chapter 12, the law also recognizes a different type of

partnership—a “limited partnership.” When used alone, “partnership” most often refers to a general partnership.
20. A business that complies with the formalities necessary to become a corporation, limited liability company, or limited partnership cannot be a general partnership, even if in every other respect the business matches the key characteristics of a partnership.
21. See sections 7.4.3 and 8.7.
22. Partnerships with large numbers of partners are not typical. Unless the partnership is a limited liability partnership (“LLP”) (see section 17.2), partners are personally liable for the debts of the partnership. See section 7.3. Regardless of LLP status, the partnership is liable for the misconduct of its partners. See Chapter 10. The larger the number of partners, the greater is this risk of vicarious liability. Also, UPA (1914) partnerships are susceptible to dissolution (which requires the business of the partnership to be “wound up”), and increasing the number of partners increases the problems inherent in that susceptibility. See Chapter 11.
23. See section 7.3.2 (restrictions on business forms available to professionals).
24. UPA §6(1); UPA (1997) §202(a); UPA (2013) §202(a).
25. Because a partnership is essentially a contractual relationship, the “intent” at issue is objective rather than subjective.
26. UPA (2013) makes this point explicitly. See §202(a), quoted in section 7.2.1.
27. The parties’ self-description is not necessarily useless. The parties’ label can be influential in “close call” situations. See section 7.4.3.
28. As explained in section 7.1.4, the partners can displace the default rules, but they can do so only by agreement.
29. See sections 7.3 and 7.4 (contesting and establishing the existence of partnerships). Since the participants do not consider themselves partners, they will not obtain the liability protection of an LLP. See section 17.2.
30. See sections 7.4.3 and 7.4.4, which discuss other business relationships that may involve profit sharing.
31. For simplicity’s sake, the Example lists only a few of the costs an actual company would incur. The concepts being illustrated would apply as well in a realistically complicated situation.
32. Section 7.2.3.
33. UPA §18(a); UPA (1997) §401(b), UPA (2013) §401(a) (unless otherwise agreed, losses to be shared in the same proportion as profits are shared). See section 8.3.1.
34. Kopka v. Yockey, 131 N.E. 828, 829 (Ind. Ct. App. 1921).
35. See section 7.2.7.
36. For a discussion of the co-ownership “consequences” of partnership, see Chapter 8.
37. UPA (1914) reflects this lay construct in its approach to partnership property and the management rights of partners. See section 8.7.2.
38. See section 8.7.
39. Recall from section 2.1.4 the difference between *power* and *right*. Under UPA (1914), each partner always has the *power* to call an end to the partnership. See section 11.2.1. The situation is different under UPA (2013). See sections 11.10 and 11.11.
40. A partner’s fiduciary duty may limit this right. See section 11.7.1.
41. Mack v. Mack, 613 N.W.2d 64 (S.D. 2000) (affirming the trial court’s finding that the partnership was at will).
42. For example, UPA (1914) §25 (partners have no individual rights in property owned by the partnership, but do have collective rights to use and possess the partnership’s property for partnership purposes).
43. Statev. Pielsticker, 225 N.W. 51 (Neb. 1929). *Compare* Peoplev. Knapp, 99 N.E. 841 (N.Y. 1912) (reaching the opposite conclusion in an essentially identical situation, because the court considered the partnership to be a mere aggregation of individuals).

44. UPA (1997) §201(a). This approach also allowed UPA (1997) to simplify partnership law's approach to partnership property. See section 8.7.
45. Some aggregate aspects remain "under the surface" in the modern acts. See Daniel S. Kleinberger, "The Closely Held Business through the Entity-Aggregate Prism," 40 WAKE FOREST L. REV. 827, 841-842 (2005).
46. UPA (2013) §§201, 401(i), 603(a).
47. Section 17.2 explains limited liability partnerships.
48. See section 7.3.2.
49. UPA (1997) §307(d); UPA (2013) §306(a).
50. For a discussion of how a partner's misconduct could give rise to a partnership debt, see sections 10.5 and 10.6. For a discussion of other ways in which partners can bind their partnership to third parties, see sections 10.2-10.4. In addition, a partnership can be bound through the conduct of its agents.
51. Of course, the creditor cannot collect more than the amount owed. That amount will be reduced to judgment. Once the creditor has collected the full judgment amount, the judgment is satisfied.
52. UPA (1997) §306(a); UPA (2013) §306(a). Under all three acts, a new partner's personal liability does not extend to a partnership obligation incurred before the person became a partner. UPA §17; UPA (1997) §306(b); UPA (2013) §304(b). The question of when a partnership obligation is actually incurred is complex and a matter of case law. For a detailed discussion, see UPA (2013) §306(b) and (c), cmts.
53. Larry will, however, be entitled to indemnity from the partnership. See sections 8.9 (Partner's Right to Indemnity) and 8.3.1 (loss sharing applied when third party has collected from one partner and the partnership has failed to indemnify).
54. Of course, even with a corporation or LLC, owners of start-up businesses often have to give personal guarantees to important creditors (e.g., banks, major suppliers). However, such particularized guarantees cause far less exposure than does the simple fact of partner status.
55. The so-called S Corporation can avoid double-taxation, but faces limitations on who can own stock and how the stockholders can structure their *inter se* financial relationship. See section 13.1.3.
56. For a detailed discussion of the advantages of partnership tax status, see section 13.1.2.
57. For a discussion of limited liability companies, see Chapters 13 through 16. For a discussion of LLPs, see section 17.2.
58. Section 7.1.4.
59. See section 7.2.2.
60. In re KeyTronics, 744 N.W.2d 425 (Neb. 2008). The consequences could have been much worse, if the business had been insolvent and its creditors sought to hold the co-owners liable as partners. For a discussion of partnership dissolution and winding up, see Chapter 11. For a discussion of the accounting remedy, see section 9.9.
61. See sections 17.2.2 and 17.2.5.
62. This Example is based on Schaefer v. Bork, 413 N.W.2d 873 (Minn. Ct. App. 1987).
63. Stanford Carr Dev. Corp. v. Unity House Inc., 141 P.3d 459 (Haw. 2006).
64. UPA (2013) §202(c)(3).
65. UPA §7(4). Under UPA (1914), profit sharing is prima facie evidence of a partnership. The official Comment to UPA (1997) §202 characterizes the difference between prima facie evidence and a presumption as merely "a more contemporary construction." However, unlike a presumption, prima facie evidence does not shift the burden of proof. Prima facie evidence means that a party has submitted enough evidence to satisfy the burden of proof, but, as the fact finder considers all the evidence, the burden of persuasion remains on the party seeking to establish partnership status. A presumption means that the party contesting partnership status has the burden of persuasion.
66. UPA (2013) §202(c)(3)(E), cmt.
67. UPA (1914) §7(4). A comment to UPA (2013) §202(c) explains the difference as follows:

UPA (1997) recast [sharing profits] as creating a rebuttable presumption of partnership rather merely constituting prima facie evidence. “Prima facie” means that the party with the burden of proof has adduced sufficient evidence to carry that burden, subject to the finder of fact’s view of any contrary evidence. The burden of persuasion is unchanged. In contrast, “rebuttable presumption” switches the burden of persuasion.

68. UPA §7(4)(d). In the modern acts, the comparable language is “in payment ... of a debt by installments or otherwise.” UPA (2013) §202(c)(3)(A); UPA (1997) §202(c)(3).

69. UPA (2013) §202(c)(3)(B). UPA §7(4)(b) refers to profits received “[a]s wages of an employee.”

70. See section 7.2.4.

71. See sections 8.1 and 8.5.

72. See section 8.6.

73. VIDIVIXI, LLC v. Grattan, 155 F. Supp. 3d 476, 478 (S.D.N.Y. 2016).

74. An “ideal type” possesses all the key attributes described by a concept; it epitomizes the concept even though the epitome may rarely, if ever, exist in pure form. (The concept derives from the works of the German social theorist Max Weber.)

75. UPA (1914) §16.

76. UPA (2013) §308.

77. If the partnership is an LLP, no partner is personally liable for the partnership’s debts, so no *partnership-based* liability will attach to the person making the misrepresentation. However, other common law claims might be available, e.g., misrepresentation, fraud in the inducement. See section 4.2.3 (“a tort is a tort is a tort”).

78. For a discussion of the rules that reflect this perception, see Chapter 10.

79. Even though partnerships do not pay income taxes (see section 7.3.2) they must nonetheless file tax returns.

80. This question will have great practical importance if, for example, Paul attempts to “fire” Eli or decrease Eli’s remuneration.

81. UPA (2013) §202(a) (definition of partnership).

82. UPA (2013) §202(c)(3)(E).

83. See section 6.3.2 n.32.

CHAPTER 8

# Financial Aspects of a Partnership (Creation and Operation)

## §8.1 THE PRACTICAL BACKGROUND

Like any other business, a partnership needs two types of inputs in order to function: the working efforts of human beings ("labor") and the use of at least some property, be it as elaborate and tangible as a fleet of delivery trucks, as simple as paper on which to write out bills, or as conceptual as a trademark, copyright, or patent.[1]

A partnership typically obtains both labor and property from its partners, although not every partner necessarily provides both.[2] Of course, a partner who provides something of value to the partnership will want something in return, and all three uniform acts provide a comprehensive set of default rules that determine how and when partners receive a return.[3] This chapter discusses how those rules apply to the creation and operation of a partnership.[4]

Partnerships can and often do obtain inputs from outsiders (i.e., from nonpartners). A partnership can, for example:

- rent office space from a landlord;
- borrow money from a bank; and
- obtain services from employees, nonemployee agents, and independent contractors.

The remuneration rules for these relationships come from contract law and, in particular, the contract defining the relationship between the partnership and the outsider.[5]

## §8.2 THE PARTNER'S BASIC RETURN AND PARTNERSHIP LAW'S BASIC PREMISE

Absent a contrary agreement, a partner's financial return has two main components: (i) a right to an equal allocation and eventual distribution of the profits of the partnership, if any; and (ii) a right, when the partnership ends, to receive the value of any property whose ownership the partner transferred to the partnership. Partnership law refers to any such transfer as a "contribution" or "contribution of capital," and the contribution is valued as of the moment of contribution. Absent a contrary agreement, a partner has no right to remuneration based on the amount of labor expended (e.g., no wages or salary) or on the amount of capital contributed (e.g., no interest).[6]

In this area, the key premise of partnership law is that — unless the partners manifest otherwise — the partners consider what each partner brings to the table as roughly comparable to what each other partner brings. Put another way: The premise is that if the partners do not assume equality of interests, they will manifest their contrary views through an agreement — whether formal or informal, express or implied — that will displace the default rule.

A partner may also have other financial arrangements with the partnership. For example, a partner may rent property to the partnership or lend the partnership money. But such arrangements result from particular agreements between the partner and the partnership. They do not inhere in partner status.

A partner also has the right to be indemnified against expenses and liabilities incurred in the service of the partnership.[7]

## §8.3 RULES FOR ALLOCATING PROFITS AND

# LOSSES

# §8.3.1 The Size of the Share (Percentages)

## a. Profits

All three acts have a simple default rule on the size of each partner's profit share. Absent a contrary agreement, each partner is allocated an equal share.[8] The rule applies regardless of how much property individual partners have contributed to the partnership, and regardless of how much individual partners work for the partnership.

**Example**

> Larry, Moe, and Curley form a partnership to manufacture and sell whoopee cushions. To get the business started, Larry and Curley each contribute $10,000. They each work in the factory 60 hours per week. Moe, in contrast, contributes $0 and works 20 hours per week, in his words, "closing big deals." The partners have no agreement, either express or implied, regarding profit sharing. Despite the differing contributions and efforts, the partners share profits equally (i.e., one-third each). Absent a contrary agreement, the default rule applies. ◂◂◂

## b. Losses

Absent a contrary agreement, partners share losses in the same percentage as they share profits. UPA (1914) §18(a) states: "Each partner . . . must contribute towards the losses . . . sustained by the partnership according to his share in the profits." UPA (2013) §401(a) states: "Each partner . . . is chargeable with a share of the partnership losses in proportion to the partner's share of the distributions."

If there is *no inter* se agreement addressing profits or losses, then — because the default rule on profits provides for equal profit sharing —the partners will share losses equally. If a partnership agreement establishes profit-sharing percentages but neglects to address loss sharing, the loss sharing percentages will mirror the profit-sharing percentages.

**Example**

> Larry, Moe, and Curley form a whoopee cushion partnership. The partnership agreement gives Moe a 60 percent share of profits and Larry and Curley each a 20 percent share. The agreement does not mention losses. If the partnership suffers losses, the partners will share the losses 60/ 20/20. Because the default rule applies, the loss shares match the profit shares. ◂◂◂

### c. No Impact on Third-Party Claims

Loss sharing arrangements *among* partners do not affect the personal liability of each partner to creditors for the debts of the partnership. If the partnership is a limited liability partnership (LLP), the partners are not by their status liable for the partnership's obligations.[9] If the partnership is not an LLP, each partner is either jointly liable or jointly and severally liable for each partnership debt regardless of the *inter se* situation.[10]

*Inter se* arrangements *do*, however, affect what happens when a creditor succeeds in collecting a partnership debt from an individual partner. If the partnership lacks the funds to indemnify that partner,[11] then the *inter* se arrangements will determine how much each of the other partners must compensate the partner who took the hit.

**Example**

> The Larry-Moe-Curley partnership goes out of business. The partnership is not an LLP, and a creditor of the partnership subsequently collects $21,000 from Curley on a debt owed by the partnership. The partnership has no funds to reimburse Curley. The partners had agreed to share losses equally. Curley has a right to collect $7,000 each from Larry and Moe. ◂◂◂

## §8.3.2 Timing

### a. Determining When Profits (and Losses) Are Allocated

None of the uniform acts specify how often profits and losses are allocated among the partners. However, tax law requires an annual allocation. Although a partnership pays no tax, it must annually provide each partner a "K-1" form, indicating each partner's share of profits or losses from the past tax year.

## b. Determining When Profits Are Paid Out (Distributed)

### *1. Default Rules under the Acts*

As to when profits are actually distributed (i.e., paid out), the three acts each use different language to reach roughly the same result.

- UPA (1914) provides that "[e]ach partner shall be repaid his contributions . . . and share equally in the profits and surplus remaining *after* all liabilities . . . are satisfied."[12] The language suggests that a partnership must repay the value of all contributions and discharge all liabilities before it pays out any profit.
- UPA (1997) addresses the issue only through a comment which states: "Absent an agreement to the contrary, . . . a partner does not have a right to receive a current distribution of the profits credited to his account, the interim distribution of profits being a matter arising in the ordinary course of business to be decided by majority vote of the partners."[13]
- UPA (2013) states specifically that "a person has a right to a distribution before the dissolution and winding up of a partnership only if the partnership decides to make an interim distribution."[14]

### *2. In Practice*

In virtually all general partnerships the timing of interim distributions is a matter of agreement — either express or through a course of conduct — and most agreements contemplate some sort of annual distribution. Likewise, by express agreement or by custom, partners in many operating (as distinguished from investment) partnerships take "draws" throughout the year against their anticipated annual profit share. Under most such arrangements, matters are evened up at year's end. If a partner has overdrawn, the partner must repay the excess. If a partner has drawn too little, the partner may then withdraw the remainder.[15]

Annual reconciliation is not mandatory as a matter of partnership law. For example, a partnership agreement can appoint a later time for the "evening up" process or provide that overdraws simply be subtracted from the value of any contributions the partner has made to the partnership. Likewise, a

partnership agreement could allow partners to leave in some or all of their profit share and have that amount treated as if the partners had contributed it back to the partnership.[16]

### c. Determining When Losses Are "Shared"

None of the three acts specifies the timing of loss sharing. Typically, the partnership's books keep track of loss allocations on an annual basis, as required by tax law, and the recorded losses affect what each partner receives when the partnership comes to an end.[17]

## §8.4 REMUNERATION FOR LABOR PROVIDED BY PARTNERS TO THE PARTNERSHIP

If partners spend time and effort furthering the partnership's business, what compensation do they receive? Under all three partnership acts, the default rule is simple. Absent a contrary agreement — be it express or implied — they receive nothing beyond their share in the profits: no wages, no salary, and no extra compensation of any kind.[18]

**Example**

> Larry, Moe, and Curley form a partnership to manufacture and sell whoopee cushions. They agree to share profits equally. To get the business started they each contribute $5,000 to the partnership. Larry and Curley each work in the factory 60 hours per week. Moe works 20 hours per week "closing big deals." Larry and Curley contend that they should get "something extra" for working more. They are incorrect, unless they can show either an express or implied agreement. ◂◂◂

Although in concept the mechanism for determining whether a partner has a right to additional compensation is clear-cut, in practice fact disputes about alleged implied or oral agreements can be quite intense.

# §8.5 REMUNERATION FOR PROPERTY PROVIDED BY PARTNERS TO THE PARTNERSHIP

## §8.5.1 Contribution — the Basic and Simple Paradigm

Partners who provide property to a partnership most often do so by contributing the property — i.e., transferring ownership from the partner to the partnership. In such circumstances, the default remuneration rule is simple and the same under all three uniform acts. The partner's contribution is valued as of the date of contribution, and, when the partnership dissolves, the partner is entitled to the return of that amount of value (and not the contributed property itself). The contributed capital itself belongs to the partnership, and can be any property — real or personal, tangible or intangible — in which the contributing partner had a right to transfer an interest.

As with partners who expend labor and receive nothing for the "use" of their labor beyond their share in the profits, absent a contrary agreement partners who contribute "capital" receive nothing for the use of the capital beyond their share in the profits; Such partners receive no interest or extra compensation of any kind;[19] they receive merely the return of the original contribution *value* when the partnership comes to an end.[20]

**Example**

> Autumn agrees to contribute to the Seasons Partnership a parcel of land valued at $500,000, in return for a 20 percent share of partnership profits. During the next five years, rental from the land accounts for 25 percent of the Partnership's profits, and the land itself increases in value by 200 percent. The benefits from the land belong to the partnership, not Autumn, whose remuneration as a partner is the agreed-upon 20 percent share. If the Seasons Partnership were to dissolve, Autumn would have a right to a return of $500,000, no matter how valuable (or worthless) the parcel of land had become.

## §8.5.2 The Complexity — Additional Modes of Providing Property

Complexity can exist in this area of law and practice because two other methods exist by which a partner might provide property for the use of a partnership. The partner might:

- *furnish* property, providing the partnership only the use of the property for either the duration of the partnership or some other period of time, retaining title to the property and receiving no remuneration beyond the partner's share in the profits; or
- *lease* or *lend* the property, providing the partnership the use of the property for either the duration of the partnership or some other period of time, retaining title to the property and receiving rent, interest, or royalties as compensation.

**Example**

> Larry, Moe, and Curley form a partnership. Larry *contributes* $10,000 in cash. Moe has a right under a lease to occupy certain business premises, and he *furnishes* those premises to the partnership at no charge; making the premises available is part of what Moe "brings to the party" in return for becoming a partner. Curley *leases* his truck to the partnership. ◂◂◂

## §8.5.3 Consequences of the Complexity — Different Rules for Property-Related Remuneration

It is important to distinguish among the three modes through which a partner might provide property to a partnership, because the remuneration consequences vary with the characterization. Under all three acts, the consequences have multiple, though related, aspects:

- What compensation, if any, does the partner receive for providing property to the partnership?
- Does the partner ever receive back the property? This question in turn implies two further issues:
  - If the property depreciates while being used by the partnership, who bears the loss?
  - If the property appreciates, who enjoys the gain?

The following figure describes and compares the consequences pertaining to each characterization.[21]

**Figure 8.1. Modes of Providing Property — Consequences**

| Mode of Providing Property | Title to Property | Remuneration for Use | Property Returned to Partner? | Risk of Depreciation/ Benefit of Appreciation |
|---|---|---|---|---|
| contribution | transfers to partnership | none beyond partner's profit share | no | for partnership |
| furnishing | remains with partner | none beyond partner's profit share | yes, as part of winding up | for partner |
| leasing/ lending[22] | remains with partner | per the lease/loan agreement | yes, per the lease/loan agreement | for partner |

**Example**

A partner "furnishes" to the partnership the royalty-free use of a patent. After five years the partnership dissolves, and the partner regains full rights in the patent. In those five years, the patent has become more valuable because a major competing product has been discontinued as unsafe. The partnership has no right to share in that increased value. Absent a contrary agreement, the benefits of increasing value stay with the party who owns the property. ◂◂◂

**Example**

A partner leases to the partnership several new pieces of construction equipment, and the partnership agrees to pay rent of $5,000 per month. After five years, the partnership comes to an end and the lease terminates. The partner regains the right to possess, use, and dispose of the equipment. Although the equipment is now far less valuable than it was originally, the partnership is not obliged to compensate the lessor/partner for the decrease.[23] Absent a contrary agreement, and assuming no abuse of the property by the partnership, the risk of diminishing value stays on the party who owns the leased property.

◂◂◂

**Example**

> To help the Larry-Moe-Curley partnership get started making whoopee cushions, Moe contributes equipment worth, at the time, $500,000. Moe makes no warranty on the equipment. A year later the equipment breaks down and becomes worthless. When the partnership later comes to an end, the partnership owes Moe $500,000, the value of his contribution. ◂◂◂

**Example**

> Larry contributes to the partnership land worth $400,000. The land appreciates during the partnership's existence, and is worth $1,000,000 when the partnership comes to an end. Larry has no right to the return of the land; it belongs to the partnership. Larry does have a right to the return of the original value of his contribution, that is, $400,000. The $600,000 in appreciation belongs to the partnership.[24] ◂◂◂

# §8.5.4 Distinguishing the Modes of Providing Property

## a. The UPA (1914) Approach[25]

UPA (1914) contains no rules for distinguishing the modes of providing property.[26] The rules come from the case law, which is plentiful. Whether a partner has leased, loaned, furnished, or contributed property to a partnership depends on the intent of the parties — that is, of the partner providing the property, and the partnership. Intent is a question of fact, to be determined objectively from the parties' manifestations. Express agreements provide the clearest manifestation.

In the absence of an express agreement, a court is unlikely to find a lease or a loan unless the partnership has in fact made payments that can be fairly construed as rent, interest, or royalties. As for distinguishing contributed

*property* (ownership transfers to the partnership) from merely *furnished* property (partner retains ownership), the following factors indicate *contribution*:

- the use of the property in the partnership business, especially if the property is crucial or central to that business;
- the use of partnership funds in improving, maintaining, insuring, or paying taxes on the property;
- indications in the partnership's books that the property belongs to the partnership;
- nonreceipt of rent or other compensation by the partner who provided the property.

For two reasons, the listed factors do not include the partnership holding formal legal title to the property. First, only real property and a few forms of personal property (e.g., motor vehicles) even *have* record title. Second, in many states, before the enactment of UPA (1914), a partnership could not hold title to real property in the partnership's name.[27] It was therefore common for individual partners, or for partners jointly, to hold title to real estate that in a functional and equitable sense belonged to the partnership. As a result of custom and inertia, such arrangements have continued even under the modern uniform acts.

## b. The Modern Approach

UPA (1997) changed the law on this subject, placing considerable emphasis on title. The change was consistent with the entity approach ofUPA (1997) as well as with the statute's concern to clarify record title for real estate.[28] UPA (2013) made no changes to the statutory text but provided further explanatory comment:

> Section 204 states the rules *inter se the partners and partnership* for determining when property is acquired by the partnership and so becomes partnership property. . . .
>
> These rules provide three separate approaches — according to:
>
> - the name or names used in acquiring the property (formalities of acquisition);
> - when a partner's name appears as a transferee, the capacity in which the partner is acting property (formalities of acquisition); and
> - for property acquired by purchase, whether the partnership provided the consideration for the property.
>
> These approaches are complementary, not mutually exclusive.[29]

### *1. Formalities of Acquisition*

Property is partnership property if acquired:

- "in the name of . . . the partnership"[30]
- in the name of "one or more partners" if "the instrument transferring title to the property" indicates "the person's capacity as a partner or . . . the existence of a partnership."[31]

**Example**

> Rachael executes a deed to a parcel of land, with the transferee shown as "Eli, a partner." Eli is a partner in the Eli-Ilan Scissor Company, a general partnership under one of the modern partnership acts. The land belongs to the partnership. ◂◂◂

### *2. Assets Used to Accomplish the Acquisition*

If the just-stated rule does not determine ownership, then the source of funds or credit used to acquire the property raises an ownership presumption.

- "Property is presumed to be partnership property if purchased with partnership assets."[32]
- "Property acquired . . . without use of partnership assets, is presumed to be separate property, even if used for partnership purposes."[33]

Although the modern rules work best with property with record title, they apply with equal force to all forms of property — e.g., real, personal, tangible, and intangible.[34]

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# §8.6 SPECIAL ISSUES WITH K-AND-L PARTNERSHIPS

## §8.6.1 K-and-L Partnerships Described

A partner may "buy into" a partnership by providing or promising to provide capital, labor, or both. There is no requirement, however, that each partner provide both capital and labor. In some partnerships one partner provides all the capital (the *K* partner) and another partner provides all the labor (the *L* partner).[35] In the context of such *K*-and-*L* partnerships, courts occasionally

have difficulties applying the statutory default rules on remuneration and loss sharing.

## §8.6.2 Problems with Loss Sharing

The default rule on loss sharing is the same in each of the three acts,[36] and under each act, the rule applies regardless of the inputs the partners provide to "buy into" the partnership. Therefore, if a *K*-and-*L* partnership loses money, the *L* partner (i.e., the one who provided only labor) will receive nothing from the partnership. There will be no profits to share, and absent a contrary agreement, a partner receives no remuneration for services provided the partnership outside of winding up.[37] Moreover, the *L* partner will have to "kick in" money so that *K* and *L* share losses according to the statutory default rules.[38]

**Example**

> Cliff and Lilith form a partnership to run a dating service. They do not make any agreements displacing the remuneration and loss default rules. Lilith provides $250,000 in start-up money and does not work in the business. Cliff works full-time in the business, but contributes no capital. The partnership comes to an end after a year, having lost $250,000. (That is, the partnership manages to pay off all creditors, but then has nothing left over. Since the partnership began with $250,000, the partner-ship has suffered a $250,000 loss.)

For his year of work, Cliff has received nothing. There are no profits, and, whatever the applicable general partnership act, it bars any other form of compensation in the absence of an agreement. At first glance, Lilith appears to have lost $250,000. However, the partners have made no agreement as to loss sharing, so the statutory default rule on loss sharing is in effect, i.e., Cliff and Lilith share losses as they would have shared profits; that is, equally. For Cliffs *out-of-pocket* losses to equal Lilith's, $125,000 must make its way from Cliff to Lilith. Cliff will pay $125,000 to the partnership, which will then distribute that amount to Lilith. Both Cliff and Lilith will then have lost $125,000. ◂◂◂

This result may appear harsh. After all, without loss sharing Cliff and Lilith appear each to have lost roughly comparable value. They have lost, that is, the value they provided the partnership in return for becoming partners.[39] Accordingly, if Cliff has to transfer $125,000 to Lilith, his loss of value will exceed hers.

Seeking to avoid such apparently harsh results, some courts have held that the *L* partner shares losses only if he or she has expressly agreed to do so. Appearances can mislead, however, and those courts have ignored the concept of "opportunity cost"[40] and consequently have misunderstood the balance of losses between K-and-L partners. In the example above, Cliff lost whatever value he could have derived from using his labor elsewhere during the partnership's year of operation. Lilith had a parallel loss — whatever income she could have derived from investing the $250,000 elsewhere for a year. In addition, without loss sharing, Lilith also lost the $250,000 itself.

Whether the statutory default rule is unfair to Cliff (or perhaps unfair to Lilith) will depend on how the value of Cliff's forgone labor opportunity compares with the value of Lilith's forgone capital opportunity. If Lilith could have earned 10 percent interest by investing her money elsewhere for a year, and if Cliff s lack of skills and odd personality mean that he could have earned no more than $20,000 in salary in some other position, then even after Cliff pays Lilith $125,000 Lilith will have suffered greater detriment than Cliff. Cliff will have lost $125,000 out-of-pocket, plus the forgone opportunity to earn $20,000 by working elsewhere for the year. Total detriment: $145,000. Lilith will have lost $125,000 out-of-pocket ($250,000 contributed, offset partially by Cliff s $125,000), plus the forgone opportunity to earn $25,000 interest on her capital. Total detriment: $150,000.

In any event, the language of each general partnership act expressly mandates loss sharing.

## §8.6.3 Problems with Appreciation

Under the statutory default rules, when a partner contributes property to the partnership and that property subsequently increases in value, the partnership benefits, not the partner.[41] Eventually, when the partnership realizes the appreciation, that value either offsets business losses or adds to profits. To the extent the appreciation adds to profits, all partners share in the benefit

according to their respective profit shares. The partner who originally contributed the property has no special claim on the appreciation.

Occasionally, courts dealing with *K*-and-*L* partnerships ignore or misunderstand the default rules and allocate all the appreciation to the *K* partner (i.e., the partner who contributed the property). They do so either by miscalculating the amount they award each partner or by returning the appreciated asset itself to the *K* partner.

**Example**

> Cliff and Lilith form a partnership to raise chickens, agreeing to share profits equally. Cliff contributes a small farm worth $50,000. Four years later the partnership comes to an end. By selling all of its assets other than the farm, the partnership has enough cash to exactly pay off its debts.[42] During the life of the partnership, land values have increased sharply, so the partnership manages to sell the farm for $200,000. How the proceeds are divided will depend on whether the court follows the applicable partnership statute:

- *Applying the Default Rules of All Three Acts* — The partnership pays $50,000 to Cliff, returning to him the value of his contribution.[43] The remaining
- $150,000 represents post-contribution appreciation and is therefore profits. Cliff and Lilith each receives half.
- *Overcompensating the K Partner* — The partnership either allocates all $200,000 to Cliff or simply transfers ownership of the farm back to him. In either event, Cliff gets the benefit of all the appreciation. ◂◂◂

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# §8.7 PARTNER’S INTERESTS IN PARTNERSHIP PROPERTY

## §8.7.1 Partner’s Rights as to Partnership Property

Concerning a partner’s rights as to partnership property, UPA (1914) and the two modern acts each reach the same result. However, the modern acts both differ substantially from UPA (1914) in how the rules are stated.

## §8.7.2 The UPA (1914) Approach: Partner's Property Rights in the Partnership

According to UPA (1914) §24, each partner has three *property* rights in the partnership: "(1) his rights in specific partnership property, (2) his interest in the partnership, and (3) his right to participate in the management." As to the first and third rights, the "property" label borders on the bizarre; the rights relate to management prerogatives, not property interests. The key to understanding the UPA (1914) approach is therefore to disregard the label and attend instead to the specific content of the rights being described.

### a. Management Prerogatives Disguised as Property Rights

A partner's "property" rights under UPA (1914) include two management prerogatives: (i) the right to use the assets of the partnership in furtherance of the partnership's business (UPA (1914) §25) and (ii) the right to participate in the management of the partnership (UPA (1914) §24).[44]

The upshot is a fairly straightforward and commonsense notion. Absent a contrary agreement each partner has the right to possess and use partnership property for the purposes of the business, but no partner has the right to use partnership property for other purposes. Unfortunately, UPA (1914) §25 states this notion in an unnecessarily intricate way. Taking an aggregate approach, the provision describes the right to use business assets for business purposes as "tenancy in partnership."[45]

### b. The Partner's Interest – The Partner's Economic Rights

Under UPA (1914) §26 a partner's "interest in the partnership" consists of a right to share in the profits of the partnership and the right to receive, when the partnership ends, the value of any property contributed to the partnership.[46] Although labeling these rights "property" is not misleading, it is redundant. UPA (1914) §18(a) independently establishes that being a partner involves having a right to share in the profits of the business. Likewise, that subsection provides that "[e]ach partner shall be repaid his contributions."[47]

### §8.7.3 The Modern Approach

UPA (1997) replaced the oblique approach of UPA (1914) with two straightforward pronouncements, which UPA (2013) has continued:

- "A partner is not a co-owner of partnership property and has no interest in partnership property which can be transferred, either voluntarily or involuntarily."[48]
- "A partner may use or possess partnership property only on behalf of the partnership."[49]

**Case in Point — Cogar v. Lafferty**

> A partnership's real property was sold at a tax sale after the partnership failed to pay its real estate taxes. The partnership was served notice of the right to redeem, but the individual partners were not individually served. One partner sought to invalidate and set aside the sale to a third-party purchaser because he, a partner, was not served with notice of the right to redeem. Noting that that partners of a general partnership are not co-owners of partnership property, the court held that the individual partners had no interest in partnership property and no right to notice of the right to redeem partnership property separate from that notice provided to the partner- ship.[50] ◄◄◄

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## §8.8 THE "PICK YOUR PARTNER" PRINCIPLE AND RESTRICTIONS ON THE TRANSFERABILITY (ASSIGNABILITY) OF PARTNERSHIP INTERESTS AND ON THE REMEDIES AVAILABLE TO CREDITORS OF PARTNERS AND TRANSFEREES

### §8.8.1 A Note on Nomenclature: Transferee versus Assignee

Consistent with the notion that a partnership reflects a contract among the partners,[51] UPA (1914):

- uses the contract label “assignment” to describe the transfer of a partner’s ownership rights in a general partnership; and
- refers to the transferee accordingly as an “assignee.”[52]

An early version ofUPA (1997) replaced “assignment” and “assignee” with “transfer” and “transferee.” That usage continued into the final version of UPA (1997) and was followed in the original Uniform Limited Liability Company Act (1996), the 2001 version of the Uniform Limited Partnership Act, and the Revised Uniform Limited Liability Company Act (2006). The Harmonization Project confirmed the usage.[53]

The language change is almost entirely a matter of style. Although “assignment” can be read as limited to voluntary transfers, case law under UPA (1914) has taken a broader view.[54] Moreover, the same limited reading could apply to UPA (1997), which defines “transfer” to “include [] an assignment, conveyance, lease, mortgage, deed, and encumbrance.”[55]

In any event, UPA (2013) removes all doubt on this point, defining “transfer” to specifically include “a transfer by operation of law.”[56] A comment notes that, given this definition, the act’s transfer restrictions apply “for example, to transfers ordered by a family court as part of a divorce proceeding and transfers resulting from the death of a partner.”[57]

# §8.8.2 Transferability of a Partner’s Ownership Interest Restricted — the Rationale (“Pick Your Partner” Principle)

To give meaning to the notion that a partnership is a *voluntary* association,[58] the law must allow partners collectively the untrammeled right to determine with whom to associate as copartners and with whom to share management and information rights. This untrammeled right reflects what has come to be called the “pick your partner” principle. Per a comment to UPA (2013): “One of the most fundamental characteristics of partnership law is its fidelity to the ‘pick your partner’ principle.”[59]

The principle underlies all three acts, and each act protects the principal by substantially limiting (i) the transferability of partnership interests and (ii)

the ability of a judgment creditor of a partner or partner's transferee to access the partner's rights in the partnership.

## §8.8.3 Transferability of a Partner's Ownership Interest Restricted — the Rules

All three partnership acts have essentially the same set of default rules pertaining to the transferability of a partner's ownership interest. All three acts bifurcate the ownership interest into economic rights and all other rights. The other rights are sometimes called "management rights" or "governance rights," although the category also includes certain rights to information.[60]
A partner's economic rights are freely transferable. In sharp contrast, no partner can transfer (or assign) any other ownership rights to a nonpartner without the consent of all the other partners. In particular, a partner cannot effect a transfer to a nonpartner that causes the nonpartner to become a partner. In the words ofUPA (1997):

> The only transferable interest of a partner in the partnership is the partner's share of the profits and losses of the partnership and the partner's right to receive distributions.[61]

Further, all three acts follow centuries of common law and restrict significantly the rights of a transferee/assignee. The statutory language has changed only slightly over the past 100 years. UPA (1914) §27(1) provided:

> A conveyance by a partner of his interest in the partnership does not of itself dissolve the partnership, nor, as against the other partners in the absence of agreement, entitle the assignee, during the continuance of the partnership, to interfere in the management or administration of the partnership business or affairs, or to require any information or account of partnership transactions, or to inspect the partnership books; but it merely entitles the assignee to receive in accordance with his contract the profits to which the assigning partner would otherwise be entitled.
>
> UPA (2013) provides:
>
> A transfer, in whole or in part, of a transferable interest: (1) is permissible; (2) does not by itself cause a person's dissociation as a partner or a dissolution and winding up of the partnership business; and (3) [except for very limited rights of a decedent's estate] does not entitle the transferee to: (A) participate in the management or conduct of the partnership's business; or (B) except [for very limited financial information when the partnership dissolves], have access to records or other information concerning the partnership's business.[62]

### Example

Larry wants to assign his right to receive profits in the Larry-Moe-Curley partnership to the First National Bank. The Bank wants the assignment as security for a loan it is about to make to Larry. The Bank also wants the right to exercise Larry's management rights while the loan is outstanding and if Larry defaults. The partnership agreement is silent on the subject. To assign the management rights to the Bank, Larry needs the consent of Moe and Curley. An attempted assignment ofthose rights without that consent will be ineffective. ◂◂◂

**Case in Point — In re Dews**

As part of a divorce settlement, Debtor executed a note in favor of his exwife. When he failed to make payments, she obtained a judgment against him. In satisfaction of the judgment, Debtor transferred to his ex-wife a 17 percent interest in a partnership. In the bankruptcy proceeding, Debtor sought to avoid the transaction. The court's decision turned on when the transfer was effected. In determining the date of transfer, the court held in the alternative that (i) a transfer of all rights (governance as well as economic) occurred because the partnership had consented to the assignment, and (ii) even if no consent had been given and no management rights had transferred, Debtor's right to partnership profits (e.g., economic rights) were freely assignable and occurred when the transfer was made.[63] ◂◂◂

This approach to transfer/assignment is consistent with partnership law's default approach to admitting new partners. To transfer or assign governance rights is tantamount to bringing the transferee or assignee into the partnership. Under UPA (1914) §18(g), absent a contrary agreement: "No person can become a member of a partnership without the consent of all the partners." Similarly, under UPA (1997) §401(i), "A person may become a partner only with the consent of all of the part-ners."[64] Under UPA (2013): "After formation of a partnership, a person becomes a partner . . . with the affirmative vote or consent of all the partners.[65]

These default rules are subject to change by the partnership agreement. An agreement permitting the transfer of management rights may be made to apply generally or may pertain solely to a particular category of transfers.

The partnership agreement can also restrict transferability, limiting partners' rights to assign even their economic interests.[66]

## §8.8.4 "Pick Your Partner" and Restrictions on the Rights of a Partner's Judgment Creditors — the Charging Order

In general, a judgment creditor may enforce the judgment against all nonexempt property of the judgment debtor. A person's interest in a partnership is property, but judgment creditors seeking to reach that property face substantial barriers and limitations.

First, a judgment creditor of a partner (or a transferee) may not attach or levy on the partnership's property, because

- conceptually, that property belongs to the partnership and not to any individual partner.
- Under all three acts, an individual partner has no rights in partnership property.[67]
- Although under UPA (1914) individual partners are said to have rights in partnership property, those rights are for the purpose of the partnership business and are in any event inalienable without the agreement of the other partners.[68]

Second, a partner's judgment creditor has no access or right to the partner's noneconomic rights. Those rights are not transferable without the consent of the other partners. All three acts protect the "pick-your- partner" principle by making a *charging order* the sole remedy for a judgment creditor of a partner or transferee.

This special remedy, first invented under English law,[69] is in the nature of a lien on a partner's *economic* rights. The charging order thus recognizes and reinforces the "off-limits" nature of management rights and channels efforts to obtain access solely to economic rights.

The charging order first functions as a type ofgarnishment. The creditor applies to a court for an order that, if granted, obligates the partnership to pay to the creditor any amounts that would otherwise be paid to the debtor partner as distributions.[70]

A charging order also functions as a judgment lien. "Upon a showing that distributions under a charging order will not pay the judgment debt within a reasonable time, the court may foreclose the lien and order the sale of the transferable interest."[71] In that event, the economic rights of the debtor partner are sold just like any other property subject to a judgment lien. "The purchaser at the foreclosure sale obtains only the transferable interest [and] does not thereby become a partner."[72] The other partners can use their own, separate funds to redeem the charged rights or buy them at the foreclosure

sale, and partnership funds may be used, in the words of UPA (1914), with "the consent of all the partners whose interests are not so charged or sold."[73]

The same rules apply to a creditor of a non-partner (i.e., a transferee) when the creditor seeks to access the non-partner's transferable interest.

**Example**

> The Larry-Moe-Curley partnership owns considerable property, including a modern factory and a large inventory of whoopee cushions. Moe personally owes Shemp $500,000, and that amount has been reduced to judgment. Shemp cannot levy against the factory or the inventory, since that property belongs to the partnership. Shemp can, however, obtain a charging order against Moe's economic rights in the partnership. With that order in place, Shemp will receive any distributions the partnership would otherwise make to Moe. ◂◂◂

A charging order and any foreclosure and sales relate only to the debtor partner's economic rights. Neither the creditor nor any foreclosure purchaser obtains any rights to participate in the management of the partnership or to possess or use partnership property.

**Example**

> Although the Larry-Moe-Curley partnership enjoys good long-term prospects, the business is not currently making any profits. Shemp wishes to collect on his judgment now and persuades a court to foreclose the charging order. The charged interest is sold at auction to Lucille, who in essence now owns whatever economic interests Moe had as a partner. However, neither the foreclosure nor the sale make Lucille a partner or entitle her to participate in the operation and management of the business. ◂◂◂

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# §8.9 A PARTNER'S RIGHT TO INDEMNITY

UPA (1914) §18(b) states, as a default rule, that

> The partnership must indemnify every partner in respect of payments made and personal liabilities reasonably incurred by him in the ordinary and proper conduct of its business, or for the preservation of its business or property.

The most recent formulation appears in UPA (2013) §401(b)-(c):

> A partnership shall reimburse a partner for any payment made by the partner in the course of the partner's activities on behalf of the partnership, if the partner complied with this section [pertaining to management rights] and Section 409 [stating a partner's duty to partnership and fellow partners] in making the payment.
>
> A partnership shall indemnify and hold harmless a person with respect to any claim or demand against the person and any debt, obligation, or other liability incurred by the person by reason of the person's former or present capacity as a partner, if the claim, demand, debt, obligation, or other liability does not arise from the person's breach of this section or Section 407 [pertaining to unlawful distributions from a limited liability partnership] or 409.

However worded, this rule closely resembles an agent's right of indemnity from its principal.[74]

**Example**

> In the Larry, Moe, and Curley whoopee cushion partnership, all partners share in the marketing work. A potential customer comes to town to discuss the possibility of placing a large order. Moe spends $300 wining and dining the customer, but the customer decides against placing the order. The partnership must reimburse Moe. His efforts were reasonable in light of the shared marketing responsibilities, and the amount of expense was reasonable in light of the potentially large order. ◂◂◂

**Example**

> Same situation, except the partners have agreed that Larry alone will handle marketing efforts and sales promotion.[75] Under UPA (1914), that agreement means that Moe's payments for wining and dining expenses have not been "made ... in the ordinary and *proper* conduct of [the partnership's] business,"[76] and, therefore, he is not entitled to reimbursement. Under UPA (1997), the result is arguably the same, on the theory that the agreement puts Moe's entertaining outside the "the ordinary course of the business of the partnership."[77] Under UPA (2013), Moe likely will not be reimbursed. Given the agreement as to

marketing, Moe's expenses were not a "payment made by the partner in the course of the partner's activities on behalf of the partnership."[78] ◂◂◂

***Problem 59***

> The partnership agreement of a law firm provides a complicated formula for determining each partner's annual profit share. The formula takes into account billable hours, payments actually received on account of work billed, and work brought into the firm ("rainmaking"). At the end of one year, one partner seeks "a more egalitarian approach" and contends that the partnership statute requires partners to share profits equally. Is that partner correct? ◂◂◂

**Explanation**

No. All three uniform general partnership acts provide for equal profit shares *as a default rule*. When partners displace the default rule by agreement, the agreement governs. ◂◂◂

***Problem 60***

> Paul and Dennis operate a basketball camp as an ordinary general partnership. Theirs is a handshake deal; they have no written agreement.

A camper who is hurt at the camp successfully sues the partnership for negligence and recovers a judgment of $250,000. The partnership has no money, and the camper collects the entire amount from Paul. Assuming that the partnership has sustained no other losses but has no money with which to reimburse Paul, how much, if anything, can Paul collect from Dennis? Can Dennis successfully argue that "the losses should lie where they fall"? ◂◂◂

**Explanation**

Dennis owes Paul $125,000. Absent a contrary agreement, partners share losses as they do profits — equally. Collection by a third party does not change how losses are allocated.[79] ◂◂◂

### *Problem 61*

> In 2005, Larry, Moe, and Curley became partners in an entertainment business. Their partnership agreement set a term of 10 years and stated

> Profits shall be calculated and paid on an annual basis, with the fiscal year being the calendar year. For any profit made in any fiscal year, Larry will receive 60 percent, Moe 25 percent, and Curley 15 percent. Losses will be shared as provided in the Uniform Partnership Act.

Each year in the period 2005 through 2008, the partnership broke even. In 2009, the partnership lost $100,000. How should that loss be apportioned under UPA (1914)? UPA (1997)? UPA (2013)? ◂◂◂

### Explanation

> The loss should be apportioned 60/25/15. Under all three general partnership acts, absent a contrary agreement losses are apportioned the same way as profits.[80]

### *Problem 62*

> Rachael and Natasha go into partnership together to own a natural foods store. They each put up $5,000 and jointly select a storefront to rent. During the first year, Natasha is the "silent" partner. She does no work for the business. Rachael, in contrast, works about 50 hours per week in the store, with no vacation. At the end of the year, the partnership has made a profit of $30,000. Rachael proposes a profit split of $20,000 for herself and $10,000 for Natasha. She explains, "I put in at least 2,500 hours this year, and our lowest paid clerk got $4 per hour. I figure I'm worth at least that. Four times 2,500 is $10,000,

leaving another $20,000, which we split equally." Is Natasha obliged to agree to Rachael's proposal? ◂◂◂

**Explanation**

No. Absent a contrary agreement, Rachael's work in the partnership business brings her no right to extra remuneration.[81] Absent a contrary agreement, the partners split profits equally.[82] ◂◂◂

***Problem 63***

Joseph owns 500 acres of land on which he grows pine trees for harvest and for sale each year at Christmas time. The land is worth $500,000, and land values in the region are increasing steadily. Joseph asks Vladi to operate the Christmas tree business for him. In return for Vladi's promise to stay for five years, Joseph promises Vladi an annual salary of $10,000 plus half the profits.

Assume that (i) Vladi makes a number of changes to the land, including harvesting some trees, planting others, and putting in a few dirt roads; (ii) at all times relevant title to the land is in Joseph's name; and (iii) a court finds that the arrangement between Joseph and Vladi constitutes a partnership with a five-year term. If UPA (1914) governs, at the end of the five years, will Joseph still own the land? Does the result differ under UPA (1997) or UPA (2013)? ◂◂◂

**Explanation**

Under all three acts, the answer depends on whether Joseph has contributed the land to the partnership or merely furnished its use.

Under UPA (1914) case law, there are facts that point in the direction of *contribution*. The land was of central importance to the partnership, and the partnership did (through Vladi) make some improvements to the property.

However, it seems unlikely that Joseph intended to give up ownership of the land. Even under UPA (1914), a partnership can own land in its own name, and Joseph never transferred title to the partnership. More importantly,

to view the land as contributed is to construe into existence an extraordinary sweetheart deal for Vladi.

The deal was sweet for Vladi even assuming that Joseph merely *furnished* the *use* of the land to the partnership. Vladi brought to the partnership only his labor, for which he received not only a salary but also half of the profits. At minimum, Joseph furnished the use of land worth $500,000 and contributed any trees that Vladi harvested from the land on behalf of the partnership. For that, Joseph received in return less than Vladi — i.e., merely a 50 percent profit share.

If Joseph *contributed* the land, then the deal is even sweeter for Vladi. The land itself belongs to the partnership; any appreciation will belong to the partnership; and Vladi will have a right to half of that appreciation. That deal seems too good to be either true or intended.

Under UPA (1997) and UPA (2013), the result would be the same, with the analysis buttressed by the presumption established by section 204(d) of both acts:

> Property acquired in the name of one or more of the partners, without an indication in the instrument transferring title to the property of the person's capacity as a partner or of the existence of a partnership and without use of partnership assets, is presumed to be separate property, even if used for partnership purposes. ◂◂◂

***Problem 64***

This Problem is based on a children's poem by Eugene Field:

> Wynken, Blynken, and Nod one night Sailed off in a wooden shoe —
> Sailed on a river of crystal light,
> Into a sea of dew.
> "Where are you going, and what do you wish?"
> The old moon asked the three.
> "We've come to fish for the herring fish That live in this beautiful sea;
> Nets of silver and gold have we!"
> Said Wynken,
> Blynken,
> And Nod.

Assume that Wynken, Blynken, and Nod are partners. Last year, before the partners divided profits, the "nets of silver and gold" were purchased using some of the revenues generated by the sale of herring fish. Wynken is taking her family fishing and wants to take one-third of the nets with her on the

outing. Under UPA (1914), does she have the legal right to do so? ◀◀◀

**Explanation**

No — not without the consent of her fellow partners. The nets belong to the partnership, not to the partners. "Unless the contrary intention appears, prop-erty acquired with partnership funds is partnership property."[83] Under UPA (1914) §25(2)(a), Wynken has an equal right to possess partnership property, but only for partnership purposes. To use partnership property for personal purposes requires the consent of the other partners. ◀◀◀

***Problem 65***

Although the Rachael/Natasha health food store partnership is doing well enough, Natasha has fallen on hard times. One of her personal creditors is about to sue her. To avoid that embarrassment, Natasha persuades the creditor to release the claim in return for "an assignment of all of my rights in the partnership I co-own with Rachael." The creditor then approaches Rachael and insists upon a voice in running the health food store. Is Rachael obliged to accede? ◀◀◀

**Explanation**

No, regardless of which act applies. Absent a contrary agreement, Natasha may transfer her economic rights in the partnership — her "transferable interest" — but cannot transfer her rights to participate in management.[84] ◀◀◀

***Problem 66***

Rosie, Philip, and Sylvia operate a dental supply business as partners. Rosie and Philip are the "outside salesmen," and Sylvia runs the office. Rosie and

Philip both do a lot of driving, and every two years, partnership money is

used to buy them each a new car. Title to the cars is in the partnership's name, and the partnership pays for the car insurance. However, the price of each car is reported as profit on Rosie's and Phil's respective K-1 forms. A judgment creditor of Rosie's tries to levy on the car she currently drives. What result under UPA (1914)? Under UPA (2013)? ◀◀◀

**Explanation**

> Under either statute, the levy will be successful only if the car is not partnership property. A personal creditor of a partner cannot levy on partnership property.[85]

Under UPA (1914), several factors suggest that Rosie's car is partnership property. Partnership funds were used to purchase and to insure it. Title is in the partnership's name. Moreover, the car is of central use in the partnership's business.

