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Should History Lock in Lock-In?

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Abstract

The corporation does not allow owners, at least by default, to cash out their interests. This feature of "capital lock-in" facilitates durable and centralized management of corporate assets. It has been argued that capital lock-in is what has made the corporation the dominant business form and has enabled the modern firm. This argument for the historical significance of capital lock-in is intended to provide a rationale for rejecting reforms that would compromise lock-in. However, lock-in has costs, including inhibiting effective monitoring of managers. Moreover, the historical argument is inaccurate, since lock-in has always been available in the partnership form. Lock-in should be viewed as just one of many features of firms that evolve to meet business needs, not frozen in place by a dubious account of the past.

SHOULD HISTORY LOCK IN LOCK-IN?

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ABSTRACT

The corporation does not allow owners, at least by default, to cash out their interests. This feature of "capital lock-in" facilitates durable and centralized management of corporate assets. It has been argued that capital lock-in is what has made the corporation the dominant business form and has enabled the modern firm. This argument for the historical significance of capital lock-in is intended to provide a rationale for rejecting reforms that would compromise lock-in. However, lock-in has costs, including inhibiting effective monitoring of managers. Moreover, the historical argument is inaccurate, since lock-in has always been available in the partnership form. Lock-in should be viewed as just one of many features of firms that evolve to meet business needs, not frozen in place by a dubious account of the past.

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In a series of articles about the history of the corporation,[1] Margaret Blair argues that the Industrial Revolution created a need for a reliable and sustainable business entity form that would protect the various investments of the participants in the firm. The corporation crucially filled, and still fills, that need. The story is enlivened by historical anecdotes of how particular firms had to solve the continuity problem in order to become successful.

In Blair's account, the business forms that preceded the corporation, mainly the sole proprietorship and partnership, did not work because they were destabilized by owners' ability to withdraw their shares. The sole proprietorship is vulnerable to everything that might happen to the proprietor, including death and inheritance. The partnership form was inadequate because a partner could dissolve the firm at will. A variant on the partnership, the joint stock company, also was not a complete solution because of its default aggregate features. Only the corporate form prevented the cash-out of owners' interests, and thereby facilitated the creation of large-scale business enterprises. Blair continues the story to the present, arguing that the corporation still, uniquely among business forms, effectuates lock-in.[2]

This story has an important policy implication. The fact that recognition of a

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[1] *See, e.g.,* Margaret M. Blair, *The Neglected Benefits of the Corporate Form: Entity Status and the Separation of Asset Ownership from Control*, in Corporate Governance and Firm Organization: Microfoundations and Structural Forms (Anna Grandon, ed.) at 45-66 (Oxford University Press, 2004) ("Blair, *Neglected*"); Margaret M. Blair, *Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century,* 51 UCLA L. Rev. 387 (2003) (Blair, "*Locking in*"); Margaret M. Blair, *Reforming Corporate Governance: What History Can Teach Us,* 1 BERK. BUS. L. J. 1 (2004) (Blair, "*Historÿ*).

[2] *Id.*

durable corporate entity was necessary to enable the industrial revolution indicates that the corporate feature of "capital lock-in" was necessary to the growth of modern business, and continue to be essential features of the corporation.

While this makes an interesting story, it is questionable law, history and economics. First, Blair has not precisely identified the economic problem for which capital lock-in supposedly is a solution. This is important because capital lock-in may have significant costs in some contexts that must be balanced against any economic benefits. The cost-benefit tradeoff depends on the circumstances of particular firms, and may vary over time.

Second, Blair assumes that capital lock-in was not available in the partnership, thereby necessitating use of the corporation. However, partners always have been able to contract to prevent liquidation through the partnership agreement, as well as deter partner exit by contracting for buyout rights. This undermines Blair's theory that the corporate form was necessary for capital lock-in, even if lock-in aided the development of modern business. Moreover, the joint stock company, a variant on partnership, offered any continuity that the standard-form partnership lacked.

Third, even if the corporation offered stronger default entity features than partnership, this still does not demonstrate the need for the corporate form. Partnership law was already developing continuity and other entity features by the early nineteenth century, the period Blair discusses. The fact that partnerships now can have all of the entity aspects of corporations indicates that these features never were *inherently* inconsistent with partnership. The partnership form clearly could have developed entity features had the corporation never been invented.