The question is, however, ultimately one of the partners' intent, and the K-1 forms argue strongly that the car is Rosie's personal property. By treating the price of the car as profit allocated to Rosie, the K-1 form effectively characterized the car as her personal property. It is hard to dismiss that characterization as self-serving or artificial, because (i) it was integrally connected with the way the partners structured their relationship, and (ii) it created tax liability for Rosie.[86]

Under UPA (2013), the result may be different, because section §204(a)(1) applies. That provision states: "Property is partnership property if acquired in the name of. . . the partnership." Because the car is titled in the partnership's name, it is evident that the car was acquired "in the name of the partnership." The creditor's only hope is to argue that the K-1 form reflects an agreement between the partnership and Rosie, making Rosie the car's owner despite the title being in the partnership's name. ◀◀◀

***Problem 67***

> Suzanne and Bernard run a dance school as a partnership. The school serves children between the ages of 4 and 14. The highlight of each year is a splendiferous dance recital held at a public auditorium rented by the partnership. Suzanne takes care of the business side of operations, and Bernard has agreed that Suzanne alone has the right to

sign checks and make payments for the partnership. Bernard handles the artistic side of the business.

This year, disaster threatened the school. On the night of the big recital, Bernard arrived at the auditorium and found it locked. After some frantic telephoning, he located the auditorium manager, who said that she had never received the dance school's rental check. (It had apparently been lost in the mail.) The manager refused to open the auditorium without a check in hand. Suzanne was out of town, so Bernard wrote a personal check for the rental fee. Under UPA (1997), is Bernard entitled to reimbursement from the partnership, or does his foray into the business side of the partnership disqualify the expense? What result if UPA (2013) applies? ◂◂◂

**Explanation**

Under UPA (1997), Bernard is entitled to reimbursement. Canceling or rescheduling the recital at the last minute could have been disastrous for the dance school's business. While Bernard's payment (his "foray") was probably not "in the *ordinary* course of the business of the partnership,"[87] the payment *was* "for the preservation of [the partnership's] business."[88]

The analysis under UPA (2013) §401(c) is less clear. Bernard is entitled to reimbursement for

'any payment made by the partner in the course of the partner's activities on behalf of the partnership, if the partner complied with this section [401 — pertaining to management rights] and Section 409 [pertaining to a partner's duties] in making the payment.'[89] Bernard would have to argue that the task allocation between Suzanne and him contains an implied exception for emergency circumstances. If that argument prevails, Bernard should have no problems under Section 409. ◂◂◂

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1. In this context, property is often referred to as "capital," but "capital" also has a narrower meaning: i.e., property owned by the partnership. That narrower meaning is a term of art under partnership law, as explained below.
2. In some partnerships, for example, one partner provides all the property, while the other partner provides only labor. See section 8.6.
3. As explained in section 7.1.4, default rules apply except to the extent the partners have agreed otherwise. For a discussion of the history of the three uniform general partnerships acts and an explanation of this book's approach to them, see section 7.1.2.
4. UPA (2013) §401 contains most of the default rules relevant to this chapter. In UPA (1914), §18 is

the main section. When a partnership comes to an end, other financial aspects surface and other statutory provisions become relevant. Chapter 11 discusses those aspects and provisions in detail.
5. Whether the partners are personally liable on such contracts is a question of partnership law. See section 7.3 and Chapter 17.
6. See UPA (2013) §401(j), UPA (1914) §18(f) (no right to remuneration for labor provided to the partnership); UPA (1997) §401(g), UPA (1914) §18(d) (stating circumstances under which a partner is entitled to interest, omitting from those circumstances interest on contributions, and thereby implying no right to ongoing remuneration for capital contributed to the partnership). For the rules applicable once a partnership has dissolved, see Chapter 11.
7. See section 8.9.
8. UPA (2013) §401(a); UPA (1997); §401(b); UPA (1914) §18(a). When a partnership actually distributes profits to partners is a different issue. See section 8.3.2.
9. See section 17.2.
10. Statutory rules governing relationships with outsiders cannot be changed by agreements among partners. See section 7.3.1 (relationship between partners' liability to third parties and partners' *inter se* loss sharing). Under the modern uniform acts, liability is always joint and several. Under UPA (1914), some liabilities are joint and others are joint and several. See section 7.3.1. In an LLP, the rules on loss sharing are changed somewhat to protect the liability shield. See section 17.2.7.
11. See section 8.9.
12. UPA (1914) §18(a) (emphasis added).
13. UPA (1997) §401, Comment 3. An "interim distribution" is one that occurs before the winding up and termination of the partnership. For a discussion of partner management rights, see Chapter 9. For a discussion of winding up and termination, see Chapter 11.
14. UPA (2013) §405(b). The provision refers to "person" rather than "partner" to take into account the rights of transferees. See section 8.8.
15. Profit draws are thus quite different from salary and wages. Salary and wages reflect a definite commitment by the partnership to pay a fixed amount, regardless of how much profit (if any) the partnership makes.
16. See section 8.5.1 (contributions) and section 11.5.3(b) (capital accounts). However, tax law has accounting requirements of its own (which are far beyond the scope of this book), and those requirements strongly influence partnership arrangements.
17. Section 11.5.3 explains both the recordkeeping process and the eventual effect of the allocated losses.
18. This rule has one exception. Under UPA (2013) §401(j) and UPA (1997) §401(j), each partner is entitled to "reasonable compensation for services rendered in winding up the business of the partnership." Under UPA (1914) §18(f), the exception is narrower; reasonable compensation for winding up is available only to a sole surviving partner.
19. See section 8.2.
20. See section 11.5.3.
21. Like almost all matters *inter se* the partners, these consequences are subject to any contrary agreement between the partner and the partnership or among the partners. For example, a partner might agree to furnish a truck for the first three years of the partnership.
22. This situation implicates both ordinary contract principles (lessor-lessee) and a partner's duty of loyalty. For a discussion of the latter, see section 9.7.
23. Of course, if the lessor/partner has figured the lease payments rationally, those payments will have taken the depreciation into account. Nonetheless, as a formal matter the risk of depreciation stays with the owner.
24. Larry will receive some of the $600,000 as shared profits. See section 11.5.3.
25. This section is drawn from Kleinberger & Wrigley, "Who Owns the Christmas Trees? The Disposition of Property Used by a Partnership," 39 Kansas L. Rev. 245, 256-57 (1991).

26. UPA §8(2) does provide a rule for characterizing property purchased with partnership funds. “Unless the contrary intention appears, property acquired with partnership funds is partnership property.”
27. This disability reflected the aggregate approach to partnerships. See section 7.2.7.
28. See section 10.4.3 (discussing statements of authority, limitation, and denial).
29. Section 204, comment (emphasis in original).
30. UPA (2013) §204(a)(1) UPA (1997), *Id*.
31. UPA (2013) §204(a)(2); UPA (1997), *Id*.
32. UPA (2013) §204(c); UPA (1997), *Id*.
33. UPA (2013) §204(d); UPA (1997), *Id*.
34. See UPA (2013), §204, comment (“These rules apply to ‘all property, whether real, personal, or mixed or tangible or intangible, or any right or interest therein.”’) (citing UPA (2013) 102(16) (defining “property”)).
35. In the shorthand used by economists, *K* represents capital and *L* represents labor.
36. See section 8.3.1(b).
37. See section 8.2.
38. Technically, the *L* partner would pay the partnership, which would then distribute the money to the *K* partner. See section 11.5.3.
39. As explained in section 8.2, the statutory default rules assume that those values are roughly comparable; that is the premise for allocating to Cliff and Lilith equal shares of the profits.
40. When a person has a choice between two mutually exclusive courses of action, the “opportunity cost” of pursuing one is the foregone opportunity to pursue the other.
41. See sections 8.5.1 and 8.5.3.
42. Life does not usually work out so precisely, but this premise simplifies the explanation of the point at issue.
43. See sections 8.5.1 and 8.5.3.
44. A partner’s “right to participate in the management” under UPA §24(3) is redundant of UPA §18(e). Sections 9.1—9.4 discusses management rights in detail.
45. UPA §25 (1914) (1).
46. UPA §26 (1914) (share of profits and surplus).
47. As for a partner’s right to receive back the value of its contribution, see section 8.5.1 and section 11.5.3 (describing how UPA (1914) §40 implements UPA (1914) §18).
48. UPA (1997 and 2013) §501.
49. UPA (2013) §401(i); UPA (1997) §401(g).
50. Cogar v. Lafferty, 639 S.E.2d 835 (W. Va. 2006). Partners are co-owners of the partnership business. See section 7.2.5. However, “business” and “property” are not synonymous. See, e.g., Farmers State Bank & Trust Co. v. Mikesell, 51 Ohio App. 3d 69, 70, 554 N.E.2d 900, 901 (1988) (“Although a partner may not assign his interest in particular assets of the partnership, he may assign his interest in the partnership, that is, his right to share in the partnership’s profits and surplus.”).
51. See section 7.2.2.
52. UPA (1914) §27(1).
53. For a discussion of the Harmonization Project of the Uniform Law Commission, see Introductory Notes — the ULC Harmonization Project.
54. See, e.g., Block v. Lea, 5 Haw. App. 266, 273-74, 688 P.2d 724, 731 (1984) (stating that, under the Hawaii version ofUPA (1914) §27(1), a divorce decree would lack the power to substitute one former spouse for another as a partner in a preexisting partnership).
55. UPA (1997) §101(14).
56. UPA (2013) §102(22)(G).
57. *Id*., comment.
58. See section 7.2.2.

59. UPA (2013) §503, comment.
60. See UPA (2013) §503, comment: “A partner’s rights in a partnership are bifurcated into economic rights (the transferable interest) and governance rights (including management rights, consent rights, rights to information, rights to seek judicial intervention).”
61. UPA (1997) §502. Perhaps inadvertently, UPA (2013) does not contain the same statutory language. However, an official comment states pointedly that: “Absent a contrary provision in the partnership agreement or the consent of the partners, a ‘transferable interest’ is the only interest in a partnership that can be transferred to a person not already a partner.” UPA (2013) §502, comment. Under both modern acts, a transferable interest encompasses solely economic rights. UPA (2013) §102(23); UPA (1997) §502.
62. UPA (2013) §502(a). UPA (1997) §503(a) used language very similar to the 1914 language:
A transfer . . . of a partner’s transferable interest in the partnership . . . is permissible [but] does not, as against the other partners or the partnership, entitle the transferee, during the continuance of the partnership, to participate in the management or conduct of the partnership business, to require access to information concerning partnership transactions, or to inspect or copy the partnership books or records.
63. In re Dews, 152 B.R. 982, 985 (D. Colo. 1993).
64. Essentially the same language appears in UPA (1914) §18(g) (“(g) No person can become a member of a partnership without the consent of all the partners.”).
65. UPA (2013) §402(a)(3).
66. Other law may affect the enforceability of transfer restrictions imposed by statute as well as those imposed by agreement. See UPA (2013) §503, cmt. “Other law may affect the applicability of this section. See 11 U.S.C. §541(c)(1) (providing that, initially at least, all property of a debtor becomes part of the bankruptcy estate regardless of restrictions on transfer); UCC §§9-406, 9-408 (overriding specified restrictions on assignment in specified circumstances, regardless of whether state law or a contract imposes the restrictions).”
67. As explained in section 8.7, the modern acts state this proposition more directly than does UPA (1914).
68. UPA §25(2)(c). Creditors seeking to collect a debt of the partnership can, in contrast, levy on the partnership’s property. Id.
69. English Partnership Act of 1890, §23(2). UPA (1914) §28 is derived from the English statute, and UPA (1997) §504 is derived from UPA (1914) §28. UPA (2013) §504 substantially modernizes the statutory language but without intending any change in meaning.
70. UPA (1914) §28(1); UPA (1997) §504(b); UPA (2013) §504(a).
71. UPA (2013) §504(c).
72. *Id*.
73. UPA (1914) §28(2)(b). See also UPA (1997) §504(c)(2) and (3); UPA (2013) §504(e).
74. See section 4.3.1.
75. For the enforceability of such agreements *inter se* the partners, see section 9.6. For the effect of such agreements on the *power* of partners to bind the partnership to third parties, see sections 10.1-10.4.
76. UPA (1914) §18(b).
77. UPA (1997) §401(c).
78. UPA (2103) §401(b).
79. See section 7.3.1(c).
80. See section 8.3.1.
81. See section 8.4.
82. See section 8.3.1.
83. UPA (1914) §8(2). The result would be the same under both modern acts.
84. See section 8.8.4.
85. UPA §25(2)(c); RUPA §504(e).

86. See section 7.3.2(a) (profits allocated to a partner are taxable income for that partner).
87. UPA (1997) §401(c) (emphasis added)
88. *Id*.
89. UPA (2013) §401(b).

CHAPTER 9

# Management Issues and Fiduciary Duties

## §9.1 THE PANOPLY OF MANAGEMENT RIGHTS

Co-management is a key attribute of a partnership, and—under the default rules of all three uniform general partnership acts—each partner has a full panoply of management rights:

- the right to know what is going on in the partnership;
- the right to be involved in conducting the business, including in some circumstances the right to bind the partnership to third parties;[1]
- the right to participate in collective decision making, with decisions made in some circumstances by "majority rule" and in other circumstances only with unanimous consent; and
- the right to veto certain other types of decisions.

## §9.2 THE RIGHT TO KNOW

Under all three uniform acts, each partner has a right to obtain from the partnership and from fellow partners full and complete information concerning the partnership and its business.

## §9.2.1 Under UPA (1914)

Under UPA (1914), the right to information rests on four sources, with sections 19 and 20 providing the most direct authority. UPA (1914) §19 states that "every partner shall at all times have access to and may inspect and copy any of [the partnership books]." UPA (1914) §20 states: "Partners shall render on demand true and full information of all things affecting the partnership to any partner. . . ."[2]

UPA (1914) §18(e) provides authority by implication, entitling each partner to an equal right "in the management and conduct of the partnership business." A partner who lacks information cannot meaningfully manage or conduct business; therefore, for §18(e) to be meaningful, the provision must by implication encompass access to all relevant business information.

The concept of fiduciary duty also provides authority by implication. As discussed in section 9.7, partners are mutual fiduciaries. Each partner owes fellow partners a duty of loyalty, which includes a duty of candor. If Partner *A* owes Partner *B* a duty of candor, by implication Partner *B* has a right to whatever information Partner *A* is duty bound to provide.

## §9.2.2 Under UPA (1997)

### a. In General

UPA (1997) provides far more detail on this issue than did UPA (1914). UPA (1997) §403 contains a comprehensive set of information access rules that recognize three categories of information: information in the partnership's books and records; information that one partner is obliged to volunteer to another; and information that one partner is entitled to demand and receive from another. The rules can be as succinctly quoted as paraphrased:

> (b) A partnership shall provide partners and their agents and attorneys access to its books and records. . . . The right of access provides the opportunity to inspect and copy books and records during ordinary business hours. A partnership may impose a reasonable charge, covering the costs of labor and material, for copies of documents furnished.
>
> (c) Each partner and the partnership shall furnish to a partner, and to the legal representative of a deceased partner or partner under legal disability:

> (1) without demand, any information concerning the partnership's business and affairs reasonably required for the proper exercise of the partner's rights and duties under the partnership agreement or this [Act]; and
>
> (2) on demand, any other information concerning the partnership's business and affairs, except to the extent the demand or the information demanded is unreasonable or otherwise improper under the circumstances.

UPA (1997) does not require a partnership to maintain any formal records,[3] recognizing that "general partnerships are often informal or even inadvertent."[4] However, the official Comment to Section 403 counsels:

> In general, a partnership should, at a minimum, keep those books and records necessary to enable the partners to determine their share of the profits and losses, as well as their rights on withdrawal. . . . The partnership must also maintain any books and records required by state or federal taxing or other governmental authorities.[5]

If books and records do exist, a partner is entitled to access under UPA (1997) §403(b) without having to demonstrate, state, or even possess a proper purpose. The Comment explains that "A partner's unlimited personal liability justifies an unqualified right of access to the partnership books and records."[6] However, nothing in the statutory text or comments qualifies this right when a partnership is an LLP.[7]

In contrast, the duty to volunteer information is confined to information related to a particular function—namely, information "reasonably required for the proper exercise of the [recipient] partner's rights and duties."[8] This phrase reaches not only to the conduct of the partnership business but also to some partner-to-partner interactions.

**Example**

> Rachael and Sam are each partners in a general partnership governed by UPA (1997), and Rachael is considering selling her transferable interest to Sam. While the two partners are negotiating price, Sam learns some business information that suggests that the partnership is about to enter a "boom" period. Because Rachael's transfer of her transferable interest is her right under UPA (1997) §503(a)(1), Sam's disclosure of that information is "reasonably required for the proper exercise of [Rachael's] rights . . . under . . . this [Act]." ◂◂◂

If a particular item of material information is apparent in the partnership's

records, whether UPA (1997) obliges a partner to disseminate that information to fellow partners depends on how the circumstances array against the pivotal legal question—i.e., whether, in the circumstances, disclosure by one partner is "reasonably required for the proper exercise of [another] partner's rights and duties."[9]

**Example**

> A partnership governed by UPA (1997) has two partners, each of whom is regularly engaged in conducting the partnership's activities, both of whom are aware of and have regular access to all significant partnership records, and neither of whom has special responsibility for or knowledge about any particular aspect of those activities or the partnership records pertaining to any particular aspect of those activities. Most likely, neither partner is obliged to draw the other partner's attention to information apparent in the partnership's records. ◂◂◂

**Example**

> A partnership governed by UPA (1997) has three partners; one of the three is the managing partner with day-to-day responsibility for running the partnership's business. The other two meet periodically with the managing partner, and together with that partner make "all decisions relating to any substantial change in policy." Most likely, the managing partner has a duty to draw the attention of the other partners to important information, even if that information would be apparent from a review of the partnership's records.[10] ◂◂◂

In some circumstances, another section of UPA (1997) may come into play. UPA (1997) §404(d) codifies the common law obligation of good faith and fair dealing,[11] and comment 4 states, somewhat cryptically (and without examples or illustration): "In some situations the obligation of good faith includes a disclosure component. Depending on the circumstances, a partner may have an affirmative disclosure obligation that supplements the Section 403 duty to render information."[12]

## b. A Departure from Prior Law — Duty to Inform Not a

## Fiduciary Duty

Case law under UPA (1914) generally characterized a partner's obligation to provide information to fellow partners as a fiduciary duty. UPA (1997), in contrast, clearly states the contrary.[13] Section 404(a) provides: "The *only* fiduciary duties a partner owes to the partnership and the other partners are the duty of loyalty and the duty of care set forth in subsections (b) and (c)." The duty to provide information is "set forth" in §403, not subsection (b) or (c) of §404.[14]

The difference between UPA (1997) and prior law is more than a matter of labels. Courts typically take an expansive approach to construing and applying fiduciary duties. They are rarely as liberal when imposing liability under a statute. Moreover, a breach of fiduciary duty can support a claim for disgorgement[15] and, in egregious circumstances, for punitive damages.[16] In contrast, one who breaches a statutory duty typically risks only a claim for ordinary damages.

## c. The Role of the Partnership Agreement

The information access provisions of UPA (1997) are "quasi-default rules" —i.e., subject to change by the partnership agreement within limits specified by the act. In particular, "[t]he partnership agreement may not . . . unreasonably restrict the right of access to books and records under Section 403(b)."[17]

As with other aspects of the partnership agreement, a provision limiting information rights may be written, oral, or implied through conduct.[18]

### Case in Point—Brennan v. Brennan Associates

> After the death of a partner, another partner brought an action seeking *inter alia* access to the partnership's books and records. The trial court: (i) noted that the plaintiff merely wanted to "peruse" the records with no particular information in mind; (ii) found in the history of this partnership that partners had not been permitted to "peruse" the records, but rather had to ask the bookkeeper to locate and deliver a specific record; and (iii) rejected the access claim. The Connecticut Supreme Court affirmed, treating the custom of the

partnership as an implied agreement limiting the statutory right of access.[19] ◀◀◀

### §9.2.3 Under UPA (2013)

UPA (2013) derives in part from UPA (1997) provision and in part from provisions developed in the 2001 version of the Uniform Limited Partnership Act. The principal differences between the 1997 and 2013 versions are as follows:

- As explained in detail in section 9.7.2(b), UPA (2013) rejects UPA (1997)'s "cabined in" approach to partner fiduciary duty. Under UPA (2013), a partner's fiduciary and related duties "include" but are not limited to those stated in the statute. As a consequence, in some circumstances fiduciary duty will oblige a partner to disclose information to fellow partners, and a failure to disclose will occasion the panoply of remedies available for a breach of fiduciary duty.[20]
- UPA (2013) provides substantially more detail as to the information rights of former partners.[21]
- UPA (2013) contains an additional authorization for limiting access to information:

> In addition to any restriction or condition stated in its partnership agreement, a partnership, as a matter within the ordinary course of its business, may impose reasonable restrictions and conditions on access to and use of information to be furnished under this section, including designating information confidential and imposing nondisclosure and safeguarding obligations on the recipient.[22]

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## §9.3 THE RIGHT TO BE INVOLVED IN THE BUSINESS

Each partner has the right to be involved in the business: to get his, her, or its[23] hands dirty, to actually take part in the work of the partnership. This right brings no extra compensation, because under the default rules of all three acts working in the business does not increase a partner's payout.[24] The right to participate can be psychologically important, however, and working in the business can be a very effective way to keep "in the know."

All three acts establish this right to be involved in essentially the same language, according each partner "equal rights in the management and *conduct* of the [partnership] business."[25]

# §9.4 THE RIGHT TO PARTICIPATE IN DECISION MAKING: SOME DECISIONS SUBJECT TO MAJORITY VOTE OR CONSENT; OTHERS SUBJECT TO EACH PARTNER'S VETO

## §9.4.1 The Basic Default Structure

### a. The Basic Approach

When partners disagree, under the default rules of all three acts, subject to any contrary provision in the partnership agreement:

- the partners resolve the disagreement by some form of collective decision making: typically via consent (written, oral, or implied in fact) or a vote;[26]
- each partner has equal decision-making power; thus voting or consent is *per capita*, regardless of how much: (i) each partner has contributed to the partnership; and (ii) each partner works in the partnership's business;[27] and
- some disputes are resolved by majority consent or vote, while other actions require unanimity (thus according each partner a veto right).[28]

### b. Determining What Vote Is Required — UPA (1914)

Three provisions in UPA (1914) comprise the default rules for determining the consent or vote required for resolving disagreements among the partners. UPA (1914) §§9(3) and 18(g) list particular matters requiring unanimous consent. Section 18(h) provides a general rule for disagreements not covered by UPA §§9(3) or 18(g).

#### *1. Particular Matters Requiring Unanimous Approval*

Under UPA (1914) §9(3), unless a partnership agreement provides otherwise, the following actions require unanimous approval:

- assigning the partnership's property in trust to creditors or in return for the assignee's promise to pay the partnership's debts;
- disposing of the good will of the business;
- doing any other act which would make it impossible to carry on the partnership's ordinary business;

- confessing a judgment against the partnership;
- submitting a claim by or against the partnership to arbitration.

UPA (1914) §18(g) adds another matter: "No person can become a member of a partnership without the consent of all the partners."

## 2. The General Rule of UPA §18(h)

For matters not covered by UPA (1914) §§9(3) or 18(g), the general rule of §18(h) appears simple enough:

> Any difference arising as to ordinary matters connected with the partnership business may be decided by a majority of the partners; but no act in contravention of any agreement between the partners may be done rightfully without the consent of all the partners.

**Example**

> Rachael, Sam, and Carolyn form a partnership to raise chickens and eventually have a disagreement about where to buy their chicken feed. Rachael wants to buy from Eli's Feed and Stock. Both Sam and Carolyn prefer Rebecca's Ranching Necessities. The partnership agreement is silent. On this ordinary matter, covered by neither UPA (1914) §9(3) nor §18(g), Sam and Carolyn will prevail. Each partner has one vote, UPA (1914) §18(e), and a majority vote controls, UPA (1914) §18(h). ◂◂◂

**Example**

> The Rachael-Sam-Carolyn partnership buys chicken feed from Rebecca's Ranching Necessities. Later a dispute develops over the quality of the feed. Rebecca proposes submitting the dispute to binding arbitration. Sam and Carolyn think arbitration is a good idea, but Rachael objects. Rachael's objection means that none of the partners has the right to commit the partnership to the arbitration. Under UPA (1914) §9(3), unanimity is necessary unless the partnership agreement provides otherwise.[29] ◂◂◂

## *The Problem of the Omitted Category*

The rule of UPA (1914) §18(h) is problematic, because its language omits

a category of conduct: matters that are not “ordinary” (i.e., that are highly unusual or significant) but that do not involve “an act in contravention” of a partnership agreement. See Figure 9.1.

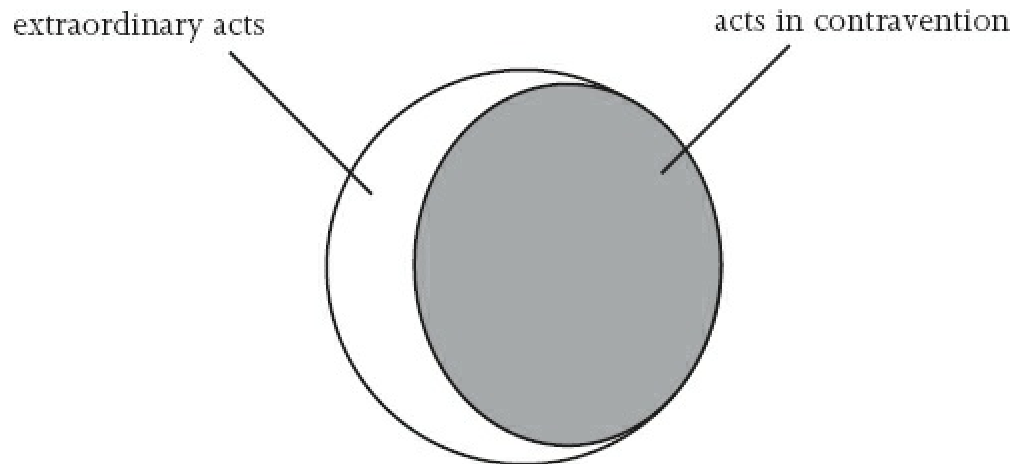


**Figure 9.1. How the Set of “Extraordinary” Matters Extends Beyond the Set of “Acts in Contravention”**

## Example

> For five years the Rachael-Sam-Carolyn partnership profitably raises and sells chickens. Then Rachael and Sam decide the partnership should “branch out” into raising cattle, which involves significantly different equipment, feed, skills, and contacts than chicken farming and would require the partnership to invest a substantial amount of money in purchasing equipment and stock. Carolyn objects to the change, but nothing in the partnership agreement limits the scope of the partnership’s business. The decision on expansion is not “ordinary,” but neither would expansion contravene an express provision of the partners’ agreement. ◂◂◂

The case law under UPA (1914) resolves this conundrum by generally holding that extraordinary changes require unanimous consent. Some cases hold that a decision to depart substantially from past practices actually does contravene an agreement, because the past practices imply an agreement among the partners. Other cases pay less homage to the language of §18(h), recognize the omitted category, and establish a rule for it. Noting that a partnership is a *voluntary* association, and that each partner is *personally* liable for debts arising from the partnership’s operations, these cases hold as

a matter of policy that each partner must consent to any fundamental change in a partnership or its operations.[30]

### c. Determining What Vote Is Required — the Modern Acts

Under the modern acts, the rule is simpler. The list of decisions specifically requiring unanimous consent has been winnowed down to two items: the admission of a partner and amendment of the partnership agreement.[31] The “omitted category” has been expressly included as requiring unanimous consent:

> A difference arising as to a matter in the ordinary course of business of a partnership may be decided by a majority of the partners. An act outside the ordinary course of business of a partnership and an amendment to the partnership agreement may be undertaken only with the affirmative vote or consent of all the partners.[32]

### d. The Boundary Between “Ordinary” and “Extraordinary”

The precise boundary between “ordinary” and “extraordinary” is easier to find in a diagram than in actual cases or other real-life situations. A few generalizations are possible, however, and they are equally applicable under all three acts. Substantial changes to the nature of the partnership’s business are likely to require unanimous consent. So too are decisions to increase substantially the size of the business, where that increase requires a significant increase in the liability exposure or investment risk of each partner. Changes in the standards for admitting new partners or expelling old ones probably also require unanimity.[33]

**Example**

> Robert, Martin, and John have a partnership that invests in real estate. Each partner contributed $50,000 to get the business going, and for the five years of its existence the partnership has invested in properties averaging approximately $100,000 each in value. The partnership agreement does not mention any limit on the size of any single investment. Robert and Martin wish to have the partnership buy a large apartment building that has just come on the market. To buy the building, the partnership will have to assume a $1.2 million

mortgage. Although the purchase would not contravene any express provision of the partnership agreement, it would fundamentally change the nature of the partnership business and significantly increase each partner's exposure to personal liability. Most likely, Robert and Martin need John's consent to rightfully make this extraordinary decision. ◂◂◂

## §9.4.2 The Special Problem of Management Deadlock

What happens when the partners are in disagreement, a majority vote is necessary to resolve the disagreement, but no majority is possible?

**Example**

Alice and Ariel have a partnership that operates a grocery store. They have for several years purchased bread from National Bakery. Alice decides that the bread is inferior and the price too high. She wants to find a new supplier. Ariel thinks that both the bread and the price are fine. This is certainly an "ordinary" matter, but neither partner can muster a majority vote. ◂◂◂

This problem arises most often in two-person partnerships. The cases hold that the partner proposing the change loses, i.e., the status quo prevails. As one authority put it, "[I]f the partners are equally divided, those who forbid a change must have their way."[34] This rule is consistent with all three acts; each requires at least a majority to take action in the event of a dispute. How the rule works in practice, however, can depend on how the partners (and eventually sometimes a court) conceptualize the matter in dispute.

**Example**

Alice and Ariel are meeting to discuss Alice's opposition to buying bread from National Bakery. Ariel says, "What's at issue is your idea that we discontinue using National. I vote no. There's no majority, so you lose." Alice says, "Oh no. You don't understand. What's at issue is where we buy bread this week. You're proposing National. I vote no. There's no majority, so you lose. And there will be no majority

until you agree on another supplier.” ◂◂◂

If the deadlock concerns a substantial matter, the partners might resolve the problem by dissolving the partnership.[35]

# §9.5 AGREEMENTS THAT CHANGE MANAGEMENT RIGHTS

## §9.5.1 Importance and Ubiquity

One of the great advantages of the partnership form is its flexibility, and almost every partnership with a formal partnership agreement varies the management rules in some way. Moreover, the course of conduct among partners can imply agreements about management rights.

The following is a nonexclusive list of important areas in which partners often vary the default management rules provided by the relevant partnership act:[36]

- delegating to one partner or a committee of partners some or all decisions on the conduct of the business;
- changing the “one partner/one vote” rule (e.g., weighting each partner’s rights to vote or consent in proportion to the capital contributed to the partnership, or allocating more votes to partners who work fulltime in the business);
- changing the unanimous consent requirements (e.g., allowing the admission of new partners on a two-thirds vote of the current partners, or by approval of a management committee);
- requiring supermajority votes for important decisions (e.g., major financial commitments);
- creating a right to expel partners;
- requiring partners to seek approval before making certain kinds of commitments on behalf of the partnership; and
- delegating to a management or executive committee the right to bind the partnership to any significant obligations.

**Example**

The partnership agreement of Sachs & Harris, a 100-partner law firm, provides for the annual election of a five-partner “Management Committee” and includes the following provision:

> *Admission of New Partners:* The Management Committee shall in its sole discretion determine whether to admit any new member to the partnership. A vote of four of the five members of that Committee is necessary to admit a new partner. ◂◂◂

Agreements among partners can go quite far in changing the management structure of a partnership, even to the extent of removing the unanimous consent requirement for amending the partnership agreement.

**Example**

> The partnership agreement of Sachs & Harris contains the following provision:

> *Amendments:* This Partnership Agreement may be amended only upon a majority vote of the members of the Management Committee followed by a two-thirds majority vote of all Partners. ◂◂◂

## §9.5.2 Limits on *Inter Se* Agreements That Restructure Management

### a. Under UPA (1914)

Under UPA (1914), agreements that restructure management face three constraints. First, although agreements can waive certain fiduciary duties and define others, no agreement among partners can remove totally the fiduciary obligations that partners owe each other.[37] Second, the more fundamental the obligation involved, the more likely it will be subject to judicial scrutiny. For example, a court will examine carefully any agreed-upon restrictions on a partner's right to information.[38] A restriction is most likely to be upheld if it: (i) has some important justification; (ii) is not overbroad; and (iii) does not leave the partners who lack access vulnerable to oppression.

Third, dicta in at least one noted case suggests that a partner may have the *nonwaivable* right to veto any fundamental changes in the partnership agreement which would substantially prejudice the partner's interests.[39] Later cases suggest to the contrary, however, at least where the partners are sophisticated.[40]

### b. Under the Modern Acts

Both UPA (2013) and UPA (1997) collect in one place all the statutory limits on the power of the partnership agreement. UPA (2013) §105(c) lists 17 restrictions. The one directly relevant here appears in subsection (c)(4). A partnership agreement may not "unreasonably restrict the [information-related] duties and rights under section 408."[41]

UPA (1997) states a roughly equivalent limitation in its section 103(b). Both acts also limit the power of the partnership agreement to curtail fiduciary duties and the obligation of good faith and fair dealing.[42] Those duties and that obligation therefore overhang every partnership agreement subject to either of the modern acts.

# §9.6 MANAGEMENT DUTIES

## §9.6.1 Duty to Furnish Services

### a. Does and Should a Duty Exist?

As previously discussed,[43] absent a contrary agreement each partner has a right to participate in partnership affairs. Is there also a duty to participate? Is each partner obligated to furnish labor, services, or some other form of effort to the partnership business?

Some, mostly older cases suggest that such a duty exists. However, none of the three acts contain any support for the notion, and the case law authority may reflect an antiquated notion of the typical partnership. Perhaps at one time it made sense to imply a duty to provide services, because with only rare exceptions partnerships consisted exclusively of active partners. For a partner to decline to serve, therefore, defeated the reasonable expectations of the copartners.

Today, that inference makes far less sense. Although partnerships with exclusively active partners probably still predominate, passive partners are by no means rare—especially with the advent of LLPs.

Of course, a partnership agreement may expressly establish duties to participate, and such duties may also be implied by circumstances, including partner conduct in the formation or operation of the partnership.[44] But no duty

should be presumed solely on account of partner status.

### b. Remedies for Breach of the Duty

A partner who breaches a duty to provide services may be held liable for the cost of hiring someone else to perform the services, the reasonable value of the services withheld, or other damage. If the withheld services are crucial to the business, the copartners may obtain a court order bringing the partnership to an end.[45] In that case, the breaching partner would probably be liable for damages caused by the partnership's premature demise.

## §9.6.2 Duty of Care

Under all three acts, each partner *qua* partner is an agent of the partnership, and under agency law the agent owes the principal a duty of care.[46] Partnership law is similar, but the standard is lower. UPA (1997) §404, comment 3, explains that "[t]he standard of care imposed by RUPA is that of gross negligence, which is the standard generally recognized by the courts" under UPA (1914).[47]

Several points are worth noting with regard to this standard:

- Gross negligence is a less demanding standard than that applicable to paid agents,[48] perhaps on the assumption that partners, who are simultaneously agents and principals, are better positioned than an ordinary principal to watch out, supervise, and, when necessary, intervene.
- A partner's misconduct may suffice to inculpate the partner and the partnership, without breaching the partner's duty to the partnership. Negligence suffices for tort liability and, under the attribution rules of all three acts, for the vicarious liability of the partnership.
- Under both modern acts, absent a contrary provision in the partnership agreement, a partner's negligence might inculpate both the partner and the partnership, while the partnership might still have the obligation to indemnify the partner.[49]

The partnership agreement may change the duty of care, but (at least under the modern acts) may not "unreasonably reduce" it.[50]

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# §9.7 PARTNER'S FIDUCIARY DUTY OF LOYALTY

## §9.7.1 The Beauty, Ubiquity, Influence, and Vagueness of Cardozo's Language

Partners owe each other a fiduciary duty of loyalty, and the touchstone of analysis in this area is a beautiful passage in Justice Cardozo's opinion in *Meinhard v. Salmon*:[51]

> Joint adventurers, like copartners, owe to one another, while the enterprise continues, the duty of the finest loyalty. Many forms of conduct permissible in a workaday world for those acting at arm's length are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the marketplace. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.

Although *Meinhard v. Salmon* involved a joint venture rather than a partnership, Cardozo's words are equally applicable to partnerships.[52] Indeed, those words are probably the most often quoted passage in all of partnership law. They instruct courts to approach partner selfishness with a critical eye.

Beyond that general instruction, however, Cardozo's words are quite vague. It is one thing to say in general, "be your brother's keeper," but how does the principle apply when, for instance, your brother wants to watch the opera, you want to watch the football game, and your house has only one TV and no TiVo, DVR, or VCR? What does "the punctilio of an honor the most sensitive" mean when the two partners in an at-will partnership are discussing a change in profit shares because one partner believes she is bringing in most of the business?[53]

The law of partner loyalty can be divided into two categories, and in one of those categories some pretty specific rules augment and define Cardozo's "punctilio." The first category consists of issues relating to the conduct or interests of the partnership's business. In that category, partner selfishness is not allowed unless the other partners consent. The second category consists of issues relating to differences of interests between or among partners. In that category the rules are less stringent and less clear. Section 9.7.3 discusses "partner versus partnership" issues, and section 9.7.4 discusses "partner versus partner" issues. Section 9.8 examines the extent to which partner agreements can change, waive, or eliminate partner fiduciary duties. Section 9.7.2 provides an overview of the differences and similarities among the three acts in this fundamentally important area of partnership law.

# §9.7.2 The Uniform Acts and the Fiduciary Duty of Loyalty

## a. UPA (1997) Codifies and “Cabins In” the Duty

During the 10 years the ULC spent drafting, debating, and adopting UPA (1997), no issue generated more controversy than that act’s treatment of the fiduciary duty of loyalty. In form, UPA (1997) differs from UPA (1914) in at least seven ways:

- While under UPA (1914) the duty of loyalty is mostly a matter of case law, UPA (1997) codifies the subject.
- While under UPA (1914) the duty of loyalty is an open-ended category, the formulation in UPA (1997) purports to be exclusive and exhaustive—that is, UPA (1997) confines (“cabins in”) the duty of loyalty to those rules stated in the act.
- While UPA (1914) §21(1) expresses the scope of a partner’s loyalty duty by referring generally to “any transaction connected with the formation, conduct, or liquidation of the partnership,” UPA (1997):
  — expressly encompasses self-dealing[54] and competition;[55]
  — provides that dissolution ends the restriction on competition;[56] and
  — entirely excludes formation activities from the duty of loyalty.[57]
- While cases under UPA (1914) generally consider a partner’s duty of loyalty to include the duty to volunteer information, UPA (1997) ousts disclosure duties from the realm of fiduciary duty.[58]
- While UPA (1914) nowhere mentions any general duty of good faith,[59] UPA (1997) §404(d) provides: “A partner shall discharge the duties to the partnership and the other partners under this [Act] or under the partnership agreement and exercise any rights consistently with the obligation of good faith and fair dealing.”
- While UPA (1914) is silent as to a partner’s right to act in his, her, or its own self-interest, UPA (1997) §404(e) states: “A partner does not violate a duty or obligation under this [Act] or under the partnership agreement merely because the partner’s conduct furthers the partner’s own interest.”[60]
- While UPA (1914) is silent on the extent to which the partnership agreement can alter or eliminate fiduciary duties, UPA (1997) §103(b) expressly prohibits elimination and provides standards for evaluating attempted alterations.

Of all the differences, the most controversial is embodied in UPA (1997) §404(a)-(b). Subsection (a) provides that “The only fiduciary duties a partner owes to the partnership and the other partners are the duty of loyalty and the duty of care set forth in subsections (b) and (c).” Subsection (b), which introduces three specific prongs of the duty of loyalty, begins with the phrase “A partner’s duty of loyalty to the partnership and the other partners is

*limited* to the following . . .” (emphasis added).

## b. The ULC Goes “Back to the Future” and Un-Cabins Fiduciary Duty

Fiduciary duty originated as an equitable concept, and courts have always taken a flexible, expansive approach to defining the obligations of a fiduciary. Critics of UPA (1997)’s “cabining in” approach have argued that the words “only” and “limited” cripple, or at least hamstring, a court’s ability to deal with ingenuously structured improprieties. Defenders of the UPA (1997) approach have responded that subsection (b) properly defines a partner’s fiduciary duties and that the obligation of good faith and fair dealing exists to capture and control other improperly opportunistic behavior. Critics rejoined that cabining in fiduciary duty “puts inordinate pressure on the concept of ‘good faith and fair dealing.”’[61] As stated at the 2006 annual meeting of the ULC:

> [W]e are already seeing pressure in the courts on the duty of good faith and fair dealing. When you say there are no other fiduciary duties and courts for hundreds of years have looked to fiduciary duties as a policing mechanism that they can develop, if you say you can’t have fiduciary duties, they will go to good faith. And, in fact, I had a conversation with . . . [t]he judge of North Carolina’s business court [who] said, if you stop us on fiduciary duty, we will just go to good faith.” [62]

The same year (1997) in which the ULC finished revising its then new general partnership act, the Conference began a project to revise the uniform limited partnership act. That project culminated in ULPA (2001), which followed UPA (1997)’s cabin-in approach.[63] However, in 2004 the ULC began a project to redraft the uniform limited liability company act, and that project categorically rejected cabining in fiduciary duties.[64] In 2011 and 2013, as part of the Harmonization Project, the ULC conformed UPA and ULPA to ULLCA (2006) approach.

> The 2011 and 2013 Harmonization amendments made one major substantive change; they “un-cabined” fiduciary duty. UPA (1997) §404 had deviated substantially from UPA (1914) by purporting to codify all fiduciary duties owed by partners. This approach had a number of problems. Most notably, the exhaustive list of fiduciary duties left no room for the fiduciary duty owed by partners to each other, *i.e.*, “the punctilio of an honor the most sensitive”. *Meinhard v. Salmon*, 164 N.E. 545, 546 (N.Y. 1928). Although UPA (1997) §404(b) purported to state “[a] partner’s duty of loyalty to the partnership *and the other partners*” (emphasis added), the three listed duties each protected the partnership and not the partners. “Un-cabining” harmonized this

act to ULLCA (2006). . . .

## §9.7.3 Partner versus Partnership Duty of Loyalty

In matters relating to partnership affairs, subject to the “cabin in” issue, all three acts have very similar views of a partner’s duty of loyalty: In general, a partner may not profit at the expense—either direct or indirect—of the partnership. In particular, without the consent of fellow partners,[65] a partner is prohibited from:

- competing with the partnership;
- taking business opportunities from which the partnership might have benefitted or that the partnership might have needed;
- using partnership property for personal gain;
- engaging in conflict-of-interest transactions.

Under UPA (1914), these restrictions begin with partnership formation and continue until the partnership terminates. Under UPA (1997 and 2013), the noncompetition restriction ends when the partnership dissolves. The other restrictions remain until the partnership terminates.[66]

### a. Noncompetition

Both modern acts expressly require each partner “to refrain from competing with the partnership in the conduct of the partnership business before the dissolution of the partnership.”[67] UPA (1914) §21(1) contains very broad language that includes a noncompete requirement:

> Every partner must account to the partnership for any benefit, and hold as trustee for it any profits derived by him without the consent of the other partners from any transaction connected with the formation, conduct, or liquidation of the partnership. . . . [68]

To engage in a competing business is to engage in “transaction[s] connected with the . . . conduct . . . of the partnership.”[69] The “account/trustee” language in section 21 means that a partner who violates the noncompete rule must disgorge to the partnership any profits made through the violation.

#### Example

Michael is a partner in a company that provides business consulting

services throughout the United States. While on a skiing vacation in Colorado, Michael meets Dorothy, who seeks some business advice. Michael at first declines, explaining, "I'm on vacation." He suggests that Dorothy use the services of another partner and offers to call his office and arrange matters. Dorothy, however, insists on Michael's services and offers to pay double his usual charges. Michael finally agrees. He takes a day out of his vacation, provides Dorothy the advice she needs, and pockets a large fee. The fee belongs to the partnership, even though: (i) Michael did the work "on his own time"; (ii) Michael tried to steer Dorothy to another partner; and (iii) Dorothy insisted on Michael performing the services and rejected Michael's suggestion that she consult with another partner. None of those facts are relevant under any of the three uniform acts. The work Michael did was precisely the type of work the partnership does, and Michael's dealings with Dorothy therefore constituted a "transaction connected with the . . . conduct ... of the partnership." UPA (1914) §21. For Michael to retain the fee would be to set himself as a competitor to the partnership at least on this occasion and to take for himself "a partnership opportunity." UPA (2013) §409(b)(1).

Under generally applicable principles of fiduciary duty, a constructive trust will arise if Michael seeks to retain the fee.[70] ◂◂◂

## b. Taking Business Opportunities

A partner's duty of loyalty also prevents a partner from taking business opportunities from the partnership, unless the copartners consent either generally through the partnership agreement or as to a particular transaction. In the latter event, the partner seeking to exploit the opportunity must disclose all material information related to the opportunity and the partner's history with and intentions toward the opportunity.

Protected opportunities include not only those from which the partnership might have profited, but also those that the partnership might have needed. The business opportunity duty somewhat overlaps the noncompetition duty: To compete with the partnership is to seek and take opportunities (i.e., customers) from which the partnership might have benefited. But the opportunity rule also has independent scope.

**Example**

> to disgorge any gain obtained from any personal use of partnershipAlice, a partner in a biotechnology partnership, knows that the partnership is looking to rent new office and laboratory space. She happens to know of a building, in the ideal location, suitable to house the firm's special equipment. She learns that the owner is willing either to lease or to sell. Alice decides that the building would make a fine personal investment, so she buys it for herself. She leases the building to a company that does not compete with the partnership, and later she resells the building at a profit. She must account to the biotechnology partnership for whatever profit she made on the building. Although Alice did not engage in directly competitive activity, the building could have been a fruitful opportunity for the partnership. Under UPA §21, Alice must therefore "hold as trustee . . . any profits derived . . . from [this] transaction connected with the . . . conduct ... of the partnership." Under UPA (2013) and UPA (1997) §404(b)(1), the result is the same and the language more direct: Alice must "account to the partnership and hold as trustee for it any property, profit, or benefit . . . derived from a use by the partner of partnership property, including the appropriation of a partnership opportunity." ◂◂◂

Like other aspects of the duty of loyalty, the opportunity rule can be waived by copartners' informed consent. The consent is ineffective unless, when making the decision, the consenting partners have all material information concerning the opportunity and the history with and intentions toward the opportunity of the partner seeking consent.

Unless the partnership agreement provides otherwise, such consent must be unanimous.[71] However, a partner may be able to avoid the unanimity requirement by presenting the opportunity to the partnership and having the partnership vote on taking the opportunity for itself. Arguably such a decision is an ordinary matter, and a majority vote will control.[72] If the majority rejects the opportunity and a partner then proceeds individually, the partnership will have a difficult time persuading a court to order disgorgement.

## c. Using Partnership Property for Personal Gain

All three uniform acts prohibit a partner from using partnership property for personal purposes without copartner consent,[73] and each requires a partner to disgorge any gain obtained from any personal use of partnership property, unless the other partners have consented.[74]

**Example**

> Alex is a partner in a landscaping company that works exclusively on commercial projects. On weekends, without the permission of his copartners, Alex uses company equipment to do landscaping at private homes. Although Alex's weekend activities neither compete with the partnership nor usurp a partnership opportunity, he must disgorge his profits to the partnership. They result from his use of partnership property. ◂◂◂

This rule is subject to a *de minimis* requirement. For example, a partner in a law firm who occasionally uses the firm's telephones to talk with a stockbroker will not have to disgorge profits made from stock trading.

## d. Conflict of Interest

A partner has a conflict of interest when the partner causes or allows the partnership to do business with:

- the partner him-, her-, or itself;
- a closely related member of the partner's family; or
- an organization in which the partner has a material financial interest.

**Example**

> Alice is a partner in a biotechnology partnership that is looking to rent new laboratory space. Alice happens to own a building, in the ideal location, suitable to house the firm's special equipment. If Alice leases or sells the building to the partnership, she will be "on both sides of the deal." She has a conflict of interest. ◂◂◂

Transactions like the one just described are often called *self-dealing*.

A partner also has a conflict of interest when acting on behalf of a party

whose interests are adverse to the partnership.

**Example**

> A partnership is considering the purchase of one of two warehouses. Acting without the knowledge of his copartners, John, one of the partners, advises May, the owner of one of the warehouses, how to present the merits of her warehouse in a way most likely to impress the partnership. John has breached his duty of loyalty. ◂◂◂

Both modern acts specifically prohibit conflicts of interest and self-dealing. Each partner must "refrain from dealing with the partnership in the conduct or winding up of the partnership business as or on behalf of a party having an interest adverse to the partnership."[75] The broad "account/ trustee" language ofUPA (1914) §21(1) establishes the same prohibition under that statute.

### e. Remedies

A partner who breaches the fiduciary duty of loyalty must disgorge all profits gained through the disloyal act. It is not necessary for the partnership to prove damages in order to obtain disgorgement. However, if the partnership can prove damages, the partnership may also bring a damage action. In a self-dealing situation, the partnership may rescind any executory portion of a contract tainted with partner conflict of interest.[76]

## §9.7.4 Obligation of Good Faith and Fair Dealing

Unlike UPA (1914), UPA (1997) includes among the duties of partners an express obligation of good faith and fair dealing. "A partner shall discharge the duties to the partnership and the other partners under this [Act] or under the partnership agreement and exercise any rights consistently with the obligation of good faith and fair dealing."[77] The obligation is *not* a fiduciary duty and the obligation's meaning has been controversial since UPA (1997) first codified and then commented on the obligation.

The Harmonization Project gave particular attention to the implied

obligation and section 15.4.8 explains the results, which apply equally to the uniform general partnership, limited partnership, and limited liability company acts.

# §9.7.5 Differences of Interest Between and Among Partners

## a. Fiduciary Duty and a Partner's Legitimate Self-Interest

According to Cardozo, partners may not use tactics appropriate to "arm's length" transactions in their *inter se* dealings. But even if partners are never fully at arm's length, they are nonetheless occasionally on opposite sides of the negotiating table. In such circumstances, self-interest is inherent and inevitable. It therefore cannot be *per se* evil.

UPA cases recognize this reality, and UPA (1997) §404(e) makes the point explicitly: "A partner does not violate a duty or obligation under this [Act] or under the partnership agreement merely because the partner's conduct furthers the partner's own interest." UPA (2013) §409(e) is identical, except for substituting "solely" for "merely."

It may seem difficult to harmonize self-interest with fiduciary duty, and indeed comment 1 to UPA (1997) §404 states: "Arguably, the term 'fiduciary' is inappropriate when used to describe the duties of a partner because a partner may legitimately pursue self-interest." The comment to the 2013 version takes a different approach, differentiating between a partner's responsibilities as a co-manager and rights under the partnership agreement:

> A partner in a general partnership has at least two different roles: (i) as a party to the partnership agreement, with rights and obligations under that agreement; and (ii) as co-manager of the enterprise. This provision pertains to the first role. A partner's exercise of rights under the partnership agreement is subject to the obligation of good faith and fair dealing, Subsection (d), but a partner does not breach that contractual obligation "solely because the partner's conduct furthers the partner's own interest." In contrast, this provision is ineffective with regard to a partner's duties as co-manager. For example, a partner's liability under section 409(b)(3) (prohibiting competition) is not "solely because the partner's conduct furthers the partner's own interest."
>
> Rather, the liability results from the breach of a specific obligation, i.e., the codified aspect of the duty of loyalty that prohibits competition.[78]

In the *inter se* context, only excessive self-interest is wrongful, and questions about excess fall generally into two main categories:

- Partner-to-partner transactions (when partners engage each other in partnership-related financial transactions), including:
  - — formation of the partnership (under UPA [1914] but not UPA [1997] or UPA [2013];
  - — renegotiation of profit shares, particularly in an at-will partnership; and
  - — sale or purchase of a current partner's interest in the partnership.
- Partners' exercise of discretion vis-a-vis copartners, including:
  - — exercise of a right created by the partnership agreement to expel a partner "without cause";[79] and
  - — rightfully calling an end to a partnership, when the end disadvantages one partner and advantages another.[80]

On any such occasion, one partner's interests will inevitably be adverse to another's. For example, if several partners seek to buy out one of their copartners, that copartner will want as high a buyout price as possible. The would-be buyers, naturally enough, will want a low price. Similarly, when one partner wishes a higher profit share, any gain must come at the expense of some other partner or partners.

The issues raised by no-cause expulsion and ending an at-will partnership are more complicated. In each situation, the acting partner or partners apparently have absolute discretion. The law appears to entitle them to act for any reason they choose—even if their actions benefit them to the prejudice of copartners.

## b. How the Three Acts Approach the Issue

The three uniform partnership acts differ in how they approach partner-to-partner duties, although the practical results are likely to be similar regardless of which statute applies. UPA (1914) §21 pertains only to a partner's duty to the partnership, so under UPA (1914) rules in this area come exclusively from case law—including Cardozo's famous opinion in *Meinhard v. Salmon*.

Under UPA (1997) the situation is more complex. Like UPA (1914) §21, UPA (1997)'s duty of loyalty provision, §404, seems to run only to the benefit of the partnership:

- subsection (b)(1)—"to account to the partnership and hold as trustee for it . . .";
- subsection (b)(2)—"to refrain from dealing with the partnership . . . as or on behalf of a party having an interest adverse to the partnership";
- subsection (b)(3)—"to refrain from competing with the partnership . . . ."

What complicates matters is that, unlike UPA (1914), UPA (1997) insists that

its statutory treatment of the duty of loyalty is exhaustive.[81] As a result, any partner-to-partner duties under UPA (1997) must have some other, nonfiduciary source.

UPA (1997) §403 is one such source, detailing each "partner's rights and duties with respect to information."[82] UPA (1997) §404(d), the statutory obligation of good faith and fair dealing, might be another.

As explained in section 9.7.2, ULLCA (2006) "un-cabined" fiduciary duty, enabling courts to police partner-to-partner transactions under the traditional rubric of fiduciary duty. As a result of the Harmonization Project, UPA (2013) follows ULLCA (2006).

## c. The Practical Consequences—Likely Similar Results

Although case law in this area under UPA (1997) is still scant, neither the statutory text nor the comments indicate any intention to depart from prior law. It is therefore likely that courts will use UPA (1997) §§403 and 404(d) to produce substantive rules consistent with case law under UPA (1914).[83] And, as noted above, ULLCA (2006) re-opened this area of law to the case law of fiduciary duty, and the Harmonization Project adopted ULLCA (2006) approach. It is likely therefore that under all three acts partners will have similar duties in partner-to-partner dealings. When partners' interests are potentially or actually adverse, a partner is obliged to: (i) provide full disclosure (which is a well-defined concept); and (ii) engage in "fair dealing" (which is not).

## *1. Full Disclosure in Partner to Partner Transactions*

A partner selling a partnership interest to a fellow partner, or buying a partnership interest from a fellow partner, has an affirmative duty to disclose any material information that:

- relates to the value of the partnership interest or the partnership itself; and
- could not be learned by examining the partnership books.

The partner who possesses the information must volunteer it. "You didn't ask" is no excuse.[84]

**Example**

> Sam and Todd are partners in a real estate investment partnership. The partnership has a term of 10 years, but after 5 years Sam wants to get his money out. Todd offers to buy him out and names what appears to be a reasonable price. Sam does not know, however, that Todd has received a very good offer on one of the partnership's parcels. Todd does not volunteer the information, and Sam accepts Todd's offer. Sam has a claim against Todd. Under UPA (1914), Todd breached his fiduciary duty by failing to disclose information relating to the value of the partnership which could not be learned by reviewing the partnership's books.

As to UPA (1997), the analysis must pick its way through the relevant statutory provisions, but the result is the same. The sale involves the transfer of Sam's transferable interest and therefore involves Sam's exercise of a right under UPA (1997) §503(a)(1).[85] Todd has therefore violated UPA (1997) §403(c)(1) by failing to furnish, without demand, "information concerning the partnership's business and affairs reasonably required for the proper exercise of [Samantha's] rights . . . under . . . this [Act]." Under UPA (2013), both analyses apply. ◂◂◂

## *2. Fair Dealing*

The vague concept of "fair dealing" has two aspects: process and substance. The process aspect concerns the manner in which partners deal with each other. The substance aspect concerns the fairness of the outcome of partner-to-partner dealings.

***A. Process*** As a matter of *process*, partners are obliged to deal with each other in a candid, noncoercive manner. They have, as just discussed, a duty of full disclosure. They must also avoid exacting agreements through threats or other forms of intimidation. Conduct which in an arm's-length relationship would *not* amount to actionable duress or procedural unconscionability may nonetheless suffice to invalidate a transaction between partners.

***B. Substance*** As a matter of *substance*, the cases speak of a partner's obligation to provide a "fair price" in partner-to-partner transactions. However, almost without exception "unfair price" cases are also "nondisclosure" cases. That is, the partner who agreed to the bad deal did so in the absence of material information that the other partner possessed and

failed to disclose. It seems unlikely that a court would use "unfair price" to overturn a partner-to-partner deal if the partner who benefited from the deal made full disclosure, and avoided abusive negotiating tactics. In deference to freedom of contract, a partner who complies with the process aspect of "fair dealing" in a partner-to-partner transaction should not have to worry about the substantive aspect. Any *post hoc* attack on the fairness of the outcome should be rejected as "buyers' (or sellers') remorse" or "20/20 hindsight."

### *3. When Partners Exercise Discretion* **vis-á-vis** *Copartners*

The process aspect of "fair dealing" has little relevance to a partner's right to dissolve a partnership. To cause the end of the partnership, a partner must manifest *express will*.[86] This manifestation typically involves giving notice to fellow partners, but there is no fiduciary duty to consult with them before making the decision or to hear them out ifthey object to ending the partnership.

Process fair dealing likewise has little relevance when a partner is expelled under a partnership agreement. Those doing the expelling must comply with any process requirements stated in the agreement, but fiduciary duty does not impose additional requirements. Unless the partnership agreement so provides, fair dealing does not mean "due process," a warning, an opportunity to be heard, or even a statement of reasons.

Substance fair dealing has slightly greater impact in controlling partners' exercise of discretion. Partners may not end a partnership or effect an expulsion for the malicious purpose of depriving a fellow partner of benefits, if:

- the fellow partner had a right to expect the benefits;
- the benefits would have naturally accrued to the fellow partner absent the exercise of discretion; and
- the exercise of discretion transfers the benefits to the partner or partners exercising the discretion.

Succeeding with a claim based on this substantive aspect of fair dealing is not easy. The claimant partner must show conduct amounting to expropriation or unjust enrichment.[87]

### *4. Remedies*

Under UPA (1914) and UPA (2013), a court has available the full panoply of remedies for breach of the duty of loyalty: damages, disgorgement (constructive trust), and rescission. Under UPA (1997), in contrast, the analysis is more complex and the remedies perhaps somewhat limited. As explained earlier in this section, under UPA (1997) partner-to-partner duties come not from the duty of loyalty but rather from UPA (1997) §§403 and 404(d). Neither of these provisions expresses a fiduciary duty.

As a result, punitive damages will likely be unavailable, and courts will have to combine common law concepts such as fraudulent nondisclosure and fraud in the inducement in order to set aside tainted transactions. Concepts of unjust enrichment may empower a court to order disgorgement.

# §9.8 THE IMPACT OF AGREEMENTS ON PARTNER FIDUCIARY DUTY

## §9.8.1 Limits on Agreements

Like other facets of partners' *inter se* relationships, partner fiduciary duties are subject to contrary agreement. However, fiduciary duties are not merely default rules. Although so-called "contractarian" scholars have argued vehemently to the contrary,[88] "freedom of contract" is not identical to "freedom from fiduciary duty," especially within general partnerships.[89] Accordingly, in most states there are limits on a partnership agreement's power over fiduciary duty.[90]

Under all three acts, some duties can be completely waived and *a fortiori* may also be changed or limited. For example, the duties under UPA §21(1) (1914) all give way with "the consent of the other partners." Likewise, under UPA (1997) §103(b)(3)(ii) "all of the partners or a number or percentage specified in the partnership agreement may authorize or ratify, after full disclosure of all material facts, a specific act or transaction that otherwise would violate the duty of loyalty." In addition, under UPA (1997) §103(b)(3)(i) "the partnership agreement may identify specific types or categories of activities that do not violate the duty of loyalty, if not manifestly unreasonable." In no event, however, may a UPA (1997) partnership

agreement "eliminate" the duty of loyalty or the obligation of good faith and fair dealing.[91]

UPA (2013) goes further, including all the provisions just listed as in UPA (1997) and adding: "If not manifestly unreasonable, the partnership agreement may: alter or eliminate the aspects of the duty of loyalty stated in Section 409(b) . . . [and] alter or eliminate any other fiduciary duty."[92] As noted in a comment to UPA (2013):" [A] properly drafted partnership agreement may substantially alter and even eliminate fiduciary duties."[93] However, as that comment further notes:

> Two important limitations exist. First, arrangements subject to this subsection may not be "manifestly unreasonable." Second, the partnership agreement may not transform the relationship inter se partners and the partnership into an entirely arm's length arrangement. For example, displacement of fiduciary duties is effective only to the extent that the displacement is stated clearly and with particularity. This rule is fundamental in the jurisprudence of fiduciary duty [and the partnership agreement may not eliminate the rule].[94]

Under case law, a UPA (1914) partnership agreement is likewise powerless to eliminate the duty of loyalty, but under both UPA (1914) and UPA (1997) it is difficult to determine exactly when a substantial limitation amounts to an elimination. Note, for example, that UPA (1997) §103(b)(3)(ii) does not require that the authorization or ratification be by *disinterested* partners. An interested partner that participates in the authorization or ratification process is subject to the obligation of good faith and fair dealing, but UPA (1997) §404(e) provides that a "partner does not violate a duty or obligation under this [Act] . . . merely because the partner's conduct furthers the partner's own interest."

### Case in Point —J & J Celcom v. AT & T Wireless Services Inc.

> AT&T, as majority partner of several partnerships, offered to buy out the interests of the minority partners. After the minority partners rejected AT&T's offer, AT&T then invoked the various partnership agreements and sold the partnerships' assets to AT&T-affiliated entities. The Washington Supreme Court, answering a certified question from the Ninth Circuit Court of Appeals, held that AT&T did not breach its fiduciary duty of loyalty because AT&T complied with the relevant partnership agreements, which expressly permitted the sale of partnership assets or dissolution of the partnership upon a

> majority vote. The court found that this discretion could be exercised to make a sale to an affiliated party, thereby interpreting the partnership agreement as effectively limiting the duty of loyalty.[95] ◂◂◂

In this area of law, as in many others, "pigs get fat and hogs get slaughtered." Attempts to waive process fair dealing in partner-to-partner transactions will likely be ineffective, as will attempts to authorize the expropriating use of discretion. In contrast, agreements that authorize partners to compete with the partnership, or permit self-dealing by a managing partner, are commonplace and ordinarily enforceable.

## §9.8.2 Ambiguous, Oral, and Implied Agreements

Under all three acts, agreements or conduct purporting to waive or alter partner fiduciary duties are carefully scrutinized and strictly construed. The duties are fundamental to the character of a partnership and protect important interests that are potentially vulnerable to abuse. Ambiguity is construed against the purported alteration or waiver, not only because the person asserting the alteration or waiver has often drafted language at issue (*contra proferentem*)[96] but also because, as a separate doctrinal matter, any waiver pertaining to a fiduciary duty must be established by clear and convincing evidence. Under UPA (1997 and 2013), the same approach is likely to be applied to attempts to "prescribe the standards by which the performance of the obligation [of good faith and fair dealing] is to be measured."[97]

None of the three acts requires agreements altering or waiving fiduciary duties to be in writing, but alleged oral agreements can produce wasteful and expensive "swearing contests." Courts can infer waivers from the conduct of the partners, but such inferences do not come easily. Insisting on clear and definitive evidence, courts are wary of making too much out of mere acquiescence to past conduct.

**Example**

> Alice, a partner in a biotechnology partnership, knows that the partnership is looking to rent new office and laboratory space. She happens to know of a building, in the ideal location, suitable to house

the firm's special equipment. She learns that the owner is willing either to lease or to sell. Alice decides that the building would make a fine personal investment, so she buys it for herself. Her partners later discover the transaction but make no objection. Two years later, when the partnership is looking for additional laboratory space, Alice again buys an opportune location for herself. This time her partners object, and under each of the three acts their objection is valid.[98] Their acquiescence to the first transaction did not waive Alice's duties as to the second transaction. ◂◂◂

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## §9.9 ENFORCING *INTER SE* OBLIGATIONS

### a. Action for an Accounting

When one partner raises a breach of duty claim against another, the resulting dispute can be exceedingly complicated. Any situation nasty enough to produce litigation is likely to signal the end of the partnership at least if the partnership has few partners. If so, it may be impossible (or at least extremely difficult) to determine the breach of duty claim without also settling accounts generally among all the partners.[99]

To keep this complexity within bounds, partnership law provides an equitable action for an accounting. The accounting sorts out the partners' various claims and rights and avoids piecemeal adjudication.

According to much UPA (1914) case law, an accounting is generally a condition precedent to bringing a claim for damages arising out of the partnership's affairs or business.[100]

**Example**

The whoopee cushion partnership of Larry, Moe, and Curley is governed by UPA (1914) and has fallen on hard times. Larry accuses Moe of failing to use his best efforts, as promised in the partnership agreement, to secure new clients. Curley claims Larry has taken excessive draws against profits and owes money to the partnership. Moe believes that the partnership owes him $5,000 in reimbursement

for customer entertainment expenses. None of the partners can pursue their claims unless their prayer for relief includes an accounting. ◂◂◂

**Case in Point – Arnold v. Burgess**

> "Generally, the only action which will lie between partners regarding partnership business is an action for an accounting. An accounting is an equitable proceeding for comprehensive investigation of transactions and adjudication of the rights of the partners. Other actions are premature until the business is wound up and accounts settled. This rule is based upon the inconvenience to the parties, the fact that equitable relief may be necessary to protect the right of the parties, and the notion that only after a balance has been struck can the relative rights of the parties be established. Dissolution alone does not change this rule. If partners are unable to settle their own affairs, an action in equity for an accounting is the appropriate, and sometimes exclusive, remedy to adjust and settle the affairs of a partnership. . . . The decree in an accounting action should provide for a final adjustment of all controverted questions before the trial court with "respect to a partnership accounting and distribution."[101] ◂◂◂

UPA (1997) takes a different approach:

(b) A partner may maintain an action against the partnership or another partner for legal or equitable relief, *with or without an accounting* as to partnership business, to:

(1) enforce the partner's rights under the partnership agreement;

(2) enforce the partner's rights under this [Act] . . . ; or

(3) enforce the rights and otherwise protect the interests of the partner, including rights and interests arising independently of the partnership relationship.[102]

According to the official Comment, this change "reflects the increased willingness courts have shown to grant relief without the requirement of an accounting, in derogation of the so-called 'exclusivity rule."'[103] UPA (2013) §410(b) is identical. "The Harmonization Project did not change the section other than to renumber it."[104]

## b. Partner Standing to Sue Fellow Partner for Damage to the

## Partnership

To the extent a partnership is considered an entity separate from its partners,[105] it might appear that only the partnership itself (or a partner asserting a derivative claim)[106] has standing to sue a partner whose misconduct has injured the partnership. However, under UPA (1914), the aggregate concept prevails in this context; such claims are typically sorted out through an accounting.

As for UPA (1997), despite its expressed entity approach, one of the act's official comments flatly rejects derivative claims. "Since general partners are not passive investors like limited partners, RUPA does not authorize derivative actions, as does [the Revised Uniform Limited Partnership Act], section 1001."[107] The same comment asserts that under UPA (1997) §405(b) "a partner may bring a direct suit against the partnership or another partner for almost any cause of action arising out of the conduct of the partnership business."[108]

However, UPA (2013) takes a less categorical view: "The statutory language does not contemplate derivative claims; thus, this act neither authorizes nor precludes such claims. . . . The case law does generally recognize the direct/derivative distinction in the context of general partnerships, and some cases permit a partner to sue derivatively. . . .[109]

***Problem 68***

> A 30-partner law firm has a partnership agreement that delegates most management decisions to a 5-partner Executive Committee elected annually by all the partners. The partnership agreement states a formula for determining each partner's profit share and allocates to the Executive Committee the exclusive authority to apply the formula and determine the profit shares. The formula allows the Executive Committee some discretion, but depends very heavily on objective factors such as billable hours, payments received from clients, and clients brought to the firm.

A partner is dissatisfied with the profit share he received this year and wishes to see the partnership records the Executive Committee used in determining shares for all the partners. The Committee claims that this

information “relates to the individual performance of the several partners and is therefore confidential.” The Committee offers to show the partner only the records directly relevant to him. The partner accurately points out that the formula requires the Committee to compare the performance of all the partners. He insists on seeing all the relevant records. Who is right under UPA (1914)? Under UPA (2013)? ◂◂◂

**Explanation**

> Under UPA (1914), the partner is right. UPA §20 provides that “[p]artners shall render on demand true and full information of all things affecting the partnership to any partner.” The partner has made demand, and the records are connected to the fundamental partnership question of profit shares. Given that connection, they certainly contain “information of . . . things affecting the partnership.”

The delegation of management authority to the Executive Committee makes no difference to this issue. A partner’s right to information can be waived by agreement, but the agreement must be specific to be effective.[110]

The partner may also be right under UPA (2013). Section 408(b) provides categorically that:

> On reasonable notice, a partner may inspect and copy during regular business hours, at a reasonable location specified by the partnership, any record maintained by the partnership regarding the partnership’s business, financial condition, and other circumstances, to the extent the information is material to the partner’s rights and duties under the partnership agreement or this [act].[111]

However, the result would change if the partnership were to invoke UPA (2013) §408(j): “In addition to any restriction or condition stated in its partnership agreement, a partnership, as a matter within the ordinary course of its business, may impose reasonable restrictions and conditions on access to . . . information to be furnished under this section, . . .” ◂◂◂

***Problem 69***

> Bernard and Suzanne form a partnership to run a dance school for children ages 4 to 14. Their partnership agreement delegates all artistic control to Bernard, and states that “all business decisions shall be decided by Suzanne in her sole discretion.” The school sells ballet

> and tap shoes to its students, at a very healthy markup. Bernard thinks the shoes should be sold at cost. “We make our money from our teaching,” he says. “We are not shopkeepers.” Under UPA (2013), does Suzanne have a right to continue the partnership to sell at a markup, despite Bernard’s objections? ◂◂◂

**Explanation**

> Yes. Although under UPA (2013) §401(k) partners decide any “difference arising as to a matter in the ordinary course of business” by majority vote, that provision is a default rule. These partners have agreed to allocate all business decisions to Suzanne. Therefore, on matters such as the price of shoes, Bernard no longer has “equal rights in the management and conduct of the partnership business.”[112]

***Problem 70***

> Larry, Moe, and Curley form a partnership to operate a whoopee cushion factory. Larry invests $100,000; Moe, $80,000; Curley, $20,000. They agree that (i) each will work full-time in the business; (ii) each will receive a salary of $20,000 (separate from whatever profits they may receive),[113] and (iii) none will withdraw their capital for at least three years. They make no other specific agreements.

At the end of the first year of operation, the partnership has a profit (after salaries) of $100,000. Larry and Moe want to distribute profits in proportion to the partners’ respective contributions—50 percent to Larry, 40 percent to Moe, and 10 percent to Curley. They assert that profits are an ordinary part of partnership business and that therefore a majority vote controls. Are they correct under UPA (2013)? Under each of the other two uniform general partnership acts? ◂◂◂

**Explanation**

> No. UPA (2013) §401(a) provides for partners to share distributions equally. The provision is a default rule,[114] and to amend the partnership agreement to change the default rule requires unanimous

consent, not a mere majority vote.[115]

The result is identical under UPA (1997) §§401(b) (default rule of equal share of profit) and 103(a) (subject to exceptions not relevant here, partnership agreement controls relations inter se the partners), and UPA §18(a) (partners share profits equally, "subject to any agreement between them."

***Problem 71***

This Problem is based on a children's poem by Eugene Field:

Wynken, Blynken, and Nod one night
Sailed off in a wooden shoe —
Sailed on a river of crystal light,
Into a sea of dew.
"Where are you going, and what do you wish?"
The old moon asked the three.
"We've come to fish for the herring fish That live in this beautiful sea;
Nets of silver and gold have we!"
Said Wynken, Blynken, and Nod.

Assume that Wynken, Blynken, and Nod are partners in a UPA (2013) partnership. Since the inception of the partnership, Wynken, Blynken, and Nod have always given the same answer to the old moon's question. If Wynken and Blynken want to have the partnership take up vegetable farming, and Nod opposes the idea, what results? ◂◂◂

**Explanation**

Absent a contrary agreement, UPA (2013) §§401(k) governs this type of situation. If the dispute over vegetable farming is a "difference arising as to a matter in the ordinary course of business," then the majority rules and Wynken and Blynken will prevail. If the dispute concerns "[a]n act outside the ordinary course of business" or constitutes an amendment to the partnership agreement, taking up vegetable farming will require unanimous consent and Nod will prevail.

The facts suggest that Nod will prevail. The partners' repeated answers to the old moon would support a finding that the partnership's ordinary course of business is fishing. In addition, the same facts could evidence an implied-in-fact agreement among the partners that the partnership will confine itself to fishing. In either case UPA (2013) §§401(k) would require unanimous agreement to take up vegetable farming.[116] ◄◄◄

***Problem 72***

> Oscar is a partner in a partnership governed by UPA (2013) and formed, in the words of the partnership agreement, "for the purpose of investing in real estate." The agreement contains no other limitation on the scope of the partnership's business. In the five years since its formation, the partnership has invested exclusively in residential real estate located in either Minnesota or Iowa. While on vacation in Hawaii, Oscar comes across an attractive investment opportunity in an office building located there. Without informing his partners or obtaining their consent, Oscar uses his own money and buys the building. Two years later, while the partnership is still in existence, Oscar sells the building and makes a profit of $300,000. When the other partners learn of the transaction, they insist that Oscar share the profits with the partnership. Must he? ◄◄◄

**Explanation**

> Probably. The profits certainly come from "investing in real estate," and so arguably involve "the appropriation of a partnership opportunity." UPA (2013) §409(b)(1)(C), Oscar's partners will therefore prevail, unless Oscar can show that the partnership's practice of investing solely in residential real estate impliedly limited the scope of the partnership business.[117] ◄◄◄

***Problem 73***

Same facts as Problem 72, except that:

1. Two weeks before his trip to Hawaii, Oscar attended a partnership meeting at which the partners reviewed the partnership's then-current finances.

2. During that review, it was apparent that the partnership had on hand only sufficient funds to meet operating expenses and did not have any cash available to make any further investments.
3. Before purchasing the Hawaii building, Oscar telephones you, his attorney, and asks, “Am I going to be in trouble with that partnership if I buy this building?”

What advice should you give Oscar? ◂◂◂

## Explanation

Despite the partnership’s current “cash poor” situation, the Hawaii building may still be a partnership opportunity. If made aware of the opportunity, the partners may choose to raise the necessary cash by, for example, selling some of the partnership’s current holdings or borrowing against those holdings. Oscar’s safest course therefore is to disclose the situation to his copartners and either: (i) obtain their unanimous consent for him to take the opportunity personally; or (ii) obtain a vote of the partners rejecting the opportunity.

If Oscar can obtain unanimous consent, the first approach is better. It has the virtue of certainty. The second approach rests on the argument that: (i) a decision to take or reject a business opportunity is an ordinary matter and is therefore subject to a majority decision under UPA (2013) §§401(k); and (ii) the fact that a partner wishes to take the opportunity individually does not transform the decision into an extraordinary matter requiring unanimous consent.[118] ◂◂◂

## *Problem 74*

Same facts as Problem 72, except that:

1. At a partnership meeting that took place three weeks before the Hawaii trip, the partners rejected by a vote of 3-2 a proposal to invest in an office building in Minneapolis.
2. One of the partners who voted against the proposal expressed the opinion that the partnership should “stick with residential real estate.”

Will these new facts change the outcome of the partnership’s disgorgement claim? ◂◂◂

## Explanation

No. Neither the partnership’s decision to reject an opportunity nor one

partner's opinion on the subject generally will change the scope of matters constituting "a partnership opportunity."[119] If that scope does in fact include commercial real estate, then only an amendment to the partnership agreement can put such investments beyond the partnership's reach. ◂◂◂

### *Problem 75*

Same facts as Problem 72 except that:

1. The office building is located in Minneapolis.
2. Oscar first discovers the building while inspecting several apartment complexes owned by the partnership and while driving in a car owned by the partnership.
3. The partnership agreement limits investments to residential real estate.

Will these new facts change the outcome of the partners' disgorgement claim? ◂◂◂

### Explanation

Yes. Oscar will not have to disgorge, even though, strictly speaking, he learned of the investment "in the conduct ... of the partnership business" and through ". . . a use by the partner of partnership property."[120] He discovered the opportunity while engaged in the partnership's business and while driving the partnership's car. However, a *de minimis* exception applies to this rule. Because the connection is so insubstantial, and because the partnership agreement places the opportunity so clearly beyond the partnership's scope, the partnership has no claim. ◂◂◂

### *Problem 76*

Same facts as Problem 72, except that:

1. Instead of making a profit of $300,000, Oscar loses $100,000.
2. The partnership agreement provides that all investment decisions will be made by majority vote.
3. he partnership agreement requires all partners to share partnership losses equally.

Under UPA (1997), can Oscar get any reimbursement from his copartners? ◂◂◂

**Explanation**

No. The reach ofUPA (1997) §401(c), the 1997 Act's indemnification provision, is different from the reach of section 404(b)(1). Section 401(c) obligates the partnership to "reimburse a partner for payments made and indemnify a partner for liabilities incurred by the partner in the ordinary course of the business of the partnership or for the preservation of its business or property." Oscar's investment satisfies neither condition. He acted outside the "ordinary course of the business of the partnership" (i.e., without the authority of a partner vote) and did not act to preserve partnership "business or property." Oscar therefore must bear his losses alone, even though he might have been obliged to share his profits. ◂◂◂

***Problem 77***

Sweeney & Todd, a modest-sized metropolitan law firm, has been growing steadily and now has 50 partners. Plans call for adding another 40 partners over the next five years. Under the current partnership agreement all partners have one vote on all matters, including the annual election of the firm's management committee. Some of the more senior partners wish to give greater control to partners who have been with the firm at least 10 years. Under which of the three uniform general partnership act should such an arrangement be lawful? If lawful, how might the arrangement be accomplished? ◂◂◂

**Explanation**

Such an arrangement would certainly lawful under each of the three acts. UPA (1997 and 2013) §401 and UPA (1914) §18 each states default rules, and each allows partners to shape their management structure virtually as they see fit. The partnership agreement could, for example, give extra votes to partners who have been with the firm at least ten years. Or, the agreement could create two separate classes

> of partnership interests, allocate the "senior" interests to partners who have been with the firm at least ten years, and reserve specified management matters to partners holding senior interests.

To establish either structure, the partners would have to amend the partnership agreement. Unless the agreement provides for amendment on a less-than-unanimous basis, all the current partners will have to agree to any change. See UPA (1997) §401(j). ◂◂◂

***Problem 78***

> In addition to its 50 partners, Sweeney & Todd has 50 associates and 125 other employees. The partnership agreement dates from when the firm had only ten partners and requires unanimous consent for any amendment.

The firm's elected Management Committee wishes to implement a sexual harassment policy for dealing with complaints from firm employees. Upon the advice of counsel experienced in employment law, the Committee wishes to implement a policy that provides for confidential investigations of employee complaints and allows the Committee to impose discipline, either confidential or public, on any employee found to have engaged in harassing conduct. (This particular policy will not apply to partners. The Committee hopes soon to propose a policy on that subject.)

The Committee is quite concerned about confidentiality. "Leaks" can discourage employees from making complaints, ruin ongoing investigations, and subject the firm to damages for defamation. The Committee wants to make sure that only partners on the Management Committee will have access to information relating to complaints made, determinations reached, and sanctions imposed under the policy.

Are there any partnership law "wrinkles" to the Committee's concern under and UPA (1914) and UPA (1997)? ◂◂◂

**Explanation**

> Yes. As to UPA (1914), §20 may give each partner a right to the information the Committee seeks to protect. Claims of sexual harassment are exceedingly serious, and their proper handling is

> essential to the welfare of the partnership. Obversely, poor handling of a complaint could imperil both the partnership and the partners.[121] The complaint information is therefore "information of . . . things affecting the partnership" and subject to disclo-sure to any partner on demand.

Since the partnership agreement can be amended only through unanimous consent, under UPA (1914) the only solution to this problem is to have each partner waive his or her right to the problematic information.

A similar "wrinkle" exists under UPA (1997) §403. If the information is retained in the partnership's books and records, absent a contrary agree-ment each partner has a categorical right of access.[122] If the partnership never memorializes the information—a dangerous option under employment law—each partner still has an unbridled right of access to the extent the information is "reasonably required for the proper exercise of the partner's rights and duties under the partnership agreement or [UPA (1997)]."[123]

The partnership agreement can place reasonable restrictions on access to partnership books and records and can completely eliminate the access rights granted by UPA (1997) §40 3.[124] However, in the stated situation the partnership agreement can be amended only with unanimous consent. Under UPA (1997), therefore, the partnership's best hope is to argue that:
(i) information about these matters has not been memorialized into the partnership's books and records; (ii) because these matters are within the authority of the Management Committee and information concerning them is not "reasonably required for the proper exercise of the partner's rights and duties" and therefore not within UPA (1997) §403(c)(1); and

(iii) under RUPA §403(c)(2), the partner has no right of access because—due to the importance of confidentiality—"the demand or the information demanded is unreasonable or otherwise improper under the circumstances." ◄◄◄

***Problem 79***

> Same facts as in Problem 78, except that the partnership agreement provides: "This Agreement may be amended at any time upon the vote of 3/5 of the members of the Management Committee and the vote or written consent of a majority of all partners." Can Sweeney &

Todd protect the complaint information through a nonunanimous amendment ofthe partnership agreement under UPA (1914)? UPA (1997)? UPA (2013)? ◂◂◂

**Explanation**

Probably. The analysis is the same under all three acts. There is some UPA (1914) dicta to the effect that, despite agreements to the contrary, all partners must consent to changes that affect their fundamental rights. That dicta should not be problematic here. Although the duty to render information is a core fiduciary duty, the contemplated waiver is limited in scope, is well defined, and will clearly serve the partners' overall interests. ◂◂◂

***Problem 80***

Xena, Gabriel, and Ares, Inc. (a corporation in which Xena is the sole stockholder) are going to form a UPA (2013) partnership, with Xena to act as the active managing partner. Xena wishes the partnership agreement to provide that it is not a breach of the duty of loyalty for her to cause the partnership to retain Ares, Inc., to furnish services to the partnership regardless of the amount Xena causes the partnership to pay for those services. As Xena's lawyer, you have advised her that the desired provision might fail the "manifestly unreasonable" standard of UPA (1997) §103(b)(3)(i). Paraphrasing J.P. Morgan, Xena exclaims, "I don't hire lawyers to tell me what I can't do. I hire them to tell me how to do what I want to do." She adds, "Find me another way." Do so. Would the analysis, outcome, or both change under UPA (2013)? ◂◂◂

**Explanation**

UPA (1997) §103(b)(3)(ii) may offer you that way. It states that "a number or percentage [of partners] specified in the partnership agreement may authorize or ratify, after full disclosure of all material facts, a specific act or transaction that otherwise would violate the duty of loyalty." If the partnership agreement provides for ratification of self-dealing transactions by a two-thirds majority of the partners,

the votes of Xena and Ares, Inc., will suffice to ratify the partnership's contracts with Ares, Inc. UPA (1997) §103(b)(3)(ii) does *not* require that the ratifying partners be disinterested and is not subject to the manifestly unreasonable standard applicable to partnership §103(b)(3)(i). If Xena and Ares, Inc., ratify a grossly unfair fee, their votes could be attacked as a breach of the duty of care. However, UPA (1997)'s gross negligence standard is substantially more lenient than the duty of loyalty as applied to self-dealing transactions.

The analysis and outcome change materially under UPA (2013), because the language of the relevant provision, section 105(d)(1)(A), is materially different from UPA (1997) provision. Section 105(d)(1)(A) states: "The partnership agreement may . . . specify the method by which a specific act or transaction that would otherwise violate the duty of loyalty may be authorized or ratified by *one or more disinterested and independent persons* after full disclosure of all material facts. (Emphasis added.) Xena and Ares, Inc. are not disinterested. Any other restriction comes on the duty of loyalty under the not manifestly unreasonable standard of UPA (2013) §105(d)(3). ◄◄◄

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1. Chapter 10 considers a partner's right and power to bind the partnership to third parties.
2. In some situations, a partner has an affirmative duty to disclose information to a fellow partner, even without a demand. Section 9.7.5 discusses those situations.
3. UPA (1997) §403(a) (referring to a partnership's "books and records, *if any*") (emphasis added).
4. UPA (1997) §403, comment 1.
5. *Id.*
6. *Id.*, comment 2. The same comment states: "An abuse of the right to inspect and copy might constitute a violation of the obligation of good faith and fair dealing for which the other partners would have a remedy." For a discussion of this obligation, see section 9.7.4. If the information is misused in connection with a violation of a partner's duty of care or loyalty, the partnership and other partners might have a remedy for a breach of those duties. See section 9.7.3.
7. In an LLP, no partner is liable for the partnership's debts solely by reason of being a partner. See section 17.2.
8. UPA (1997) §403(c)(1).
9. UPA (1997) §403(c)(1).
10. These Examples, and the passage that precedes them, are taken from the official comments to the Uniform Limited Partnership Act (2001), §407(b)(1). The author served as Reporter for the ULC committee that drafted that Act.
11. See section 9.7.4.
12. ULLCA (2013) has a very different view of this implied covenant. See section 15.4.8.
13. Fiduciary duty is discussed in detail in section 9.7.
14. UPA (2013) does not "cabin in" a partner's fiduciary duties. See section 9.7.2(b).

15. For an explanation of disgorgement, see section 9.7.3(a).
16. See section 9.7.3.
17. UPA (1997), §103(b)(2). Note that this limit does not protect the access rights under UPA (1997) §403(c). The partnership agreement can also expand a partner's access rights beyond those specified in UPA (1997).
18. As for the dangers inherent in oral and implied agreements, see section 9.8.2.
19. Brennan v. Brennan Associates, 977 A.2d 107, 122-124 (Conn. 2009).
20. See section 9.9.
21. UPA (2013) §408(e).
22. UPA (2013) §408(j). The subsection also provides that: "In a dispute concerning the reasonableness of a restriction under this subsection, the partnership has the burden of proving reasonableness." In contrast, if partner challenges a restriction stated in the partnership agreement, ordinary rules of civil procedure put the burden of proof on the partner.
23. A partner that is an organization (e.g., a limited liability company or corporation) would take part through its agents.
24. UPA (2013) §401(j); UPA (1997) §401(h); UPA (1914) §18(f). See sections 8.2 and 8.4.
25. UPA (2013) §401(h); UPA (1997) §401(f); UPA (1914) §18(e) (emphasis added). UPA §25(2)(a) buttresses the point with its concept of co-tenancy in partnership: Each partner has, as a property right, "an equal right with his partners to possess specific property for partnership purposes." As previously explained, under the modern acts, management rights do not masquerade as property rights. See section 8.7.3.
26. UPA (2013) §401(k); UPA (1997) §401(j); UPA (1914) §18(h). "Vote" impliesamore formal procedure than "consent," and UPA (1914) uses only the latter term. The Merriam Webster Dictionary(3d ed. 1974) defines "consent" as "to give assent or approval" and "vote" as "a usually formal expression of opinion or will in response to a proposed decision." SeeYorkv. Mathis, 68 A. 746, 750 (Me. 1907) ("It is not necessary that [consent] should be created by a formal vote passed at a formal meeting or proved by a formal record. It may be inferred from the situation and conduct of the parties."). See, e.g., UPA (1914) §§18(j) ("No person can become a member of a partnership without the consent of all the partners."); 25(2)(a) ("A partner, subject to the provisions of this act and to any agreement between the partners, has an equal right with his partners to possess specific partnership property for partnership purposes; but he has no right to possess such property for any other purpose without the consent of his partners."); 41(3) (Liability continues "[w]hen any partner retires or dies and the business of the dissolved partnership is continued . . . , with the consent of the retired partners or the representative of the deceased partner."). UPA (1997) is less consistent. Sometimes the act refers to "consent," sometimes to "vote," and sometimes simply to "majority." See, e.g., UPA (1997) §§401 (i) ("A person may become a partner only with the consent of all of the partners."); 401(j) ("An act outside the ordinary course of business of a partnership and an amendment to the partnership agreement may be undertaken only with the consent of all of the partners."); 1001(b) ("The terms and conditions on which a partnership becomes a limited liability partnership must be approved by the vote necessary to amend the partnership agreement. . . .": and 401(j) ("A difference arising as to a matter in the ordinary course of business of a partnership may be decided by a majority of the partners."). UPA (2013) refers to "vote or consent." See, e.g., UPA (2013) §§402(b)(3) (providing for a person to become a partner "with the affirmative vote or consent of all the partners"); 601(4) (providing that in specified circumstances a person may be "expelled as a partner by the affirmative vote or consent of all the other partners").
27. UPA (2013) §401(h); UPA (1997) §401(f) and (j); UPA (1914) §18(e) and (h).
28. UPA (2013) §401(k); UPA (1997) §401(j); UPA (1914) §§18(h) and 9(3).
29. As for the *power* to commit the partnership to binding arbitration, see sections 10.3.6 and 10.4.1.
30. These cases generally predate the advent of the limited liability partnership.
31. UPA (2013) §TBD; UPA (1997) §401(i) and (j). Section 301 the modern acts, the analog to UPA (1914) §9, contains nothing of section 9(3). Under UPA (1914), amending the partnership agreement

also requires unanimous consent, although UPA (1914) does not state so particularly. The rule follows from general principles of contract law and the notion that the partnership agreement is an agreement "of the partners." For further discussion of the partnership agreement, see section 7.1.4.

32. UPA (2013) §401(k). UPA (1997) §401(j) is identical except that it refers only to consent and not also to voting.

33. For a discussion of partner expulsion, see sections 9.7.5(c), 9.7.5(d)(1), and Chapter 11, Problem 99.

34. Ernest H. Scamell, Lindley on the Law of Partnership (15th ed.), at 477 (1984), quoted in Summers v. Dooley, 481 P.2d 318, 321 (Idaho 1971).

35. The mechanics depend on whether the partnership is "at will" and also on which partnership act applies. See Chapter 11.

36. Partners may also by agreement alter the other default rules, such as the rules on profit sharing or no remuneration for labor. See generally Chapter 8.

37. Section 9.7 discusses partners' fiduciary duty, and section 9.8 focuses on agreements that waive, limit, or define fiduciary duty.

38. See section 9.2 (partner's right of access to information) and section 9.7.5 (full disclosure).

39. McCallum v. Asbury, 393 P.2d 774 (Or. 1964).

40. E.g., Bailey v. Fish & Neave 868 N.E.2d 956 (N.Y. 2007).

41. The paragraph also states, however, that "the partnership agreement may impose rea-sonable restrictions on the availability and use of information obtained under that section and may define appropriate remedies, including liquidated damages, for a breach of any reasonable restriction on use." *Id.* A partner's information rights are discussed in section 9.2.2.

42. See UPA (2013) §105(c); UPA (1997) §103(b). UPA (2013) also contains two companion sections to its section 105. See UPA (2013) §§106 (effect of partnership agreement on partnership and person becoming partner); 107(effect of partnership agreement on third parties and relationship to records effective on behalf of partnership). Fiduciary duty is discussed in section 9.8. The statutory codification of on the obligation of good faith and fair dealing is discussed in section 9.7.4. The relationship between these concepts and the partnership agreement is discussed in section 9.8.

43. See section 9.3.

44. For example, it seems reasonable to expect services from a partner who has contributed neither money nor other property to the partnership.

45. See section 11.7.

46. See section 4.1.4.

47. UPA (2013) §409(c) provides: "The duty of care of a partner in the conduct or winding up of the partnership business is to refrain from engaging in grossly negligent or reckless conduct, willful or intentional misconduct, or a knowing violation of law." UPA (1997) §404(c) is essentially the same.

48. See section 4.1.4.

49. See section 8.9.

50. UPA (2013) §105(d)(3)(c); UPA (1997) §103(b)(4).

51. 164 N.E. 545 (N.Y. 1928).

52. As explained in section 7.2.6, in most jurisdictions the law of joint ventures is essentially identical to the law of partnerships.

53. Recall from section 7.2.6 that in an at-will partnership any partner has the right to call an end to the partnership at any time. That right will have an inevitable impact on negotiations between partners.

54. UPA (1997) §404(b)(2).

55. UPA (1997) §404(b)(3).

56. UPA (1997) §404(b)(3) (requiring a partner to"refrain from competing . . . before the dissolution of the partnership").

57. All three paragraphs of subsection (b) refer to the "conduct" or the "conduct and winding up" of the partnership business. In contrast with UPA §21, RUPA §404(b) never uses the word "formation."

58. See section 9.2.2.

59. UPA (1914) §3(1) uses the concept of "bad faith" to define "knowledge."

60. The newest uniform limited partnership act replicates this provision, ULPA (2001), §305(c) (limited partners) and 408(e) (general partners). The Re-ULLCA, however, does not. A comment explains: "As a proposition of contract law, the language is axiomatic and therefore unnecessary. In the context of fiduciary duty, the language is at best incomplete, at worst wrong, and in any event confusing." *Id*. §409(e), cmt.

61. Daniel S. Kleinberger, Carter G. Bishop, The Next Generation: The Revised Uniform Limited Liability Company Act, 62 Bus. Law. 515, 523 (2007).

62. *Id*. at n.49 (quoting the remarks of the author of this book, who was serving as coreporter for the ULC committee drafting ULLCA (2006)).

63. See section 12.3.3.

64. See section 15.4.8.

65. See section 9.7.3.

66. Under all three acts, dissolution does not terminate a partnership. Instead, the partnership enters a period of "winding up" and terminates only when winding up is complete. See sections 11.10.1.

67. UPA (2013) §409(b)(3); UPA (1997) §409b)(3).

68. The phrase "hold as trustee" appears also in the two modern acts, but caution is required in understanding the phrase: The phrase "hold as trustee" dates back to UPA (1914) §21 and reflects the availability of disgorgement remedies, such as a constructive trust. In contrast to an actual trustee, a person subject to this duty does not: (i) face the special obstacles to consent characteristic of trust law; or (ii) enjoy protection for decisions taken in reliance on the governing instrument and other sources of information. UPA (2013) §409(b)(1), comment.

69. In some circumstances, the competition might relate to formation or liquidation of the partnership.

70. See section 4.1.7 (constructive trust and disgorgement as remedies for an agent's breach of the duty of loyalty).

71. See section 9.8.

72. UPA (2013) §401(k); UPA (1997) §401(j); UPA (1914) §18(h). See section 9.5.1.

73. UPA (2013) §401(i); and UPA (1997) §401(g); UPA (1914) §25(2)(a).

74. UPA (2013) §409(b)(1)(b); and UPA (1997) §404(b)(1); UPA (1914) §21(1).

75. UPA (2013) §409(b)(2); UPA (1997) §404(b)(2).

76. For the procedures to be followed in bringing both damage actions and claims for equitable relief, see section 9.9.

77. UPA (1997) §404(d).

78. ULLCA (2013) §409(e), cmt.

79. Partnership agreements often authorize a specified majority of partners (or, in some agreements, a specified majority of a management committee) to expel a partner without having to state or possess "cause." Under such agreements, if the required majority decides that a partner should be out, the partner is out. There is no obligation to prove that the partner did anything wrong. See the more detailed discussion in this section and in Chapter 11, Problem 99.

80. Under UPA (1914) default rules, this situation exists only in an at-will partnership. See section 11.2.1. A comparable situation exists, however, when one partner wrongfully dissolves a term partnership. Under UPA §38(2)(b), the other partners then have the right to preserve the partnership assets and carry on the business until the end of the original term—but only if all the remaining partners agree. Section 11.4.2. Under UPA (1997), the situation exists always in an at-will partnership, UPA (1997) §801(1), and often in a partnership for a definite term or particular undertaking. UPA (1997) §801(2)(i). Section 11.9.3.

81. UPA (1997) §404(b) begins with the phrase, "A partner's duty of loyalty to the part-nership and the other partners is *limited* to the following." (Emphasis added.)