This does not mean that the development of the corporate form was anomalous or unnecessary. There is some value to offering different sets of features in distinct standard forms because the development of the alternative corporate form theoretically economized on contracting by firms. [3] Blair is not wrong in concluding that corporate *features* were important, but in suggesting that the creation of the modern *corporate form* was necessary for the development of modern business. In fact, like other aspects of business association standard forms,[4] these features are only contingently important in responding to the business needs that exist at any particular form.

Blair's use of capital lock-in to explain the corporation matters for two reasons. First, even if the same basic features always have been available in partnerships and in corporations, there is an important distinction between the two forms: In this country, creation of a corporation historically required state intervention, and therefore could be considered a sort of concession of state power.[5] Thus, and argument that corporations were necessary to enable the modern firm implicitly supportsthe significant role of the state that necessarily accompanies the corporate form. Conversely, relying more on the contractual partnership form might diminish the state's role in regulating business

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[3] *See* Larry E. Ribstein, *Statutory Forms for Closely Held Firms: Theories and Evidence from LLCs,* 73 WASH. U. L. Q. 369 (1995).

[4] *See* Larry E. Ribstein, *Important Role of Non-Organization Law,* 40 WAKE FOREST L. REV. 751 (2005).

[5] *See infra* text accompanying note 80. 80

associations.

Second, characterizing capital lock-in as the corporation's central feature suggests that it should be preserved against any tinkering by courts or legislatures. Blair's history therefore would shore up the normative justification found in Blair's work with her co-author Lynn Stout. They argue for the role of the board as "mediating hierarchs" who act on behalf of all groups that contribute resources to the firm rather than just the shareholders.[6] Empowering investors to cash out of the firm would weaken managers' ability to control corporate assets for the benefit of non-shareholder constituencies. Blair & Stout suggest that this mediating hierarch role is in the interests of all corporate constituencies, including the shareholders, because it enables the firm to make the binding commitment to mediating hierarchy these constituencies demand. It arguably follows that all corporate constituencies would want to mandate capital lock-in as a way to effectuate the strong role of managers they envision.

The problem with this justification of capital lock-in is that it is not clear that shareholders always would want capital lock-in even though it encourages contributions by other constituencies. The power to withdraw capital may be a necessary way to control agency costs by managers or opportunism by majority shareholders. Moreover, relationships between other constituencies and the corporation may be adequately covered by contracts rather than by firm-type fiat, particularly as markets develop past the early Industrial Revolution stage. Accordingly, capital lock-in may not be essential to attract investments by these constituencies. In short, the costs of lock-in sometimes may exceed the benefits. Reducing the case for corporate lock-in to historical inevitability bypasses these details.

This essay proceeds as follows. Part I identifies the economic problem that justifies the capital lock-in solution. Unlike in Blair's explanation, the problem does not directly concern the multifarious contributions made by the parties to corporate contracts. These contributions may give rise to *shirking* because of the difficulty of measuring each party's contribution to the entity's surplus. Shirking might be addressed by monitoring, including by the firm's managers. Lock-in addresses the separate problem of *opportunism*, which may arise because of a contributor's ability to, in effect, appropriate more than its share of the firm's surplus by withdrawing a resource that helps produce that surplus. But whether that is a problem depends on several factors, including the nature of the contribution and the effect of withdrawal on the enterprise. Moreover, lock-in may have costs, including inhibiting monitoring of managers by preventing dissatisfied owners from removing their investments.

Part II shows that, even if lock-in is efficient, it has always been available in the partnership form. Not only has partnership law permitted at least contracting around liquidation at will, but it has also allowed the partners to contract around any obligation to return to the partners the full value of their investments in the firm. Moreover, the joint stock company variant on partnership provides any continuity the "standard form" partnership lacks. To be sure, as Blair discusses, the partners might be able to hold up the firm by withdrawing their human capital, but neither partnership nor corporate law has ever been able to fully prevent this. This simple legal fact casts significant doubt on Blair's capital lock-in account of the rise of the corporation.

Part III discusses the policy implications of Blair's historical account, and

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

therefore the significance of its flaws. If the corporate form is not essential to modern business, neither are the corporation's particular attributes, particularly including its regulatory nature. The partnership approach to lock-in would have better enabled firms to balance the costs and benefits of lock-in in particular situations, and to choose alternatives to strong form corporate-type lock-in as they became more viable. Corporate lock-in is not essential to the theory of the firm, but rather to Blair & Stout's particular normative vision of corporate managers as mediating hierarchs. History cannot save Blair the effort of normatively defending this view.

Part IV offers concluding remarks.