82. See section 9.2.2.

83. Remedies may be a different matter. See the discussion in section 9.7.5(c)(4).
84. The partner's obligation differs substantially from the situation of a party to an arm's- length transaction. In an arm's-length transaction, a party may not misrepresent information, but—absent some special relationship—the party has no duty to volunteer. Partnership is a special (i.e., fiduciary) relationship.
85. See section 8.8.3.
86. UPA §31(1)(b); UPA (1997) §801(1) and (2)(i); UPA (2013) §801(1).
87. For further discussion of this vague and rarely satisfied standard, see sections 11.2.1(d) and 11.2.1(e) Depending on the language of the partnership agreement, the implied obligation of good faith and fair dealing may offer some protection.
88. For a discussion of this debate in the context of LLCs, see section 15.4.7.
89. See UPA (2013) §105(d)(3), cmt. "This act rejects the ultra-contractarian notion that fiduciary duty within a business organization is merely a set of default rules and seeks instead to balance the virtues of 'freedom of contract' against the dangers that inescapably exist when some persons have power over the interests of others."
90. As explained in section 15.4.7, Delaware law is the most hospitable to restrictions on fiduciary duty.
91. UPA (1997) §103(b)(3) and (5).
92. UPA (2013) §105(3)(A) and (D). Section 409(b) codified the three principal aspects of the duty of loyalty: no taking a partnership opportunity; no acting as or for a party adverse to the partnership; and no competition with the partnership.
93. UPA (2013) §105(d)(3), cmt.
94. Id.
95. J & J Celcom v. AT & T Wireless Services Inc., 169 P.3d 823 (Wash. 2007).
96. Black's Law Dictionary (8th ed. 2004) defines the term as naming "[t]he doctrine that, in interpreting documents, ambiguities are to be construed unfavorably to the drafter."
97. UPA (1997) §103(b)(5); UPA (2013) §105(c)(6).
98. UPA (2013) §409(b)(1); UPA (1997) §404(b)(1); UPA §21.
99. Sections 11.5.3-11.5.5 discuss the rules that apply to settle partner accounts when the partnership comes to an end.
100. Some exceptions do exist to UPA (1914)'s condition precedent rule, including claims between the partners that do not relate to the partnership business and claims that are so simple that no accounting is necessary.
101. Arnold v. Burgess, 747 P.2d 1315, 1319-1320 (Idaho App. 1987) (citations and internal quotations omitted).
102. UPA (1997) §405(b) (emphasis added).
103. UPA (1997) §405, Comment 2.
104. UPA (2013) §410, cmt.
105. See section 7.2.7.
106. A derivative claim is a claim asserted on behalf of an entity by one or more of its owners rather than under the direction of those with the regular authority to manage the entity. Before the advent of limited liability companies, the predominant example was in corporate law, where shareholders sue derivatively when they believe the directors of the corporations should but will not cause the corporation to sue. For further discussion in the context of limited liability companies, see section 16.4.
107. UPA (1997) §405, comment 2.
108. Id.
109. UPA (2013) §410(b) (citations omitted).
110. There is a counterargument, based on the delegation of management authority to the Executive Committee. That delegation establishes a system of profit allocation that, arguably at least, requires confidentiality in order to work. When the partners agreed to the delegation of authority, they implicitly

agreed to the necessary confidentiality.
111. UPA (2013) §410(b).
112. UPA (2013) §401(h). Without the partnership agreement, the partners would be deadlocked. See section 9.4.2.
113. Even though the partnership agreement refers to “salary,” tax law will consider the amount a “guaranteed payment” to be reported on each partner’s K-1 form and not salary to be reported on a form W-2.
114. UPA (2013) §105(a)(1).
115. The result would be different if the partnership agreement permitted amendment by majority vote. See section 7.1.4.
116. UPA §18(h) would involve the same analysis and produce the same result.
117. Under UPA (1914) §21, the key language would be “connected with . . . the conduct of the partnership.” However, essentially the same analysis would apply, with the same result.
118. Again, the analysis under UPA (1914) is parallel. See UPA (1914) §§21(1) and 18(h).
119. UPA (2013) §§404(b)(1)(C).
120. UPA (2013) §404(b)(1)(A) and (C).
121. Recall that, except in an LLP, partners are personally liable for the debts of the partnership. UPA (1914) §15. See sections 7.3 and 17.2.
122. UPA (1997) §403(b).
123. Id., §403(c)(1).
124. UPA (1997) §103(b)(2) limits the partnership agreement’s power to curtail access to books and records, but UPA (1997) §103 contains no restrictions on curtailing access to the other information covered by UPA (1997) §403.

# CHAPTER 10 The Partner's Right and Power to Bind the Partnership

## §10.1 OVERVIEW

### §10.1.1 The Foundational Construct — Partner as Agent

For the most part, the rules for attributing partner conduct to the partnership reflect the rules of agency law. Justice Story, in his famous nineteenth-century treatise on partnership, wrote: "Every partner is an agent of the partnership,"[1] and the R.2d states: "[I]f, as is usual, a partner is a general agent for the other members of the group, rules with reference to his liability and to the liability of the others because of his conduct both to third persons and to the others, are determined by the rules stated herein [i.e., the rules of agency law])."[2]

### §10.1.2 "Agent as Partner" Codified

All three uniform general partnership acts echo Justice Story's words[3] but spread the attribution rules among several different statutory provisions. All

three acts give special attention to misuse of funds provided to the partnership by third parties.[4]

Although UPA (1997) "retains the basic principles reflected in UPA [(1914)] Section 9(1), the 1997 act significantly changed the formu-lation."[5] The Harmonization Project made only one substantive change.

The following chart analyzes how UPA (1997) and UPA (1914) codify the "partner-as-agent" construct.[6] The material immediately after Table 10.1 refers to the one substantive change made by UPA (2013).

**10.1 Partner as Agent**

| Agency Law Attribution Rule | Where Codified in UPA (1997) [key language] | Where Codified in UPA (1914) [key language] | Principal Function (i.e., what typically is attributed) | Notes |
|---|---|---|---|---|
| Actual authority | §301(1) first clause, "Each partner is an agent of the partnership for the purpose of its business." | §9 first clause, "Every partner is an agent of the partnership for the purpose of its business. . . ." | Contractual matters; infor-mation[7] | Neither act expressly delineates the scope of a partner's actual authority |
| Apparent authority | §301(1), "apparently/ ordinary course" — subject to the "no author-ity constraining rule" discussed in section 10.4.2 | §9 "apparently/ usual" — subject to a somewhat different "no authority con-straining rule" discussed in section 10.3.5 | Contractual matters; infor-mation[8] | Useful to think of as "statutory apparent authority" |

**10.1 Continued**

| Agency Law Attribution Rule | Where Codified in UPA (1997) [key language] | Where Codified in UPA (1914) [key language] | Principal Function (i.e., what typically is attributed) | Notes |
|---|---|---|---|---|
| Inherent agency power | §305(a) "a wrongful act or omission, or other actionable conduct, of a partner acting in the ordinary course of business of the partnership" | §13 "any wrongful act or omission of any partner acting in the ordinary course of the business of the partnership" | Wrongful acts causing harm | Provisions are the analog to *respondeat superior* but apply also to harms other than physical injury to persons and property |
| Apparent authority in the context of receiving property | §305(a) "a wrongful act or omission, or other actionable conduct, of a partner acting . . . with [apparent] authority of the partnership"[9] | §14(a) "[w]here one partner acting within the scope of his apparent authority receives money or property of a third person and misapplies it" | Misuse of property placed with the partnership | Reflects history—at one time professionals seeking to practice in a firm . . . |
| Actual authority and inherent agency power in the context of receiving property | §305(b) "in the course of the partnership's business or while acting with [actual] authority of the partnership, a partner receives or causes the | §14(b) "[w]here the partnership in the course of its business receives money or property of a third person and the money or property so received is | Misuse of property placed with the partnership | . . . had no choice other than a general partnership |

| 10.1 Continued | | | | |
|---|---|---|---|---|
| **Agency Law Attribution Rule** | **Where Codified in UPA (1997) [key language]** | **Where Codified in UPA (1914) [key language]** | **Principal Function (i.e., what typically is attributed)** | **Notes** |
| | partnership to receive money or property of a person not a partner and the money or property is misapplied by a partner"[10] | misapplied by any partner while it is in the custody of the partnership" | | |
| Special rules for attributing information possessed by partners | §102(f) "A partner's knowledge, notice, or receipt of a notification of a fact relating to the partnership is effective immediately as knowledge by, notice to, or receipt of a notification by the partnership" | §12 "Notice to any partner of any matter relating to partnership affairs, and the knowledge of the partner acting in the particular matter, acquired while a partner or then present to his mind, and the knowledge of any other partner who reasonably could and should have communicated it to the acting partner" | Information pertaining to the partnership | Neither actual nor apparent authority necessary; enterprise liability—i.e., inherent agency power; subject to the "fraud on the partnership" exception[11] |

UPA (2013) made only one substantive change, pertaining to the "no authority constraining rule" discussed in section 10.4.2.

## §10.2 ACTUAL AUTHORITY — DEDUCING THE SCOPE

Partners may by agreement define the authority of each partner to bind the partnership, and partnership agreements often do so. Such definition is wise, for the statutory default rules are deficient in this area; they do not directly address the subject. It is, however, possible to infer the default scope of a partner's actual authority from the language of various statutory provisions. The scope is the same under all three statutes, although the analysis differs slightly because the relevant language differs.

The clearest exposition comes from UPA (2013) §401 and its comments. Section 401(h) and (k) provide:

> (h) Each partner has equal rights in the management and conduct of the partnership's business.
>
> ...
>
> (k) A difference arising as to a matter in the ordinary course of business of a partnership may be decided by a majority of the partners. An act outside the ordinary course of business of a partnership and an amendment to the partnership agreement may be undertaken only with the affirmative vote or consent of all the partners.

The comment to UPA (2013) §401(h) explains (somewhat at length):

> The actual authority of a partner is a question of agency law, and depends fundamentally on the contents of the partnership agreement. If, however, the partnership agreement is silent on the issue, this subsection helps delineate that actual authority. Acting individually, a partner:

- has no actual authority to commit the partnership to any matter for which this act requires the affirmative vote or consent of all partners;
- has the actual authority to commit the partnership to usual and customary matters, unless the partner has reason to know that: (i) other partners might disagree; or (ii) for some other reason consultation with fellow partners is appropriate; and
- has no actual authority to take unusual or non-customary actions that will have a substantial effect on the partnership.

The first point follows self-evidently from the language of this act. Where this act requires unanimity, no partner could reasonably believe to the contrary (unless the partnership agreement provided otherwise).

The second point follows because:

- Subsection (h) serves as the gap-filler manifestation from the partnership to its partners and does *not* require partners to act *only* in concert or after consultation. To the contrary, subject to the partnership agreement, this subsection expressly provides that "each partner has equal rights in the management and conduct of the partnership's business."
- It would be impractical to require collective action on even the smallest of decisions.
- However, to the extent a partner has reason to know of a possible difference of opinion among the partner, subsection (k) requires a decision by at least "a majority of the partners"

and by unanimous consent if the matter is "outside the ordinary course of the business."

The third point is a matter of common sense. The more serious the matter, the less likely it is that a partner has actual authority to act unilaterally. *Cf*. RESTATEMENT (THIRD) OF AGENCY §3.03, cmt. c (2006) (noting the unreasonableness of believing, without more facts, that an individual has "an unusual degree of unilateral authority over a matter fraught with enduring consequences for the institution" and stating that "[t]he gravity of the matter from the standpoint of the organization is relevant to whether a third party could reasonably believe that the manager has authority to proceed unilaterally").[12]

The analysis under UPA (1914) and UPA (1997) is quite similar, although earlier editions of this book also looked to the statutory provisions on statutory apparent authority and indemnification. For the analysis made in the comment above, sections 18(e) (equal rights in management) and 18(h) (how partners decide matters) provide the statutory basis under UPA (1914). For UPA (1997), sections are 401(f) (equal rights in management) and 401(j) (how partners decide matters) are the relevant ones.

## ***UPA*****Case in Point — Concklin v. Holland**

Homeowner, who co-owned the house with another individual, served illicit drugs and alcohol to an individual who subsequently died. Plaintiffs (decedent's parents) alleged partnership liability on the basis that the coowners of the property intended to remodel and resell the property (thereby making it a profitable venture). The court of appeals affirmed dismissal on the pleadings on the claim of partnership liability. The "general rule is that each partner is a general agent of the firm but only for the purpose of carrying on the business of the partnership. Any sale by a partner to be valid, it must be in furtherance of the partnership business. Assuming *arguendo* that Will and Lewis bought the Fenwick property to resell, Will's distribution of illicit drugs and alcohol to third-party visitors would not be for the purpose or in furtherance of the partnership."[13] ◂◂◂

## **Example**

Rachael, Sam, and Carolyn form a chicken farming partnership, but

the partnership agreement does not specify who may commit the partnership to sell chickens. One day Carolyn overhears Sam discussing a sale of 500 chickens to an established customer. Before Sam can close the deal, Carolyn says, “I don’t think we should sell to that customer. They’re on the verge of bankruptcy.” Sam has no actual authority to make the deal. He must refer the matter to a decision by the partners. ◂◂◂

**Example**

Sam does have the partners decide the matter, and he and Rachael vote in favor of continuing to sell to that customer on a “C.O.D.” basis.[14] Sam closes the deal with the customer. The next week Carolyn learns that Sam proposes to sell another 1,000 chickens to the customer. She again objects. Since a partner vote has already settled the matter, Sam’s awareness of Carolyn’s objection does not by itself remove Sam’s actual authority.[15] ◂◂◂

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# §10.3 STATUTORY APPARENT AUTHORITY — UPA (1914) §9

## §10.3.1 UPA (1914) §9 — the Paragon of Complexity

### a. Statutory Apparent Authority — From 1914 to 1997 to 2013

UPA (1914) §9 is a complex and somewhat problematic provision, which in effect codifies a partner’s apparent authority to bind the partnership. Fortunately UPA (1997) §301 formulates the rule more simply and more clearly, and UPA (2013) follows the 1997 formulation.

Nonetheless, for several reasons it makes sense to begin by understanding UPA (1914) §9. First, UPA (1914) continues to be the law in more than a dozen states. Second, UPA (2013 and 1997) §301 can be best understood in historical context; UPA (1997)’s improvements make most sense when compared to UPA (1914) §9, and the former’s remaining problems derive

from the latter. Third, many limited liability company statutes incorporate UPA (1914) §9 language to provide power-to-bind rules for members and managers of LLCs. (These statutes were enacted before the widespread acceptance ofUPA (1997).)[16]

## b. UPA (1914) Analyzed

UPA §9 (1914) provides:

### 9. Partner Agent of Partnership as to Partnership Business

> (1) Every partner is an agent of the partnership for the purpose of its business, and the act of every partner, including the execution in the partnership name ofany instrument, for apparently carrying on in the usual way the business of the partnership of which he is a member binds the partnership, unless the partner so acting has in fact no authority to act for the partnership in the particular matter, and the person with whom he is dealing has knowledge of the fact that he has no such authority.
>
> (2) An act of a partner which is not apparently for the carrying on of the business of the partnership in the usual way does not bind the partnership unless authorized by the other partners.
>
> (3) Unless authorized by the other partners or unless they have abandoned the business, one or more but less than all the partners have no authority to:
>
> (a) assign the partnership property in trust for creditors or on the assignee's promise to pay the debts of the partnership,
> (b) dispose of the good will of the business,
> (c) do any other act which would make it impossible to carry on the ordinary business of a partnership,
> (d) confess a judgment,
> (e) submit a partnership claim or liability to arbitration or reference.
>
> (4) No act of any partner in contravention of a restriction on authority shall bind the partnership to persons having knowledge of the restriction.

The difficulty in mastering UPA §9 (1914) comes from three sources: (i) the section states a very intricate set of rules; (ii) at key points the section uses language carelessly; and (iii) much of the case law is superficial and unenlightening.

## *1. Intricacy*

The intricacy exists because UPA §9 (1914) contains multiple rules that run

in opposite directions. The section's basic structure reflects a common but unfortunate tendency of lawyers to write rules in the mode of "two steps forward, but one step back." UPA §9 (1914) follows this "cha-cha" approach by providing two rules that establish a partner's power to bind, and three rules that confine that power:

- *the "agency law" empowering rule (§9(1), first clause),* which invokes (albeit ambiguously) the law of agency;
- *the "apparently/usual" empowering rule (§9(1), second clause),* which is partnership law's analog to apparent authority (and can be usefully labeled "statutory apparent authority");[17]
- *the "not apparently/usual" constraining rule (§9(2)),* which looks like the "flip side" of the "apparently/usual" empowering rule, but which serves to substantially undercut the "agency law" empowering rule;
- *the "no authority" constraining rule (§9(1),* third and fourth clauses, §9(4)), which is apparently so important that UPA (1914) states it twice; and
- *the "unanimous consent" constraining rule (§9(3)),* which is the clearest of all the five rules.

### *2. Careless Language*

UPA §9 (1914) deals sometimes with the power to bind, sometimes with the right to bind, and sometimes with both at once, and the section never states explicitly when it is doing which. For example, the terms "authority" and "authorized" appear six times in the section, with no express indication whether they encompass apparent and inherent as well as actual authority.

### *3. Unenlightening Case Law*

Many of the cases applying UPA §9 (1914) do so without much analysis, neglecting important nuances and focusing on individual parts of the rules out of context. It is impossible to construe UPA §9 (1914) in a way that reconciles all or even most of the cases.

## §10.3.2 The Agency Law Empowering Rule—Less Than First Meets the Eye

Broadly and seemingly without qualification, the first clause of UPA §9(1) (1914) states that "[e]very partner is an agent of the partnership for the purpose of its business." Although, as explained above, this language reflects

a basic construct of partnership law, the language's practical effect is limited by the rest of §9. The clause is best understood as a reminder that a partner's power to bind the partnership includes the partner's actual authority.[18] Any broader reading would either overlap or undercut the more specific rules stated in the rest of the section.

# §10.3.3 The "Apparently/Usual" Empowering Rule (Statutory Apparent Authority)

## a. The Basic Rule

The second clause ofUPA (1914) §9(1) reads in pertinent part: "the act of every partner for apparently carrying on in the usual way the business of the partnership of which he is ... a member binds the partnership." This "apparently . . . usual" power is analogous to the agency law concept of apparent authority by position and is usefully labeled "statutory apparent authority."[19] A person seeking to use this attribution rule must that show that:

- at the time of the transaction
- it reasonably[20] appeared to the person that the partner's act was:
- for carrying on the business of the partnership and
- for doing so "in the usual way."[21]

The rule cannot apply when the partnership is undisclosed.

**Example**

> Al, a partner in the Ventura Company, buys a computer for the partnership to use in its offices. It is quite usual for Ventura partners to make such purchases, and indeed Ventura partners have previously made such purchases from this seller. However, the seller does not know that Al is a partner in Ventura, and Al does not mention the partnership. Instead, Al signs an installment contract in his own name. The apparently/usual power will not bind the partnership,[22] because the seller cannot satisfy the "appearance" element. ◂◂◂

## b. Relationship to Actual Authority

It is possible for a partner to have apparently/usual power while lacking actual authority and *vice versa*.

**Case in Point—Herr v. Brakefield**

> Two partners owned and raised cattle as part of their partnership business. One partner (Brakefield) sold 43 head of cattle to Plaintiffs and agreed to keep the cattle on the partnership's property until Plaintiffs would pick them up. Before Plaintiffs could fully do so, the other partner (Stidham) sold for slaughter the cattle still on the partnership property. Plaintiffs sued alleging conversion. Stidham defended, in part, on the basis that Brakefield had no authority (apparent or otherwise) to sell the cattle. The Washington Supreme Court held that — even though Brakefield lacked actual authority — he had apparent authority and the Plaintiffs did not have knowledge sufficient to contravene Brakefield's apparent authority.[23] ◂◂◂

## c. Partnership Need Not Benefit

As with common law apparent authority, statutory apparent authority can apply even if the "agent" rather than the "principal" takes the benefits of the transaction.[24]

**Example**

> Al is a partner in the Ventura Company. Purporting to act for the Company, Al buys a computer on credit from a computer store. Ventura partners have made such purchases from the computer store in the past. This time, however, Al does not deliver the computer to the partnership. Instead, he resells the computer to a friend and pockets the cash. The computer store may nonetheless collect from the Ventura Company. From the perspective of the computer store Al's act in buying the computer was "for apparently carrying on in the usual way the business of the partnership." The partnership is therefore bound. ◂◂◂

This interpretation is not universally accepted, but it (i) seems compelled by the language of the statute; (ii) finds support in the case law; and (iii)

comports with analogous tenets of apparent authority.[25] Moreover, the interpretation serves basic notions of efficiency and fairness. It is generally easier for members of a partnership to monitor each other than for third parties to inquire deeply into the bona fides of every partner who reasonably appears to be acting for the partnership. If a partner's dishonesty causes loss, that loss should fall on those better positioned to avoid it.

# §10.3.4 The "Flip Side" Constraining Rule: Not "Apparently/Usual" and No Actual Authority

Under UPA §9(2) (1914), a partner lacks the power to bind the partnership if

- the partner is not "authorized by the other partners" (i.e., if the partner lacks actual authority);[26] and
- the partner's act "is not apparently for the carrying on of the business of the partnership in the usual way."

**Example**

> Sara is a partner in Ventura Company. Under the partnership agreement, Sara has no authority to commit Ventura to any trades. Sara makes a purchase of soybeans in her own name from a farmer who is unaware of the partnership's existence. Under UPA (1914) §9(2), Sara's act cannot bind Ventura, because (i) the act was not "apparently/usual" and (ii) Sara lacked actual authority.[27] ◂◂◂

Although both the "apparently/usual" empowering rule of UPA (1914) §9(1) and the "not apparently/usual" constraining rule of UPA (1914) §9(2) have a common component, the constraining rule does not follow automatically from the empowering rule. The empowering rule states conditions under which a partner's act binds the partnership, but that rule does not itself foreclose other empowering conditions. UPA (1914) §9(2) performs that function. Taken together the two "apparently/usual" rules mean that:

- a partner who has actual authority binds the partnership within the scope of that authority, regardless of what appears to the third party; and
- a partner who lacks actual authority can bind the partnership *only* by satisfying the "apparently/usual" empowering rule.

## §10.3.5 The "No Authority" Constraining Rule

UPA (1914) §9(4) and the last lines of §9(1) state the same rule. Regardless of the "apparently/usual" empowering rule, the partnership is not bound if: (i) the partner acts without actual authority; and (ii) at the time of the act the third party knows of the lack of authority.

**Example**

> To finance its commodities purchases the Ventura Company establishes a $4 million line of credit with the First National Bank. When Ventura applies for the line of credit the Bank asks for and receives a copy of the Partnership Agreement. The Agreement specifies that the signatures of two partners are necessary to commit the partnership to borrow money. Four months later, Al approaches the Bank to arrange a loan outside the line of credit to finance the partnership's purchase of a $10,000 server for the partnership's network. A loan officer approves the loan, and Al signs the loan agreement on behalf of the partnership. The partnership is not bound. Although Al's act may appear "apparently/usual," under the Partnership Agreement he lacks the actual authority to borrow the money. Having received a copy of the Agreement, the Bank knows of that lack.[28] According to both §§9(1) and 9(4), therefore, the partnership is not bound.[29] ◂◂◂

**Case in Point — Bank of the West v. Early Farm Partnership**

> Mother (Sheila) and son (Kevin) were the sole partners in a partnership which, based on its partnership agreement, required unanimous consent for any decisions which would have a "substantial effect upon the interest of the partnership." Kevin was also a stockholder of a corporation which sought debt financing and offered as collateral the assets of the partnership he owned with his mother. Kevin closed the deal and obtained the loan without Sheila's signature. After Kevin defaulted on the note, the lender's successor in interest sought to foreclose on the partnership's assets. The partnership defended the suit, in part, on the basis that the lender

"received notification that Kevin lacked authority" — oral statements by Kevin and his attorney explaining that Sheila was a "required signatory" on any instrument relating to the partnership assets — thereby negating any claims that Kevin had authority to bind the partnership. The court of appeals affirmed summary judgment in favor of the lender's successor in interest, holding that a statement pertaining to a formality (required signatory) did not give notice that all partners had to consent to the transaction.[30] ◂◂◂

## §10.3.6 The "Unanimous Consent" Constraining Rule

Under UPA (1914) §9(3), unless the other partners have abandoned the business, a partner needs either *actual* authority or unanimous consent from copartners to:

1. assign the partnership property in trust for creditors or on the assignee's promise to pay the debts of the partnership
2. dispose of the good will of the business
3. do any other act which would make it impossible to carry on the ordinary business of a partnership
4. confess a judgment
5. submit a partnership claim or liability to arbitration or reference

In these specified areas, a partner who lacks the authority to bind the partnership also lacks the power to bind.

If a partner lacks actual authority, the copartners' unanimous consent can remedy the situation. If the consent precedes the partner's act, the consent creates actual authority. If the consent follows the act, the consent amounts to ratification. In either event, the partner's act becomes rightful, and can therefore bind the partnership.

## §10.3.7 The Import of the Partnership's Receipt of Benefits

Under ordinary contract and agency law principles, a partnership's acceptance of benefits from a transaction can bind the partnership to that transaction under theories of ratisfication,[31] *quantum meruit*, or unjust

enrichment.

# §10.4 STATUTORY APPARENT AUTHORITY — UPA (1997) §301

## §10.4.1 UPA (1914) Compared with UPA (1997) and UPA (2013)

UPA (1997) "retains the basic principles reflected in UPA Section 9(1)"[32] and also maintains that section's basic structure. With one exception (described in section 10.4.2), UPA (2013) follows UPA (1997). Both UPA (1997) §301 and UPA (2013) §301 are considerably shorter than UPA (1914) §9. UPA (1997) §301 provides:

SECTION 301. PARTNER AGENT OF PARTNERSHIP. Subject to the effect of a statement of partnership authority under Section 303:

(1) Each partner is an agent of the partnership for the purpose of its business. An act of a partner, including the execution of an instrument in the partnership name, for apparently carrying on in the ordinary course the partnership business or business of the kind carried on by the partnership binds the partnership, unless the partner had no authority to act for the partnership in the particular matter and the person with whom the partner was dealing knew or had received a notification that the partner lacked authority.

(2) An act of a partner which is not apparently for carrying on in the ordinary course the partnership business or business of the kind carried on by the partnership binds the partnership only if the act was authorized by the other partners.

Length is not the only difference between the two provisions. UPA (1997) §301 differs from UPA (1914) §9 in six noteworthy ways. UPA (1997) §301:

1. Replaces UPA "apparently/usual" formulation ofUPA (1914) with the phrase "for apparently

carrying on in the ordinary course."

- This change in wording has no effect on meaning.[33]

2. Delineates a partner's "apparently/ordinary" power by referring both to "the ordinary course [of] the partnership business" and to "business of the kind carried on by the partnership."
   - This change eliminates a problem of interpretation that existed under UPA (1914) §9(1) and broadens the scope of statutory apparent authority.
3. Eliminates as inflexible the "unanimous consent" constraining rule ofUPA (1914) §9(3).
   - The biggest practical effect of this change is to remove an outdated barrier to agreements to arbitrate.[34]
4. Eliminates as redundant UPA (1914) §9(4).
   - This change has no effect on meaning.[35]
5. Modifies the "no authority" constraining rule, so that it applies not only if the third party knew that the partner lacked actual authority, but also if the third party "had received a notification that the partner lacked authority."
   - This change alters the balance of risk between partners and third parties and is discussed further in section 10.4.2.
6. Establishes a system of recorded statements of authority, and limitations ofauthority, which can significantly affect both the apparently/ ordinary empowering rule, and the "no authority" constraining rule.
   - The system's primary impact is on the power to transfer real property and is discussed in section 10.4.3.

# §10.4.2 Modifying the "No Authority" Constraining Rule

UPA (1997) §301(1) modifies the "no authority" constraining rule, so that it applies not only if the third party knew that the partner lacked actual authority, but also if the third party "had received a notification that the partner lacked authority." Under UPA (1997) §102(d), "A person receives a notification when the notification: (1) comes to the person's attention; or (2) is duly delivered at the person's place of business or at any other place held out by the person as a place for receiving communications."[36]

As between a partnership and third party, this change shifts somewhat the risk arising from a partner's unauthorized act.[37]

**Example**

> In the Rachael-Sam-Carolyn chicken-breeding partnership, each partner has the authority to purchase chickens for the partnership. During a cash-flow crunch, however, the partners by a 2-1 vote decide not to buy any chickens during the next 30 days. The partnership

> sends a letter to each of its regular suppliers, stating, “For your convenience in scheduling, we are informing you that we will not be making any purchases during the next 30 days. We look forward to making further orders after this brief hiatus.”

One week later, however, Carolyn finds what she considers a “golden opportunity” to purchase 500 chicks, cheap, from Gili’s Golden Hens, one of the partnership’s regular suppliers. Carolyn places an order on behalf of the partnership, and Gili accepts the order. The partnership’s “hiatus” letter is sitting unopened on Gili’s desk.

Under UPA (1914), the partnership is probably bound. Carolyn lacked actual authority, but she had apparently/usual power. At the relevant moment Gili had no “knowledge of the fact that [Carolyn had] no such authority.” UPA (1914) §9(1). Under UPA (1914) §3, a person has knowledge of a fact not only through “actual knowledge thereof but also when he [or she] has knowledge of such other facts as in the circumstances shows bad faith.” Most likely, Gili’s failure to promptly open her mail does not amount to “bad faith.”

Under UPA (1997) §§301(1) and 102(d), in contrast, the partnership is probably *not* bound. The partnership’s “hiatus” letter is a “notification” which has been “duly delivered at [Gili’s] place of business.” ◂◂◂

“The Harmonization Project shifted the risk a bit further.”[38] Under UPA (2013) §301(1) the “no authority constraining rule” applies if “the person with which the partner was dealing *knew or had notice* that the partner lacked authority.”[39]

## §10.4.3 Establishing a System of Recorded Statements That Can Significantly Affect the Operation of UPA (1997) §301 and UPA (2013) §301

As one of its major innovations, UPA (1997) established a system of publicly filed statements to provide what is often termed “constructive notice.”[40] The system, which is mechanically complex, “was refined in ULLCA (2006) and further refined in the Harmonization Project.”[41]

In both UPA (1997) and UPA (2013), the key provision is section 303,

which provides both for statements recognizing authority and statements limiting authority. As explained in a comment to UPA (2013) §303:

> This section is conceptually divided into two realms: (i) statements pertaining to the power to transfer interests in the partnership real property; and (ii) statements pertaining to other matters. In the latter realm, statements are filed only in the records of the filing office and operate only to the extent the statements are actually known and relied on by a third party.
> As to interests in real property, in contrast, this section: (i) requires double filing—with the filing office and in the appropriate land records; and (ii) provides for constructive knowledge of statements limiting authority. Thus, a properly filed and recorded statement can protect the partnership, and, in order for a statement pertaining to real property to be a sword in the hands of a third party, the statement must have been both filed and properly recorded, section 303(f). Experience suggests that statements of authority will most often be used in connection with transactions in real estate.[42]

The Harmonization Project made two noteworthy, substantive improvements to the statement of authority provision. First, while the 1997 version authorized statements of authority pertaining only to partners,[43] UPA (2013) §303(a)(3) authorizes a statement to pertain to any “person.” Second, UPA (2013) §303(a)(2) provides that, “with respect to any position that exists in, or with respect to the partnership, [a statement of authority] may state the authority, or limitations on the authority, of all persons holding the position.” As explained in a comment:

> This paragraph [i.e., section 303(a)(2)] permits a statement to designate authority by position (or office) rather than by specific person, thus avoiding the need to file anew whenever a new person assumes the position or the office. This type of a statement will enable partnerships to provide evidence of ongoing power to enter into transactions without having to disclose to third parties the entirety of the partnership agreement.

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# §10.5 BINDING THE PARTNERSHIP THROUGH A PARTNER’S WRONGFUL ACTS (UPA (1914) §13; UPA (1997 AND 2013) §305(a))

## §10.5.1 The Attribution Rule

### a. The Rule in the Three Acts

All three acts provide a rule for attributing certain “wrongful” acts or omissions of a partner to the partnership. UPA (1997) “Section 305(a) ... is derived from UPA [(1914)] section 13,”[44] and the provisions state very similar rules.

UPA (2013) §305(a) differs from the 1997 version only by moving an important point of clarification from a comment to the statute itself. The text ofUPA (1997) §305(a) provides: “A partnership is liable for loss or injury caused to a person, or for a penalty incurred, as a result of a wrongful act or omission, or other actionable conduct, of a partner acting in the ordinary course of business of the partnership or *with authority of the partnership*.”[45] The official comment then states: “‘[W]ith the authority of the partnership’ ... is intended to include a partner’s apparent, as well as actual, authority.”[46]

In contrast, UPA (2013) §305(a) provides:

> A partnership is liable for loss or injury caused to a person, or for a penalty incurred, as a result of a wrongful act or omission, or other actionable conduct, of a partner acting in the ordinary course of business of the partnership or *with the actual or apparent authority of the partnership*.[47]

Table 10.2 details the similarities and mostly minor differences among the three acts.

| 10.2 A Partner's Wrongful Conduct | | | | |
|---|---|---|---|---|
| Provision | Nature of Partner's Conduct | Connection of Partner's Conduct to the Partnership | Resulting Liability of the Partnership | Applicable to Third-Party Claimants Only, or also to Injured Partners |
| UPA (1914) §13 | "Any wrongful act or omission" | "In the ordinary course of the business of the partnership or with the [actual] authority of his copartners" | "The partnership is liable therefore to the same extent as the partner so acting or omitting to act." | Only third-party claimants |
| UPA (1997 and 2013) §305(a) | "A wrongful act or omission, or other actionable conduct" | "In the ordinary course of business of the partnership or with [the actual or apparent] authority of the partnership"[48] | "Partnership is liable for loss or injury caused." | Attribution rule also available to partners |

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## b. Wrongful but Ordinary?

When a claimant invokes section 305(a) ofUPA (1997) or UPA (2013), or section 13 ofUPA (1914), can the partnership argue that, while the "rightful" version of the partner's conduct may be "ordinary course" or authorized, the wrongful conduct is not? Cannot the partnership say, for example, "Yes, it's normal and proper for our partners to describe our products, but it is both extraordinary and unauthorized for them to make misrepresentations when doing so"?

Although superficially attractive, this argument should fail. The proper question under all three acts is not whether the specific *wrongful* act *is* "ordinary course" or authorized, but rather whether that *type* of act, *if done rightfully, would be*. For example, the question is not whether attending a Chamber of Commerce luncheon, and then driving negligently back to the office meets the scope requirement, but rather whether attendance and non-negligent driving would do so.[49] Similarly, the question is not whether a

partner's inaccurate disparagement of a competitor's product meets the scope requirement, but rather whether an accurate criticism of the product would be "ordinary course" or authorized.

**Example**

> Ventura Partnership trades in agricultural products. In the course of discussing a soybean trade with a customer, Al offers to sell (for the partnership) 20,000 bushels "99 percent free of vermin infestation." Al knows that the soybeans in question actually have a troublesome 8 percent infestation rate. The partnership is legally responsible for Al's misstatement. Since Al's intentional misrepresentation (a wrongful act) occurred in the ordinary course of the business of the partnership, whichever uniform act applies will attribute the misrepresentation and any resulting liability to the Ventura Partner- ship.[50] Ventura cannot defend by claiming that "We are an honest company, and this is the first misrepresentation any of our partners have ever made." The issue is not whether misrepresentation is "ordinary course," but rather whether product description is.[51] ◂◂◂

**Case in Point —Albeit Wrongly Decided — Jackson v. Jackson**

> In *Jackson v. Jackson*, the North Carolina Court of Appeals stated that, while "[a]dvising the initiation of a criminal prosecution is clearly within the normal range of activities for a typical law partnership, . . . taking such action maliciously and without probable cause is quite a different matter." The court held that "[i]n view of [ethics] rules, which clearly forbid any attempt by a lawyer to prosecute a person without cause, it cannot be held that malicious prosecution is within the ordinary course of business of a law partnership."[52]
>
> The comment to UPA (2013) §305(a) criticizes *Jackson*'s reasoning: "It is difficult to identify a reasonable limit to this approach. Presumably, at least, a partner's 'plain vanilla' malpractice is within a law firm's ordinary course of business despite the ethical rules requiring lawyers to act zealously and competently."

### §10.5.2 *Respondeat Superior* Compared to UPA (1914) §13 and UPA (1997 and 2013) §305(a)

UPA (1914) §13 and UPA (1997 and 2013) §305(a) each state a rule of vicarious liability, and in that general respect they resemble the agency doctrine of *respondeat superior*:[53] A first legal person (the partnership or the master/employer, as the case may be) becomes liable on account of the tortious conduct of a second person[54] (the partner or the servant/employee agent), without the claimant needing to establish that the first person is at fault or directly responsible for the claimed harm. All that a claimant need show is that:

- the second person (the partner or the servant/employee agent) incurred tort liability;
- the first and second person stand in a specified relationship to each other (partner/partnership or servant-master/employee-employer); and
- the tort is sufficiently related to the first person's enterprise ("ordinary course of' the partnership or "scope of employment").

There is one major difference, however. Under *respondeat superior* the claimant must show that the master had the right to control the means by which the tortfeasor performed his, her, or its functions. This showing is crucial to establishing servant/employee status.[55] The partnership rules have no parallel requirement; they apply regardless ofwhether the tortfeasor is the most subservient junior partner or the most dictatorial managing partner.

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## §10.6 BINDING THE PARTNERSHIP THROUGH A PARTNER'S INVOLVEMENT IN A MISAPPLICATION OF PROPERTY OWNED BY A NON-PARTNER (UPA §14; UPA (1997 AND 2013) §§305(a) AND (b))

### §10.6.1 The Attribution Rule

The attribution rules under the three uniform general partnership acts are

similar in structure, although the the 1997 version expands and clarifies the 1914 version, and the 2013 version clarifies the 1997 version.

The three acts take roughly similar approaches to this topic. As shown in the following list and figure, each act uses roughly the same three elements to establish attribution:

- Who received the property (i.e., partner or partnership)?
- Did the circumstances of receipt justify holding the partnership liable?
- Who misapplied or misappropriated property?

**Figure 10.1. When Partnership Is Liable for Partner's Misapplication of Non-Partner's Property[56]**

| Who received the property and relevant statutory section | Circumstances of receipt justifying attribution | Who misapplied or misappropriated the property |
|---|---|---|
| **A PARTNER** | | |
| UPA §14(a) | "Acting within the scope of his [sic] apparent authority" | The partner who received the money |
| UPA (1997) §305(b) | "In the course of the partnership's business or while [the partner is] acting with authority of the partnership" | A partner |
| UPA (1997) §305(a) | "Acting . . . with authority of the partnership"[57] | A partner[58] |
| UPA (2013) §305(b) | In the course of the partnership's business or while acting with actual or apparent authority of the partnership | A partner |
| **THE PARTNERSHIP** | | |
| UPA (1914) §14(b) | "The partnership in the course of its business" | "Any partner while [the property] is in the custody of the partnership" |
| UPA (1997) §305(b) | "A partner . . . causes the partnership to receive . . . property" | Any partner |
| UPA (2013) §305(b) | "A partner . . . causes the partnership to receive . . . property" | Any partner |

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## Example

Chris, an attorney in a law partnership, represents a hospital in a malpractice case. Chris arranges a settlement, and the hospital sends a

check, made out to the partnership, to cover the settlement amount and Chris's fees. Chris takes the entire amount for himself.

The law partnership is liable to the hospital. The position of partner in a law firm probably creates by itself the apparent authority to receive settlement checks. If so, UPA (1914) §14(a) applies. In any event, UPA (1914) §14(b) applies because (i) receiving settlement checks is undoubtedly within "the course of [a law partnership's] business," (ii) Chris probably had actual authority and undoubtedly had "apparently/usual" power to receive the check for the partnership, so under UPA (1914) §9(1) the partnership received and had custody of the check, and (iii) Chris misapplied the check while it was "in the custody of the partnership." ◂◂◂

## §10.6.2 A Core Concern of UPA (1914) §14 — Defalcations by Professionals

Many of the most interesting cases under UPA §14 have involved defalcations by partners in professional partnerships, and the same is likely to be true under UPA (1997). For example, a partner in a law firm induces a grieving widow to entrust him with the investment of her late husband's estate and then steals the funds. A partner in an accounting firm supervises a client's accounts receivable and then embezzles funds collected from the client's customers. In each case the partnership, while perhaps sympathizing with the victim, asserts that such fund handling involved is foreign to the normal business of the partnership.

The older leading cases deny recovery against the partnership. Rationales include the following:

- The mere fact of partner status does not constitute a "holding out" that a partner is authorized to handle the funds on behalf of the partnership. Therefore, without some other manifestation of authority attributable to the partnership, no apparent authority exists. Therefore, no UPA (1914) §14(a) liability. (Nor would there have been any liability under the "apparent authority" aspect ofUPA (1997) §305(a).)
- The fund handling is not within "the course of [the partnership's] business." Therefore, no UPA (1914) §14(b) . . . liability. (Nor
- would there have been any liability under UPA (1997 and 2013) §305(b), because the partner was acting neither "in the course of the partnership's business [n]or with [the actual or apparent] authority of the partnership.")
- The fund handling is not "within the ordinary course of the business of the partnership" and is

not “authorized by [the] copartners.” Therefore, no UPA §13 liability. (Nor likewise under UPA (1997 and 2013) §305(a).)

Some of the newer cases allow recovery, or at least reverse a summary judgment in favor of the defendant partnership. Rationales include:

- Apparent authority should be determined from the perspective of the client, not the profession. It may, for instance, be unreasonable for a fellow lawyer to believe that a partner in a law firm has authority to act as an investment advisor. But the proper question is whether a *client* might reasonably have that belief.
- In modern professional practices, handling funds may indeed occur in the course of the partnership’s business, especially when the client entrusts the funds to a partner in connection with advice or services that themselves clearly constitute traditional “course of business” matters.
- When professionals are involved, the need to protect the public and to hold professionals to high standards of responsibility argue for an expansive interpretation of vicarious liability provisions.

## Case in Point — Husted v. McCloud

Defendant partner (Edgar), acting as attorney for an estate (McCloud — the deceased mother), received money from the executor of the estate (McCloud — the son) for the purpose of making payments due from the estate to the IRS. Edgar subsequently misappropriated the funds for his own use. The trial court held “the partnership responsible to [the estate] for compensatory damages,” and the Indiana Supreme Court affirmed. “Edgar was acting within the ordinary course of the partnership’s business and with apparent authority since Edgar’s request for and acceptance of money from [son] McCloud to pay [deceased mother] McCloud’s estate tax liability was well within the work parameters of an attorney properly handling a decedent’s estate. We therefore find that even though fraud and conversion of a client’s funds are not part of the ordinary course of a law partnership’s business, the trial court correctly found pursuant to [UPA (1914)] §14 that the partnership was responsible for partner Edgar in taking money entrusted to him and misapplying it.[59] We also find that the trial court was justified in finding that McCloud’s money was in the partnership’s possession when it was in Edgar’s possession[60] since Edgar deviated from McCloud’s plan and converted the money to his own use only after he received it in the ordinary course of the partnership’s business.”[61] ◂◂◂

## §10.7 BINDING THE PARTNERSHIP THROUGH INFORMATION KNOWN OR RECEIVED BY A PARTNER (UPA (2013) §l02(e); UPA (1914) §12)

### §10.7.1 The Attribution Rules — Overview

UPA (2013) §103(e) attributes to a partnership a "partner's knowledge or notice of a fact relating to the partnership."[62] UPA (1914) §12 attributes to the partnership "notice" made to a partner and "knowledge" possessed by a partner. Comparing the two provisions is somewhat tricky, because: (i) what UPA (1914) §12 means by "notice" is not what UPA (2013) means by notice; and (ii) UPA (2013) §102(e) relies on three defined terms while UPA (1914) §12 relies on only two. Under both Acts, the attribution rules are subject to the "fraud on the partnership" exception.

Table 10.3 provides the necessary comparison.

**10.3 Attributing a Partner's Information**

| Type/Source of Information | UPA (1914) | UPA (2013) |
|---|---|---|
| *Knowledge* | "A person has 'knowledge' of a fact . . . not only when he has actual knowledge thereof, but also when he has knowledge of such other facts as in the circumstances shows bad faith." UPA §3(1).[63] | "A person knows a fact if the person: (1) has actual knowledge of it; or (2) is deemed to know it under subsection (d)(1) [providing constructive knowledge of specified public filings] or law other than this [act]. . . ." UPA (2013) §§103(a). |
| *Receipt of information* | "A person has 'notice' of a fact . . . when the person who claims the benefit of the notice: (a) States the fact to such person, or (b) Delivers through the mail, or by other means of communication, a written statement of the fact to such person or to a proper person at his [i.e., such person's] place of business or residence." UPA §3(2). | "[A] person notifies another person of a fact by taking steps reasonably required to inform the other person in ordinary course, whether or not those steps cause the other person to know the fact." UPA (2013) §103(c). |
| *Reason to know* | No provision | "A person has notice of a fact if the person: (1) has reason to know the fact from all the facts known to the person at the time in question; or (2) is deemed to have notice of the fact under subsection (d)(2) [providing constructive notice of specified public filings]" UPA (2013) §103(b). |

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As with agency law, the relevant substantive law determines the significance of any attributed information.

## §10.7.2 Attributing Knowledge

UPA (1914)'s approach to attributing a partner's knowledge to the partnership is more nuanced (and therefore more complex) than the UPA

(2013) approach. According to UPA (1914) §12, the attribution rule varies depending on whether the partner with knowledge is "acting in the particular matter":

> . . . the knowledge of the partner acting in the particular matter, acquired while a partner or then present to his mind, and the knowledge of any other partner who reasonably could and should have communicated it to the acting partner, operate as . . . knowledge of the partnership, except in the case of a fraud on the partnership committed by or with the consent of that partner.

If a UPA (1914) partner *is* acting in the matter, subject to an exception for fraud,[64] the partner's knowledge inescapably binds the partnership. UPA (1914) §12 attributes both (i) knowledge "acquired while a partner" and (ii) knowledge acquired earlier if at the time of the action the acting partner still retains the knowledge.[65]

The knowledge of a UPA (1914) partner *not* acting in a particular matter binds the partnership only if the partner "reasonably could and should have communicated it to the acting partner." The Official Comment to §12 explains the rationale:

> It seems clear that . . . the partnership should be charged [with the nonacting partner's knowledge] only when the partner having "knowledge" had reason to believe that the fact related to a matter which had some possibility of being the subject of partnership business and then only if he was so situated that he could communicate it to the partner acting in the particular matter before such partner give[s] binding effect to his act.[66]

The rule under UPA (2013) is simpler and makes no distinction between a partner who acts in the matter and one who does not, and therefore imposes greater risks on the partnership than does UPA (1914). Subject to the same fraud exception as exists under UPA (1914), under UPA (1997) a "partner's knowledge ... of a fact relating to the partnership is effective immediately as knowledge by . . . the partnership."[67]

Under both UPA (1914) and UPA (2013), attribution of a partner's knowledge occurs regardless of whether the partner shares the knowledge with fellow partners.

**Example**

> Vladi is the managing partner of the Waterville Ski Company, a general partnership that owns and operates several ski slopes. The company has an important contract with Michael, its principal ski instructor, which requires Michael to give four weeks' notice to

terminate the contract. Michael attempts to give notice by sending a letter to Vladi's home address, although Vladi does not normally do business from that address. If the letter is delivered to Vladi's home, the notice is effective under UPA (1914). Under UPA (1914) §3(2)(b), Vladi, as partner, "has 'notice' of [the contents of the letter] . . . when the person who claims the benefit of the notice [i.e., Michael] . . . [d]elivers through the mail . . . a written statement of the fact to [Vladi] at his . . . residence." Under UPA (1914) §12, notice to Vladi is notice to the partnership.

The result is different under UPA (2013) §103(c). Under that provision, the question is whether Michael has "tak[en] steps reasonably required to inform the other person in ordinary course." If so, Michael has "notified" Vladi, and Vladi therefore has knowledge of the fact of the notice and its contents "whether or not those steps [have] cause[d] [Vladi] to know the fact." Under UPA (2013) §103(f), Vladi's knowledge is attributed to the partnership ◂◂◂

## §10.7.3 Attributing Information a Partner Has Reason to Know

UPA (2013) handles this category of information by using the defined term "notice," defining the term to include information that a partner "has reason to know from all of the facts known to the [partner] at the time in question,"[68] and providing that a "partner's . . . notice ... of a fact relating to the partnership is effective immediately as . . . notice to . . . the partnership."[69] UPA (1914) has no comparable provisions. The closest UPA (1914) comes is to attribute a partner's knowledge to the partnership and to define knowledge to include situations in which a person "has knowledge of such other facts as in the circumstances shows [the person's ignorance to be in] bad faith."[70]

## §10.7.4 The "Partner Fraud on the Partnership" Exception

The attribution rules ofUPA (2013) §103(e) and UPA (1914) §12 do not

apply “in the case of a fraud on the partnership committed by or with the consent of [the] partner” whose knowledge or receipt of notice is to be attributed. In this context the concept of“fraud” probably includes a breach of the partner’s duty of loyalty (sometimes called “equitable fraud”). Fraud blocks the attribution even if the third party was ignorant of the fraud, and has no reason to know of it.

**Example**

> Seeking to preclude the Ventura Company from additional borrowing against its line of credit, the First Regional Bank delivers a written “no more borrowing” notice to Al, a partner. For some time, Al has been borrowing from the line of credit in the partnership’s name but for his own personal benefit. Neither the Bank nor the partnership is aware of Al’s misconduct. Because Al is committing “a fraud on the partnership,” notice to him is not notice to the partnership. ◂◂◂

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# §10.8 EFFECT OF THE PARTNERSHIP AGREEMENT ON QUESTIONS OF POWER TO BIND

In some circumstances, partners’ *inter se* management agreements can increase a third party’s ability to hold the partnership liable. In other, more restricted circumstances, an *inter se* agreement can undercut a third- party claim.

## a. Increasing the Third Party’s Ability to Hold the Partnership Liable

If a partnership agreement gives a partner the right to act for the partnership on particular matters, then the partner has actual authority within that specified scope. A partner who acts with actual authority binds the partnership as a matter of agency law. There is no need to rely on any of the special partnership law rules for binding the partnership to third parties.

## b. Undercutting a Third Party's Claim

Just as a partnership agreement can convey actual authority, so too can an agreement negate that authority. If a partner who lacks actual authority has purported to bind the partnership to a third party, the partnership is not bound:

- under UPA (1914) §9(1), if the third party "has knowledge of the fact that [the partner] has no such authority;
- under UPA (2013) §301(1), if third party knows "knew or has received a notification that the partner lacked authority"; and
- under UPA (2013) §301(1), if the third party "knew or had notice that the partner lacked authority."[71]

### *Problem 81*

> In the aftermath of a bitter divorce, Ronald goes into partnership with Robert in a donut shop. Ronald wishes to hide his income from his exwife, so he and Robert agree that Ronald will be a very "silent" partner. Ronald will provide 60 percent of the capital and will share in all major decisions. Robert will handle all transactions with third parties. He will appear to third parties as the sole owner of the business. Accordingly, after consultation with Ronald, Robert signs a long-term lease for a building in which the donut shop will operate.

The business eventually fails, and only afterward does the lessor discover the relationship between Robert and Ronald. If UPA (2013) applies, can the lessor hold the partnership liable on the lease? Under UPA (1914)? ◂◂◂

### Explanation

> Yes, under either act. The arrangement between the partners gave Robert actual authority to sign the lease on behalf of the partnership. The fact that the partnership was undisclosed is therefore immaterial. ◂◂◂

### *Problem 82*

> The Ventura Company partnership agreement gives wide-ranging authority to Beatrice, the partnership's managing partner. However,

all decisions to initiate or settle litigation must be approved by a majority vote of the part-ners. On two occasions during the past five years, Beatrice has recommended to the partners that the partnership arbitrate a dispute, and on each occasion the partners approved.

Ventura has a dispute with Central California Soybean ("CCS") concerning a particular trade. No suit has been filed, but litigation seems inevitable. Aware that Ventura has arbitrated disputes in the past, CCS proposes arbitration. Beatrice agrees, this time without consulting the other partners. In determining whether Ventura is bound to arbitrate the dispute, does it matter which of the three acts applies? ◂◂◂

## Explanation

Yes. Under UPA (1914), Ventura is not bound. Under the modern acts, the partnership might well be.

Under UPA (1914) §9(3)(e), part of UPA's "unanimous consent" constraining rule, no partner has the power to "[s]ubmit a partnership claim or liability to arbitration" unless either all the partners consent or the partner agreeing to arbitration has actual authority to do so. In this instance, the other partners have not consented, and under the partnership agreement Beatrice lacks actual authority to agree to arbitration on her own. The partnership's past practices conform with and confirm this interpretation of the partnership agreement. To obtain actual authority, Beatrice needs the consent of a majority of her partners.[72]

In contrast, neither of the modern acts has a "unanimous consent" constraining rule, and UPA (1997) §301, comment 4 states that "it seems archaic that the submission of a partnership claim to arbitration always requires unanimous consent." Because CCS is "[a]ware that Ventura has arbitrated disputes in the past," Beatrice's act is probably within her

"apparently/ordinary" power. If so, the partnership is bound to arbitrate. The result would be same under UPA (2013) §301. ◂◂◂

### *Problem 83*

Two brothers, Caleb and Adam, operate a farm as an ordinary general partnership, known as AdCal Farming Company. The two brothers are well respected. Their partnership is well known in the community, as is the fact that each partner regularly makes equipment purchases for the partnership business.

One day, Caleb goes to the local Ford dealer and buys a $35,000 Ford pickup truck on credit, signing the purchase agreement "AdCal Farming Company, by Caleb, general partner." In fact, the truck has nothing to do with the partnership business. Caleb has decided to give up farming and go "on the road." The truck is for his personal use. Under UPA (2013), maythe Ford dealer hold *Adam* liable on the purchase agreement? ◂◂◂

**Explanation**

Yes. Adam is liable under UPA (2013) §§306(a) because the partnership is liable under UPA (2013) §§301(1). Caleb's truck purchase was "for *apparently* carrying on in the ordinary course of the partnership business."[73] The dealer knew Caleb to be a partner and saw nothing unusual in an individual AdCal partner committing the partnership to an equipment purchase. To the contrary, the partnership had a reputation for doing business this way. Moreover, Caleb asserted that he was acting for the partnership, and nothing in Caleb's reputation gave the dealer any reason to doubt that assertion.[74] ◂◂◂

***Problem 84***

Hiview Company is a UPA (1914) partnership which operates a drive-in movie theater. Rachael, its managing partner, purports to sell the land where the theater is located to a development company. The partnership agreement authorizes the managing partner to "make all management decisions in the ordinary course of the business." Has Rachael's action bound the partnership? Would the analysis change under UPA (1997) or UPA (2013)? ◂◂◂

**Explanation**

For three reasons, under UPA (1914), Rachael has not bound the

partnership. Her “ordinary course” actual authority does not extend to the extraordinary decision to sell the crucial assets of the business. Her doing so could not have appeared “apparently/usual” to the buyer. Her doing so runs afoul of UPA (1914) §9(3)(c) (partner lacks power to do “any ... act which would make it impossible to carry on the ordinary business of a partner-ship,” unless partner has actual authority or all partners agree).

The analysis is the same under the two modern acts, except that neither contains an analog to UPA §9(3)(c). ◂◂◂

### *Problem 85*

Illegitimus, Non, and Carborundum have formed a UPA (2013) partnership as a “handshake deal” and gave explicit thought to only two issues. First, they agreed that the sole purpose of the partnership would be to function as a locator of “spot” grapes for the makers of wine. Second, they agreed that they would share equally all profits from the partnership.

Locators of spot grapes play an important part in the production of nonvintage wines.[75] From time to time vineyards producing nonvintage wine find themselves short of a particular type of grape that they want to add to a mixture of other grapes. Locators of spot grapes are in the business of knowing which vineyards have a need for which types of grapes, and which vineyards have a surplus of that type of grape. Based on this knowledge they act to get surplus grapes to the vineyards that need them.

The overwhelming majority of locators act only as agents, never taking a position in grapes. This means that when they have a customer who needs a particular type of grape, they locate a supply of those grapes in another vineyard. Then, acting merely as the agent of the customer who needs the grapes, they arrange for the sale of grapes from the vineyard with the surplus to the vineyard with the need. In this conventional approach, the locator never takes title to the grapes, and never commits itself to pay for the grapes.

The partnership carries on its business at variance with this typical pattern. On occasion, it will buy and take title to surplus grapes held by a vineyard, speculating that it (i.e., the partnership) can find

another vineyard to which it can resell the grapes. Although with this approach the partnership faces greater risk than it would if it followed the conventional pattern, the potential rewards are greater. Where it takes a position and then resells the grapes, the partnership charges a markup that exceeds the amount of commission the partnership would have received for simply acting as a locator agent.

When Illegitimus, Non, and Carborundum began the partnership, they needed start-up capital. Illegitimus contributed $30,000. Non and Carborundum each contributed $10,000. Each year the partners have fully drawn out all profits. They have never withdrawn any capital.

Last spring Non and Carborundum became concerned about some of the deals that Illegitimus had made. At a regularly scheduled partnership meeting, they voted to prohibit Illegitimus from making any further purchases of grapes on behalf of the partnership. They expressly allowed him to continue arranging deals of the more conventional sort; that is, where the partnership would act only as an agent. Illegitimus objected to and voted against the limitation.

Soon after the meeting, Illegitimus took a buying tour out into the countryside and visited Schekainery Vineyard. The owner of the vineyard, Sally Schekainery, knew generally of the partnership and of Illegitimus' status as a partner. She had no particular knowledge about the partnership or about its business practices, and had never done business with the partnership before. During the visit Illegitimus learned that the Schekainery Vineyard had several tons of surplus of a particular variety of red grape. Illegitimus believed, and reasonably so at the time, that several regular clients of the partnership would soon need this grape. Over dinner he began to negotiate with Sally for a price, and eventually Illegitimus and Sally agreed to a price of $5,000 per ton for eight tons, to be delivered within the next 30 days. The next morning Sally wrote a memorandum expressing the deal, and Illegitimus signed on behalf of the partnership.

As it turned out, several ofthe clients whom Illegitimus had in mind did not need that particular variety of grape. Moreover, throughout the entire valley, vineyards that needed to purchase the grapes were able to purchase easily at a price significantly below the price Illegitimus had committed to pay. When Non and Carborundum learned what Illegitimus had done, they wrote to Sally: (i) explaining

that Illegitimus had no authority to act for the partnership in this matter; and (ii) stating that the partnership had no interest in purchasing the grapes. As evidence of Illegitimus' lack of authority, they enclosed a certified copy of the minutes of the meeting at which Non and Carborundum voted to "defrock" Illegitimus of his authority to enter into this particular type of transaction.

Sally consulted an attorney, who advised her to warn the partnership that: (i) she intended to hold them to the contract; and (ii) if they did not take delivery as agreed, she would mitigate her damages by selling the grapes elsewhere and would then file suit against the partnership for any difference between the mitigation price and the contract price. Hearing no response from the partnership, she proceeded as she had indicated. The difference amounted to $20,000. Sally sued the partnership. What result? ◂◂◂

## Explanation

The partnership will be liable if either: (i) Illegitimus' act was "apparently/ ordinary" or (ii) Illegitimus had actual authority to make the deal.

Sally's apparently/ordinary claim will fail. She cannot show that Illegitimus' act appeared for "carrying on in the ordinary course the partnership business or business of the kind carried on by the partnership." UPA (2013) §301(1). As to businesses "of the kind carried on by the partnership," industry practices suggest that Illegitimus' act should have appeared quite unusual. As to reasonable appearances and the ordinary course of *this* partnership's business, Sally has no evidence to offer. She knew nothing in particular about this partnership. She could only suppose that its commercial practices resembled those of similar partnerships.

Sally will probably fare better with her actual authority claim. Illegiti- mus certainly had authority to make comparable deals when the partnership began, and it is unlikely that a mere majority vote of the partners could have ended that authority. Defrocking a partner seems an extraordinary act, requiring unanimous consent. The partners' 2-1 vote did not suffice.[76]

The partnership could, however, advance a less aggressive interpretation of the 2-1 vote that, ironically, could give Sally difficulty. The partnership could argue that (i) the vote and the discussion that preceded it informed Illegitimus that his partners would differ with him anytime he contemplated making a purchase of spot grapes; (ii) Illegitimus therefore knew that any grape purchase he might contemplate would involve a “difference arising as to a matter in the ordinary course of business of [the] partnership,” to be decided in each particular instance by majority vote, UPA (2013) §401(k); and (iii) as with any such difference, knowledge of the difference eliminated the acting partner’s authority pending resolution “by a majority of the partners.” *Id*.

If this latter interpretation prevails, the partnership will not be liable. ◂◂◂

***Problem 86***

Suppose that immediately after the 2-1 vote, Non and Carborundum executed and properly filed a statement of partnership authority in the appropriate filing office stating that Illegitimus lacked the authority to purchase any grapes on behalf of the partnership. Would this fact change the result? ◂◂◂

**Explanation**

No. Grapes are personal property, and the only statement authority which can provide constructive notice is a statement regarding real property.[77]

***Problem 87***

Since graduating from law school five years ago, Able, Baker, and Charlene have practiced law in a partnership that is not an LLP. The partners “cover” for each other during vacations, and the partnership has in place a system for avoiding conflicts of interests. Otherwise, however, each partner is responsible for his or her own files. Three years ago, attorney Able filed a consumer fraud lawsuit in state district court against Defendant, Inc. Consumer fraud was one of

Able’s principal areas of practice, but in this instance the claims were frivolous. Able had signed the complaint without having made any investigation into the facts.

Neither Baker nor Charlene had any involvement in the case. Indeed, Baker was not even aware that the case had been filed. The court eventually dismissed the lawsuit and, citing Rule 11 of the state Rules of Civil Procedure, ordered Able to pay Defendant, Inc., the $47,000 in attorney’s fees that Defendant, Inc., had incurred in defending the lawsuit. The court specifically found that Able had violated Rule 11 by “failing to make a ‘reasonable inquiry’ into the facts before filing a complaint that was neither ‘well grounded in fact’ nor ‘warranted by existing law or a good faith argument for the extension, modification, or reversal of existing law.”’ The court of appeals affirmed the award against Able. Under UPA (1914), can Defendant, Inc., hold Baker and Charlene personally liable for the Rule 11 award? Under UPA (2013)? ◂◂◂

**Explanation**

Baker and Charlene are liable jointly and severally under UPA (1914) §15(a), because the partnership is liable for the award under UPA (1914) §13.[78]

To establish the partnership’s liability under UPA (1914) §13, Defendant, Inc., must show that: (i) it suffered harm from a partner’s wrongful act or omission; and (ii) the conduct occurred either in the ordinary course of the partnership’s business or with the authority of the other partners. Able was a partner, and filing a frivolous lawsuit is clearly a wrongful act. Defendant will therefore have no trouble on the first element ofUPA (1914) §13. As to the second element, Defendant can actually meet both requirements of the either/or test. The business of the partnership ordinarily included the filing of lawsuits. Therefore, when Able filed the frivolous claim, he was “acting in the ordinary course of business of the partnership.” Able was also acting with actual authority. UPA (1914) §18(e) gives all partners “equal rights in the . . . conduct of the partnership business.” The partners augmented this statutory authority by granting each partner autonomous authority over his or her own files. It is not clear

from the facts whether the partners agreed to this grant expressly, but the way they conducted their business certainly implied an agreement.

The fact that Baker and Charlene had no part in this misconduct is irrelevant to Defendant, Inc.'s claim. UPA (1914) §13 states arule ofvicarious liability, and UPA (1914) §15 states a rule of liability by status.

The analysis and results are the same under UPA (2013). Only the citations differ.[79] ◂◂◂

***Problem 88***

Mrs. Rouse recently lost her husband. He left a small estate, mostly in cash. The widow is an elderly lady who throughout her life left business affairs to her husband. She confides to her lawyer, Mr. Pollard, that she does not know how best to invest the funds.

Mr. Pollard has been a lawyer for 20 years and for the past 15 years has served as the Rouse family lawyer. For the past 16 years, he has been a partner in the law firm of What, Me, and Worry. The firm is organized as a general partnership. Mr. Pollard tells Mrs. Rouse, "My dear lady, I would be delighted to handle your investment decisions for you. Place yourself in my hands. Entrust your funds to our firm. We have quite a bit of experience in such matters."

Mrs. Rouse agrees to "put the money with the firm." She writes a check for almost the entirety of her assets. At Mr. Pollard's direction, she makes the check payable to him.

Unfortunately, Mr. Pollard is a crook. The law firm of What, Me, and Worry does not handle investments for clients. Indeed, law firms in general do not ordinarily serve as investment advisors. Mr. Pollard deposits Mrs. Rouse's check in his personal checking account and appropriates her money to his own use. For a few months he sends her checks drawn on his personal account purporting to represent a return on her investments. Then his financial house of cards topples, and his fraud is exposed.

Mr. Pollard goes into bankruptcy and thence into jail. Mrs. Rouse sues the law firm partnership for return of the money she entrusted to Mr. Pollard. What result under UPA (1914) and under UPA (2013)?

◂◂◂

## Explanation

Whether Mrs. Rouse will prevail depends on how liberal a view the court takes of UPA (1914) §14(b) and UPA (2013) §305(b).

Neither UPA (1914) §13 nor the "actual authority" aspect of UPA (2013) §§305(a) can help Mrs. Rouse. To successfully invoke either of those provisions she must show either that Mr. Pollard handled her funds in the ordinary course of the business of the partnership, or that he did so with actual authority. Mrs. Rouse can make neither showing. The law firm never acted as an investment advisor, and never authorized Mr. Pollard to do so.

For similar reasons Mrs. Rouse will be unsuccessful invoking UPA (1914) §14(b). For that provision to apply, the partnership must have received the money "in the course of its business." Arguably at least, the *partnership* never received the money at all.[80] In any event, "the course of its business" did not include investing clients' funds.

Mrs. Rouse may fare better under UPA (1914) §14(a) and UPA (2013) §§305(b). She can certainly show that Mr. Pollard, a partner, misapplied her money. It is only doubtful whether she can show that Mr. Pollard received the money within the scope of his apparent authority.

Under the older case law, Mrs. Rouse would likely lose on this point. The older cases suggest, almost as a matter of law, that no reasonable client can believe that a lawyer has the authority to handle client funds for investment purposes. More modern cases, however, treat the question as one of fact. They do not simply assume that every reasonably prudent client understands the limitations on a law firm's business.

Mrs. Rouse may therefore be able to prevail by proving that: (i) Mr. Pollard had apparent authority by position; and (ii) despite Mr. Pollard's direction that the check be made out to him personally, Mrs. Rouse was reasonable in believing that Mr. Pollard's authority extended to handling client funds for investment. Mr. Pollard's assertions about the firm's business and his own authority would not

suffice as manifestations of the firm, but they could help show the reasonableness of Mrs. Rouse's belief. The long relationship of trust and confidence between Mr. Pollard, as a partner of the firm, and the Rouse family would also support Mrs. Rouse's reasonableness argument.

If Mrs. Rouse prevails on the apparent authority issue, under either UPA (1914) §14(a) or UPA (2013) §305(b), the partnership will be liable. ◂◂◂

***Problem 89***

For the past 15 years Lucille, Phyllis, and William have operated a fishing guide business from a piece of lakefront property in the United States near the Canadian border. They operate the business as a general partnership, share in all the work, make business decisions by consensus, and share profits equally.

The partnership rents rather than owns its lakefront location. The lease has a two-year term and renews automatically unless either party gives written notice of nonrenewal "at least 90 days but no more than 120 days in advance of the renewal date."

The lease was up for renewal last January 1. On the preceding September 15th, the lessor handed a written notice of nonrenewal to William. The notice was in an envelope and the lessor did not say specifically what the envelope contained. The lessor did say, "William, this is important. Don't put it aside."

Unfortunately, William did just that. Unbeknownst to the lessor or William's partners, William was suffering a relapse into alcoholism. He lost the envelope, forgot its existence, and never mentioned it to Lucille or Phyllis. They first learned of the lessor's intention on November 15th, when the lessor telephoned to discuss "transition issues." The November 15th conversation occurred too late to constitute valid notice ofnonrenewal. Under UPA (1914), did the lost letter constitute valid notice to the partnership? Under UPA (2013)? ◂◂◂

**Explanation**

Yes, under either statute. Under UPA (1914) §3(2)(b), the lessor gave

notice to William by “deliver[ing] a written statement” to William. It is irrelevant that William never read the statement. Under UPA §12 (1914), “[n]otice to any partner of any matter relating to partnership affairs . . . operate[s] as notice to . . . the partnership.” It is also irrelevant that the partner never mentioned the notice to any other partner. UPA §12 (1914) contains an exception applicable “in the case of a fraud on the partnership committed by or with the consent of [the] partner” receiving notice. However, William’s dereliction of duty does not constitute fraud.

The analysis is different but the results are the same under UPA (2013) §103(c). The lessor has notified William by “taking steps reasonably required to inform [William] in ordinary course.” William therefore has knowledge of the fact of the notice and its contents “whether or not those steps [have] cause[d] [William] to know the fact.” *Id*. Under UPA (2013) §103(f), William’s knowledge is attributed to the partnership. ◂◂◂

### *Problem 90*

Their dispute over the nonrenewal notice convinces Lucille, Phyllis, and William to buy a piece of lakefront property. After William regains sobriety, the three partners locate an apparently suitable parcel on another lake. They negotiate with the parcel’s owner (“the seller”) and eventually sign a contract on behalf of the partnership. During the negotiations, the seller assures all three partners that “this lake is real quiet. There’s no rule against motorboats, but almost no one ever uses them here.” That representation is central to the partners’ decision to have the partnership buy the land.

After the contract is signed, Phyllis learns that motorboats are quite common on the lake and that during the summer months waterskiing is the dominant lake activity. The partnership seeks to rescind the contract, asserting fraud in the inducement.

In the relevant jurisdiction, a party asserting fraud in the inducement must show not only a material misstatement and reliance, but also that the reliance was reasonable. The seller contends that the partnership could not have reasonably relied on his assertions because, “Two years ago William was over here all the time, and he

saw all the motorboats and the waterskiing all over the lake."

His memory prompted by the seller's contention, William acknowledges it as true. Just as truthfully, he states that (i) he visited the lake on vacation and not on partnership business and (ii) his recent bout with alcohol had previously suppressed all memory of that vacation.

Assuming that UPA (1914) applies and the seller's representations about the quiet and the lack of significant motorboat activity were false and material, what result on partnership's fraud in the inducement theory? Any difference under UPA (2013)? ◂◂◂

## Explanation

If UPA (1914) applies, the partnership will lose.

The outcome turns on UPA (1914) §12 and its rule for attributing a partner's knowledge to the partnership. William was "acting in the particular matter," so the rule will attribute to the partnership any "knowledge acquired while a partner or then present to his mind." UPA (1914) §12. Although at the time of the negotiations and contract formation, William's knowledge about the motorboats was not "present to his mind," that phrase is in the disjunctive with the phrase "acquired while a partner." That is, any knowledge the acting partner acquires while a partner is attributed to the partnership, regardless ofwhether the acting partner happens to remember the information at the critical moment. The phrase "then present to his mind" serves only to limit attribution of information acquired before the partner became a partner. Therefore, William's dormant knowledge of the motorboat traffic is attributed to the partnership and defeats the partnership's claim of reasonable reliance.

Under UPA (2013), in contrast, the partnership might prevail. UPA (2013) §102(e) will attribute William's knowledge, if any, to the partnership, but it is arguable that at the relevant moment William had no relevant knowledge. Under UPA (2013) §102(a)(1), "knowledge" is confined to actual knowledge, and, at least according to a comment to UPA (1997), "[k]nowledge is cognitive awareness."[81] Temporary memory loss due to alcohol abuse might well negate "cognitive awareness." ◂◂◂

***Problem 91***

The Ventura Company ("Ventura") is a general partnership that manufactures widgets. Although Ventura has five partners, the partnership agreement provides that one of the partners, Maurice, is the managing partner and has sole authority to manage all partnership business. Ventura has a longterm contract with Rolande, Inc. ("Rolande"), under which Rolande supplies framjets to Ventura. (Ventura incorporates one framjet into each widget Ventura makes.) The Ventura-Rolande contract requires that

Ventura "inform Rolande of any defect in any framjet supplied under this contract within 30 days after Ventura knows of the defect, or be barred from any remedy for such defect."

One day, Alan, one of the other four partners in Ventura, happens to be walking through Ventura's factory and happens to notice that an entire pallet of Rolande framjets are defective. Alan assumes, however, that Maurice has procedures in place to check incoming products and therefore does not mention the defects to anyone.

Unfortunately, neither Maurice nor anyone else connected with Ventura notices the defect until 35 days later. In the ensuing legal struggle between Ventura and Rolande, is Ventura better off under UPA (1914) or under UPA (2013)? ◂◂◂

**Explanation**

Ventura is far better off under UPA (1914). Under UPA (2013) §102(e), Alan's knowledge of the defect is immediately attributable to the partnership, regardless of the fact that Alan is not involved in partnership operations. In contrast, that fact matters under UPA §12 (1914). Because Alan is not "the partner acting in the particular matter [of checking for and informing Rolande of defects]," his knowledge of the defects is attributed to the partnership only if he "reasonably could and should have communicated it to the acting partner." Obviously, Alan could have communicated his knowledge to Maurice, but it is at least arguable that Alan acted reasonably in assuming that Maurice had established appropriate inspection procedures. If Alan's assumption was reasonable, Rolande cannot

satisfy the "should have communicated" requirement and Alan's knowledge of the defects did not start the clock on the 30-day notice period. ◂◂◂

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1. Story on Partnership, §1 (1841), quoted in Rhode Island Hospital Trust Co. v. Copeland, 39 R.I. 193, 98 A. 273, 277-278 (R.I. 1916).

2. R.2d, §14A (Agent and Partner). R.3d has no comparable provision.

3. UPA §9(1) begins with those words exactly, while UPA (1997) §301(1) and UPA (2013) §301(1) substitute "Each" for "Every." The revision is solely a matter of drafting style.

4. History explains this special attention. At one time, professionals (e.g., lawyers and doctors) who wanted to practice in a firm had no choice other than a general partnership. See section 7.3.2(c).

5. UPA (1997), §9, cmt. 2.

6. The chart does not include UPA (1914) §11, a little-used and recondite attribution rule for admissions made by partners. Neither UPA (1997) nor UPA (2013) contains an analog and neither even mentions the concept in a comment.

7. Both acts contain specific provisions for attribution information possessed by a partner. See below.

8. These provisions also pertain to misrepresentations made with apparent authority.

9. A comment states that "authority" in this subsection "is intended to include a partner's apparent, as well as actual, authority, thereby bringing within section 305(a) the situation covered in UPA section 14(a)." UPA (1997), §305(a), cmt. See section 10.6. Redundantly to §301(a), §305(a) could also apply to a misrepresentation made with apparent authority. For how the Harmonization Project clarified section 305, see section 10.5.1(a).

10. UPA (1997), §305(b) comment indicates that in this subsection, "authority" refers to actual authority. See section 10.6. The phrase "in the course of the partnership's business" betokens inherent agency power.

11. See section 10.7.4.

12. The comment's analysis was derived from earlier editions of this book.

13. Concklinv. Holland, 138 S.W.3d215, 221 (Tenn. Ct. App. 2003) (citations and internal quotations omitted).

14. "C.O.D" stands for "cash on delivery" — i.e., no sales on credit.

15. These Examples address solely Sam's *actual* authority to bind the partnership. For apparent authority, see sections 10.3. and 10.4.

16. Section 15.5 considers the power of members and managers to bind a limited liability company.

17. This phrase first appeared in ULLCA (2006), §301(a), cmt., and has since become a useful term of art.

18. For the scope of this actual authority, see section 10.2.

19. See ULLCA (2006) §301(a), comment.

20. Although the statute does not mention reasonableness, the case law does.

21. The phrase "the usual way" is ambiguous. Some cases hold that the third party must establish that the partner's act appeared usual for the particular partnership. Other cases hold that the third party must or may establish that the partner's act appeared usual for similar partnerships. As will be seen in section 10.4.1, UPA (1997) resolved this issue by allowing a claimant to make either showing.

22. However, actual authority might well bind full partnership as an undisclosed principal. See sections 10.2 (partners' actual authority) and 2.2.3 (undisclosed principal).

23. Herr v. Brakefield, 314 P.2d 397 (Wash. 1957).

24. While the *first* clause of UPA (1914) §9(1) empowers a partner to act only "for the purpose of [the partnership's] business," the "apparently/usual" rule contains no such restriction.

25. See section 2.3.5(d).

26. In this context “authorized” must mean “actually authorized,” otherwise the subsection would swallow its own tail.
27. If, however, the partnership later accepts the benefits of the deal, the partnership will be bound to some extent. Acceptance may indicate ratification, which would bind the partnership to the deal itself. See section 2.7.2(b). Short of ratification, acceptance may oblige the
partnership to respond in *quantum meruit* for the reasonable value of benefits accepted. See section 10.3.7.
28. As for how a bank could “know” something, see sections 2.4.4 and 2.4.8.
29. However, the partnership will be bound either through ratification or in *quantum meruit* if it accepts and retains the loan proceeds. See section 10.3.7.
30. Bank of the West v. Early Farm Partnership, No. 10-1093, 2011 WL 1136247 (Iowa App. Mar. 30 2011). This opinion illustrates the rule, but the reasoning is dubious. For one thing, to parse the facts so carefully on summary judgment is unusual. For another, when a partner offers partnership assets to guarantee the debt ofa different organization, the lender may have a duty to inquire. See section 2.3.5(b) (apparent authority and the duty of inquiry).
31. See section 2.7.2(b).
32. UPA (1997) §301, comment 2.
33. According to UPA (1997) §301, comment 2, “No substantive change is intended. . . . UPA [1914] and the case law use both terms without apparent distinction.”
34. When UPA (1914) was promulgated in 1914, arbitration was disfavored. Today, arbitration is a commonplace species of “alternative dispute resolution,” and it therefore “seems archaic that the submission of a partnership claim to arbitration always requires unanimous consent.” UPA (1997) §301, comment 4.
35. The “unless” clause ofUPA (1997) “section 301(1) fully reflects the principle embodied in UPA [(1914)] section 9(4) that the partnership is not bound by an act of a partner in contravention of a restriction on his authority known to the other party.” UPA (1997) §301, comment 5.
36. This definition closely resembles the definition in UPA (1914) §3(2) for giving notice. The difference is in the operative provision, i.e., UPA (1997) §301(1)’s “no authority constraining rule” refers to knowledge or receipt of notification, while UPA (1914) §9’s “no authority constraining rule” refers only to knowledge.
37. Of course, a partner who acts without actual authority will be liable to the partnership for any resulting damages — see section 4.1.2—and, if the partnership is not bound, will be liable to the third party for breach of the warranty of authority. See section 4.2.2.
38. UPA (2013) §301(1), cmt.
39. Emphasis added. The comment to UPA (2013) §301(1) questions how much difference the change makes: “[I]t is arguable that the Harmonization Project merely made explicit a rule implicit in the case law. . . . [T]he case law requires a third party to show a reasonable belief in the partner’s authority. A third party who has reason to know of a partner’s lack of authority will be hard pressed to make that showing.”
40. UPA (2013) §303, cmt.
41. UPA (2013) §303, cmt.
42. Citations omitted.
43. UPA (1997) §303(a)(2).
44. UPA (1997) §305, comment 1.
45. Emphasis added.
46. UPA (1997) §305, cmt.
47. Emphasis added.
48. See the explanation text at n.46 concerning how the 1997 and 2013 version different express this concept.
49. This distinction parallels rules of agency law. See section 3.2.5(c) (tortious acts can be with the

scope of employment).
50. There may be contract consequences as well. If Al’s misstatement came within his apparently/usual (UPA (1914) §9(1)) or apparently/ordinary power (UPA (1997 and 2013) §301(1)), the customer may succeed with a claim either for recission or breach of warranty.
51. See UPA (2013) §305(a), cmt (quoting the 4th edition of this book).
52. 201 S.E.2d 722, 724 (N.C. App. 1974). This Case on Point is taken verbatim from UPA (2013) §305(a), cmt.
53. For a discussion of *respondeat superior*, see section 3.2.
54. UPA §13 (1914) does not encompass no-fault torts. See section 10.4.1.
55. For a discussion of the criteria for establishing employee/servant status, see section 3.2.4.
56. A partner’s misapplication of partnership property constitutes a breach of the partner’s fiduciary duty to the partnership and is treated accordingly. See section 9.7.3. A partner’s misapplication of a co-partner’s own, separate property is covered by other law.
57. According to UPA (1997) §305, cmt., in subsection (a) “authority of the partnership” is “intended to include a partner’s apparent, as well as actual, authority, thereby bringing within section 305(a) the situation covered in UPA section 14(a).”
58. UPA (1997) §305(a) does not rely on or refer to §305(b), so the latter’s reference to “property . . . misapplied by a partner” cannot be used to complete the §305(a) analysis. That is, the reference to a partner misapplication must be found in §305(a). The misapplication is “a wrongful act . . . or other actionable conduct.” *Id*.
59. This holding could rest on either UPA (1914) §14(a) (apparent authority) or (b) (course of the partnership business). Under UPA (1997), §305(a) would apply to a claim of apparent authority.
60. This holding rests on UPA §14(b). Under UPA (2013) §§305(b) would apply. UPA (1997) analysis would be more complicated. See section 10.5.1(a).
61. Husted v. McCloud, 450 N.E.2d 491, 494 (Ind. 1983).
62. UPA (1997) §102(f) attributes to a partnership a “partner’s knowledge, notice, or receipt of a notification of a fact relating to the partnership.” The Harmonization Act removes “receipt of a notification” as surplusage. The following analysis of the relevant UPA (2013) provisions applies generally to the relevant UPA (1997) provisions.
63. The phrase “shows bad faith” probably means “shows intentional, bad faith ignorance of the fact.”
64. See section 10.7.5.
65. *Id*. The precise language is: “acquired while a partner or then present to his mind.”
66. The rationale here parallels the rationale for attributing to a principal an agent’s knowledge concerning a matter within the agent’s actual authority while not attributing an apparent agent’s knowledge concerning a matter within the apparent agent’s apparent authority. In the former situation, the agent has a duty to communicate the information to the principal. In the latter, the apparent agent has no such duty. See sections 2.4 (attribution rules for information) and 4.1.5 (duty of agent to provide information to principal).
67. UPA (2013) §103(f).
68. UPA (2013) §103(b)(1).
69. UPA (2013) §103(e).
70. UPA (1914) §3(1).
71. Thus, in this limited respect, UPA (1997) §401(k) is inaccurate when it states: “This section does not affect the obligations of a partnership to other persons under section 301.” UPA (2013) contains no comparable provision.
72. CCS may well have believed that Beatrice’s agreement to arbitrate was apparently/usual. However, since UPA (1914) §9(3) applies, the apparently/usual question is immaterial.
73. Emphasis added.
74. The same analysis applies under UPA (1997).
75. The practices described in this problem do not necessarily correspond to actual commercial

practices.
76. The facts about capital contributions are red herrings. In the default mode, capital contributions have no impact on partner voting power. Absent a contrary agreement, each partner has a single vote. See section 9.5.1.
77. See section 10.4.3. For a statement regarding real property to be effective as constructive notice, the statement must also be filed in the appropriate land title records.
78. This liability may be subject to an exhaustion requirement. See section 7.3.1 (some jurisdictions require third parties to exhaust partnership assets before asserting UPA (1914) §15 claims against individual partners).
79. UPA (1914) §15(a) ! UPA (2013) §306(a); UPA (1914) §13 ! UPA (2013) §305(a); UPA (1914) §18(e) ! UPA (2013) §401(h).
80. If Pollard accepted the funds with the intent to misappropriate them, he acted without actual authority, and his possession of the funds is not attributable to the partnership unless apparent authority applies.
81. UPA (1997) §102, cmt. See also Black's Law Dictionary (10th ed. 2014), Knowledge, def. 1 (defining knowledge as "[a]n awareness or understanding of a fact or circumstance; a state of mind in which a person has no substantial doubt about the existence of a fact").

CHAPTER 11

# Partner Dissociation and Partnership Dissolution

## §11.1 UPA (1914), UPA (1997), AND UPA (2013)

In all three uniform general partnership acts, the most elaborate provisions concern:

- partner dissociation—the separation of a partner from the partnership; and
- partnership dissolution—the point at which a partnership stops functioning as a forward-looking enterprise and begins to wind up its business.

Elaborate provisions are necessary because those two topics implicate numerous interrelated issues, including:

1. the management rights of a partner who has dissociated;
2. the management rights of the other partners after a partner has dissociated;
3. the power to bind of a partner who has dissociated;
4. the power to bind of the other partners after a partner has dissociated;
5. in an ordinary general partnership, the liability of a partner who has dissociated for the debts of the partnership incurred:
   a. before the dissociation;
   b. after the dissociation;
6. the relationship between partner dissociation and partnership dissolution;
7. the question of whether dissolution (and eventual termination) of the partnership as a legal organization (whether entity or aggregate) will result in the liquidation or the continuation of the business; and

8. the manner of winding up a dissolved partnership, including how to settle accounts with third parties and among the partners.

As to these issues, UPA (2013) made few substantive changes to UPA (1997), and enactment efforts for UPA (2013) are still in their infancy. Accordingly, this chapter focuses on UPA (1914) and UPA (1997), leaving for a subsequent edition any detailed treatment of UPA (2013)'s provisions on dissociation and dissolution.[1]

In this context, the greatest difference between UPA (1914) and UPA (1997) concerns the relationship between a partner's dissociation and the partnership's dissolution.[2] Although the *structure* of UPA (1914)'s approach can be discerned in the approach of UPA (1997), the latter has departed radically from the former's *premise*. Under UPA (1914), the dissociation of any partner necessarily causes the dissolution of the partnership. UPA (1997) rejects that premise, and the connection between dissociation and dissolution is more complicated. Consequently, while the UPA (1997) and the UPA (1914) provisions in this area have a somewhat similar architecture, UPA (1997) rules produce consequences markedly at odds with the consequences produced by the rules of UPA (1914).

It is therefore necessary to study each set of rules separately, so that each is understood as a system. The first part of this chapter deals in detail with the UPA (1914) rules, the second with the rules of UPA (1997), and the third provides a comparison.[3] The final section addresses the substantive differences between UPA (2013) and UPA (1997) and provides an example of the stylistic changes.

## §11.2 UPA—FOUNDATIONAL NOTIONS

### §11.2.1 Four Fundamental Concepts and Important Related Issues

Partnership dissolution under UPA (1914) raises complex and interrelated issues. To keep those issues straight, you must keep in mind four fundamental concepts: (i) the dissociation of any partner causes dissolution of

a UPA (1914) partnership; (ii) dissolution does not end the partnership but instead puts the partnership into a period of winding up; (iii) the eventual end of a partnership is not necessarily the end of the partnership's business; and (iv) under UPA (1914), a partner always has the power (but not necessarily the right) to dissolve the partnership.

## a. Dissociation Causes Dissolution

UPA (1914) has a long list of "Causes of Dissolution,"[4] but in general, dissolution "is the change in the relation of the partners caused by any partner ceasing to be associated in the carrying on ... of the business."[5] Therefore, as a formal matter, the dissociation of any partner from the partnership automatically and unavoidably causes dissolution.[6]

Although you should familiarize yourself with all the listed causes of dissolution, you may want to note particularly the following situations:

- *Express Will Dissolution of an At-Will Partnership*—If the partners have not agreed to continue the partnership until the end of some particular term or undertaking, or have not otherwise agreed, then each partner has the power and the right to cause dissolution at any time simply by withdrawing, resigning, retiring, or otherwise making known his, her, or its *express will*.[7]
- *Express Will Dissolution of a Partnership for a Term or Undertaking*—Even if the partners have agreed to a partnership for a "definite term or particular undertaking,"[8] each partner retains the *power* to cause dissolution merely by making known his, her, or its express will.[9] The resulting dissolution will be premature and wrongful, that is, "in contravention of the agreement between the partners,"[10] but it will occur nonetheless.[11]
- *Dissolution by Expelling a Partner*—An expelled partner has been dissociated, so expulsion causes dissolution. A partnership agreement can authorize expulsion, but it cannot prevent expulsion from causing dissolution.[12]
- *Dissolution by the Death or Bankruptcy of a Partner*—Death obviously changes the deceased's relationship to fellow partners. The changes caused by bankruptcy are less permanent but often just as fundamental. Either event causes dissolution. In neither event is the dissolution wrongful.[13]
- *Expiration of a Term or Undertaking*—If the partnership agreement includes a specific term or a particular undertaking, the expiration of the term or the accomplishment of the undertaking automatically causes dissolution.[14]

## b. A Partner Always Has the Power (but Not Necessarily the Right) to Dissolve a Partnership

Among the inevitable causes of dissolution is the "express will" of a partner.

Under UPA (1914) §§31(1)(b) and 31(2), any partner can dissolve the partnership at any time simply by manifesting a desire to do so. For centuries the law has characterized partnership as a voluntary arrangement, and a partner's power to dissolve reflects and preserves that character.[15]

The power cannot be eliminated by agreement. Indeed, the power exists even when its exercise will breach an agreement.[16] "[T]he express will of any partner at any time" dissolves a partnership.[17]

## c. A Wrongful Dissolution Is a Dissolution That Contravenes a Partnership Agreement

Having the power to dissolve is not, however, the same as having the right to dissolve. Dissolutions that contravene a partnership agreement are "wrongful" rather than "rightful."[18] For example, a partner who withdraws "by express will" before the expiration of an agreed upon term and the completion of an agreed-upon undertaking does so wrongfully.

**Example**

> Five friends establish an investment club in the form of a general partnership with a term of five years. After four years, one of the friends announces that she is moving away, is quitting the club, and wants to be paid her share of the club's assets. She has dissolved the partnership, and the dissolution is wrongful.

**Case in Point—Drashner v. Sorenson**

> "In January, 1951 the plaintiff, C. H. Drashner, and defendants, A. D. Sorenson and Jacob P. Deis, associated themselves as co-owners in the real estate, loan, and insurance business at Rapid City. For a consideration of $7,500 they purchased the real estate and insurance agency known as J. Schumacher Co. located in an office room on the ground floor of the Alex Johnson Hotel building. The entire purchase price was advanced for the partnership by the defendants, but at the time of trial $3,000 of that sum had been repaid to them by the partnership. . . . The agreement of the parties contemplated an association which would continue at least until the $7,500 advance of

> defendants had been repaid from the gross earnings of the business. Hence, it was not a partnership at will. . . ."[19]

UPA (1914) §38 dichotomizes the world of general partnerships; a partnership is either, on the one hand, for a specific term or undertaking, or, on the other hand, at-will. Thus, the overwhelming majority of wrongful dissolution cases involve either a partnership for a term or an undertaking.

But the dichotomy is not the be all and end all. Suppose, for example, that a law firm partnership agreement provides that the partnership will continue until at least two-thirds of the partners vote to dissolve. A partner's withdrawal before any such vote would dissolve the partnership (UPA (1914) §29), but—given that the partnership agreement specifies neither a specific duration or undertaking—would the dissolution necessarily be rightful?

Courts in several states have answered no, recognizing that section 38's dichotomy, like almost all *inter se* rules of UPA (1914), is a default rule.

**Case in Point—Osborne v. Workman**

> A group of physicians form a general partnership subject to UPA (1914), and the partnership agreement provides that:

- the business of the partnership will continue indefinitely until the partnership is dissolved by the mutual consent of all partners;
- if a partner withdraws from the partnership without that consent:

,

- — the business of the partnership will continue uninterrupted in a successor partnership;
- — the partner will receive a specified amount in complete payment for his or her interest in the partnership; and
- — the specified amount will not include payment for the partnership's accounts receivable (A/R);[20]

A partner withdraws from the partnership. Discontented with the agreed payout amount and wanting a share of the A/R, he asserts that:

- because the partnership agreement does not provide for a definite term or undertaking, the partnership is at will; and therefore
- his dissolution is not wrongful; and therefore
- under UPA (1914) §38(1), he has the right to be paid the full value of his interest, i.e., including his share of the A/R.

The dispute goes to court, and the court emphatically disagrees with the withdrawing partner: "It is inconceivable that six doctors would form a

partnership, enter into an elaborate agreement intended to promote longevity, set up a common practice, pool their equipment, records, and resources, and intend that any one of them could end it at any time by demanding dissolution and liquidation."

As to the withdrawing partner's contention that the partnership is at will, the court again disagrees: Although "[c]ertainly any partner can withdraw at will and . . . that withdrawal is a dissolution," the dissolution is not rightful and does not occasion "the termination of the partnership [business] by liquidation." In light of the partnership agreement and the surrounding circumstances, the court "cannot agree these partners intended such a result. We think the clear intent was that dissolution by termination would occur only by mutual agreement and not by the unilateral act of a single partner."[21]

As will be discussed in detail below,[22] the wrongful/rightful distinction can significantly influence the nature of the winding-up process.

## d. Wrongful Dissolution of a Partnership at Will

It might seem impossible to have a wrongful dissolution of a partnership at will. After all, the essence of an at-will partnership is that every partner has the right as well as the power to dissolve the partnership at any time. Yet a few cases have held to the contrary. These cases all involved egregious situations, in which the dissolution either made possible a substantial and unfair economic advantage for the dissolving partner or threatened significant and unfair economic disadvantage to the other partners.

The cases that have granted relief have dealt with the at-will issue in one of two ways: (i) by finding an implied agreement for a particular term or undertaking; or (ii) by holding that partners have an implied agreement not to injure each other through breach of fiduciary duty.

### Case in Point —Vangel v. Vangel

> Three brothers formed a partnership to purchase and operate a citrus ranch. One brother was unable to furnish his share of the down payment for the ranch, so the other two brothers advanced his share. The borrower was to repay his brothers "only out of funds accumulated from the operation of the ranch or realized from its sale." The court acknowledged that the partnership agreement "does not

mention the term of the partnership." It held, however, that the borrowing arrangement "seems to negate any idea of a partnership at will for it cannot be assumed that it was the intention of the parties that the borrower was at liberty to walk out of the partnership until the loan had been paid from either the operation or the sale of the ranch." This holding meant that the partnership was for a particular undertaking and made the dissolution premature and wrongful.[23] ◂◂◂

**Case in Point—Page v. Page**

Two individuals formed a linen supply partnership, which after eight unprofitable years seemed about to turn the corner; the air force had established a base in the vicinity. Just then, one of the partners dissolved the partnership. The other partner feared that his own weak financial position and lack of management experience in the business would enable the dissolving partner to pick up the business of the dissolved partnership without providing fair compensation. The California Supreme Court rejected the claim that the partnership had an implied term to continue until the losses of previous years had been recouped. It held instead that:

> If ... it is proved that [the dissolving partner] acted in bad faith and violated his fiduciary duties by attempting to appropriate to his own use the new prosperity of the partnership without adequate compensation to his copartner, the dissolution would be wrongful and the [dissolving partner] would be liable [under the California equivalent of UPA (1914) §38(2)(a)] (rights of partners upon wrongful dissolution) for violation of the implied agreement not to exclude the non-dissolving partner wrongfully from the partnership business opportunity.[24] ◂◂◂

## e. Wrongful versus Rightful Dissolution in the Context of Expulsion

Under UPA (1914) §31(1)(d), "the expulsion ofany partner from the business bona fide in accordance with such a power conferred by the agreement between the partners" automatically dissolves the partnership. Such dissolution is ordinarily rightful, even if the agreement allows "no cause" expulsion.[25]

**Example**

The partnership agreement among nine physicians who practice medicine together states in part:

> *Expulsion:* A partner will be expelled from the partnership if six of the partners vote to expel that partner. There is no requirement that the partners voting for expulsion state a reason or give the expelled partner an opportunity to be heard. The expulsion will take effect when notice of the vote is given to the expelled partner. As full compensation for his or her interest in the partnership, the expelled partner will receive an amount determined under Paragraph *X* of this Agreement. ◂◂◂

Although such "guillotine" provisions may at first glance seem harsh, they rest on a solid rationale. The success of a partnership often depends on the ability of the partners to work together. If, as sometimes happens, one of the partners becomes troublesome or is otherwise undermining the business, an expulsion provision allows the partnership to save the business without destroying it.[26]

The "no cause" aspect of an expulsion provision can be very important, because otherwise the partnership may have to go through the time consuming, costly, and bitter process of proving partner misconduct. No-cause provisions help avoid litigation (what is there to litigate about?) and allow for the immediate, surgical removal of a problem partner. No-cause provisions also reflect the idea that if—for whatever reason—most of the partners decide they no longer want to work with one of their colleagues, then that decision by itself is adequate reason to separate the unwanted partner from the business.

## f. The Notion of Wrongful "No-Cause" Expulsion

In a few reported cases, expelled partners have challenged their expulsion as wrongful, asserting that the expelling partners have breached a fiduciary duty by acting either in bad faith or without "due process." These challenges have generally failed, with the courts holding either that the plain language of the partnership agreement allows no-cause expulsion or that the expelled partner has failed to prove bad faith.

A claim for wrongful dissolution might exist if an expelled partner could prove the type of expropriating bad faith contemplated in Page, discussed in Section 11.7.1. *Page* involved dissolution of an at-will partnership rather than no-cause expulsion, but the situations seem analogous. The rationale that led the *Page* court to constrain a partner's seemingly absolute discretion to

dissolve an at-will partnership might apply to constrain partners' seemingly absolute discretion to vote expulsion.

For very large partnerships and those with very "junior" (i.e., powerless) partners, there may be another constraint as well. If the expelled partner is a member of a protected class, he or she may be able to contest the expulsion under federal and state anti-discrimination laws. These statutes generally protect "employees," and, formally at least, partners are not employees. However, the larger the partnership and the more junior the partner, the more the situation resembles employment. Most cases raising this issue have involved large law and accounting firms and large brokerage houses, and the courts have focused primarily on the amount of management authority and responsibility enjoyed by the partner claiming employee status. So far most decisions have gone against the plaintiff, but the courts' analysis has left the door open.[27] In a related case dealing with a professional corporation, the U.S. Supreme Court has held, according to one commentator, that "formal labels do not determine the issue. What matters is the actual governance structure of the organization."[28]

## g. Dissolution Does Not End the Partnership

Dissolution is not itself the end of the partnership; it is merely the beginning of the end. Dissolution means that the partnership as a legal construct has no future, other than to finish in one way or another the work it has already begun and to settle accounts among the partners.

The finishing of business and the settling of accounts is called "the *winding up* of partnership affairs,"[29] and dissolution automatically puts the partnership into the winding-up phase. To wind up its business with outside *obligees*, the partnership must perform or otherwise satisfy the obligations. If, for example, dissolution occurs with a project under way for a customer, during winding up the partnership will complete the project, arrange to have someone else (including one of the partners, a successor partnership, or some other successor business) complete the project, or obtain the customer's permission to abandon the project.

For outside *obligors*, during winding up the partnership will receive performance, assign the right to receive performance, or release performance of the obligation. For example, during winding up a partnership will try to collect all of its accounts receivable (i.e., money that customers owe the

partnership for products sold or services rendered). For amounts owed but not yet due, the partnership may try to collect early, offering to accept a reduced amount in return for early payment. or, the partnership may sell to someone else (including one of the partners, a successor partnership, or some other successor business) the right to collect the debt when it comes due.

Winding up also involves settling accounts among the partners. If the partners have an agreement on the subject, that agreement will govern. Otherwise, the UPA (1914) default rules will control this final reckoning.

When winding up has finished, the partnership is actually and legally at an end. There are no papers to be filed or magic words to be said.[30] The end of function marks the end of existence.

### h. The End of the Partnership Is Not Necessarily the End of the Partnership Business

There is a difference between the legal construct the law calls a partnership and the business that can be carried on within the partnership form. As both a theoretical and practical matter, the “partnership business” is distinct from the legal form. It is therefore possible for a particular partnership to dissolve, wind up, and terminate while the partnership business continues.

Whether the business continues depends on whether the partners have so agreed. In the default mode, UPA (1914) gives every partner the right to require liquidation,[31] but partners often relinquish this right by agreement. Such agreements can be made either before or after the dissolution. Often the same agreement that forms the partnership also dictates what will happen after dissolution.

Whenever made, business continuation agreements typically provide for a successor partnership to take over from the dissolved partnership. The successor partnership may consist of some or all of the members remaining from the dissolved partnership and may also include some “new blood.”

## §11.2.2 Following the UPA (1914) Three-Ring Circus: Three Pathways of Post-Dissolution Concerns

Understanding what happens when a UPA (1914) partnership dissolves is a

lot like watching a three-ring circus. Three different things are happening at once, and it is almost impossible to have them all in view simultaneously. It is nonetheless useful to understand that they are all occurring. Under UPA (1997), the three post-dissolution rings (or pathways) concern: (i) how the partnership is managed during winding up; (ii) what happens to the partnership business; and (iii) what happens to the partners. The following sections deal with each pathway in turn.

## §11.3 MANAGEMENT ISSUES DURING WINDING UP

When a partnership dissolves, it does not immediately disappear; it lingers to wind up its affairs. Winding up can occur quickly, as when a successor partnership takes over, or may be quite lengthy, as when an extensive and complicated business is sold off in pieces. In any event, the same two basic categories of management issues exist both during winding up and before dissolution: (i) inter se the partners, who have the right to manage the business and make commitments on its behalf; and (ii) as between the partnership and third parties, what acts of individual partners suffice to bind the partnership.