I. CAPITAL LOCK-IN AND THE THEORY OF THE FIRM

This Part discusses the economic role of capital lock-in. Subpart A reviews the role of lock-in in the economic theory of the firm, focusing on the distinct problems of shirking and opportunism. Subpart B casts doubt on whether the benefits of lock-in were ever as clear as Blair suggests. Subpart C discusses the significant potential costs of lock-in in impeding monitoring.

A. THE THEORY: LOCK-IN, OPPORTUNISM AND SHIRKING

Blair attributes the need for capital lock-in to what she and Lynn Stout refer to as the "team production" problem – that is, "the problem of assembling and coordinating the use of complex inputs for long-term or continuous production."[7] But Blairhas identified not one, but two, quite distinct problems – *shirking* and *opportunism.* She also ignores an important problem that lock-in creates.

The shirking problem arises when production in the typical large firm, requires various inputs from several sources whose outputs cannot easily be identified to specific inputs, or members of the corporate "team." The difficulty of determining whether suppliers are providing optimal performance complicates contracting in the firm. Alchian & Demsetz theorize that participants in a firm have an incentive to "shirk," hoping that their colleagues will pick up the slack and that no one will notice who is doing what.[8] For example, a group of furniture movers might earn more money by doing more moves than each could individually, but because the profit cannot be isolated to specific movers, each has an incentive free ride on the others' efforts.[9] Blair cites Alchian & Demsetz as a source of the team production concept her work both alone[10] and with Lynn Stout.[11]

A solution to this version of the team production problem is to hire a monitor who can observe the behavior of the team members and mete out appropriate rewards and

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[7] *See* Blair, *History, supra* note 1.

[8] *See* Armen Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization,* 62 AM. ECON. REV. 777 (1972).

[9] As this example suggests, the shirking problem does not depend on the existence of distinct types of inputs.

[10] *See, e.g.,* Blair, *Locking in, supra* note 1 at 399, n.30.

[11] *See* Blair & Stout, *supra* note 6 at 265.

punishments to encourage optimal behavior, including through ex ante contracts. [12] However, this creates the "agency cost" problem inherent in delegating power to a non-owner manager.

In the second, or opportunism, version of the team production problem, the inseparability of inputs permits individual members to appropriate part of the surplus created by the other team members by threatening to withdraw their resources. [13] For example, if a daily newspaper depends on a printer to give timely service to its readers and advertisers, the printer might, in effect, "hold up" the newspaper for more money by threatening to suspend operations and thereby delaying publication.[14] The problem in this situation is one of enforcement rather than of monitoring. The parties may have been able to agree on how much of the joint product should be allocated to each contributor in order to maximize the joint surplus, but have no easy way to hold their partners to this deal when one or more of the parties can pull his resources out.

The parties might reduce opportunism by locking their resources into a jointly owned firm. Once the parties have traded their resources for ownership interests in the firm, they cannot easily appropriate the joint surplus by withdrawing their resources if the parties own and directly control only their ownership interests and not the resources themselves. They might sell these interests to third parties or leave them to their heirs, but this would leave the firm and its resources intact. Lock-in may, however, exacerbate the costs of delegating control to non-owner agents because the parties' ability to take their investments out of the firm is an important way to discipline the firm's managers.[15] Thus, while lock-in addresses the opportunism problem, it complicates the solution to the shirking problem.

The analysis so far has relied on the economic theory of the firm rather than the legal concept of the business association. Blair reasons that the Chandlerian firm created a need for a legal entity form that was "reliable and sustainable."[16] Stability and continuity would reassure resource contributors that their investments would be protected from opportunistic withdrawal by investors. Most importantly, according to Blair, this continuity would enable managers to develop and implement the broad and long-term strategies that were necessary to the creation of the modern firm. According to Blair, only the corporate form could provide the necessary continuity.

Blair bases her analysis on some anecdotes about the growth of early large

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[12] *See* Alchian & Demsetz, *supra* note 8.

[13] *See* Blair, *Lockin*, *supra* note 1 at 404-05; Blair & Stout, *supra* note 6 at 272-76. For various versions of the problem Blair and Stout discuss, *see* Oliver Williamson, MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS (1975); Oliver Williamson, THE ECONOMIC INSTITUTIONS OF CAPITALISM (1985); Benjamin Klein, Steven Crawford & Armen Alchian, *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J.L. & ECON. 297 (1978); Raghuram G. Rajan & Luigi Zingales, *Power in the Theory of a Firm,* 113 Q.J. Econ. 387 (1998); Oliver Williamson, *Transaction Cost Economics: The Governance of Contractual Relations,* 22 J. L. & ECON. 233 (1979).