### §11.3.1 *Inter Se* Issues

#### a. Actual Authority to Manage the Partnership During Winding Up

UPA (1914) §37 states the default rule: "the partners who have not wrongfully dissolved the partnership . . . [have] the right to wind up the partnership affairs."[32] The section does not indicate what happens if those partners disagree, but presumably UPA §18(h) applies. Under UPA §18(h) differences over "ordinary matters" are settled by majority vote, while acts "in contravention of any agreement between the partners" require unanimous consent.[33]

As explained previously,[34] UPA (1914) §18(h) fails to expressly provide a rule for matters not "in contravention" but nonetheless extraordinary. During winding up, this omitted category may cause serious problems. Some winding-up matters will be clearly ordinary—for example, deciding where to buy supplies. Others, such as deciding whether to compromise a claim or sell an important partnership asset, may be unprecedented. Some courts have solved the problem by holding that extraordinary matters can become ordinary during the winding-up process.

**Example**

> Larry, Moe, and Curley have an at-will partnership that owns and races a single racehorse. Fed up with Moe's abuse, Curley quits. The partnership accordingly dissolves, and Moe insists on liquidation. A third party offers $100,000 for the racehorse. Larry and Curley vote yes. Moe votes no. Before dissolution, selling the partnership's key asset would have required unanimity. But in winding up, selling off assets is probably "an ordinary matter." If so, Larry and Curley's majority vote prevails. ◂◂◂

**Case in Point—Weisblatt v. Colky**

> Plaintiff filed a legal malpractice claim against a law partnership and its individual attorneys for their work on several matters. Plaintiff and one of the attorney partners executed "a stipulation and mutual release agreement whereby, in consideration of mutual obligations, each party released and forever discharged the other from all claims." Later, Plaintiff argued that the release was invalid because the attorney lacked the requisite authority to bind the partnership. Plaintiff's argument was presumably based on the fact that one partner had died, and thus the partnership had dissolved. The court affirmed dismissal of Plaintiff's complaint: (i) holding in relevant part that dissolution does not entirely revoke a partner's authority, but rather partners maintain certain authority during the winding-up period; and (ii) implicitly rejecting Plaintiff's presupposition that a partner cannot sign a binding release as part of the winding-up process.[35] ◂◂◂

UPA (1914) §37 also provides that "any partner, his legal representative or his assignee, upon cause shown, may obtain winding up by the court." The provision does not specify what constitutes cause, but courts have held that waste, fraud, and gross mismanagement justify the appointment of a receiver to wind up the partnership. Whether mere dissension among the partners justifies appointing a receiver is an open question. Even a partner who wrongfully dissolved the partnership can seek court intervention under UPA (1914) §37. Except for the provision on "winding up by the court," the rules of UPA (1914) §37 can be altered or displaced by an agreement of the partners.

### b. Authority to Commit the Partnership to New Business

Dissolution deprives all partners of actual authority to transact new business. "Except so far as may be necessary to wind up partnership affairs or to complete transactions begun but not then finished, dissolution terminates all [actual] authority of any partner to act for the partnership."[36]

The precise timing of the deprivation depends on the cause of dissolution. If the act of some partner is responsible, then each partner's "new business" authority terminates upon knowledge of the dissolution.[37] When a partner's death or bankruptcy causes dissolution, each partner's "new business" authority ends upon knowledge or notice of the death or bankruptcy.[38] With all other causes, "new business" authority ends at the moment of dissolution.[39] The end of "new business" actual authority does not necessarily end the partners' power to bind the partnership as to new business.[40]

## §11.3.2 The Power to Bind the Partnership After Dissolution

UPA (1914) §35 describes the post-dissolution power of a partner to bind the partnership. UPA (1914) §35(1) states empowering rules, and UPA (1914) §35(3) states constraining rules.[41] For a partner's postdissolution act to bind the dissolved partnership, the act must: (i) qualify under one of the rules of UPA (1914) §35(1); and (ii) not be disqualified under any of the rules of UPA (1914) §35(3).

### a. The Empowering Rules of UPA (1914) §35(1)

The empowering rules of UPA (1914) §35(1) establish two categories of post-dissolution partner acts: (i) acts "appropriate for winding up partnership affairs or completing transactions unfinished at dissolution"[42] and (ii) acts that would bind the partnership if dissolution had not occurred.[43]

Under UPA (1914) §35(1)(a), acts in the former category bind the partnership, subject to the constraining rules of UPA (1914) §35(3).

**Example**

> A partner in a dissolved auto body shop partnership orders paint so the partnership can finish work on cars already in the shop. This is an "act appropriate for . . . completing transactions unfinished at dissolution," and UPA (1914) §35(1)(a) applies; the partner acted with actual authority, thereby binding the dissolved partnership. ◂◂◂

**Example**

> The same partner, with a view toward settling the partners' accounts with each other, hires an accountant to put a value on partnership assets. This is an "act appropriate for winding up partnership affairs," and here too UPA (1914) §35(1)(a) applies. ◂◂◂

**Example**

> The same partner accepts a new "rush" order on a '67 Corvette and hires a "detailing" expert to do the fancy paintwork. Neither the rush order nor the new hire qualifies under UPA §35(1)(a). ◂◂◂

The rule for the second category—"transactions which would bind the partnership if dissolution had not taken place" —is considerably more complicated. The rule has two branches, depending on whether the third party extended credit to the partnership before dissolution. If yes, under UPA (1914) §35(1)(b)(I), the third party must show that: (i) absent dissolution the partner's act would have bound the partnership; and (ii) at the time of the partner's act the third party had "no knowledge or notice of the dissolution."[44]

**Example**

> A partner in a dissolved body shop partnership accepts a new, "rush" order on a '67 Corvette and hires a detailing expert to do the fancy paintwork. The expert has worked for the partnership before, always billing the partnership after completing the work. No one has notified the expert that the partnership is dissolved, and she is unaware of that fact. Assuming that the partner's act of hiring the expert would have bound the partnership before dissolution, UPA (1914) §35(1)(b)(I) applies, and, even though the partner acted without actual authority, the dissolved partnership is bound. ◂◂◂

If the third party did not extend credit to the partnership before dissolution, under UPA (1997) §35(1)(b)(II) the third party must show that: (i) it knew of the partnership prior to dissolution; (ii) at the time of the partner's act it had no knowledge or notice of the dissolution; (iii) at the time of the partner's act there had been no public notice of the dissolution (through advertisement in a newspaper of general circulation in the partnership's place(s) of business); and (iv) absent dissolution the partner's act would have bound the partnership.[45]

**Example**

> A partner in a dissolved body shop partnership accepts a new, "rush" order on a '67 Corvette, and the owner of the Corvette seeks to hold the partnership to the deal. Another partner has sent letters announcing the partnership's dissolution to all the body shop's suppliers and customers and has published the announcement in the city's main newspaper. The Corvette's owner has never been a customer before, never received a copy of the letter, never read the newspaper announcement, and was unaware of the dissolution when the first partner accepted the rush order. Even assuming the first partner's act of accepting the order would have bound the partnership before dissolution, accepting the order does not qualify under UPA (1914) §35(1)(b)(II). The owner had not extended credit to the partnership before dissolution, and "the fact of dissolution had . . . been advertised in a newspaper of general circulation in the place . . . at which the partnership business was regularly carried on."[46] ◂◂◂

Under both branches of UPA (1914) §35(1)(b), the third party must show that the partner's act would have bound the partnership absent dissolution. To make that showing, the third party invokes the same rules that apply pre-dissolution—typically, UPA (1914) §9.[47]

## b. The Constraining Rules of UPA §35(3)

UPA (1914) §35(3) contains three constraining rules. The first two are straightforward. A partner's post-dissolution act cannot bind the partnership if: (i) dissolution occurred because it was unlawful to carry on the partnership business and the partner's act is not appropriate for winding up (UPA (1914) §35(3)(a)); or (ii) the partner doing the act is bankrupt (UPA (1914) §35(3)(b)).

**Example**

> A partner in a body shop partnership files for personal bankruptcy, causing the partnership to dissolve. The same partner then orders paint so the partnership can finish work on cars already in the shop. Although this is an "act appropriate for . . . completing transactions unfinished at dissolution," UPA (1914) §35(1)(a) does not bind the partnership. Because the acting partner is bankrupt, the partnership can invoke UPA (1914) §35(3)(b) to override UPA §35(1)(a). ◂◂◂

The third constraining rule is more important as a practical matter and decidedly more complex. The third rule determines whether a partner's *unauthorized* post-dissolution act binds the partnership.[48]

Like the empowering rule of UPA (1914) §35(1)(b), the constraining rule of UPA (1914) §35(3)(c) has two branches, depending on whether the third party extended credit to the partnership before dissolution. If yes, UPA (1914) §35(3)(c)(I) bars a third party from recovering only if the third party had "knowledge or notice of [the partner's] want of authority." If the third party had not extended credit to the partnership before dissolution, UPA (1914) §35(3)(c)(II) bars a third party from recovering if either the third party had "knowledge or notice of [the partner's] want of authority" or there has been public notice of the partner's lack of authority (through advertisement in a newspaper of general circulation in the partnership's place(s) of business).

**Example**

Larry, Moe, and Curley have a partnership that owns and races a single racehorse. The partnership agreement provides that: (i) the partnership has a term of five years; (ii) after dissolution Moe will handle all discussions with third parties interested in buying the horse; and (iii) any decision to sell the horse following dissolution will be made by a majority vote of the partners. When the partnership dissolves, it places an announcement in all the major racing publications. The announcement states in part: "We are dissolving our partnership and looking for buyers for our horse. All interested parties should contact Moe."

Despite the partnership agreement, Curley starts looking for potential buyers on his own. He finds a hot prospect who has never previously done business with the partnership, has not seen the announcement in the trade papers, and is unaware that Curley is acting for a dissolved partnership. After a half-hour of hard bargaining, Curley and the prospect agree that the prospect will buy the horse for $75,000.

Despite the partnership agreement and the public announcement, the partnership is bound. Curley's act is "appropriate for winding up partnership affairs,"[49] and so qualifies under the empowering rule of UPA (1914) §35(1)(a). Curley's lack of authority does not negate this power, because under UPA (1914) §35(3)(c)(II) the prospect had "no knowledge or notice of [Curley's] want of authority" and the public notice about Moe was not in a newspaper of general circulation.[50] ◂◂◂

## §11.3.3 Partner Self-Protection: The Importance of Notice

Whether a partner's postdissolution act binds the partnership to a third party often depends on what the third party knows or has notice of. Therefore, following dissolution a partnership can limit its liability for unauthorized acts by promptly "spreading the word" both about the dissolution and about any limitations on the winding-up authority of particular partners.[51]

To spread the word effectively, the partnership should: (i) run an

advertisement in "a newspaper of general circulation" published in the partnership's regular place(s) of business, stating the fact of dissolution and detailing any limitations of partner authority; and (ii) send a letter, containing the same information as the advertisement, to all third parties that have provided goods or services to the partnership. The advertisement will limit claims by those who have not previously extended credit to the partnership.[52] Technically, the letter need only go to those who have previously "extended credit to the partnership,"[53] but it may be difficult to determine from the partnership records which businesses have extended credit and which have acted solely on a cash basis. It is better to be overinclusive and safe than under-inclusive and sorry.

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# §11.4 THE FATE OF THE PARTNERSHIP BUSINESS

## §11.4.1 The Fundamental Decision: Whether to Liquidate

Regardless of which uniform general partnership act applies, the most fundamental question after any dissolution is whether the partnership business will be liquidated or continued.[54] Under all three statutes, the partnership agreement can completely answer this question.

From a business standpoint, liquidation usually produces inferior results. Unless a buyer can be found for the business as a whole, the partnership will have to sell off its assets piecemeal. Usually, a business is much more valuable as a going concern, so a piecemeal sale will produce an inferior payout. Moreover, liquidation sales are often in the nature of fire sales—everything must go within a relatively short period of time, and potential buyers know it. As a result, the seller rarely gets top dollar.

Despite the practical problems with liquidation, UPA (1914) default rules conduce toward that result. Following a rightful dissolution, absent a contrary agreement, UPA (1914) §38(1) gives every partner the right to have the assets of the partnership liquidated and the partners paid in cash.[55] In the

default mode, the right to compel liquidation also exists following a wrongful dissolution unless all the partners who did not wrongfully dissolve agree to carry on the business of the partnership and meet certain other statutory requirements.[56]

## §11.4.2 Who Decides

Although the decision whether to liquidate or continue affects third parties, the decision itself is an *inter se* matter. Like all *inter se* matters, it is subject to the agreement of the partners. Agreement may precede or follow the dissolution.

**Example**

> Rachael, Sam, and Carolyn have a partnership that operates a chicken breeding farm. There is no written partnership agreement and no commitment to continue the partnership for any particular time or undertaking. One day Carolyn decides that she is getting out of chicken farming and going to attend art school. Carolyn's friend, Randi, expresses an interest in joining the business. After discussing the matter, Rachael, Sam, Carolyn, and Randi agree that Randi will buy "Carolyn's share." Randi joins the business, Carolyn leaves for art school, and chicken breeding continues through the successor partnership of Rachael, Sam, and Randi. Carolyn's withdrawal has dissolved the old partnership, but Rachael, Sam, and Carolyn have each agreed not to compel liquidation. ◂◂◂

Where the partners have not agreed, the UPA (1914) default rules govern. Which particular rule applies depends on whether the dissolution was rightful or wrongful.

### a. Rightful Dissolution

Following a *rightful* dissolution, liquidation is the typical default result. Under UPA (1914) §38(1), "each partner . . . , unless otherwise agreed, may have the partnership property applied to discharge its liabilities, and the

surplus applied to pay *in cash* the net amount owing to the respective partners."[57] An exception exists when "dissolution is caused by expulsion of a partner, bona fide under the partnership agreement." In that event, the expelled partner has no right to force liquidation if the continuing partners: (i) "cash out" the expelled partner without liquidating the business;[58] and (ii) cause the expelled partner to be released from (not merely indemnified for) personal liability for the debts of the dissolved partnership.[59] Authority is divided as to whether the estate of a deceased partner can force liquidation. The language of UPA (1914) §38(1) implies that the estate has no such right, but language in UPA (1914) §41(3) points the other way.[60] The cases are also divided.

### b. Wrongful Dissolution

Following a *wrongful* dissolution, the analysis is a bit more complicated. Under UPA (1914) §38(2), the first choice belongs to the partners who did not wrongfully dissolve:

- "The partners who have not caused the dissolution wrongfully, if they all desire to continue the business in the same name, either by themselves or jointly with others, may do so, during the agreed term for the partnership. . . ."[61]
- The remaining partners must agree unanimously and in addition must "indemnify [the wrongful dissolver] against all present or future partnership liabilities" (with the indemnity backed by a bond approved by a court) *and either* cash out the wrongful dissolver immediately[62] *or* promise to pay the cash-out amount at some later date and obtain a court-approved bond to secure the payment. If these criteria are met, the continuing partners "may possess the partnership property" and use it for the rest of the dissolved partnership's original term.[63]

If these conditions are not met, each partner—including the wrongful dissolver—has the right to demand liquidation just as if the dissolution had been rightful.[64]

## §11.4.3 Continuing the Business Through a Successor Partnership (An Example)

The following Example may help you follow the various issues inherent in a decision to continue the business of a dissolved partnership through a

successor partnership.

**Example**

> Three law students, Charlotte, Paul, and Sophie, form a UPA (1914) partnership to sell used law textbooks. They place no term on the partnership, agreeing instead to continue "just as long as we all want to." The three partners rent a room in their law school, take books from fellow students on consignment, open a partnership checking account, and do a profitable business. After a year, Sophie is nearing graduation and wants to "get her money out." She dissolves the partnership.
>
> Charlotte and Paul want to continue the bookstore business and decide to bring in Jacob to take Sophie's place. To carry on the bookstore business, Charlotte, Paul, and Jacob form a successor partnership. Although Sophie has the legal right to force liquidation of the dissolved partnership's business, Charlotte and Paul convince her to take a cash settlement instead. As part of the winding-up process of the dissolved partnership:
>
> 1. the dissolved partnership settles Sophie's accounts by cashing her out (that is, by paying her the settlement amount);
> 2. Charlotte and Paul take rights in the successor partnership as settlement of their respective accounts in the dissolved partnership;[65]
> 3. the dissolved partnership arranges to transfer its rights and obligations (including, for example, its lease with the law school) to the successor partnership; and
> 4. the successor partnership agrees to hold Sophie harmless from any liabilities arising from either the dissolved or successor partnership.[66]
>
> When winding up ends, the Charlotte-Paul-Sophie partnership terminates; it no longer exists. Its business, however, continues on. With the same suppliers, the same customers, and two of the same partners, Charlotte, Paul, and Jacob operate that business "at the same old stand." ◂◂◂

The following terms are useful for keeping straight the legal issues raised when the business of a UPA (1914) partnership continues despite dissolution:

- *Dissociated Partners*—Partners of the dissolved partnership who are not continuing in the

business as members of the successor partnership. In the Example above, Sophie is a dissociated partner. (UPA (1914) calls such withdrawal “retirement,” a term that is confusing because of its lay association with senior citizen status and warm climates.)

- *Continuing Partners*—Partners of the dissolved partnership who are continuing in the business as members of the successor partnership. In the Example above, Charlotte and Paul are continuing partners.
- *New Partners*—Partners of the successor partnership who were not members of the dissolved partnership. In the Example above, Jacob is a new partner. (Not every successor partnership involves new partners.)

## §11.4.4 Settling Accounts with Third Parties

The dissolution of a partnership does not abrogate obligations between the dissolved partnership and third parties. Indeed, half of the winding-up process consists of resolving those obligations.[67]

### a. When the Partnership Business Is Being Liquidated

If the partnership business is being liquidated, resolving relations with third parties is theoretically quite simple. Winding up continues until the partnership has completed all performance as an obligor and received all performance as an obligee.

As a practical matter, however, such completion may be difficult and time consuming. For example, not all amounts owed the partnership can be collected immediately. Some obligations may not be due yet, and some obligors may be “slow pays.” To the extent that prompt collection is impractical, the partnership may either sell the right to collect to a third party, assign the collection right to one of the partners,[68] or simply abandon the obligation.

For obligations the dissolved partnership owes to third parties, two pathways exist. The partnership can either pay off or otherwise perform its obligations, or it can delegate the responsibility to someone else. Delegation may be especially attractive for long-term obligations, such as constructing a building. For a dissolved partnership that has long-term obligations, delegation is the only alternative to a very extended period of winding up.[69]

### b. When the Partnership Business Is Being Continued

When the partnership business is being continued by a successor partnership, the theoretical structure is far more complex, although from a practical perspective the transition from the dissolved partnership to the successor partnership can be seamless. Resolving obligations owed to the dissolved partnership is usually simple enough. The dissolved partnership assigns its rights to the successor partnership.[70] Resolving obligations owed to third parties is more complicated. The dissolved partnership could in theory perform all these obligations. However, if the obligations are large relative to the assets of the business, that approach would require at least partial liquidation, which in turn would cripple the successor partnership's ability to function. Moreover, as discussed above, some obligations require drawnout performance. Typically, therefore, the dissolved partnership resolves its obligations to third parties by delegating them to the successor partnership.

Contract law applies to these delegations. In some instances, the transfer of responsibility may require the obligee's consent.[71] In all instances, the mere transfer of responsibility does not discharge the dissolved partnership from its obligations. As a matter of contract law, discharge occurs only if the obligee consents to a novation with the successor partnership.[72] An economically rational obligee will not agree to a novation without receiving something in return.

**Example**

> Alex, Bernice, Carl, and Donald form a partnership to do carpentry work. To equip themselves, they borrow $10,000 from First State Bank at the then current rate of 6 percent. Two years later Alex dissolves the partnership. He is willing to let the others continue the business so long as he is released from any personal liability to the bank. Over the past two years interest rates have risen, so the going rate is now 9 percent. If Bernice, Carl, and Donald are creditworthy without Alex, then the bank may well release Alex, provided the interest rate on the loan is reset nearer to or at 9 percent. ◂◂◂

# §11.4.5 Successor Liability When a Successor Partnership Continues the Business of a Dissolved Partnership

If a successor partnership continues the business of a dissolved partnership, then both contract law and partnership law make the successor partnership liable for the obligations of the dissolved partnership. The agreement transferring the business typically calls for the successor partnership to assume the obligations of the dissolved partnership, and, as a matter of contract law, creditors of the dissolved partnership can enforce the assumption agreement as intended third party beneficiaries. Even without an assumption agreement, if the successor partnership includes any continuing partners (i.e., any members from the dissolved partnership), UPA (1914) §41 makes the successor partnership liable for the debts of the dissolved partnership as a matter of partnership law.[73]

This successor liability extends to all the partners in the successor partnership,[74] with one exception. The liability created by *partnership law* for *new partners* is limited. Under UPA (1914) §41(7), "The liability of a third person becoming a partner in the partnership continuing the business, under this section, to the creditors of the dissolved partnership shall be satisfied out of partnership property only." Although the language of the statute is confusing, the phrase "a third person" refers to persons who are members of the successor partnership but were not members of the dissolved partnership. In other words, newcomers have no *personal* liability for the debts of the dissolved partnership. The entire value of their interest in the successor partnership may be consumed in paying those old debts, but those debts do not put a newcomer's personal assets at risk.[75]

UPA (1914) §41(7) expressly limits its reach to "liability . . . under this section," so a newcomer's protection relates only to liability arising from section 41. Because successor partnerships typically agree to assume the obligations of the dissolved partnership, liability typically arises not only from section 41 but also from contract law. The protections of section 41(7) do not extend to liability arising from contract law.

**Example**

> Charlotte, Paul, and Sophie form a partnership to operate a used bookstore in the law school. When Sophie nears graduation, she dissolves the partnership. Jacob joins Charlotte and Paul, and they form a successor partnership to carry on the business of the dissolved partnership. En masse the professors assign new editions, the market

for used books plummets, and the bookstore goes under. The business can no longer make its lease payments to the law school. Under UPA (1914) §41(1), “creditors of the . . . dissolved partnership are also creditors of the partnership . . . continuing the business.” Therefore, the law school can pursue the successor partnership for the lease payments. Under UPA (1914) §15, the law school can also pursue the successor partnership’s partners.[76] If the law school bases its claims solely on UPA (1914) §41, the personal assets of Jacob (the newcomer) are not at risk, due to UPA (1914) §41(7). Jacob’s protection under

UPA (1914) §41(7) will be of no use, however, if the successor partnership contractually assumed the lease obligation of the dissolved partnership. (In any event, Charlotte, Paul, and Sophie are liable as partners of the dissolved partnership.)[77] ◂◂◂

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# §11.5 THE IMPACT OF DISSOLUTION ON THE PARTNERS

## §11.5.1 Impact on Partners’ Fiduciary Duties

Since dissolution does not end the partnership, dissolution does not end the partners’ reciprocal fiduciary duties.[78] Indeed, these duties can take on a special importance if the partners seek to negotiate an agreement to continue the business or to buy each other out.[79]

## §11.5.2 Impact on Partners’ Personal Liability

Dissolution by itself does nothing to change the partners’ personal liability for the debts of the dissolved partnership. In the words of UPA (1914) §36(1), “The dissolution of the partnership does not of itself discharge the existing liability of any partner.” Discharge *will* occur, however, under two circumstances that may follow from dissolution.

## a. Post-Dissolution Discharge by Agreement with the Creditor

UPA (1914) §36(2) states "A partner is discharged from any existing liability upon dissolution of the partnership by an agreement to that effect between himself, the partnership creditor, and the person or partnership continuing the business. . . ." Presumably under such an agreement "the person or partnership continuing the business" will assume responsibility for the discharged partner's obligations.

UPA (1914) §36(2) also states that an agreement to discharge a member of the dissolved partnership "may be inferred from the course of dealing between the creditor having knowledge of the dissolution and the person or partnership continuing the business." The statute provides no guidance on what factors support an implied agreement. At least one case suggests, however, that a creditor risks implied discharge by acting as if the dissociated partner is no longer liable.

### Case in Point—Gjovik v. Strope

> A farmer borrowed money from a finance company and secured the debt by giving the finance company a mortgage on some farmland and a security interest in some farm equipment. The farmer subsequently sold the land and equipment (subject to the financing company's interests) to a partnership on credit. One of the partners then withdrew from the partnership, and the other continued the business. The dissociated partner assigned all his interests in the partnership to the continuing partner. From these facts the court implied an agreement by the continuing partner to assume the obligations of the dissociated partner. The court found an implied agreement by the farmer to release the dissociated partner based on the following facts: (i) the farmer learned that the dissociated partner had withdrawn from the partnership business; (ii) the continuing partner signed an agreement to assume the farmer's obligations to the finance company, but the dissociated partner did not, and apparently the farmer did not insist on the dissociated partner's signature; and (iii) when the continuing partner was unable to make a payment on the debt to the finance company, the continuing partner and the farmer agreed to sell off some farm equipment to reduce that debt.

> The dissociated partner was not consulted.[80] ◂◂◂

### b. Discharge by Material Alteration in the Obligation

Under UPA (1914) §36(3) a creditor may inadvertently discharge UPA (1914) partners from their pre-dissolution liabilities. Discharge occurs if: (i) someone has agreed to assume the obligations of the dissolved partnership; (ii) the creditor knows of the agreement; and (iii) the creditor consents to a material change in the obligation.

Most of the cases under UPA (1914) §36(3) concern the meaning of "material alteration." Many of those cases use analogies from surety law.[81] Changes found to be material under UPA (1914) §36(3) include: extension of time to pay a debt; renewal of a promissory note; and agreement to surrender leased premises in advance of the surrender date stated in the original lease. Changes found not to be material include assignment to the creditor of accounts receivable as additional security for the debt (no change in the nature of the obligation, no possible prejudice to dissociated partner); and failure of creditor to immediately sue business to collect on overdue account (no consented-to change in the obligation).

## §11.5.3 Settling Accounts Among Partners When the Business Is Liquidated

When the business is being liquidated, settling accounts among the partners is a crucial part of winding up. An agreement among the partners can govern this *inter se* matter.

**Example**

> Burt and Dorothy form a partnership to raise and race thoroughbred horses. The partnership has a term of five years. Burt provides all the money to buy the horses, and Dorothy contributes her considerable expertise as a trainer. Profits are split 60 percent to Dorothy, 40 percent to Burt. The partnership agreement states in part:
>
> > ***Distribution of assets following dissolution*** Upon dissolution, the partnership shall pay or secure the discharge of all liabilities that it owes. Any remaining partnership property—

other than horses—shall be sold and the net proceeds divided according to the partners' respective profit shares. All horses shall become the property of Burt. ◂◂◂

In the absence of an agreement, UPA (1914) §§38, 40, and 42 supply the default rules. Which particular rules apply depends on whether the business is being continued or liquidated and on whether the dissolution was wrongful or rightful.

## a. Liquidation Following Rightful Dissolution

When the partnership business is to be liquidated following a rightful dissolution,[82] the UPA (1914) default rules provide a theoretically simple approach for distributing the assets of the partnership and settling accounts among the partners. Property that a partner has merely loaned or rented to the partnership returns to the partner as the partnership business comes to an end.[83] The assets that belong to the partnership are marshaled and liquidated.[84] From those assets:

- outside creditors are paid off;
- inside creditors (i.e., partners who have made loans or leased property) are paid off;
- partners are repaid their capital (i.e., the value of any property they have contributed to the partnership, plus any profits previously allocated to the partners, less any distributions previously made); and
- any remaining funds are divided, as profit, according to each partner's ordinary profit percentages and are distributed accordingly.[85]

If the partnership has insufficient funds to pay its creditors and repay capital contributions, then the partners must pay into the partnership according to their respective obligations to share losses.[86]

UPA (1914) expressly provides for the settling of accounts among partners in cash.[87] Division of assets in kind raises significant problems of valuation and so is disfavored. Partners may ofcourse agree to settle accounts with each other through an in-kind asset distribution, but absent such an agreement, in-kind distribution is permissible only to avoid great unfairness or extraordinary waste.

### Example

A partnership grew Christmas trees on land rented from one of the partners. When the partnership dissolved, growing trees not ready for

harvest were a substantial partnership asset. Liquidation was impractical; to order the trees harvested and sold would have wasted the asset. Instead the court divided the growing trees between the partners. ◂◂◂

## b. The Function of Partners' Capital Accounts in Dissolution

As part of the settling-up process, partners are paid the amounts owed "in respect of capital."[88] The bookkeeping devices that track the amount the partnership owes each partner "in respect of capital . . ." are called "capital accounts."[89] Property contributed to the partnership increases the contributing partner's capital account by an amount equal to the fair market value of the asset as of the time of contribution, as do profits allocated to partners from ongoing activities.[90] Distributions made to partners decrease their respective capital accounts, as do losses allocated to partners from ongoing activities.[91] Post-contribution depreciation or appreciation of a contributed asset does not affect the contributing partner's capital account. The contribution severs the contributor's direct connection to the asset; subsequent vicissitudes in the asset's value are "for the partnership's account" (i.e., for the partnership's benefit or detriment).[92]

When the partnership dissolves and the partners settle accounts, each partner receives as a return of capital the amount in his, her, or its capital account. If the partnership has neither made nor lost money, has experienced neither depreciation nor appreciation in its assets, and has generated no saleable good will, then the sum of the capital accounts at dissolution will equal the net worth of the firm.

Such equality is by no means the norm, however. If, for example, the firm's assets have appreciated in value, then the net worth of the firm will exceed the sum of the partners' capital accounts. Any surplus remaining after paying creditors and discharging the capital accounts is profit—to be distributed according to the partners' respective profit shares.

In contrast, if the firm has lost money or its assets have depreciated, then at dissolution the sum of the capital accounts will exceed the firm's net worth. The loss or depreciation will have affected the firm's assets, but not the separate claims of the partners to be repaid the value of their respective contributions. The partners will have to contribute additional funds to the partnership, either to permit a full return of capital or at least to adjust the

capital accounts so that losses are shared appropriately.[93]

The following Example, modeled in simplified form on *Langness v. "O" Street Carpet Shop, Inc.*,[94] illustrates how capital accounts and UPA (1914) §§38(1) and 40 determine each partner's return when the partnership business is liquidated following rightful dissolution.

**Example**

Three individuals, *A*, *B*, and *C*, form a partnership governed by UPA (1914). They agree to share profits equally. *A* contributes $14,000. *B* contributes the vendee's interest in a real estate purchase agreement. At the time, the fair market value of the real estate is $65,000. The purchase agreement sets a price of $56,000, so the value of the contribution is $9,000. *C* makes no capital contribution, providing instead legal services in the drafting of the partnership agreement. At that point the capital accounts would stand as follows:

A $14,000

B 9,000

C 0

(C's providing of legal services qualifies *C* for a share of the profits, but not for any credit in C's capital account.)[95]

*An Interim Return of Capital*: Soon after, by agreement, *B* receives $8,000 as a return of capital. The capital accounts would then stand at:

A $14,000

B 1,000

C 0

*Interim Capital Contributions*: The partnership later purchases the property subject to the purchase agreement, and *B* and *C* each contribute $2,000 in cash to be used toward the down payment. The capital accounts would then stand at:

A $14,000

B 3,000
C 2,000

*Interim Losses*: The next year the partnership suffers a $6,000 operating loss. The partners have no explicit agreement on loss sharing, so under

UPA (1914) §18(a) they share losses “according to [their respective] share in the profits.” The capital accounts would then stand at:

A $12,000
B 1,000
C 0

*Dissolution and Settling Up Among the Partners*: Later the partnership sells the real estate, making a profit of $46,000 on the sale. The partnership then dissolves, owing $3,000 to outside creditors. The sale profits are the partnership’s only asset. Under UPA (1914) §40(b)(I), the “first” $3,000 of the $46,000 goes to pay the creditors. Then, under UPA (1914) §40(b)(III), A and B receive the value of their respective capital accounts. The three partners then divide the remaining $30,000 equally, according to their original agreement on sharing profits.

| | |
|---|---|
| Assets of the partnership | $46,000 |
| Less payment to creditors; per §40(b)(I) | (3,000) |
| Available prior to return of capital | 43,000 |
| Less payout of A’s capital account; per §40(b)(III) | (12,000) |
| Less payout of B’s capital account; per §40(b)(III) | (1,000)[96] |
| Remaining for distribution as profits; per §40(b)(IV) | 30,000 |

Per agreement, each partner receives one third ($10,000) of the profits. Total payout per partner:

A $22,000 (capital account of $12,000, plus profits of $10,000)
B 11,000 (capital account of $1,000, plus profits of $10,000)

C 10,000 (no capital to return; profits of $10,000) ◂◂◂

### c. Settling Accounts Following Wrongful Dissolution

If the business is being liquidated following a wrongful dissolution, the settling of accounts among the partners is the same as if the dissolution were rightful—except that the wrongfully dissolving partner's share may be decreased by the amount of damages due the other partners "for breach of the [partnership] agreement."[97]

## §11.5.4 Settling Accounts Among Partners When the Business Is Continued: Rightful Dissolution

### a. Settling Accounts by Express Agreement

For the partnership business to continue after dissolution, there must be some agreement among the partners. The agreement can be made before or after dissolution, and, if the dissolution is wrongful, need not include the wrongful dissolver. But some agreement there must be; the default mode is liquidation.[98]

The agreement that provides for the continuation of the business will normally govern how the partners will settle their accounts. Indeed, any business continuation agreement should at minimum address the following five topics:

1. the transfer of the rights and obligations of the dissolved partnership to the successor partnership;
2. the conversion of the continuing partners' rights in the dissolved partnership to rights in the successor partnership;
3. the compensation of the dissociated partner for that partner's rights in the dissolved partnership;
4. the indemnification or (if possible) the release of the dissociated partner for debts of the dissolved partnership; and
5. the indemnification of the dissociated partner for debts of the successor partnership.

### b. The Possibility of a Tacit Agreement to Continue the Business

If a partner rightfully dissociates from a partnership and fails to seek liquidation of the partnership business, a court may decide that the partner tacitly consented to a continuation of the business. One case found implied consent even though, throughout the period of supposed acquiescence, the dissociated partner sought to have the continuing partners buy out his interest.

Such a result is not preordained, however. For example, in another case another court rejected the tacit consent argument even though liquidation was delayed for years following dissolution. During the delay a lawsuit was pending, challenging the partnership's ownership of important assets. The court treated the delay as a long, drawn-out wind up.

## c. Compensating the Dissociated Partner

A finding of tacit agreement does stave off liquidation but leaves open the question of how to compensate the dissociated partner (among other issues).[99] The same issue exists when all the partners expressly agree to continue the business but neglect the compensation issue.[100]

For these situations, UPA (1914) §42 provides a default rule, essentially treating the value of the dissociated partner's interest in the dissolved partnership as a loan to the successor partnership. Under UPA (1914) §42:

a. the value of the dissociated partner's interest in the dissolved partnership is calculated as of the date of dissolution; and

b. as compensation for the business's use of that value from the date of dissolution to the date the successor partnership cashes out the dissociated partner, the dissociated partner receives (at the dissociated partner's election) either:

> i. interest on that value; or
> ii. a share of the profits attributable to the successor partnership's "use of [the dissociated partner's] right in the property of the dissolved partnership."

The language of UPAUPA (1914) §42 leaves open at least seven important questions. The relevant case law is scarce, and much of the reasoning is muddy. Following are the seven troubling questions and the author's view of the answers.

### *1. How Long May the Successor Partnership Wait to Cash Out the Dissociated Partner?*

In some circumstances, the dissociated and continuing partners may expressly or impliedly agree on a pay-out deadline. If not, the law must give the successor partnership some breathing room. An obligation to immediately cash out the dissociated partner could force the continuing partners to liquidate the business in order to come up with the necessary cash.[101]

### *2. Must the Successor Partnership Make Interim Payments to the Dissociated Partner Pending the Cash-Out?*

The cases do not contemplate interim payments, because they all involve actions for an accounting.[102] In each of these actions, the continuing partners had disputed the cash-out amount and had made no interim payments. Nothing in the cases prejudices the continuing partners for failing to make interim payments. Nor does anything in the law prevent the partners from agreeing on interim payments.

### *3. When Does the Dissociated Partner Elect Between the Interest Option and the Profit-Sharing Option?*

The dissociated partner may wait until an accounting reveals both the value of the partnership at dissolution and the value of the dissociated partner's interest. If the dissociated partner has to bring an accounting action to obtain the cash-out, then the dissociated partner can delay the election until the partner can determine which option will be the more lucrative. The dissociated partner's right to delay election creates an incentive for the continuing partners to cash out the dissociated partner as soon as possible.

### *4. May the Dissociated Partner Change the Election?*

A representative of a deceased partner's estate may lack the authority to make a binding election before an accounting has revealed the value of the partnership and the value of the deceased partner's interest. Otherwise, it appears that a dissociated partner is stuck with the election once made. It does

not make sense for a dissociated partner to make an election prior to cash-out unless the continuing business is making interim payments.

### *5. How Is the Interest Rate Determined?*

There is very little authority on this point. Among the arguable positions: the legal rate for interest on judgments, the legal rate for prejudgment interest, and the amount the successor partnership would have to pay to borrow funds in an arm's-length transaction.

### *6. How Is the Profit Share Calculated?*

The case law and commentaries indicate that the profit share equals the ratio of the value of the dissociated partner's interest in the partnership at dissolution to the value of the entire partnership at dissolution, regardless of the profit share enjoyed by the dissociated partner prior to dissolution.

**Example**

> When Sophie dissolves her used bookstore partnership with Charlotte and Paul, the partnership's net worth is $10,000 and Sophie's capital account is at $5,000. Sophie agrees that the business will be continued without liqui-dation, but no agreement is made on compensating Sophie for her interest. If Sophie chooses the profit-sharing option, her share of the successor partnership's profits will be 50 percent ($5,000/$10,000), even though in the dissolved partnership the partners shared profits equally. ◂◂◂

### *7. How Long May the Business Continue Before Fully Cashing Out the Dissociated Partner?*

Under the aegis of UPA (1914) §42, the successor partnership may continue the business indefinitely, subject, of course, to the power of the members of the successor partnership to dissolve that partnership. If the continuing partners do not pay the dissociated partner the cash out amount (plus interest or profit), then the dissociated partner can sue to collect the amount due. The dissociated partner can proceed against both the partners of the dissolved

partnership and against the successor partnership and its members.[103] But the dissociated partner will proceed “as an ordinary creditor”[104] and will therefore have no special rights to compel liquidation of the business of the successor partnership.

# §11.5.5 Settling Accounts Among Partners When the Business Is Continued: Wrongful Dissolution

## a. The Default “Package” for the Wrongful Dissolver

Following a wrongful dissolution, the partnership business may be continued either: (i) by agreement of all of the partners (typically in place before the dissociation); or (ii) under UPA (1914) §38(2)(b), by the unanimous consent of the partners who did not wrongfully dissolve. In the former instance, the partners’ agreement will likely set the payout rights of the wrongful dissolver. In the latter instance, UPA (1914) §38(2) provides the wrongful dissolver a compensation package consisting of three elements:

- the right (at the option of the continuing partners) either to be cashed out immediately or to be cashed out later (with the delayed payment guaranteed);
- the right to be protected against personal liability for partnership debts; and
- if the cash-out payment is not immediate, the right to compensation on account of the delay.

## b. Calculating the Cash-Out Amount

When the default package applies, UPA (1914) §38(2)(c)(II) requires that “the value of [the wrongful dissolver’s] interest in the partnership” be ascertained. The calculation proceeds as if the dissolution were rightful,[105] with two important exceptions:

- “in ascertaining the value of the [wrongfully dissolving] partner’s interest the value of the good-will of the business shall not be considered;”[106] and
- the value of the wrongful dissolver’s interest is to be decreased by “any damages caused to his co-partners by the [wrongful] dissolution.”[107]

## c. Timing and Securing the Payment

If the wrongful dissolver has a large stake in the partnership, requiring immediate payment of the cash-out amount might interfere with or even preclude the continuation of the business. UPA (1914) therefore allows the continuing partners an option. They can either pay the wrongful dissolver immediately, or they can delay payment until the end of the original term of the dissolved partnership.[108]

If the continuing partners delay payment, they must "secure the payment by bond approved by the court."[109] That is, they must obtain a guarantee from a bonding company stating that, if the successor partnership fails to pay the cash-out amount when due, the bonding company will make payment to the wrongful dissolver. The statute does not specify whether the bond must be for the full amount of the obligation and does not indicate whether the bond can require the wrongful dissolver to first try to collect from the members of the successor partnership. Presumably the court granting approval to a proposed bond would consider these matters.

Except for the bond, a wrongful dissolver awaiting payment has the status of "an ordinary creditor."[110] UPA §42 applies, and the wrongful dissolver appears to have no greater rights to interim payments than does any rightfully dissociated partner who becomes subject to that provision.[111]

## d. Protecting the Wrongful Dissolver from Partnership Debts

UPA (1914) §38(2)(b) plainly requires that the continuing partners "indemnify [the wrongful dissolver] against all . . . future partnership liabilities." The statute's approach to current liabilities is less clear. UPA (1914) §38(2)(b) requires indemnification "against all present . . . partnership liabilities," but UPA (1914) §38(2)(c)(II) entitles the wrongful dissolver "to be released from all existing liabilities of the partnership." Neither the statute nor its official comments explain the inconsistent language. The major commentators note but do not resolve the problem.

From the perspective of the wrongful dissolver, the release approach is certainly superior. The indemnity does nothing to the underlying obligation; the obligee is still entitled to pursue the wrongful dissolver. The indemnity is therefore only as good as the solvency of the indemnitor.

From the perspective of the continuing partners, the release approach may be impractical. Generally, obligees are unwilling to release partners without receiving full payment or perhaps an increase in interest rates. After all, why

should the obligee give up something—the right to pursue the wrongful dissolver—without getting something in return?

## e. Rationale for Protecting the Wrongful Dissolver from Liability

It makes sense for the continuing partners to protect the wrongful dissolver against future partnership liabilities, because the wrongful dissolver will have no part in the creation of those liabilities. At most, if the cash-out payment is delayed, the wrongful dissolver will relate to the continuing business as an ordinary creditor.

The rationale for protecting the wrongful dissolver against existing liabilities is that the valuation of the dissolver's stake in the partnership takes into account those liabilities.

**Example**

> George, Bernard, and Shaw form a partnership with a term of five years to sell widgets. They agree to share profits equally. After three years George wrongfully dissolves the partnership. Bernard and Shaw decide to continue the business under UPA (1914) §38(2).
>
> The value of George's interest (the cash-out amount) must therefore be ascertained. The partnership's assets, other than goodwill,[112] are as follows:

| Assets | |
|---|---|
| Cash | $50,000 |
| Accounts receivable | 35,000 |
| Orders in, but not yet billed | 5,000 |
| TOTAL | $90,000 |
| *Liabilities* | |
| Loan due to the bank | $25,000 |
| Accounts payable | 5,000 |
| TOTAL $30,000 VALUE OF PARTNERSHIP: $90,000 - $30,000 = $60,000 ◂◂◂ | |

To keep the analysis as simple as possible, assume that none of the partners has anything in his capital account.[113] The $60,000 value is therefore all surplus (i.e., as yet undistributed profit) to be divided equally per the original partnership agreement. George's share is $20,000. This figure is reached by *subtracting liabilities from assets* and then dividing by 3. In effect, the $20,000 figure assumes that the partnership will pay its $30,000 in liabilities, and George's cash-out amount has been decreased by his share of those liabilities. In essence, therefore, George has already "paid" his share. He should be protected against having to pay again.

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# §11.6 AVOIDING UPA DISSOLUTION BY AGREEMENT (A SPECIOUS IDEA)

According to the language of UPA (1914), certain events automatically and inevitably cause dissolution. Under UPA (1914) §31(4), for example, "Dissolution is caused ... by the death of any partner." Under UPA (1914) §31(1)(d) the expulsion of a partner under a power conferred by the partnership agreement likewise causes dissolution. And, most fundamentally, the express will of any partner causes dissolution even when done in breach of the partnership agreement.[114]

Unlike many other provisions of UPAUPA (1914), these automatic dissolution provisions are not default rules—that is, they are not by their terms subject to contrary agreement among the partners. Nonetheless, some partnership agreements seek to avoid disruption to the partnership business by ignoring the statutory language. Typically, such agreements provide that the dissociation of a partner does not cause dissolution.

**Example**

> The law firm of Tinkers, Evers, and Chance has a partnership agreement that provides, in part: "Neither the death, retirement, resignation, or withdrawal of any partner shall dissolve this partnership, but the partnership will buy out the dissociated partner's interest in the partnership as provided in paragraph *Z* of this agreement." ◂◂◂

Although there are cases upholding these agreements in disputes among the partners, such agreements are dangerous. The conflict between the language of the agreement and the language of the statute invites litigation.

Moreover, ignoring UPA (1914)’s approach to dissolution subjects the dissociated partner to an added risk of personal liability if the partnership business continues. UPA (1914) provides a panoply of protections for the dissociated partner, but all those protections revolve around the concept of dissolution:

1. UPA (1914) §§33 and 34 end the actual authority (though not the power) of the continuing partners to bind the dissolved partnership
 (and thereby the dissociated partner) on obligations related to new business.[115]
2. UPA (1914) §35 limits the power of the continuing partners to bind the dissolved partnership (and thereby the dissociated partner).[116]
3. UPA (1914) §36 provides, under certain circumstances, for the dissociated partner to be discharged from personal liability for debts of the dissolved partnership.[117]
4. UPA (1914) §15 imposes personal liability on the dissociated partner only for the debts of the dissolved partnership and not for the debts of any successor partnership.[118]

If dissolution does not occur, these protections are inapposite.

The answer for partners trying to avoid business disruption is to provide carefully for dissolution rather than attempt to preclude it. A well-drafted partnership agreement can ensure continuity by providing for the partnership business to be continued even as the partnership itselfis wound up and terminated.[119]

# §11.7 JUDICIAL DISSOLUTION

UPA (1914) §32 provides several bases for a court to “decree a dissolution.” The most interesting are UPA (1914) §§31(1)(d) and (e) and 31(2). Section 32(1)(d) makes dissolution by decree of court available on “application by or for a partner” when another “partner willfully or persistently commits a breach of the partnership agreement, or otherwise so conducts himself in matters relating to the partnership business that it is not reasonably practicable to carry on the business in partnership with him.” Section 32(1)(e) permits a partner to apply for judicial dissolution when “[t]he business of the partnership can only be carried on at a loss.”

Section 31(2) permits a “purchaser of a partner’s interest” (i.e., an assignee or a person who has purchased through a foreclosure of a charging order) to petition for dissolution “(a) [a]fter the termination of the specified term or particular undertaking, [and] (b) [a]t any time if the partnership was a partnership at will when the interest was assigned or when the charging order was issued.” The rationale seems to be that a third party’s right to a liquidating distribution “vests” when the third party acquires the interest (or, in the case of a charging order, acquires the equivalent of a lien on the interest).[120]

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# §11.8 UPA (1997)—FOUNDATIONAL NOTIONS

## §11.8.1 Four Foundational Concepts

Although UPA (1914)’s provisions on partner dissociation and partnership dissolution are as elaborate as those in UPA (1914), the approach of UPA (1997) is simpler to follow because it tilts *toward* continuity and away from dissolution. UPA (1997)’s approach rests on four major concepts:

- The dissociation of a UPA (1997) partner does *not* necessarily cause the dissolution of the partnership.
- UPA (1997) contains a “switching provision”[121]—if a partner’s dissociation results in dissolution, the “switch” activates Article 8 (dissolution and winding up); if not, the “switch” activates Article 7 (buyout of dissociated partner and continuation of the partnership).
- UPA (1997) provides for statements of dissociation and dissolution, the public filing of which significantly affects power-to-bind and personal liability issues.
- Almost all of UPA (1997)’s provisions on dissociation and dissolution are subject to change by the partnership agreement, making it possible for a partnership subject to UPA (1997) to be almost as indissoluble as a limited liability company or corporation.

## §11.8.2 Dissociation Described

### a. Events Causing Dissociation

Under UPA (1997), partner dissociation is a pivotal term and carries forward a UPA (1914) concept—namely, that “any partner ceasing to be associated in

the carrying on as distinguished from the winding up of the [partnership's] business" is an event significant both to the partner and the partnership.[122] UPA (1997) does not directly define "dissociation," but section 601 lists ten events "upon the occurrence" of which a "partner is dissociated from a partnership." The ten events divide roughly into four categories:[123]

I. "the partnership's having notice of the partner's express will to withdraw as a partner or on a later date specified by the partner";[124]

II. an event specified in the partnership agreement as causing dissociation;[125]

III. expulsion:

   A. as provided in the partnership agreement;[126]

   B. by unanimous vote of the other partners; if

      1. it is unlawful to carry on the business with the to-be-expelled partner;[127]
      2. the partner being expelled no longer has any economic stake in the business, because "there has been a transfer of all or substantially all of that partner's transferable interest in the partinership;"[128] or
      3. the partner being expelled is a corporation or partnership which has lost its right to take on new business;[129]

   C. by court order, if the partner being expelled has engaged in seriously wrongful conduct;[130]

IV. the partner's ability to participate in the partnership affairs comes to an end, or the partner's economic stake in the partnership comes to an end,[131] including:

   A. the partner becoming a debtor in bankruptcy, or taking other, non-bankruptcy actions which indicate insolvency;[132]

   B. if the partner is an individual, the individual's ability to participate in partnership affairs coming to an end, either by:

      1. death; or
      2. mental incompetency, as indicated either by:

         a. "the appointment of a guardian or general conservator;" or
         b. "a judicial determination that the partner has otherwise become incapable of performing the partner's duties under the partnership agreement";[133]

   C. if the partner is a trust or estate, its economic stake in the partnership coming to an end by the distribution (typically to the beneficiaries) of the partner's "entire transferable interest in the partnership";[134]

   D. "termination of a partner who is not an individual, partnership, corporation, trust, or estate. [135]

## Example

Dardale Company is a general partnership subject to UPA (1997) and has three partners: Amos, Eli, and Alan. The partnership is at-will, and the partnership agreement does not alter UPA (1997)'s provisions on dissociation. Following an intense meeting of the partners, Amos

is walking home with Eli and says, "I'm tired of all this nonsense. I'm done. I quit." At that moment, Amos is dissociated. Eli has notice of Amos's "express will" (UPA (1997) §102(b)(1) defining "notice" to include knowledge) and notice to a partner is notice to the partnership. UPA (1997) §102(f).[136] Therefore, "the partnership [has] notice of [Amos's] express will to withdraw as a partner." ◂◂◂

**Example**

Same situation, except that Dardale Company is a partnership formed for a particular term or undertaking. Amos is dissociated, although the dissociation may be wrongful (as explained below). ◂◂◂

**Example**

Same situation, except that instead of quitting, Amos sells his entire transferable interest to Paul. Amos is not dissociated. However, if Alan and Eli vote to expel Amos, he will be expelled and thereby dissociated. UPA (1997) §601(4)(ii). Paul does not have a vote, because he is not a partner. UPA (1997) §§401(i) (person becomes a partner only with the consent of all the partners)[137] and 503(a)(3) (transferee has no rights in management).[138] ◂◂◂

## b. Consequences of Dissociation—Whether or Not Dissolution Results Is Generally Dependent on Whether the Dissociation Is Wrongful or Rightful

Many of the consequences of partner dissociation depend on whether the dissociation is wrongful or rightful and on whether the dissociation results in dissolution of the partnership.[139]

## c. Rightful versus Wrongful Dissociation

UPA (1997) §602(b) expressly defines and carefully delimits "wrongful" dissociation:

A partner's dissociation is wrongful only if:

(1) it is in breach of an express provision of the partnership agreement; or

(2) in the case of a partnership for a definite term or particular undertaking, before the expiration of the term or the completion of the undertaking:

(i) the partner withdraws by express will, unless the withdrawal follows within 90 days after another partner's dissociation by death or otherwise under section 601(6) through (10) [dissociation because either the partner's ability to participate in the partnership affairs has come to an end, or the partner's economic stake in the partnership has come to an end] or wrongful dissociation under this subsection;

(ii) the partner is expelled by judicial determination under section 601(5);

(iii) the partner is dissociated by becoming a debtor in bankruptcy; or

(iv) in the case of a partner who is not an individual, trust other than a business trust, or estate, the partner is expelled or otherwise dissociated because it willfully dissolved or terminated.

**Example**

Dardale Company is a general partnership subject to UPA (1997) and has four partners: Amos, Eli, Alan, and Paul. The partnership is for a term of 10 years, and the partnership agreement does not alter UPA (1997)'s provisions on dissociation. Following an intense meeting of the partners, Amos is walking home with Eli and says, "I'm tired of all this nonsense. I'm done. I quit." Amos's dissociation is wrongful, because it occurs "by express will" of a partner "before the expiration of the term" of the partnership. UPA (1997) §602(b)(2)(i). ◂◂◂

**Example**

As soon as Alan learns that Amos has quit, Alan announces that he is also quitting. Like Amos's dissociation, Alan's dissociation comes before the expiration of the partnership's term. However, Alan's dissociation is not wrongful, because it comes "within 90 days after another partner's . . . wrongful dissociation." UPA (1997) §602(2)(b)(i). ◂◂◂

UPA (1997) §602(b) effectively rejects cases like *Page* and *Vangel*.[140] Under UPA (1997), a dissociation is not wrongful merely because it constitutes a breach of fiduciary duty or the obligation of good faith and fair dealing. Such a breach may be separately actionable, but the consequences that attach to "wrongful dissociation" do not apply.

## d. Consequences of Wrongful Dissociation

There are several consequences when a partner wrongfully dissociates:

- the wrongfully dissociated partner "is liable to the partnership and to the other partners for damages caused by the dissociation";[141]
- in a partnership for a term or undertaking, the dissociation creates the possibility of partnership dissolution, which occurs if "within 90 days after a partner's . . . wrongful dissociation . . . the express will of at least half of the remaining partners [is] to wind up the partnership business ;[142]
- if the partnership continues (i.e., does not dissolve), the wrongfully dissociated partner is not entitled to any payout until the end of the original term "unless the partner establishes to the satisfaction of the court that earlier payment will not cause undue hardship to the business of the partnership";[143] and
- if the dissociation results in dissolution of the partnership, the wrongfully dissociated has no right to participate in winding up.[144]

## Example

Amos's premature and wrongful departure from the Dardale Company causes the partnership to have to hire an employee to provide the technical expertise that Amos had been providing. Dardale's cost for this employee exceeds what Amos was receiving as a partner as remuneration for that work. The extra expense puts the partnership into a "cash poor" situation. Amos is liable in damages to the partnership to the extent of the extra expense.[145] Moreover, Amos is not entitled to any payout until the end of the original term.[146] ◄◄◄

**Case in Point—Saint Alphonsus Diversified Care, Inc. v. MRI Associates, LLP**

Various entities formed a partnership for the purpose of acquiring and providing services relating to diagnostic equipment.[147] Eventually, one partner notified the other partners that it intended to dissociate and become a partner of another business. The dissociating partner filed suit seeking a determination of the value of its interest in the partnership. The Supreme Court vacated the trial court judgment and remanded, because the trial court had found as a matter of law that Plaintiff wrongfully dissociated from the partnership. The Supreme Court determined that the provision in the partnership agreement, allegedly breached by the dissociating partner, was "not an express provision limiting the right to dissociate rightfully."[148] ◄◄◄

### e. Power of Partnership Agreement over Dissociation

With only two exceptions, UPA (1997) §601 is a default rule. The partnership agreement can change or omit each of the listed causes of dissociation, except that the partnership may not eliminate a partner's power to dissociate[149] nor vary the right of a court to expel a partner.[150] As a result, the partnership agreement can dramatically restrict the circumstances under which a partner may rightfully exit a UPA (1997) partnership.

In addition, as explained in comment 2 to UPA (1997) §602, because UPA (1997) §602(b) is also "merely a default rule, the partnership agreement may eliminate or expand the dissociations that are wrongful or modify the effects of wrongful dissociation."

## §11.8.3 The Nexus Between Partner Dissociation and Partnership Dissolution

Under UPA (1914), the dissociation of any partner inevitably causes dissolution.[151] The situation under UPA (1997) is dramatically different. First, the statutory provisions that connect partner dissociation and partnership dissolution are merely default rules. The partnership agreement can sever the nexus completely, or to any lesser extent the partner's desire. Second, even with the default rules in place, not every dissociation causes dissolution. Dissolution follows dissociation only in two circumstances:

- in an at-will partnership, the "express will" dissociation of a partner who has not been previously dissociated through some other cause; and [152]
- in a partnership for a term or undertaking:
  - the express will of at least half of the remaining partners to wind up the partnership business," which is
  - manifested "within 90 days after a[nother] partner's dissociation by death or otherwise under section 601(6) through (10)[153] or wrongful dissociation under section 602(b)"[154]

### Example

> The Sachs Company is an at-will partnership subject to UPA (1997) and its partners are Todd, Teri, Mikki, and Samantha. After Todd transfers his entire transferable interest to Jeff, the remaining partners

vote unanimously to expel Todd. Todd has no right to cause dissolution of The Sachs Company. ◂◂◂

**Example**

The Sachs Company is a partnership subject to UPA (1997) and has a term of 10 years. The company's partners are Todd, Teri, Mikki, and Samantha. Todd quits the partnership, and two weeks later Teri, Mikki, and Samantha meet to decide what to do with the partnership. Mikki and Samantha vote to dissolve, and Teri votes to continue. The partnership is dissolved. ◂◂◂

# §11.8.4 The "Switching Provision"—UPA (1997) §603(a)

Different consequences follow from a partner's dissociation, depending on whether the dissociation results in dissolution of the partnership. UPA (1997) §603(a) segregates those consequences from each other by functioning as a switching provision: "If a partner's dissociation results in a dissolution and winding up of the partnership business, [Article] 8 applies; otherwise, [Article] 7 applies."

**Example**

The Sachs Company is a partnership subject to UPA (1997) and has a term of 10 years. The Company's partners are Todd, Jeff, Teri, Mikki, and Samantha. Todd quits the partnership, but during the next 90 days the remaining partners do not vote to dissolve the partnership. A few months later, as permitted by UPA (1997) §801(2)(ii),[155] all the remaining partners unanimously vote to dissolve the partnership. Todd wishes to be involved in winding up the partnership, but he has no right to be. Even assuming Todd's dissociation was not wrongful, UPA (1997) §803(a) is the only provision permitting a dissociated partner to participate in winding up. That provision is not available to

Todd, because it is part of [Article] 8 of UPA (1997). That Article applies to Todd only if *his* "dissociation results in a dissolution and winding up of the partnership business." ◂◂◂

# §11.9 DISSOCIATION THAT DOES NOT CAUSE DISSOLUTION

## §11.9.1 Overview

When a partner's dissociation does not result in partnership dissolution, the partnership business continues without interruption and the partnership itself continues as the same entity that existed before the dissociation. The dissociated partner has no further role in management[156] and no further fiduciary duties.[157] A dissociated partner does, however, have a lingering power to bind the partnership and, unless the partnership is an LLP, a lingering exposure to personal liability for future partnership obligations.

Unless the partnership agreement provides otherwise, the partnership must cause the dissociated partner's interest to be bought out at a price determined under a statutory formula and must indemnify the dissociated partner against all partnership liabilities. Subject to an exception derived from UPA (1914), the dissociation does not discharge the dissociated partner from liability for partnership obligations.

## §11.9.2 Statement of Dissociation

As part of its system of public filings,[158] UPA (1997) provides for the filing of a statement of dissociation, "stating the name of the partnership and that the partner is dissociated from the partnership."[159] Either the dissociated partner or the partnership may file the statement.[160] If filed by the partner, the statement must be executed by that partner.[161] If filed by the partnership, the statement "must be executed by at least two partners.[162]

If properly filed, a statement of dissociation functions as a statement limiting the authority of the dissociated partner[163] and, in addition, gives

constructive notice of the partner's dissociation.[164] As with statements of authority under UPA (1997) §303, statements of dissociation are to be filed "in the office of [the Secretary of State]."[165] For a statement of dissociation to have its full effect with regard to real property owned in the name of the partnership, "a certified copy of the filed statement . . . [must be] of record in the office for recording transfers of that real property."[166]

As soon as that recording is done, the dissociated partner loses all power to transfer real property owned in the name of the partnership.[167] With regard to any other lingering power of the dissociated partner to bind the partnership and any lingering exposure the dissociated partner may have to personal liability for future partnership obligations, "a person not a partner is deemed to have notice of the dissociation 90 days after the statement of dissociation is filed" with the appropriate filing office.[168]

## §11.9.3 Dissociated Partner's Lingering Power to Bind

When a partner dissociates and the partnership does not dissolve, the dissociated partner loses any "right to participate in the management and conduct of the partnership business."[169] However, consistent with notions of apparent authority, a dissociated partner's "apparently/ordinary" power to bind the partnership lingers after the dissociation and can continue for up to two years. Under UPA (1997) §702(a), a dissociated partner's act binds the partnership if:

- before the dissociation the act would have bound the partnership under RUPA §301; and
- at the time the other party enters into the transaction:
  - less than two years has passed since the dissociation;
  - the other party does not have notice of the dissociation and reasonably believes that the dissociated partner is still a partner;
  - fewer than 90 days have passed since the filing of a statement of dissociation;[170] and
  - if the transaction involves the transfer of real property owned in the name of the partnership, "a certified copy of [a] filed statement . . . [of dissociation is not] of record in the office for recording transfers of that real property."[171]

**Example**

> The Ofek-Noam Company ("the Company") is a general partnership subject to UPA (1997) that purchases land and subdivides it for sale to home builders. The Company has three partners—Suzanne, Eli,

> and Gili—and for years all three have acted for the partnership in selling land to home builders. The partnership has filed a statement of authority with the Secretary of State, indicating that each partner has the authority to transfer land owned in the name of the partnership. The partnership owns a large parcel of land in Dakota County, and a certified copy of the statement of authority has been recorded with the Dakota County Registrar of Deeds.

Acting pursuant to the partnership agreement, Gili and Suzanne expel Eli from the partnership. They then execute and file a statement of dissociation with the Secretary of State and record a certified copy of the statement with the Dakota County Registrar of Deeds. Two days later, Eli purports to enter into a contract to sell some of the Dakota land to a home building firm. The Company is not bound, even if the firm could establish that Eli's act "would have bound the partnership under section 301 before [the] dissociation" of Eli.[172] "A statement of dissociation is a limitation on the authority of a dissociated partner for the purposes of section 303 . . . (e)."[173] Therefore, UPA (1997) §702(a)(3) bars the firm's claim because the firm "is deemed to have knowledge [of the limitation of Eli's authority] under section 303(e)." ◄◄◄

**Example**

> A month after his expulsion, Eli purports to buy a new car for the Ofek-Noam Company. The Company has regularly purchased company cars from this particular dealer, and often Eli has acted for the Company. The dealer has no idea that Eli has been expelled from the partnership. Eli purchases the car on credit, takes a $1,500 "manufacturer's incentive" in cash, and takes delivery of the car. The Company is bound. Before the dissociation Eli's act would have bound the Company under UPA (1997) §301, the dealer had neither knowledge nor notice of Eli's dissociation, the transaction does not involve real property owned in the name of the Company, and fewer than 90 days have passed since the partnership filed the statement of dissociation. ◄◄◄

**Example**

> Same facts as the immediately prior Example, except that the transaction occurs 91 days after the filing of the statement of dissociation. The partnership is not bound. ◂◂◂

A partner's lingering power to bind has nothing to do with actual authority. If the act of a dissociated partner binds the partnership, the "dissociated partner is liable to the partnership for any damage caused to the partnership arising from [the] obligation."[174] Like the lingering power itself, this liability is consistent with agency law principles.[175]

## §11.9.4 Dissociated Partner's Liability for Partnership Obligations

### a. Partnership Obligations Incurred Before Dissociation

In this context, UPA (1997) continues much of the UPA (1914) approach:

> A partner's dissociation does not of itself discharge the partner's liability for a partnership obligation incurred before dissociation. . . . A dissociated partner is released from liability for a partnership obligation if a partnership creditor, with notice of the partner's dissociation but without the partner's consent, agrees to a material alteration in the nature or time of payment of a partnership obligation.[176]

### b. Partnership Obligations Incurred After Dissociation—Lingering Liability

Because third parties may deal with a partnership believing that a dissociated partner is still a partner, UPA (1997) §703(b) creates a "lingering liability" rule whose structure mirrors the structure of the rule creating a lingering power to bind. Under UPA (1997) §703(b), a "partner who dissociates without resulting in a dissolution and winding up of the partnership business is liable as a partner to the other party in a [post-dissociation] transaction" if at the time the other party enters into the transaction:

- the partnership is not an LLP;
- less than two years has passed since the dissociation;
- the other party does not have notice of the dissociation and reasonably believes that the dissociated partner is a still a partner;

- fewer than 90 days have passed since the filing of a statement of dissociation; and
- if the transaction involves the transfer of real property owned in the name of the partnership, "a certified copy of the filed statement . . . [is not] of record in the office for recording transfers of that real property." [177]

**Example**

> Four months after expelling Eli from the Ofek-Noam Company, the Company sells to a home builder a lot from the Company's Dakota County parcel, giving a warranty deed. The builder has previously dealt with the Company and believes Eli to be one of the partners. Eli is liable for the partnership obligations created by the warranty deed. ◂◂◂

**Example**

> Same situation, except that a week after being expelled Eli executes and files with the Secretary of State a statement of dissociation. He is not liable for the partnership obligations created by the warranty deed. A "person not a partner is deemed to have notice of the dissociation 90 days after the statement of dissociation is filed." UPA (1997) §704(c). As a result, Eli is protected under UPA (1997) §703(b)(3); the home builder "is . . . deemed to have had notice under Section 704(c)."[178] ◂◂◂

As part of the mandatory buyout discussed below, a dissociated partner is entitled to be indemnified "against all partnership liabilities, whether incurred before or after the dissociation," except for partnership liabilities that result from the dissociated partner's lingering power to bind.[179]

# §11.9.5 Buyout of the Dissociated Partner

## a. Dissociated Partner's Entitlement

If a partner's dissociation does not result in dissolution, UPA (1997) §701(a) provides as a default rule that the dissociated partner is entitled to be bought out: "the partnership shall cause the dissociated partner's interest in the

partnership to be purchased." Unless otherwise provided in the partnership agreement, "[t]he buyout is mandatory. The 'cause to be purchased' language is intended to accommodate a purchase by the partnership, one or more of the remaining partners, or a third party."[180]

## b. Determining the Buyout Price

UPA (1997) §701(b) and (c) provide the default rule for determining the buyout price:

- assume the partnership was terminated on the date of dissociation;[181]
- calculate the amount the partnership would have received for its assets on that date, both through liquidating those assets piecemeal and through a "sale of the entire business as a going concern";[182]
- using the higher of those two values, calculate the amount that would have been due the dissociated partner (taking into account all liabilities of the partnership);[183]
- subtract from that amount any "[d]amages for wrongful dissociation . . . and all other amounts owing, whether or not presently due, from the dissociated partner to the partnership";[184]
- add to that amount interest "from the date of dissociation to the date of payment."[185]

## c. Timing of and Tendering the Payment

If the partnership is for a term or undertaking and the dissociation was premature and wrongful, the partnership is presumptively entitled to defer payment:

> A partner who wrongfully dissociates before the expiration of a definite term or the completion of a particular undertaking is not entitled to payment of any portion of the buyout price until the expiration of the term or completion of the undertaking, unless the partner establishes to the satisfaction of the court that earlier payment will not cause undue hardship to the business of the partnership. A deferred payment must be adequately secured and bear interest. [186]

In all other situations, unless otherwise agreed, the partnership "shall pay, or cause to be paid, in cash" its estimate of the buyout price "120 days after a written demand for payment."[187]

The payment must be accompanied by specified financial information, "an explanation of how the estimated amount . . . was calculated" and a written notice warning that the estimate becomes final unless "within 120 days . . . the dissociated partner commences an action to determine the buyout price."[188] If the partnership is exercising its right to defer payment, it

must provide the same information (including the warning) together with "a written offer to pay the amount it estimates to be the buyout price . . . stating the time of payment, the amount and type of security for payment, and the other terms and conditions of the obligation."[189]

## d. Power of the Partnership Agreement

UPA (1997) §701 is entirely subject to the partnership agreement:

> The section 701 rules are merely default rules. The partners may, in the partnership agreement, fix the method or formula for determining the buyout price and all of the other terms and conditions of the buyout right. *Indeed, the very right to a buyout itself may be modified*, although a provision providing for a complete forfeiture would probably not be enforceable.[190]

**Case in Point—Laplace v. Estate of Laplace ex rel. Laplace**

A deceased partner's heirs brought suit against the partnership's last surviving partner for a buyout of the deceased partner's interest. The partnership agreement provided for a buyout price of $100,000, but, over 45 years, this provision had been amended five times—frequently in anticipation of the death of a partner—to provide for a different price. Each amendment had a "sunset" provision restoring the agreed-upon buyout price to $100,000 if the partner did not die in the timeframe originally anticipated. However, the partnership agreement had not been amended in reference to the plaintiffs' decedent. Plaintiffs sought to escape the $100,000 price, arguing that: (i) the buyout provision of UPA (1997) was not a default provision; (ii) all buyouts must be of "fair value"; (iii) in this case $100,000 did constitute "fair value"; and (iv) the provision of the partnership agreement had been modified or waived as a result of the partnership's course of conduct. The trial court dismissed the claim on summary judgment, and the appellate court affirmed.[191] ◄◄◄

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# §11.10 DISSOCIATION THAT CAUSES DISSOLUTION

## §11.10.1 Overview

If a partner's dissociation results in dissolution, the approach of UPA (1997) is quite similar to that of UPA (1914).[192] Dissolution does not end the partnership but instead commences a period of winding up.[193] "The partnership is terminated when the winding up of its business is completed."[194] Unless the partnership agreement provides otherwise, any "partner who has not wrongfully dissociated may participate in the winding up of the partnership's business." Each partner's duty "to refrain from competing with the partnership" ends at dissolution,[195] but the other fiduciary duties and the obligation of good faith and fair dealing remain in effect.

In winding up its business, the partnership:

- may preserve the partnership business or property as a going concern for a reasonable time, prosecute and defend actions and proceedings, whether civil, criminal, or administrative, transfer the partnership's property, settle disputes by mediation or arbitration, and perform other necessary acts; and
- must discharge the partnership's liabilities, settle and close the partnership's business, and marshal the assets of the partnership and distribute the net proceeds to the partners "in cash."[196]

The settling of accounts among partners is essentially the same as under UPA (1914), except that: (i) under UPA (1997), debts owed by the partnership to partners are treated the same as debts owed to third parties;[197] and (ii) UPA (1997) expressly refers to each partner having an account reflecting the partner's contributions, share of partnership profits, distributions, and share of losses,[198] and then uses that concept to describe the "Settlement of Accounts and Contributions Among Partners."[199]

In one substantive departure from UPA (1914), UPA (1997) §802(b) permits a partnership to "undo" its dissolution "[a]t any time . . . before the winding up of its business is completed." This "180" requires the waiver by "all of the partners, including any dissociating partner other than a wrongfully dissociating partner" of "the right to have the partnership's business wound up and the partnership terminated."[200] In that event "the partnership resumes carrying on its business as if dissolution had never occurred,"[201] except that "the rights of a third party . . . may not be adversely affected."[202]

## §11.10.2 Partner’s Power to Bind During Winding Up

Like UPA (1914), UPA (1997) specifically deals with the power of partners to bind the partnership during winding up. The approach of UPA (1997), however, is far simpler and allows for the public filing of a statement of dissolution.

UPA (1997) §804 provides that, subject to the effect of a statement of dissolution, a partnership is bound by a partner’s act after dissolution that:

1. is appropriate for winding up the partnership business; or
2. would have bound the partnership under section 301 before dissolution, if the other party to the transaction did not have notice of the dissolution.

In this context, the phrase “a partner’s act” includes an act by the partner whose dissociation resulted in the dissolution.[203]

The filing and function of a statement of dissolution under Article 8 is roughly analogous to the filing and function of a statement of dissociation under Article 7. “After dissolution, a partner who has not wrongfully dissociated may file a statement of dissolution stating the name of the partnership and that the partnership has dissolved and is winding up its business.”[204]

The effect of the filed statement varies depending on whether the transaction at issue involves the transfer of real property owned in the name of the partnership. If so, as soon as “a certified copy of the filed statement ... is of record in the office for recording transfers of that real property,”[205] the statement has the immediate effect of “restrict[ing] the authority of all partners to real property transfers that are appropriate for winding up the business.”[206]

A filed statement of dissolution also has the immediate effect of canceling all previously filed statements of partnership authority granting authority.[207] In addition, 90 days after filing, a statement of dissolution “operates as constructive notice conclusively limiting the apparent authority of partners to transactions that are appropriate for winding up the business.”[208]

**Example**

> The Ofek-Noam Company (“the Company”) is a general partnership subject to UPA (1997) that purchases land and subdivides it for sale

to home builders. The Company has three partners—Suzanne, Eli, and Gili—and for years all three have acted for the partnership in selling land to home builders. The partnership has filed a statement of authority with the Secretary of State, indicating that each partner has the authority to transfer land owned in the name of the partnership. The partnership owns a large parcel of land in Dakota County, and a certified copy of the statement of authority has been recorded with the Dakota County Registrar of Deeds.

The partnership dissolves, and Gili files a statement of dissolution with the Secretary of State and records a certified copy with the Dakota County Registrar of Deeds. Two days later, Eli purports to enter into a contract to grant another developer a five-year option on the Dakota County parcel. The Company is not bound:

- Granting a five-year option is hardly "appropriate for winding up the partnership business," so the partnership is not bound under UPA (1997) §804(1).
- Even if the developer could establish that Eli's act "would have bound the partnership under section 301 before dissolution," the partnership is not bound under UPA (1997) §804(2).[209] "A statement of dissolution cancels a filed statement of partnership authority for the purposes of section 303(d) and is a limitation on authority for the purposes of section 303(e)." Therefore, the developer cannot invoke the previously filed and recorded statement of authority and "is deemed to have knowledge" that each partner's authority to transfer real property is limited to transactions appropriate for winding up the partnership business.[210] ◂◂◂

### Example

Same facts as in the previous Example, plus: (i) winding up The Ofek-Noam Company is a lengthy process; and (ii) six months into that process, Gili orders on behalf of the Company $5,000 worth of gifts, explaining to the vendor, "These are to promote our relationship with our long-time customers." The Company is not bound. The gifts are clearly not "appropriate for winding up the partnership business,"[211] and UPA (1997) §804(2) does not help the would-be seller because the would-be seller had "notice of the dissolution." Under UPA (1997) §805(c), "a person not a partner is deemed to have notice of the dissolution . . . 90 days after [a statement of dissolution] is filed." ◂◂◂

## §11.11 OTHER CAUSES OF DISSOLUTION

Like UPA (1914), UPA (1997) provides a number of events of dissolution that are not connected to the dissociation of a partner. These events include:

- in a partnership for a term or undertaking:
  - "the expiration of the term or the completion of the undertaking";[212]
  - "the express will of all the partners to wind up the business" before the expiration or completion;[213]
- an event that the partnership agreement establishes as causing dissolution;[214]
- "on application by a partner, a judicial determination that: (i) the economic purpose of the partnership is likely to be unreasonably frustrated; (ii) another partner has engaged in conduct relating to the partnership business which makes it not reasonably practicable to carry on the business in partnership with that partner; or (iii) it is not otherwise reasonably practicable to carry on the partnership business in conformity with the partnership agreement";[215]
- "on application by a transferee of a partner's transferable interest, a judicial determination that it is equitable to wind up the partnership business: (i) after the expiration of the term or completion of the undertaking, if the partnership was for a definite term or particular undertaking at the time of the transfer or entry of the charging order that gave rise to the transfer; or (ii) at any time, if the partnership was a partnership at will at the time of the transfer or entry of the charging order that gave rise to the transfer."[216]

The grounds for judicial dissolution on application by a partner mirror the grounds for judicial expulsion under UPA (1997) §601(5) and are derived in part from UPA (1914) and in part from the Revised Uniform Limited Partnership Act. The grounds for judicial dissolution on application by a transferee come from UPA (1914) §32(2), but "[t]he requirement that the court determine that it is equitable to wind up the business is new."[217] Allowing a transferee to seek dissolution is a major exception to the general rule that transferees have no right to meddle in the management of the partnership.

**Example**

> Larry, Moe, and Curley agree to form a partnership with a term of five years. Two years later, Moe's transferable interest becomes subject to a charging order and is eventually transferred to Shemp, a nonpartner, in a foreclosure sale.[218] Moe dissociates from the partnership, but neither Larry nor Curley wants to dissolve the

partnership before the expiration of its original term.[219] They continue with their original business plan, under which they each take small salaries for the work they do, while "plowing back" all profits into the business. When the end of the five-year term approaches, Larry and Curley decide that the business is "on the cusp of a great opportunity." They believe that "with a little staying power, a little delayed gratification, we might make it big, big, big." They agree therefore to extend the partnership's term for another three years. As soon as the original five-year term expires, Shemp may go to court seeking an order dissolving the partnership despite Larry's and Curley's agreement to the contrary. Shemp's chances are greatest if Larry's and Curley's plans to "make it big, big, big" are very risky or if the court considers the extension of the partnership term a bad faith effort to deprive Shemp of the value of his transferable interest. ◂◂◂

The partnership agreement may not vary the power of a court to order dissolution on application by either a partner or transferee.[220]

## §11.12 DISSOCIATION AND DISSOLUTION—THE THREE ACTS COMPARED

### §11.12.1 UPA (1914) AND UPA (1997)

The following chart shows how UPA (1914) and UPA (1997) approach the key issues of partner dissociation and partnership dissolution. Unless marked by an asterisk (*) each provision is a default rule, subject to change by the partnership agreement.

## 11.1 Dissociation/Dissolution — UPA (1914) and (1997) Compared

| Issue | UPA (1914) | UPA (1997) |
|---|---|---|
| "Dissociation" used as a statutory term of art | No | Yes* |
| Events of dissociation | Labeled "Causes of Dissolution" and listed in §31* | Labeled "Events Causing Partner's Dissociation" and listed in §601 |
| Rightful and wrongful dissociation distinguished | Yes, characterized as causing "wrongful dissolution"; e.g., §§37, 38(2) | Yes, "wrongful dissociation" defined in §602(b) |

**11.1 Continued**

| Issue | UPA (1914) | UPA (1997) |
| --- | --- | --- |
| Partner has power to dissociate even when wrongful effect; of partner dissociation on partnership entity/ aggregate | Yes, §31(2)* Partnership inevitably dissolves, §29* | Yes, §602(a)* Dissolution not inevitable, §603(a); if no dissolution, post-dissociation partnership is the same entity which existed before dissolution* |
| Other causes of partnership dissolution | Yes, primarily: termination of term or undertaking, §31(1)(a), unanimous consent of partners, §31(1)(c), judicial intervention (including on behalf of assignees), §32* | Essentially the same: termination of term or undertaking, §801(2)(iii), unanimous consent of partners, §801(2)(ii), judicial intervention (including on behalf of transferees, although, UPA (1997), unlike UPA (1914), requires transferees to show that "it is equitable to wind up the partnership business"), §§801(5) and (6)* |
| Effect of partner dissociation on partnership business | Must be wound up, unless: (i) in rightful dissolution all partners agree to continue the business in a successor organization, §38(1); (ii) in wrongful dissolution, all partners except the wrongful dissolver agree to continue the business in a successor partnership, §38(2)(b) | None, if partnership not dissolved; must be wound up if partnership dissolved, unless by agreement some partners continue the business in a successor entity |
| Effect of partner dissociation on partner fiduciary duties | Duties continue through winding up | If dissociation does *not* → dissolution, fiduciary duties of dissociated partner end, §603(b)(2) and (3);<br>Whenever dissolution occurs, noncompete duties of all partners end, §404(b)(3);<br>If dissociation does not → dissolution, dissociated partner has no further |

## 11.1 Continued

| Issue | UPA (1914) | UPA (1997) |
|---|---|---|
| | | participation in partnership affairs, §603(b)(1) |
| Dissociated partner's role in management | May participate in winding up, unless dissociation caused wrongful dissolution, §37 | If dissociation → dissolution, dissociated partner may participate in winding up, unless dissociation was wrongful, §803(a) |
| Post-dissociation power to bind of dissociated partner | Lingering power to bind, subject to the complex rules of §35, and especially §35(3)(c)* | If dissociation does *not* → dissolution, lingering power to bind is subject to the rules of §702 and the effect of a filed statement of dissociation, §704*; if dissolution occurs later from some other cause, a filed statement of dissolution will also affect lingering power to bind, §804* |
| | | If dissociation → dissolution, lingering power to bind is subject to the rules of §804 and the effect of a filed statement of dissolution, §805* |
| Effect of partner dissociation on dissociated partner's personal liability for predissociation obligations of the partnership; | Dissolution does not discharge the liability, but discharge is possible by agreement under §36(2), or, under §36(3), if the creditor agrees to a material change in the obligation* | Dissociation does not discharge the liability, but discharge is possible under the material change rule, §703(d)* |
| Dissociated partner's liability for post-dissociation obligations of the partnership or the partnership business | Liable, just like other partners, for partnership obligations incurred during winding up; not liable for partnership obligations incurred by successor organization that continues the partnership business unless partnership by estoppel applies, §§16 and 35(4)* | If dissociation does *not* → dissolution, lingering liability under §703; filing of a statement of dissociation, §704 can significantly curtail the exposure* |

**11.1 Continued**

| Issue | UPA (1914) | UPA (1997) |
|---|---|---|
| Ability to "lock in" the interest of a partner who has prematurely and wrongfully dissociated from a partnership for a term or undertaking | Requires unanimous consent of the remaining partners to continue the business, §38(2)(b) | Yes, unless within 90 days after the wrongful dissociation a majority of the remaining partners decide to dissolve the partnership, §801(2)(i), or, if the partnership continues, the wrongfully dissociated partner can prove that prompt pay out "will not cause undue hardship to the partnership,"§701(h) |
| Impact of wrongful dissociation on valuation of dissociated partner's interest | Partnership valued excluding good will, §38(2)(c)(II); dissociated partner's share decreased by damages caused by wrongful dissolution, §38(2)(a)(II) | Partnership valuation includes good will, §701(b); dissociated partner's share decreased by damages caused by wrongful dissociation, §701(c) |
| Settling of accounts after dissolution | According to the Rules for Distribution, §40 | Essentially the same as per UPA, according to Settlement of Accounts and Contributions Among Partners, §807 |
| Presence of a "switching provision" among the rules governing dissociation and dissolution | No, because dissociation inevitably causes dissolution | Yes, under §603(a): Article 7 governs if dissociation does *not* → dissolution; Article 8 governs if dissociation → dissolution* |
| Role of publicly filed statements | None | If dissociation does not → dissolution, statement of dissociation curtails dissociated partner's lingering power to bind and lingering liability, §§702-704* |
| | | If dissociation → dissolution, statement of dissolution curtails power to bind of all partners, §§804, 805* |

# §11.12.2 UPA (1997) AND UPA (2013)

## a. Cause and Extent of Stylistic Changes

Stylistic changes account for the overwhelming majority of differences between UPA (1997) and UPA (2013). UPA (1997)'s language reflected state-of-the-art drafting in 1997, but the Harmonization Project had the advantage of: (i) drafting developments reflected in the five uniform and two model entity-related statutes which the ULC promulgated between 1997 and 2009 (when the Project began);[221] and (ii) substantial drafting insights gained through the Project itself.

As result, the stylistic differences between UPA (1997) and UPA (2013) are generally quite substantial. For example, UPA (1997) §802(b) authorized partners to rescind the dissolution of their partnership in specified circumstances:

> (b) At any time after the dissolution of a partnership and before the winding up of its business is completed, all of the partners, including any dissociating partner other than a wrongfully dissociating partner, may waive the right to have the partnership's business wound up and the partnership terminated. In that event:
>
> (1) the partnership resumes carrying on its business as if dissolution had never occurred, and any liability incurred by the partnership or a partner after the dissolution and before the waiver is determined as if dissolution had never occurred; and
>
> (2) the rights of a third party accruing under section 804(1) or arising out of conduct in reliance on the dissolution before the third party knew or received a notification of the waiver may not be adversely affected.[222]

UPA (2013) accorded this concepts its own section. Section 803 (Rescinding Dissolution) provides:

> (a) A partnership may rescind its dissolution, unless a statement of termination applicable to the partnership has become effective or [the appropriate court] has entered an order under Section 801(4) or (5) dissolving the partnership.
>
> (b) Rescinding dissolution under this section requires:
>
> (1) the affirmative vote or consent of each partner; and
>
> (2) if the partnership has delivered to the [Secretary of State] for filing a statement of dissolution and:
>
> (A) the statement has not become effective, delivery to the [Secretary of State] for filing of a statement of withdrawal under Section 115 applicable to the statement of dissolution; or
>
> (B) the statement of dissolution has become effective, delivery to the [Secretary of State] for filing of a statement of rescission stating the name of the partnership and that dissolution has been rescinded under this section.
>
> (c) If a partnership rescinds its dissolution:
>
> (1) the partnership resumes carrying on its business as if dissolution had never occurred;
>
> (2) subject to paragraph (3), any liability incurred by the partnership after the dissolution and before the rescission has become effective is determined as if dissolution had never occurred; and

(3) the rights of a third party arising out of conduct in reliance on the dissolution before the third party knew or had notice of the rescission may not be adversely affected.[223]

## b. The Few Substantive Changes

UPA (2013) made three substantive changes to UPA (1997):

- Entity transactions—UPA (1997), Article 9 broke new ground in the law of general partnerships by providing for mergers and conversions involving general and limited partnerships.[224] UPA (2013), Article 11 authorizes mergers,[225] interest exchanges,[226] conversions,[227] and domestications[228] involving at least one general partnership.
- Providing Special Means by Which a Dissolved Limited Liability Partnership May Handle Creditor Claims
  - UPA (2013) §§807 and 808:
    - authorize a dissolved LLP to notify creditors and potential creditors of specified deadlines for asserting claims; and
    - cut off any claims not asserted by the applicable deadline.
  - UPA (2013) §809 permits a dissolved LLP to:
    - ask a court "for a determination of the amount and form of security to be provided for payment of claims that are reasonably expected to arise after the date of dissolution"[229] with regard to claims that "are contingent, have not been made known to the partnership, or are based on an event occurring after the date of dissolution;"[230] and
    - obtain a court order limiting any such claims to the courtdetermined amount.
- Consequences When a Dissociation Leaves a Partnership with Only One Partner—UPA (1997) was indefinite on this point. UPA (2013) §801(6) provides that a partnership dissolves upon "the passage of 90 consecutive days during which the partnership does not have at least two partners."

### *Problem 92*

John, Jacob, and Susan form an investment partnership with a term of five years. For the first two years everything goes fine. Then Jacob says to his partners, "I want out. I want my money out—now." Is Jacob's departure wrongful? Is the partnership dissolved? ◄◄◄

### Explanation—UPA (I9I4)

Even though the partners (Jacob included) promised each other to maintain the partnership for five years, Jacob's "express will" causes a dissolution. Because that dissolution breaches Jacob's promise—that is, because the dissolution is in contravention of the partnership agreement—the dissolution is wrongful. UPA (1914) §31(2). ◄◄◄

**Explanation—UPA (I997)**

Jacob's departure is a wrongful dissociation. "A partner's dissociation is wrongful ... if... in the case of a partnership for a definite term or particular undertaking, before the expiration of the term or the completion of the undertaking . . . the partner withdraws by express will." UPA (1997) §602(b)(2)(i). The partnership is not dissolved, unless within 90 days of Jacob's dissociation either John or Susan manifests the "express will" to dissolve. UPA (1997) §801(2)(i) (wrongful dissociation does not result in premature dissolution of a term partnership absent "the express will [manifested within 90 days of the dissociation] of at least half of the remaining partners to wind up the partnership business"). ◂◂◂

***Problem 93***

John, Jacob, and Susan form a five-year investment partnership. Two years later John dies. Is the partnership dissolved? If so, was the dissolution wrongful or rightful? ◂◂◂

**Explanation—UPA (1914)**

The death of a partner automatically dissolves the partnership. UPA (1914) §31(4). John's death and the resulting dissolution disappoints the expectations of Jacob and Susan but does not breach the partnership agreement or violate some other legally enforceable duty owed by John to his partners. Therefore, the dissolution is rightful. ◂◂◂

**Explanation—UPA (1997)**

John's death is a dissociation (UPA (1997) §601(7)(i)), but it is not wrongful. UPA (1997) §602(b). The partnership is not dissolved, unless within 90 days of Jacob's dissociation either John or Susan manifests the "express will" to dissolve. UPA (1997) §801(2)(i). ◂◂◂

***Problem 94***

John, Jacob, and Susan form an investment partnership with a five-year term. One of the partnership's assets is a classic car, which is in basically good shape but will require considerable mechanical work if it is to be profitably sold. Two years into the partnership John quits the partnership. He then hires a mechanic to prepare the classic car for sale. The mechanic is unaware of the partnership and is likewise unaware that John has quit the partnership. Is the partnership bound by John's act? ◂◂◂

**Explanation—UPA (1914)**

Most likely yes. When John quit the partnership, the partnership dissolved. UPA (1914) §31(2). If the partnership is to be wound up through liquidation, John's act is probably "an act appropriate for winding up partnership affairs." Under UPA (1914) §35(1)(a) such acts bind the dissolved partnership. Because the mechanic is unaware of the dissolution, the constraining rules of UPA (1914) §35(3)(c) cannot apply.

The answer under UPA §35(1)(a) might be different if Jacob and Susan plan to continue the partnership business under UPA (1914) §38(2)(b) and intend to wind up the affairs of the dissolved partnership by transferring them (and the dissolved partnership's assets) to a successor partnership. In that case, John's act would not be appropriate for winding-up purposes. ◂◂◂

**Explanation—UPA (1997)**

The partnership is not bound if the partnership is not dissolved. John's dissociation is wrongful (UPA (1997) §602(b)(2)(i)), but the partnership is not dissolved absent "the express will [manifested within 90 days of the dissociation] of at least half of the remaining partners to wind up the partnership business." UPA (1997) §801(2)(i). If the partnership does not dissolve, UPA (1997) §702 will determine John's power to bind the partnership. UPA (1997) §702(1) negates any such power, because "at the time of entering into the transaction the other party"—i.e., the mechanic—did not "reasonably believe[] that the dissociated partner was then a partner."

If John’s dissociation does result in dissolution, UPA (1997) §804 will determine his power to bind the dissolved partnership. In that event, the partnership might be bound, because preparing the car for sale might well be “appropriate for winding up the partnership business.” UPA (1997) §804(1).[231] ◂◂◂

***Problem 95***

Able and Baker have a partnership at will that buys finished cloth from mills and resells it to garment manufacturers. For the past two years the partnership has regularly bought cloth from Inventive Design Outlet, Inc. (“IDO”), using purchase orders signed by either partner. The terms of the sale have been “net 30 date of shipment,” that is, payment is due 30 days after the goods are shipped.

On January 15, Baker says to Able, “This partnership is over.” On that day the partnership has a few outstanding obligations to provide cloth to various manufacturers, and the partnership has sufficient cloth in stock to cover those obligations.

On January 17, Able signs and sends a purchase order to IDO for $50,000 worth of wool cloth. IDO promptly wires back its acceptance. Two days later the president of IDO telephones the partnership’s offices to express appreciation for the order. Able is not in, so the president speaks to Baker. Upon hearing of the order Baker exclaims, “That order is no good. Able had no right to issue it. We dissolved this partnership two days before.” The president of IDO quite accurately explains that IDO “knew nothing of any dissolution” and asserts, “That order is good. You’re stuck with it.”

Did Able’s purchase order bind the partnership to IDO? ◂◂◂

**Explanation—UPA (1914)**

The partnership is bound under UPA (1914) §35(1)(b)(I).

Since the partnership was at will, Baker’s January 15 statement caused a dissolution. Dissolution being caused by an act of the partner, Able lost her authority to bind the partnership for new business as soon as she knew of the dissolution—i.e., immediately. UPA (1914) §§33(1)(b) and 34(a). The facts indicate that Able’s order represented new business; at the time of the order, the partnership had

already covered its outstanding obligations to customers. Therefore, Able was acting without authority.

Under UPA (1914) §35, however, a partner can have the power to bind a dissolved partnership even if he or she lacks the authority to do so. Since Able's order constituted new business, UPA (1914) §35(1)(b) applies.[232]

Under UPA (1914) §35(1)(b)(I) a partner's post-dissolution commitment binds the partnership if: (i) the commitment would have bound the partnership prior to dissolution;(ii) the third party had previously extended credit to the partnership; and (iii) the third party had no knowledge of the dissolution.

The given facts meet all three criteria. Able's issuing of the order was an act "for apparently carrying on in the usual way the business of the partnership," (UPA (1914) §9(1)), so the transaction would indeed have bound the partnership prior to dissolution.[233] IDO had previously extended credit to the partnership (the "net 30" term), and, as IDO's president indicated, IDO received and accepted the order unaware of the dissolution.

None of the "de-powering" exceptions of UPA (1914) §35(3) apply. The only exception remotely connected to the facts is found in UPA (1914) §35(3)(c) (partner lacks authority and creditor had notice or knowledge of the lack of authority). Able did lack authority, but IDO was totally unaware of that fact. Able's lack of authority stemmed from the dissolution, and when IDO accepted the order, it had neither knowledge nor notice of the dissolution. ◂◂◂

**Explanation—UPA (1997)**

The partnership is bound. The January 15 statement dissolved the partnership (UPA (1997) §801(1)), and therefore UPA (1997) §804 controls each partner's power to bind during winding up. Although the January 17 order was not "appropriate for winding up the partnership business," (UPA (1997) §804(1)) before the dissolution the order would have been within Baker's apparently/ordinary power. IDO "did not have notice of the dissolution," so the partnership is bound under UPA (1997) §804(2). ◂◂◂

*Problem 96*

John, Jacob, Sara, and Susan form an investment partnership with a term of five years. John prematurely and wrongfully quits the partnership, and Susan does not want to continue the business without John's participation. Jacob and Sara do want to continue, and Susan is willing to wait for her money (assuming Jacob and Sara guarantee it and she is compensated for her wait). However, John demands liquidation. The partnership agreement does not address the situation. Can John compel liquidation? ◂◂◂

**Explanation—UPA (1914)**

Yes. John's departure caused a wrongful dissolution (UPA (1914) §31(2)), but Susan's desire not to participate in a successor venture costs Jacob and Sara their right to continue the partnership business under UPA (1914) §38(2)(b). That provision allows business continuation only if all the remaining partners agree. Since UPA (1914) §38(2)(b) does not apply, under UPA §§38(2)(c)(I) and 38(1) each of the partners (including John) has the right to insist on liquidation. ◂◂◂

**Explanation—UPA (1997)**

No. John's departure is a wrongful dissociation (UPA (1997) §602(b)(2)(i)), but the partnership is not dissolved. (UPA (1997) §801(2)(i) requiring the "express will of at least half of the remaining partners"). Suzanne has the right to dissociate herself (UPA (1997) §602(b)(2)(i) wrongful dissociation of one partner in a term partnership gives other partners the right to withdraw within 90 days), but even that withdrawal will not cause dissolution.

John does have a buy-out right under UPA (1997) §701. However, under UPA (1997) §701(h) payment is not due "until the expiration of the term . . . , unless the partner establishes to the satisfaction of the court that earlier payment will not cause undue hardship to the business of the partnership."

In contrast, if Susan timely dissociates, her dissociation is not wrongful, and she is entitled to be paid "within 120 days of a written

demand for payment.” UPA (1997) §701(e). ◂◂◂

***Problem 97 (UPA (1914) Only)***

Three law students, Charlotte, Paul, and Sophie, form a partnership to operate a used bookstore at their law school. Nearing graduation, Sophie dissolves the at-will partnership. Charlotte and Paul decide, with Sophie’s consent, to con-tinue the business. They bring Jacob into the business and with him form a successor partnership. The dissolved partnership assigns its lease with the law school to the successor partnership. The law school consents to the assign-ment but does not agree to release the dissolved partnership.

Always attentive to legal niceties, Charlotte decides that the students who consigned their used books to the old partnership should be informed that the successor partnership is taking over. On credit, she buys a $40 ad in the law school newspaper. The ad proclaims, “A Changing of the Guard,” and explains the change.

Charlotte, Paul, and Jacob decide that the bookstore should expand its “product line.” They write to a supplier of the dissolved partnership, inform that supplier of their new arrangement, and buy on credit $500 worth of study aids for resale to the students.

1. The bookstore falls on hard times and fails to pay its rent to the law school. Whom can the law school hold liable?
2. No one pays for the study aids. Whom can the vendor hold liable?
3. No one pays for the ad in the law school paper, either. Whom can the paper hold liable? ◂◂◂

**Explanation**

These facially simple questions have some rather complicated answers. To keep the answers coherent, it is helpful to separate the obligors into the three groups described in section 11.4.3:

- *The Dissociated Partner*—Sophie.
- *The Continuing Partners*—Charlotte and Paul
- *The New Partner*—Jacob. ◂◂◂

## ***1. The Lease***

All four individuals are liable.

***A. Liability of Sophie (Dissociated Partner)*** The lease obligation is clearly a debt of the dissolved partnership. Absent a novation, even a withdrawing partner like Sophie remains liable for such debts. UPA (1914) §36(1) and §36(2).[234]

***B. Liability of Charlotte and Paul (Continuing Partners)*** On three different grounds, Charlotte and Paul are liable on this debt. First, like

Sophie, they are liable as members of the dissolved partnership. Second, under UPA (1914) §41(1), the debts of the dissolved partnership are also the debts of the successor partnership, and, per UPA (1914) §5, Charlotte and Paul are liable as members of the successor partnership. (UPA (1914) §41 does not limit their liability, because they are not new to the business.) Third, the successor partnership's assumption by contract of the dissolved partnership's obligations makes Charlotte and Paul, as members of the successor partnership, liable for this debt.

***C. Liability of Jacob (New Partner)*** Jacob is also liable on the lease to the school, but only on two grounds, not three. Unlike Charlotte and Paul, Jacob is not liable as a member of the dissolved partnership, but he *is* liable due to the operation of UPA (1914) §§41(1) and 15. However, unlike Charlotte and Paul, Jacob benefits from section 41(7)'s limitation on liability. Jacob is a partner new to the business. Finally, like Charlotte and Paul, Jacob is liable under contract law theory.

## *2. The Study Aids—Liability of Sophie (Dissociated Partner)*

This debt is exclusively a debt of the successor partnership, so Sophie, who is not a member of that partnership, is not liable. UPA (1914) §35(1)(a) does not bind the dissolved partnership, because the new purchase is not "appropriate for winding up." UPA (1914) §35(1)(b) is inapposite, because the supplier had notice of the dissolution.

***A. Liability of Charlotte and Paul (Continuing Partners)*** All three partners of the successor partnership agreed to expand the product line, so the study aids purchase binds the partnership. Under UPA (1914) §15 Charlotte and

Paul are liable for the resulting debt as members of the successor partnership.

***B. Liability of Jacob (New Partner)*** Jacob is personally liable for this debt as a member of the successor partnership.

## *3. The Newspaper Ad. Liability of Sophie (Dissociated Partner)*

The question of Sophie's liability turns on whether this debt is part of the winding up of the dissolved partnership, or part of the business of the successor partnership. If the former, Sophie is liable. If the latter, she is not. (UPA (1914) §35(1)(b) will not apply because the ad itself provided the vendor notice of the dissolution.)

With the facts stated, it is impossible to characterize the debt. The person who placed the ad had authority to act for and power to bind both the dissolved partnership (UPA (1914) §§37 and 35(1)(a)), and the successor partnership (UPA §§18(e) and 9(1)). The ad's purpose was ambiguous. Was it intended to announce the demise of the dissolved partnership (hence, winding up) or to advertise the advent of the new one (hence, an act of the successor partnership)? Or both?