[14] *See* Klein, et al, *supra* note 13 at __.

[15] *See infra* text accompanying note 26.

[16] *See* Blair, *Lockin, supra* note 1 at 412.

enterprises in the 19th century U.S. For example, in Lehigh Coal & Navigation Co., several individuals combined to form companies to produce and transport coal.[17] Neither branch of the business was viable without the other, thereby raising a potential opportunism problem. Blair argues that the partnership form could not bind the parties into a sustainable unit that would resist an individual party's ability to withdraw resources from the entity. Part II, below, critically analyzes Blair's claims about the relative continuity of the corporate and partnership forms.

According to Blair, having locked the assets into the strong corporate entity, functional control could be given to a board of directors, thereby separating control from the ownership of the resources.[18] The board would "mediate" among the various resource contributors. Blair says that "when decision-making authority is allocated to a board of directors, individual team members relinquish some of the ability they might otherwise have had to hold up other members."[19] In other words, the mediating hierarchy solves the opportunism problem. But she does not address lock-in's effect on agency costs, and therefore is inconclusive on whether the benefits of capital lock-in outweigh the costs.

B. THE UNCERTAIN BENEFITS OF CAPITAL LOCK-IN

Blair's account of the need for capital lock-in is based on a few examples rather than the sort of comprehensive review of 19th century business that would justify Blair's explanation of the rise of the corporate form. This is evident from studying the work of the progenitor of the theory of the firm, Ronald Coase.

Douglas Baird, in a paper based on Coase's notebooks,[20] discusses Coase's analysis of the reasons for the integration into single firms of General Motors and Fisher Body, on the one hand, and Ford Motor and Keim Mills, on the other. Based on interviews with key personnel, Coase observed that GM and Fisher Body were primarily concerned with closely coordinating their assembly operations. Fisher Body shipped sheets of stamped metal to specially built GM assembly plants and then coordinated welding the sheets into car bodies with Chevrolet's production team. This combined operation was the sort of work done in a single factory.

The interdependence of the body and assembly operations in GM and among the team members in Ford enabled one party to appropriate part of the entity's surplus by threatening to pull out. For example, GM could hardly have continued making cars without Fisher. This suggests that these firms, like those Blair discusses, needed the capital lock-in feature of the strong corporate entity. Baird, however, shows that formal legal integration was in both cases merely an afterthought to physical integration of processes rather than something the parties evidently considered vital to the transaction.

Indeed, in the case of Ford, it is not clear how legal integration or organizational form could have helped the parties, whatever the sequence of events. Ford Motor and

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[17] *See* Blair, *Locking In, supra* note 1 at 399-404.

[18] *Id.* at 433-34.

[19] *Id.* at 434.

[20] Douglas G. Baird, *In Coase's Footsteps,* U Chicago Law & Economics, Olin Working Paper No. 175 January 2003, http://papers.ssrn.com/paper.taf?abstract_id=368400.

Keim Mills were concerned with keeping intact the particular key members of the production that had worked initially for Keim Mills and helped design the Model T. Employment contracts might mitigate the problem, but these contracts also do not depend on organizational form. Similarly, in Blair's own Lehigh example, the supposed opportunism problem of the need to keep the engineer associated with the team also involves a human capital issue that cannot be resolved by organizational form.

These observations are also supported by a study of early American partnerships.[21] The study notes partners' ability to act opportunistically by withdrawing and appropriating firm-specific assets. The author observes that partnerships could address dissolution at will contractually, and that such contracts could not solve the opportunism problem because the partners would remain free to withdraw. Instead, he shows that the parties to these firms minimized the holdup problem by forming partnerships with their equals in age, productivity, and capital, so that the partners could credibly commit to refrain from opportunistic conduct. Again, organizational form and capital lock-in were irrelevant.

These questions about the role of business form in solving opportunism problems have an important implication. To the extent that integration depends on such factors as physical logistics, it would not have the sort of fundamental importance to the modern firm that Blair attributes to it. As Baird points out, echoing Coase, integration of operations depends on the relative costs of doing business within firms and in markets. As markets develop, firms become less important.[22] For example, firms like Dell contract with multiple suppliers for components that once would have been made in the manufacturing plants owned by the branded firm.[23] This suggests that Blair's story may have little relevance to today's firms even if she was right why the corporate form initially arose.