***A. Liability of Charlotte and Paul (Continuing Partners)*** Charlotte and Paul are liable no matter how this debt is characterized. If it is a winding-up debt of the dissolved partnership, then the analysis is the same as for the lease. If instead the debt is directly a debt of the successor partnership, then Charlotte and Paul are liable because they are members of that successor partnership.

***B. Liability of Jacob (New Partner)*** Jacob is liable no matter how this debt is characterized. If it is a winding-up debt of the dissolved partnership, then the analysis is the same as for the lease. If instead the debt is directly a debt of the successor partnership, then Jacob is liable because he is a member of that successor partnership.

***Problem 98***

> Jacob, Paul, and Leah form a partnership at will. They do not discuss how the business will be handled after dissolution. Later, Leah dissolves the partnership. She demands that the assets be liquidated so that she can have her share. Jacob and Paul object that liquidating the

assets will cause everybody to lose value. Can Leah successfully insist on liquidation? What argument can Jacob and Paul make against liquidation? What additional facts could strengthen Jacob and Paul's position? ◂◂◂

## Explanation—UPA (1914)

Leah can most likely compel liquidation. Since the partnership was at will, under UPA (1914) §31(1)(b) Leah's express will caused a rightful dissolution. Under UPA (1914) §38(1), absent an agreement to the contrary, following a rightful dissolution each partner has the right to compel liquidation.

Jacob and Paul might argue for an in-kind division of assets, but to succeed they will have to show something beyond the general proposition that liquidations usually do not bring best value.

With some additional facts, Jacob and Paul might also argue that the partnership had an implied term (not yet expired) or that Leah's dissolution somehow breached her duty of loyalty (e.g., by allowing her to appropriate an opportunity that otherwise the partnership would have enjoyed). Either showing would saddle Leah with the status of "wrongful dissolver." In that case, under UPA (1914) §38(2) Jacob and Paul could avoid liquidation by opting to continue the business. ◂◂◂

## Explanation—UPA (1997)

Leah may successfully insist on liquidation. Under UPA (1997) §807(a), the net proceeds of winding up are to be paid to the partners "in cash."

Jacob and Paul might be able to delay the inevitable by arguing for a slow winding up in order to maximize the net proceeds. They will not, however, succeed with any claim of breach of the duty of loyalty. There is no indication that Leah is acting for any reason other than her own legitimate self-interest. According to UPA (1997) §404(e): "A partner does not violate a duty or obligation under this [Act] or under the partnership agreement merely because the partner's conduct furthers the partner's own interest." ◂◂◂

*Problem 99*

Last year Theodora became a partner in the law firm of Grand, Summit, and St. Clair. The firm has 150 attorneys, including 85 partners. When Theodora became a partner, she signed the partnership agreement. That agreement states in part:

> Any member may be expelled from the firm by a two-thirds majority vote of the executive committee, and the committee need not have, state, or demonstrate good cause, nor need the committee afford the member being expelled any opportunity to be heard.

On May 1 of this year, Theodora gave a speech, widely reported in the local media, on the abortion issue. The next day the president of one of the law firm's most important clients called the firm and complained vociferously to a senior partner about Theodora's speech. The president said, "Where did you guys get that crazy lady? We're not going to be able to entrust our business to a firm that gets publicly branded on this issue and can't keep its people in the office doing what they're supposed to be doing."

Although Theodora is an excellent lawyer, this is not the first complaint the firm has received about her outspoken public remarks. On May 3, the firm's nine-member executive committee meets and votes 7-2 to expel Theodora. Can Theodora establish that the expulsion was wrongful? Is the partnership dissolved? ◂◂◂

**Explanation—UPA (1914)**

The expulsion dissolves the partnership. Albeit against her will, Theodora is certainly "ceasing to be associated [with the other partners] in the carrying on ... of the business." UPA (1914) §29.

The expulsion is probably not wrongful. The partnership's executive committee acted under the authority of the partnership agreement. This seems to be an expulsion "bona fide in accordance with such a power conferred by the agreement between the partners." UPA (1914) §31(1)(d).

The firm's failure to state its reasons for expulsion or to accord Theodora a hearing are not likely to change the result. By signing the partnership agreement, Theodora (like the rest of the partners) agreed to accept nocause, "no process" expulsion.

Nor will Theodora succeed if she claims that the expulsion is wrongful because it violated the constitutional guarantee of due process. The firm is a private organization, and unlike the government, has no constitutional obligation to accord due process. For the same reason, it is likely irrelevant that the expulsion has penalized Theodora for speaking out. The First Amendment does not apply to private organizations. It is therefore not wrongful to expel a partner on account of the notoriety or even the content of his or her speech.

All is not necessarily lost for Theodora, however. Perhaps the expulsion was wrongful because it was unlawful. Was the executive committee motivated in part by the characterization of Theodora as a "crazy lady"? Would the firm have been so quick to expel a male partner? If Theodora can show that the expulsion reflected sex discrimination and that, despite her formal status as a partner, her real role was that of an employee, then she will have demonstrated not only sex discrimination but also wrongful dissolution. ◂◂◂

**Explanation—UPA (1997)**

The expulsion does not dissolve the partnership, even if the partnership is an at-will partnership. The expulsion itself does not cause dissolution (UPA (1997) §801), and an expelled partner cannot dissolve an at-will partnership. UPA (1997) §801(1) (in "a partnership at will, [dissolution is caused by] the partnership's having notice from a partner, *other than a partner who is dissociated under Section 601(2) through (10)*, of that partner's express will to withdraw as a partner" (emphasis added); "expulsion pursuant to the partnership agreement" is listed in §601(3)).

As to wrongful expulsion, the analysis is the same as under UPA (1914), buttressed by UPA (1997) §404(e) ("A partner does not violate a duty or obligation under this [Act] or under the partnership agreement merely because the partner's conduct furthers the partner's own interest.") ◂◂◂

***Problem 100***

In 2005, four friends, Albert, Bernice, Carl, and Donald, form a

partnership to do carpentry work in single-family residential construction. They make no written agreement, but after an evening-long discussion, Bernice finally says, “So that’s what we’re going to do. Let’s do carpentry work on houses; we’ll all be in it together. Share and share alike.” The other three agree, and they all shake hands on the deal.

For the five years following that agreement, their partnership operates very successfully. The partners make good livings and also put a substantial amount of the partnership’s revenues toward purchasing two company trucks and state-of-the-art carpentry equipment. The partnership’s success impresses local banks, and the partnership obtains a line of credit with two of them. Each line of credit allows the partnership to borrow as it wishes up to a predetermined limit.

For its first five years the partnership decides by consensus which projects to bid on. In 2010 the partners have for the first time a serious disagreement about whether to bid on a particular project. The disagreement concerns a residential development called “the Eagan project.” Albert objects to bidding on the Eagan project because he believes that both the profit margins and the developer’s quality standards are too low. The other three partners disagree, perhaps in large part because recently the partnership has had difficulty finding work. The partners vote 3–1 to bid on the project, and the bid is successful. Albert grumbles, “I don’t like this. This is not the way we’ve always made our decisions, and this project is not our kind of business.” However, he does show up at the worksite, and for three weeks he works side by side with Bernice, Carl, and Donald.

Then, three weeks into what the partners expect to be a three-month project, Albert announces, “I’ve had it. I don’t like this work; never did. I’m outta here. I’m going to Alaska. I’ve got a chance to get in on the ground floor of a new fishing business.”

That evening Albert, Bernice, Carl, and Donald meet, and Bernice, Carl, and Donald declare that they intend to finish the Eagan project and “maybe keep going after that.” Albert reiterates that he is leaving the project and the partnership. He adds that he wants the partnership to turn over his share of the money tied up in the partnership trucks

and other equipment.

What is the status of the partnership? ◂◂◂

**Explanation—UPA (1914)**

It is dissolved. Albert's "express will" is clearly to dissociate himself from carrying on the partnership business. Under either UPA (1914) §§31(1)(b) (rightful dissolution of an at-will partnership) or 31(2) (wrongful dissolution), that express will causes dissolution. ◂◂◂

**Explanation—UPA (1997)**

The partnership is likely dissolved. Albert's "express will" has dissociated him as a partner (UPA (1997) §601(1)), the partnership is probably a partnership at-will,[235] and, as such, is dissolved by "having notice from a partner ... of that partner's express will to withdraw as a partner." UPA (1997) §801(1). ◂◂◂

***Problem 101***

Is Albert's decision to dissociate wrongful? ◂◂◂

**Explanation—UPA (1914)**

Most likely not. The original, oral partnership agreement (i) did nothing to displace the act's default dichotomy of at-will/term or understanding, and (ii) specified "no definite term or particular undertaking" Therefore, under UPA (1914) §31(1)(b) Albert's express will caused a rightful dissolution.

The fact that Albert may be leaving for greener pastures does not make the dissolution wrongful. According to some cases, a partner's duty of loyalty may constrain the right to dissolve at will. But these cases all involve the dissolving partner's exploitation of assets or opportunities that belong to or are closely associated with the partnership. Those cases would not apply here. There is no apparent connection between the partnership's carpentry business and Albert's fishing prospects.

It might be possible to argue that Albert dissolved wrongfully because he contravened an implied agreement not to dissolve with a partnership project underway. Under this analysis, each decision by the partners to undertake a project would transform their partnership at-will into a partnership for that "particular undertaking."[236] Albert's dissolution would therefore be premature and wrongful. UPA (1914) §31(2). If so, Albert would lose the right to wind up the partnership, UPA (1914) §37. Beyond that, however, nothing would change. Dissolution does not end even an at-will partnership; the partnership continues until it has wound up its affairs, including ongoing projects.

Although perhaps superficially attractive, the implied agreement argument would probably fail. It is common for at-will partnerships to take on projects. The pendency of a project means a task for winding up, not that the partners have lost their respective rights to dissolve. ◂◂◂

### Explanation—UPA (I997)

The analysis here mirrors UPA (1914) analysis. If the partnership was at will, Albert's dissociation was not wrongful. UPA (1997) §602(b).

As to the argument that the partnership became a partnership for a particular undertaking each time the partnership agreed to take on a new project, that argument would render Albert's dissociation wrongful (UPA (1997) §602(b)(2)(i)), and would deprive him of the right to participate in winding up. UPA (1997) §803(a). ◂◂◂

### *Problem 102*

Assume that the partners had originally agreed to a partnership term of seven years. Given this change in facts, is there any way for Albert to avoid the label of"wrongful dissolver" (UPA (1914)) or "wrongfully dissociated partner" (UPA (1997))? ◂◂◂

### Explanation—UPA (1914)

Probably not. Albert might be able to claim that the decision to bid on the Eagan project violated implied agreements (created through the partners' course of dealing with each other) on the type of work to be

done by the partners (e.g., no low-budget, low-quality jobs) and on the decisionmaking process to be used by the partners (e.g., projects selected by consensus only). That argument would allow Albert to claim that the decision to bid on the Eagan project constituted a wrongful dissolution.

That argument would probably fail, however, because Albert eventually consented to the Eagan project. By showing up to work on the project, Albert at least acquiesced in the decision. That acquiescence probably satisfies the requirement of UPA (1914) §18(h) that an "act in contravention of any agreement between the partners may be done rightfully [with] the consent of all the partners." Moreover, the mere violation of the partnership agreement does not dissolve the partnership. Albert's partners did not exclude him from the partnership business; he excluded himself. ◂◂◂

## Explanation—UPA (I997)

The analysis here is similar to the analysis under UPA (1914). Under UPA (1997) §401(j), Albert can argue not only that the Eagan project violated an implied agreement, but also that the project was "outside the ordinary course of business of [the] partnership."[237] ◂◂◂

## *Problem 103*

Assuming that the partnership had no specific term, can Albert force the partnership to immediately give him his share of the money tied up in the trucks and equipment? ◂◂◂

## Explanation—UPA (1914) and UPA (1997)

Not at least until the Eagan project is finished. Under either statute, Albert's strongest position is to claim that the partnership is dissolved. Even assuming dissolution, the trucks and equipment are partnership property. Regardless of whether the dissolution is rightful, Albert cannot compel liquidation until, as part of winding up, the partnership has performed or otherwise discharged its obligations on the Eagan

project. ◂◂◂

***Problem 104***

Two days after his announcement, Albert leaves for Alaska. Before leaving he writes to all the companies that had previously sold materials to the partnership. In his letters he states, “The original partnership is dissolved. I am no longer associated with the business. I am not responsible for any of its debts.” Bernice, Carl, and Donald continue to work on the Eagan project. As they continue the work, they make purchases necessary to finish the project. For example, they buy wood costing $10,000 from the Wabasco Wood Company, which happens to be a new supplier. Assuming that the partnership is not an LLP, is Albert personally liable for this debt? ◂◂◂

**Explanation—UPA (1914)**

Yes. This purchase is clearly an “act appropriate for . . . completing transactions unfinished at dissolution.” As such, the purchase binds the dissolved partnership under UPA (1914) §35(1)(a). UPA (1914) §15 makes Albert personally liable for the partnership debt. ◂◂◂

**Explanation—UPA (1997)**

Yes. The purchase “is appropriate for winding up the partnership business.” UPA (1997) §804(1). Albert is personally liable under UPA (1997) §306(a), although his liability is subject to the exhaustion rule of UPA (1997) §307(d). ◂◂◂

***Problem 105***

Bernice, Carl, and Donald also buy nails after Albert’s departure. They buy from Nantucket Nail Emporium, which previously sold the partnership nails on a “net 30 date of shipment” basis (i.e., payment due within 30 days of shipment). Bernice, Carl, and Donald order and receive nails costing $600 before the Emporium receives Albert’s letter, and they order and receive nails costing $1,100 after the letter

arrives. Is Albert personally liable for these amounts? ◂◂◂

**Explanation—UPA (1914)**

Yes, under UPA §35(1)(a). The analysis is the same as for Problem 109. Albert's letter is irrelevant to the analysis under UPA (1914) §35(1)(a). Nothing in that provision concerns the third party's knowledge of the dissolution.

Albert's letter would have made a difference if the $1,100 worth of nails ordered after the letter arrived were used for new business. In that case, under UPA (1914) §35(1)(b)(I) the nail order would not have bound the dissolved partnership. ◂◂◂

**Explanation—UPA (1997)**

The analysis here is the same as under UPA (1914). Under UPA (1997) §804(1), notice of dissolution is irrelevant to the power of a partner to bind a dissolved partnership through "an act . . . appropriate for winding up the partnership business." ◂◂◂

***Problem 106***

Bernice, Carl, and Donald fare poorly on the Eagan project. Within a month after Albert leaves, the business falls behind in its payments to both banks. One bank, the First Bank, promptly sends written notice to the partnership, complaining about the delay in payments. Prior to Albert's departure, the partnership had borrowed the full $50,000 available under the First Bank line of credit. After receiving the notice, Bernice, Carl, and Donald meet with an officer of the First Bank to explain what has been happening. To help the continuing partners "get back on their feet," the bank agrees to a four-month moratorium on payments on the loan. Is Albert personally liable on the debt to the First Bank? ◂◂◂

**Explanation—UPA (1914)**

Possibly not. Under UPA (1914) §36(1), the dissolution by itself does

not discharge him, but UPA (1914) §36(3) may. Under that latter provision, a discharge occurs if the continuing partners agree to assume the dissociated partner's liability, the creditor knows of that agreement, and the creditor agrees to a material alteration in the "nature or time of payment" of the obligation. If the continuing partners agreed to assume Albert's responsibility, and if the explanation and discussion with the Bank officer caused the Bank to know of the assumption agreement, then UPA (1914) §36(3) is probably satisfied.

A four-month moratorium is probably a material change in the "time of payment." ◂◂◂

**Explanation—UPA (I997)**

Yes. Although UPA (1997) contains a provision analogous to UPA (1914) §36(1), that provision appears in Article 7 and applies only when a partner's dissociation does not result in dissolution. UPA (1997) §603(a). Under UPA (1997) §802(a), "a partnership continues after dissolution" and, accordingly, the partnership's obligations continue as well. The only question is whether the revised obligation is an obligation of the dissolved partnership, i.e., whether the act of Bernice, Carl, and Donald bound the partnership. The answer is yes. Since all of the funds were borrowed before Albert's departure, obtaining the moratorium was "appropriate for winding up the partnership business." UPA (1997) §804(1). Albert remains personally liable under UPA (1997) §306(a), although his liability is subject to the exhaustion rule of UPA (1997) §307(d). ◂◂◂

***Problem 107***

The other bank, the Second Bank, does not initially object to or even take note of the late payments. Bernice, Carl, and Donald decide to "let sleeping dogs lie." Indeed, they decide to undertake new projects, and to fund them they actually borrow additional money under the line of credit. Before Albert's departure, the partnership had borrowed $40,000. To fund the new projects, Bernice, Carl, and Donald draw down the final $30,000 available under the original line of credit

agreement. Is Albert personally liable for any of the $70,000? ◂◂◂

**Explanation—UPA (1914)**

Yes—for all of it. As to the first $40,000, Albert is liable under UPA (1914) §15, and UPA (1914) §36(3) will not save him. Even if the continuing partners agreed to assume Albert's liability and the $30,000 drawdown constituted a material change in the nature of the obligation, there is no basis for finding that the Second Bank knew of the assumption agreement. Indeed, the Second Bank was not even aware of the dissolution; Albert notified only "companies that had previously sold materials to the partnership."

Albert is also liable as to the $30,000 drawdown, per UPA (1914) §35(1)(b)(I). The drawdown would have bound the partnership prior to dissolution; the Second Bank had previously extended credit to the partnership; and the Second Bank had no notice or knowledge of the dissolution. ◂◂◂

**Explanation—UPA (I997)**

For the reasons stated in the UPA (1997) Explanation to problem 106, Albert is liable on the initial $40,000. Albert is probably also liable on the final $30,000.

As to the $30,000, the Second Bank will likely argue that: (i) when the money was borrowed, the original partnership was still winding up; (ii) the Bank had no notice of the dissolution; (iii) borrowing the money would have bound the partnership under UPA (1997) §301 before the dissolution; and therefore (iv) under UPA (1997) §804(2) the partnership is bound even though the money was used for new projects. If the partnership is bound, under UPA (1997) §306(a) Albert is liable.

Even if Bernice, Carl, and Donald were acting as members of a new partnership when they borrowed the $30,000, Albert may still be liable. By leaving in place the line of credit and not informing the Second Bank that he had quit the partnership, Albert "purports to be a partner, or consents to being represented by another as a partner, in a partnership" now actually consisting of Bernice, Carl, and Donald.[238] Albert, as "the purported partner[,] is liable to a person to whom the

representation is made [i.e., the Second Bank], if that person, relying on the representation, enters into a transaction with the actual. . . partnership."[239] The pivotal question is whether the Second Bank allowed the $30,000 to be borrowed "relying on the representation"—i.e., whether the Bank would have closed or somehow modified the line of credit if it had known of Albert's departure. ◂◂◂

***Problem 108***

Concerned that Bernice, Carl, and Donald will continue to undertake new projects for which he may be responsible, Albert seeks your advice on preventative measures. Advise him. ◂◂◂

**Explanation—UPA (1914)**

Albert must bring the fact of his departure to the knowledge of each third party that "extended credit to the partnership" prior to Albert's departure. UPA (1914) §35(1)(b)(I). For all other third parties, it will suffice to advertise "the fact of dissolution ... in a newspaper of general circulation in the place (or in each place if more than one) at which the partnership business was regularly carried on." UPA (1914) §35(1)(b)(II). ◂◂◂

**Explanation—UPA (1997)**

Albert should immediately file a statement of dissolution, as provided in UPA (1914) §805. The statement's protective effect will begin 90 days after filing. UPA (1997) §805(c). There is no need to record a certified copy of the statement, because the partnership does not own any real property.

To protect himself during the 90 days following the filing, Albert should send a notification announcing the dissolution to as many potential customers, vendors, and other third parties as he can identify. Doing so will allow him to invoke UPA (1997) §804(2), which provides that, postdissolution, no partner has the power to bind the partnership through acts not appropriate for winding up "if the other party to the transaction [has] notice of the dissolution."

Advertising the dissolution will trigger the protections of UPA

(1997) §804(2) only to the extent that the advertisement comes to the attention of a third party or creates a situation in which a third party "has reason to know" that dissolution has occurred. UPA (1997) §102(b) (defining "notice of a fact"). ◂◂◂

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1. For a discussion of the substantive differences, see section 11.2.2.

2. UPA (1914) does not use the term "dissociation," but the word is useful shorthand for the UPA (1914) concept of "any partner ceasing to be associated in the carrying on ... of the business." UPA (1914) §29. UPA (1997) uses the word repeatedly without specifically defining it. See, e.g., UPA (1997) §601 (listing causes of dissociation) and comment 1.

3. Readers who are only concerned with UPA (1997) may be tempted to skip UPA (1914) materials. Certainly, the UPA (1997) materials can stand alone, but UPA (1997)—like any other statute—is best understood in light of the circumstances that gave rise to its promulgation. The UPA (1997) provisions discussed in this chapter are therefore best understood by those who also understand the UPA (1914) provisions that preceded them.

4. UPA (1914) §31, titled "Causes of Dissolution," lists in its six paragraphs nine different events or actions that cause dissolution. The list is actually longer, however, because UPA (1914) §31(6) incorporates another list of causes from UPA (1914) §32. The eight different causes listed in UPA (1914) §§31(1)—31(5) are all automatic and"self-actuating." If a listed event or action occurs, the partnership is dissolved. In contrast, UPA (1914) §32 lists grounds upon which "the court shall decree dissolution." A claim of dissolution under UPA (1914) §31 can nonetheless result in judicial intervention. Partners sometimes litigate over whether a dissolving event did in fact occur. They also litigate in an effort to sort out the consequences of dissolution. See section 9.9 (action for accounting).

5. UPA (1914) §29.

6. Many partnerships and partnership agreements ignored this formal rule. See section 11.6. That practical reality helped shape UPA (1997)'s very different approach to the dissociation- dissolution nexus.

7. UPA (1914) §31(1)(b).

8. UPA (1914) §31(1)(a).

9. UPA (1914) §31(2).

10. *Id*.

11. For the distinction between wrongful and rightful dissolution, see *infra* in this section. For the consequences of the distinction, see sections 11.4.2, 11.5.4, and 11.5.5.

12. UPA (1914) §31(1)(d) (dissolution is caused "[b]y the expulsion of any partner from the business bona fide in accordance with such a power conferred by the agreement between the partners"). For a discussion of expulsion issues under UPA (1914), see section 11.7.2.

13. UPA (1914) §§31(4) (death) and 31(5) (bankruptcy). Bankruptcy law has much to say about the consequences of dissolution caused by a partner's bankruptcy.

14. UPA (1914) §31(1)(a). If the partnership business continues without interruption, the successor partnership is "at will." For the distinction between a partnership as a legal construct and the partnership's business as a practical reality, see section 11.2.1(g) and (h).

15. UPA (1997) §105(b)(6) continues this approach, stating that a partnership agreement may not "vary the power to dissociate as a partner" by express will. However, the conse-quences of a partner's dissociation under UPA (1997) can differ significantly from the consequences under UPA (1914). See section 11.8.3.

16. A comparable distinction exists between wrongful and rightful terminations of agency relationships. See section 5.2.

17. UPA (1914) §31(1)(b) and (2).

18. UPA (1914) §§37, 38, and41(5) refer to a dissolution have been caused “wrongfully” but the act nowhere uses “rightfully.” However, the latter term is useful shorthand for “dissolution [being] caused . . . in contravention of the partnership agreement.” *Id*. §38(1).
19. Drashner v. Sorenson, 75 S.D. 247, 248-50, 63 N.W.2d 255, 256-58 (1954)
20. An account receivable is a payment obligation due the partnership, i.e., due but not yet received.
21. Osborne v. Workman, 273 Ark. 538, 621 S.W.2d 478 (1981). This holding is especially noteworthy because the court could have: (i) avoided the holding that the act’s dichotomy is a default rule; and (ii) held instead that—whether or not the dissolution was rightful—the partnership agreement determined the payout due a withdrawing partner.
22. See sections 11.4.2, 11.5.4, and 11.5.5.
23. Vangel v. Vangel, 254 P.2d 919, 921, 925 (Cal. App. 1953), *appeal (on other grounds) after remand*, 282 P.2d 967 (Cal. App. 1955), *rev’d in part and aff’d in part*, 291 P.2d 25 (Cal. 1955) *cen bane*.
24. Page v. Page, 359 P.2d 41, 44 (Ca. 1961) (en banc).
25. Under most no-cause provisions, the expelling partners need not even state a reason or give the expelled partner an opportunity to be heard. They just have to prove that the agreed upon number of partners voted for expulsion.
26. To be useful, the provision must authorize the remaining partners to continue the business without causing the expelled partner to be released from personal liability on existing partnership liabilities. Obtaining a release may be very difficult, see section 11.5.2(d), and UPA (1914) §38(1) provides as a default rule that an expelled partner may demand liquidation unless “discharged from all partnership liabilities.” See section 11.4.2(a).
27. See Daniel S. Kleinberger, “Magnificent Circularity and the Churkendoose: LLC Members and Federal Employment Law,” 22 Okla. CityU.L. Rev. 477 (1997), reprinted at 40 Corporate Practice Commentator 379 (1998).
28. Carter G. Bishop & Daniel S. Kleinberger, Limited Liability Companies: Tax And Business Law(Warren, Gorham & Lamont/RIA 1994, Supp. 2011-2), 1.05[2].
29. UPA (1914) §30.
30. In this respect, the death of a partnership resembles its creation. See section 7.2 (no special formalities needed to create a partnership). There may, however, be some paperwork following dissolution. To protect themselves against future liabilities, partners of a dissolved UPA (1914) partnership may wish to give notice of the dissolution to third parties who have done business with the partnership and to the public generally. See section 11.3.3.
31. In liquidation, the partnership sells off all its assets (e.g., its buildings, equipment, accounts receivable, good will) either as a whole or piecemeal. See section 11.4.1. If a partner wrongfully dissolves the partnership, that partner may lose the right to compel liquidation. See section 11.4.2.
32. When no partners survive into the winding-up period, “the legal representative of the last surviving partner, not bankrupt” may wind up. UPA (1914) §37.
33. See section 9.4.1.
34. See section 9.4.1.
35. Weisblatt v. Colky, 637 N.E.2d 1198, 1201 (Ill. App. 1994).
36. UPA (1914) §33.
37. UPA (1914) §§33(1)(b) and 34(a).
38. UPA (1914) §§33(1)(a) and 34(b).
39. UPA (1914) §33(1)(a).
40. UPA (1914) §§33(2) and 35(1)(b). See section 11.3.2.
41. UPA (1914) §35(2) limits the personal liability of individual partners for certain postdissolution obligations of the partnership, and UPA (1914) §35(4) makes clear that UPA §35 does not affect liability created under UPAUPA (1914) §16 (partnership by estoppel). For an explanation of partnership by estoppel, see section 7.5.

42. UPA (1914) §35(1)(a).
43. UPA (1914) §35(1)(b).
44. UPA (1914) §35(1)(b)(I).
45. UPA (1914) §35(1)(b)(II).
46. UPA (1914) §35Q)(b)(n).
47. If the partnership agreement granted actual authority to the partner for this type of transaction pre-dissolution, it should be unnecessary to invoke UPA (1914) §9—even if the same partnership agreement terminated that actual authority upon dissolution.
48. The power to bind is not the same as the actual authority to act. For a discussion of the latter, see section 11.3.1. Lack of authority also figures in a pre-dissolution UPA constraining rule. See section 10.2.5 (discussing the "no authority" constraining rule under UPA (1914) §9).
49. UPA (1914) §35(1)(a).
50. UPA (1914) §35(3)(c)(II) is the relevant constraining rule, because the third party had not extended credit to the partnership before dissolution.
51. A partner can also spread the word and would be well advised to do so if the partnership fails to act promptly.
52. UPA (1914) §§35(1)(b)(II) and 35(3)(c)(II).
53. UPA (1914) §§35(1)(b)(I) and 35(3)(c)(I).
54. A decision to continue the business does not relieve the dissolved partnership of its obligations to its creditors or release the partners of the dissolved partnership from their personal liability on those obligations. See section 11.5.2. The decision does, however, affect the way in which the partners settle accounts with the outside world and with each other. See sections 11.5.3-11.5.5.
55. In extraordinary circumstances, courts may divide the partnership's assets in kind. In general, however, valuation problems cause the law to disfavor in-kind division of assets. See section 11.5.3.
56. UPA (1914) §§38(2)(b), 38(2)(c)(II). A wrongful dissolution occurs when a partner dissolves in violation of the partnership agreement. See section 11.2.1. In some jurisdictions, a breach of fiduciary duty can also cause a wrongful dissolution. See section 11.7.
57. Emphasis added.
58. For how the cash-out amount is calculated, see section 11.5.4.
59. For the difficulties involved in obtaining a release, see section 11.5.2 (effect of dissolution on the liabilities of partners). Absent a contrary agreement, each of the nonexpelled partners retains the right to compel liquidation. Ordinarily, however, the same agreement that provides for expulsion overrides UPA (1914) §38(1) generally. As a result, the nonexpelled partners lose their right to compel liquidation, and the expelled partner may lose the right to be released from partnership liabilities.
60. UPA (1914) §38(1) states only that "each *partner*" has a right to compel liquidation. The right does not extend to "persons claiming through [partners] in respect of their interests in the partnership." That latter category (persons claiming through partners) includes the estate of a deceased partner. In contrast, UPA (1914) §41(3) refers to "the business of the dissolved partnership [being] continued . . . with the consent of the retired partners or *the representative of the deceased partner*." (Emphasis added.)
61. UPA (1914) §38(2)(b).
62. For how the cash-out amount is calculated, see section 11.5.5 (settling accounts among partners following wrongful dissolution).
63. UPA (1914) §38(2)(b).
64. UPA (1914) §§38(2)(a)(I) (following wrongful dissolution, "Each partner who has not caused dissolution wrongfully shall have (I) all the rights specified in paragraph (1) of this section . . .") and 38(2)(c)(I) (following wrongful dissolution, if the partnership business is not continued under §38(2)(b), wrongful dissolver has "all the rights of a partner under paragraph (1)," subject to any claims for damage on account of wrongful dissolution). As with most aspects of relations *inter se* the partners, due partnership agreement can vary those rules.
65. For a detailed discussion of settling accounts among partners, see sections 11.5.3-11.5.5.

66. This undertaking is part of the settling of accounts among the partners. See section 11.5.4.
67. The other half consists of settling accounts among the partners. See sections 11.5.2—11. 5.5.
68. Such assignments typically occur as part of an agreed-upon settling of accounts among the partners.
69. Delegating an obligation does not by itself release the dissolved partnership or its partners. If the delegatee fails to perform, the obligor may proceed against those partners—even if the dissolved partnership has long since ceased to function. Moreover, if the obligation arises from a contract, the contract may purport to prohibit or restrict delegation. See section 4.4.3 for a discussion of these issues in the agency context.
70. Complexity develops if the dissolved partnership's rights are not assignable. Certain rights to receive payments are assignable despite anything to the contrary in the contract giving rise to the rights. See UCC §§2-210 and 9-406(d) and (f). See also Fairway Development Co. v. Title Ins. Co. of Minnesota, 621 F. Supp. 120 (Ohio 1985) (holding that a successor partnership could not benefit from a title insurance policy issued to the predecessor partnership).
71. Some contracts expressly prohibit delegation without the obligee's consent, and contract law sometimes validates such provisions. See section 4.4.3 (delegation of performance to an agent).
72. See section 2.7.5. As a matter of partnership law, delegation to the successor partnership may lead to release of dissociated partners; i.e., those partners of the dissolved partnership who are not members of the successor partnership. See section 11.5.2.
73. UPA (1914) §41(1), (2), (3), (5), and (6). If the entity continuing the business includes no continuing partners, then the successor entity is liable for the debts of the dissolved partnership only if it has promised to assume those debts. UPA (1914) §41(4).
74. This personal liability follows from UPA (1914) §15.
75. Those assets are at risk, of course, for all other debts of the successor partnership. UPA (1914) §15. This approach mirrors UPA (1914)'s approach to persons who become partners in an existing partnership. UPA (1914) §17 ("A person admitted as a partner into an existing partnership is liable for all the obligations of the partnership arising before his admission as though he had been a partner when such obligations were incurred, except that this liability shall be satisfied only out of partnership property.").
76. In some jurisdictions, the law school will first have to exhaust partnership assets. See section 7.3.1. If the successor partnership is an LLP, the law school will have no claim against the partners. See section 17.2.
77. See section 11.5.2.
78. For a discussion of these duties, see section 9.7.
79. For a more detailed discussion of this point, see section 9.7.5.
80. Gjovik v. Strope, 401 N.W.2d 664 (Minn. 1987).
81. Absent a contrary agreement, a creditor releases a surety if the creditor and principal agree to a material change in the underlying obligation.
82. UPA (1914) refers to dissolution "not in contravention of the partnership agreement." UPA (1914) §38(1). The phrase "rightful dissolution" is convenient shorthand.
83. See sections 8.5.2-8.5.4 (distinguishing property contributed to the partnership from property merely loaned, leased, or furnished).
84. UPA (1914) §38(1).
85. §40(b). The rule that sets priorities among creditors has little practical significance. For the rule to be significant, the partnership must lack sufficient funds to pay all its creditors. In that event, however, the partnership would be bankrupt and federal bankruptcy law would preempt UPA (1914) rule on creditor priority.
86. UPA (1914) §§40(a)(II) and 40(d).
87. UPA (1914) §38(1).
88. UPA (1914) §40(b)(III).
89. Federal tax law contains intricate and recondite rules on partnership tax accounting, as a result

ofwhich some partnerships must use a dual approach to capital accounts. The Example in the text reflects a non-tax approach.
90. UPA (1914) §18 (a) provides the default rule on profit allocation. See section 8.3.
91. UPA (1914) §18 (a) provides the default rule on loss allocation. See section 8.3.1.
92. See section 8.5.1.
93. UPA (1914) §40(d). Absent a contrary agreement, partners share losses in the same proportion as they share profits—i.e., equally. UPA (1914) §18(a). See section 8.3.1.
94. Langness v. “O” Street Carpet Shop, Inc., 353 N.W.2d 709 (Neb. 1984).
95. UPA (1914) §18(f). See section 8.5.
96. The capital claims of A and B have equal priority.
97. UPA (1914) §§38(2)(c)(I) and (2)(a)(II). In addition, the wrongful dissolver has no right to wind up the partnership. UPA (1914) §37. See section 11.3.1.
98. See section 11.4.2 (partners’ rights to compel liquidation).
99. In theory, a finding of tacit agreement also leaves open the question of what interests the continuing partners will have in the successor partnership. In practice, however, the conduct of the continuing partners often reflects an understanding on that point. If not, it seems reasonable to assume that the continuing partners intend their respective interests to be the same in the successor partnership as they were in the old.
100. The same issue also exists when the business of a wrongfully dissolved partnership is continued without the agreement of the wrongful dissolver. See section 11.5.5.
101. The cases do not directly address this question, because they do not concern disputes about the timing of the cash-out. Instead, they involve disputes relating to the amount of the payment due or whether any payment was due at all.
102. For an explanation of the action for an accounting, see section 9.9.
103. See section 11.4.5.
104. UPA (1914) §42.
105. See section 11.5.4.
106. UPA (1914) §38(2)(c)(II).
107. *Id*.
108. For a discussion of partnership agreements that transcend the at-will/term-undertaking dichotomy, see section 11.2.1(c).
109. UPA (1914) §38(2)(b).
110. UPA (1914) §42.
111. See section 11.5.4 (UPA (1914) §42 governs when rightfully dissociated partner agrees to have the partnership business continue without liquidation, but overlooks the timing issue).
112. Goodwill is excluded from the calculation. UPA (1914) §38(2)(c)(II). See section 11.5.5(b).
113. For an explanation of capital accounts, see section 11.5.3.
114. See section 11.2.1.
115. See section 11.3.1.
116. See section 11.3.2.
117. See section 11.5.2.
118. See section 7.3 (partner’s personal liability results from status as a partner in the partnership).
119. See section 11.4.3.
120. This rationale corresponds to contract law principles pertaining to assignment. See, e.g., Restatement (Second) of Contracts §338(1) (“Discharge of an Obligor After Assignment . . . [N]otwithstanding an assignment, the assignor retains his power to discharge or modify the duty of the obligor to the extent that the obligor performs or otherwise gives value until but not after the obligor receives notification that the right has been assigned and that performance is to be rendered to the assignee”).
121. UPA (1997) §603, comment 1 (describing section 603(a)).

122. UPA (1914) §29. The significance to the partnership is that dissociation can result in dissolution. See section 11.9.3. The connection between dissociation and dissolution reflects the aggregate view of partnership. See sections 7.2.7 and 13.1.4 (discussing the "continuity of life" factor under the now-defunct Kintner Regulations on tax classification).
123. If subcategories are counted separately, there are 20 separate circumstances.
124. UPA (1997) §601(1). "Notice" is a defined term. See UPA (1997) §102(b), discussed in section 10.7.1.
125. UPA (1997) §601(2).
126. UPA (1997) §601(3). "The expulsion can be with or without cause. As under existing law [i.e., UPA], the obligation of good faith under Section 404(d) does not require prior notice, specification of cause, or an opportunity to be heard." UPA (1997) §601, comment 4.
127. UPA (1997) §601(4)(i).
128. UPA (1997) §601(4)(ii). Section 503(a)(2) is not to the contrary. It provides that the transfer of a partner's transferable interest "does not *by itself* cause the partner's dissociation." (Emphasis added.)
129. UPA (1997) §601(4)(iii) and (iv).
130. UPA (1997) §601(5).
131. UPA (1997) §601(6)—(10). UPA (1997) uses this category in its definition ofwrongful dissociation, UPA (1997) §602(b)(2)(i) (discussed *infra*), and in its provision on partnership dissolution, UPA (1997) §801(2)(i), discussed in section 11.11.
132. UPA (1997) §601(6).
133. UPA (1997) §601(7).
134. UPA (1997) §601(8) and (9).
135. UPA (1997) §601(10). Note that UPA (1997) treats partnerships and corporations differently than estates, trusts, and other nonindividual legal persons.
136. See section 10.7.
137. See section 8.5.
138. See section 8.5.
139. However, "the partner's duty of loyalty [not to compete with the partnership before dissolution] terminates" regardless of whether the dissociation was wrongful and regardless of whether dissolution has resulted. UPA (1997) §603(b)(2).
140. See section 11.7.1.
141. UPA (1997) §602(c).
142. UPA (1997) §801(2)(i).
143. UPA (1997) §701(h), discussed in section 11.9.5.
144. UPA (1997) §803(a), discussed in section 11.11.1.
145. UPA (1997) §602, comment 3: "The partnership might also incur substantial expenses resulting from a partner's premature withdrawal from a term partnership, such as replacing the partner's expertise or obtaining new financing."
146. UPA (1997) §701(h). If Amos has not previously paid the partnership for the damage caused by his wrongful association, the damage amount will be offset against his payout. UPA (1997) §701(c).
147. The partnership was a limited-liability partnership (LLP), but that fact is irrelevant to the issues considered here. For a discussion of LLPs, see section 17.2.
148. Saint Alphonsus Diversified Care, Inc. v. MRI Associates, LLP, 224 P.3d 1068, 1078 (Idaho 2009).
149. UPA (1997) §103(b)(6).
150. UPA (1997) §103(b)(7). Despite this restriction, under federal law, a partnership agreement can probably subject expulsion matters to arbitration. See also Uniform Limited Partnership Act (2001), §110, Comment to Subsection (b)(9) (discussing a comparable provision). ("Any other interpretation would put this Act at odds with federal law. See Southland Corp. v. Keating, 465 U.S. 1 (1984) (holding that the Federal Arbitration Act preempts state statutes that seek to invalidate agreements to

arbitrate) and Allied-Bruce Terminix Cos., Inc. v. Dobson, 513 U.S. 265 (1995) (same).")
151. See section 11.2.1.
152. UPA (1997) §801(1).
153. These provisions refer to dissociation that occurs either because the partner's ability to participate in partnership affairs has come to an end, or the partner's economic stake in the partnership has come to an end.
154. UPA (1997) §801(2)(i).
155. This provision is discussed in section 11.11.
156. UPA (1997) §603(b)(1).
157. UPA (1997) §603(b)(2) and (3).
158. See section 10.4.3 for another aspect of this system.
159. UPA (1997) §704(a).
160. *Id*.
161. UPA (1997) §105(c).
162. *Id*.
163. See section 11.9.3.
164. See sections 11.9.3 and 11.9.4 for the operative significance of this constructive notice.
165. UPA (1997) §105(a). The brackets indicate the ULC's recognition that in some states the central filing office is not the Secretary of State.
166. UPA (1997) §303(e).
167. UPA (1997) §704(b).
168. UPA (1997) §704(c). For a detailed explanation of how this notice curtails the power to bind and personal liability, see sections 11.9.3 and 11.9.4, respectively.
169. UPA (1997) §603(b)(1).
170. "For the purposes of[terminating a dissociated partner's lingering power to bind the partnership], a person not a partner is deemed to have notice of the dissociation 90 days after the statement of dissociation is filed." UPA (1997) §704(c).
171. UPA (1997) §303(e), referred to by UPA (1997) §702(a)(3).
172. UPA (1997) §702(a).
173. UPA (1997) §704(b).
174. UPA (1997) §702(b).
175. See section 4.1.2 (agent liable to principal for acting without authority).
176. UPA (1997) §703(a) and (d). For UPA (1914) approach, see section 11.5.2.
177. UPA (1997) §303(e), referenced in UPA (1997) §703(b)(3).
178. Eli's statement of dissociation has this effect even though not filed in the real estate records. Although the deed concerns real property, the matter at issue does not involve a question of Eli's authority to transfer real property.
179. The indemnification obligation makes sense because: (i) the buyout price presupposes the payment of all existing liabilities; and (ii) the dissociated partner should be not accountable for liabilities incurred after he, she, or it ceases to be a partner. For more discussion of the first rationale, see section 11.5.5 (discussing the point in the context of UPA (1914) §38(2)).
180. UPA (1997) §701, comment 2.
181. UPA (1997) §701(b).
182. UPA (1997) §701(b). "Liquidation value is not intended to mean distress sale value. Under general principles ofvaluation, the hypothetical selling price in either case should be the price that a willing and informed buyer would pay a willing and informed seller, with neither being under any compulsion to deal. . . . UPA (1914) §38(2)(c)(II) provides that the good will of the business not be considered in valuing a wrongfully dissociating partner's interest. The forfeiture of goodwill rule is implicitly rejected by UPA (1997)." RUPA §701, comment 3.
183. UPA (1997) §701(b).

184. UPA (1997) §701(c).
185. UPA (1997) §701(b).
186. UPA (1997) §701(h). This right to "lock in" the financial interest of a partner who wrongfully dissociates parallels the right provided by UPA (1914) §38(2) with regard to a wrongful dissolver. See section 11.5.5.
187. UPA (1997) §701(e).
188. UPA (1997) §702(g).
189. UPA (1997)) §701(f). For the mechanics of an action by a dissociated partner to determine the buyout price or contest deferral, see UPA (1997) §701(i).
190. UPA (1997) §701, comment 3 (emphasis added).
191. Laplace v. Estate of Laplace ex rel. Laplace, 220 Fed. Appx. 69 (3d Cir. 2007).
192. See sections 11.2-11.5.
193. UPA (1997) §802(a).
194. UPA (1997) §802(a).
195. UPA (1997) §803(a); UPA (1997) §404(b)(3).
196. UPA (1997) §§803(c), 807(a).
197. UPA (1997) §807(a). UPA (1914) gives higher priority to obligations owed to third parties. See section 11.4.4.
198. UPA (1997) §401(a).
199. UPA (1997) §807. The extended Example provided in section 11.5.3(b) is thus equally useful for understanding settling accounts under UPA (1997). (That Example does not include any debts owed to partners.)
200. UPA (1997) §802(b).
201. UPA (1997) §802(b)(1).
202. UPA (1997) §802(b)(2).
203. This conclusion follows from the fact that many such partners will have the right to participate in winding up, UPA (1997) §803(a) ("a partner who has not wrongfully dissolved may participate") and from the fact that no statement of dissociation may be filed when Article 8 applies. UPA (1997) §§603(b) (switching provision) and 704 (providing for statement of dissociation).
204. UPA (1997) §805(a). The statement is not filed by the partnership and therefore does not require the signatures of two partners. UPA (1997) §105(c). In some circumstances, it would be impossible to obtain the signature of two partners who had not wrongfully dissociated, i.e., a two-person partnership for a term, where one partner wrongfully dissociates before the end of the term.
205. UPA (1997) §303(e), referenced in UPA (1997) §805(b).
206. UPA (1997) §805, comment 2. The statement has this effect because it "is a limitation on authority for the purposes of section 303(e)." UPA (1997) §805(b).
207. UPA (1997) §805(b). It is unclear whether this cancellation affects statements of authority granting a partner authority to transfer real property owned in the partnership name, if no certified copy of the statement of dissolution is filed in the office for recording transfers of that real property. Arguably, the certified copy on record in that office must lose its efficacy when the underlying filing (i.e., the filing of which it is a copy) is cancelled. However, UPA (1997) §303(d)(2) provides: A grant ofauthority to transfer real property held in the name of the partnership contained in a certified copy ofa filed statement ofpartnership authority recorded in the office for recording transfers of that real property is conclusive in favor of a person who gives value without knowledge to the contrary, *so long as and to the extent that a certified copy of a filed statement containing a limitation on that authority is not then of record in the office for recording transfers of that real property*.
(Emphasis added.)
208. UPA (1997) §805, comment 3. The statement has this effect because "[f]or the purposes of sections 301 and 804, a person not a partner is deemed to have notice of the dissolution and the limitation on the partners' authority as a result of the statement of dissolution 90 days after it is filed."

UPA (1997) §805(c).
209. UPA (1997) §804(2). The Dakota County parcel is a major operating asset of the partnership. It is at best arguable whether a five-year option on such an asset comes within a partner's apparently/ordinary power. See sections 10.3.3 and 10.4.1.
210. The phrase "deemed to have knowledge" comes from UPA (1997) §303(e), which applies to this situation under UPA (1997) §805(b).
211. UPA (1997) §805(a).
212. UPA (1997) §801(2)(iii).
213. UPA (1997) §801(2)(ii).
214. UPA (1997) §801(3).
215. UPA (1997) §801(5).
216. UPA (1997) §801(6).
217. UPA (1997) §801, comment 9. In this respect, UPA (1997) §801(6) seems to correspond with Restatement (Second) of Contracts §338(2) ("DISCHARGE OF AN OBLIGOR AFTER ASSIGNMENT. ... So far as an assigned right is conditional on the performance of a return promise, and notwithstanding notification of the assignment, any modification of or substitution for the contract made by the assignor and obligor in good faith and in accordance with reasonable commercial standards is effective against the assignee. The assignee acquires corresponding rights under the modified or substituted contract.").
218. For a discussion of charging orders, see section 8.8.4.
219. See section 11.9.
220. UPA (1997) §103(b)(8).
221. In chronological order of promulgation: Uniform Limited Partnership Act (2001); Uniform Limited Liability Company (2006); Model Registered Agents Act (2006); Model Entity Transactions Act (2007); Uniform Unincorporated Nonprofit Association Act (2008); Uniform Statutory Trust Entity Act (2009); Uniform Business Organizations Code—Article 1(UBOC Hub) (2011).
222. The provision comprises 130 words.
223. This provision comprises 219 words.
224. In a merger, one or more entities are subsumed into another entity, which may pre-exist the merger or be created by the merger. In a conversion, one type of entity becomes another type of entity, e.g., a general partnership might become a limited partnership.
225. The merger provisions in UPA (2013) appear in sections 1121-26 and require that at least one participant in the merger be a domestic general partnership.
226. In an interest exchange under UPA (2013), either "(1) adomestic [general] partnership may acquire all of one or more classes or series of interests of another domestic entity or a foreign entity" or "(2) all of one or more classes or series of interests of a domestic [general] partnership may be acquired by another domestic entity or a foreign entity." UPA (2013) §1131(a)(1) and (2). The interest exchange provisions appear in UPA (2013) §§1131-36.
227. In a conversion under UPA (2013), either (i) a domestic general partnership will become another type of entity, whether domestic or foreign; or (ii) another type of entity, whether domestic or foreign, will become a domestic general partnership. The conversion provisions appear at UPA (2013) §§1141-46.
228. In a domestication, either: (i) a domestic general partnership becomes a general partnership subject to the law of another jurisdiction (i.e., a foreign general partnership); or (ii) a foreign general partnership becomes a domestic general partnership. The domestication provisions appear UPA (2013) §§1151-56. Domestications typically involve limited liability partnerships.
229. UPA (2013) §809(a).
230. UPA (2013) §809(e).
231. UPA (1997) §804(2) would not apply, because John was not authorized to act for the partnership (UPA (1997) §803(a)), and the partnership was undisclosed. Therefore, John's act "would [not] have

bound the partnership under section 301 before dissolution." See section 10.4.1 (explaining that UPA (1997) §301 binds a partnership through a partner's actual authority and through apparently/ordinary power).
232. UPA (1914) §35(1)(a) is inapposite, because Able's order was not an "act appropriate for winding up partnership affairs or completing transactions unfinished at dissolution." The partnership had on hand ample cloth to finish all pre-dissolution orders.
233. See section 10.3.
234. There has been no material alteration in the obligation, so UPA (1914) §36(3) does not apply even if the creditor was aware that the successor partnership had assumed the responsibilities of the dissolved partnership. If the school pursues Sophie on this debt, then she will probably have an action against the successor partnership and its partners. Typically, the same agreement by which the old partners provide for the continuation of the business also obliges the successor partnership to hold harmless the withdrawing partner from any further liabilities related to the dissolved partnership.
235. It is possible to argue that the partnership becomes a partnership for a particular undertaking each time the partnership agrees to take on a new project. See the Explanations to the next problem.
236. Though superficially plausible, this argument would probably fail.
237. As for judicial dissolution, UPA (1997) §801(5)(ii) and (iii) are the analogs to UPA (1914) §32(1)(d).
238. UPA (1997) §308 (Liability of Purported Partner).
239. Id.

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