C. MONITORING AND THE COSTS OF LOCK-IN

Even if capital lock-in has significant value for many large firms, there is an additional question whether the benefits of lock-in exceed the costs. Capital liquidity enables owners to discipline or minimize the costs imposed by shirking or misappropriating managers or controlling owners. This point is particularly relevant in light of the fact that many of corporations Blair discusses were closely held, or at least did not have developed markets for their shares. For perspective, consider that the New York Stock Exchange did not even have a building until 1865, and in 1830 traded as little as 31 shares in a day.[24] Thus, even if firms derived significant benefits of continuity, lock-in might also have imposed significant costs on owners who could not trade their

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[21] Howard Bodenhorn, *Partnership and Hold-Up in Early America*, http://papers.ssrn.com/paper.taf?abstract_id=302575, NBER Working Paper No. W8814 (March, 2002).

[22] *See* Baird, *supra* note 20 at 15.

[23] *See* Larry E. Ribstein, *Why Corporations?* 1 Berk. Bus. L. J. 183 (2004).

[24] *See* Chronology of the New York Stock Exchange, http://www.nysedata.com/nysedata/asp/factbook/viewer_edition.asp?mode=table&key=2169&category=4.

shares.[25]

The value of capital liquidity should be assessed in light of other potential monitoring and incentive mechanisms.[26] Owner voting rights may involve a significant free-rider problem, since each owner would incur costs of being informed and coordinating with other owners while sharing the governance benefits with all other owners. Owners may be able to transfer voting and economic rights to other owners, but changing the identity of the owner does not necessarily put pressure on the managers. The purchaser may acquire enough shares to overcome the free rider problem and to make meaningful changes, but this tactic may be costly and risky, particularly since incumbent managers with broad agency powers usually can impede control transfers. Finally, courts can supervise fiduciary breaches, but this judicial power must be limited by the business judgment rule because of the costs of courts' meddling in business decisions and placing the burden of business risks on agents.

The standard mechanisms of controlling agents therefore all have significant gaps. Empowering owners to cash out of or dissolve the firm can effectively complement or replace these devices. This power effectively permits each owner to express a judgment about the opportunity costs of an investment in the firm. If that judgment is negative, the managers lose control over some of the firm's cash. Because each owner benefits by being able to redeploy his capital, this device does not involve a free-rider problem comparable to that of shareholder voting. And the device does not invite a court to second-guess managerial decisions. Rather, exiting shareholders implicitly decide how the collective output of all of the managers' decisions compares with alternative uses of their money.

It is important to emphasize that the ability to cash out of the firm differs from the power corporate shareholders have to sell their interests to third parties. This power to sell only enables shareholders to obtain the value of their interests in the firm *less* any discount the market applies because of current management. Moreover, the sale does not remove capital from managers' control, but simply shifts it to other powerless owners. Although the power to trade shares reduces the costs of lock-in, Blair is wrong when she indicates that shareholders are not locked in merely because they can sell their shares.[27]

In short, the benefits of lock-in may not outweigh the benefits for many firms. This casts doubt on Blair's conclusion that capital lock-in was pervasively important for firms generally, either in the 19th century or today.

II. LOCK-IN AND THE CORPORATE FORM

Even if capital lock-in was important for large 19th century firms, Blair's theory raises the additional question of whether the corporate form was necessary to achieve this objective. Blair argues that partnership law during the relevant period provided by

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[25] Blair, in fact, sees the ability to trade as the antidote to lock-in. *See infra* text accompanying note 27.

[26] *See* Larry E. Ribstein, *Accountability and Responsibility in Corporate Governance,* __N.D. L. REV. __ forthcoming 2006.

[27] *See* Blair, *History, supra* note 1 at 29-30 (stating that "the provisions of corporate law. . . do not lock in particular investors, since individual investors can sell their shares to other investors").

default that each partner had the power to dissolve a partnership or seek a buyout by the firm[28] and partnerships were dissolved by a partner's death, subjecting the firm to the uncertainty of litigation over the estate.[29] Corporations, by contrast, could be dissolved only by action of the board of directors followed by a vote of a majority of the owners. Thus, according to Blair, the corporate form was necessary to ensure that the controlling shareholder's estate would not break up the business.[30]

The problem with this explanation is that partners always have been able to contract for significant continuity.[31] Partners at one time could prevent dissolution without cause just by agreeing to a definite term.[32] Even where the partnership *entity* was dissolved upon partner dissociation, partners at least could agree to continue of the partnership *business*.[33] Although partners may have had an absolute right to exit the firm – not surprisingly since they needed to terminate their personal liability for the firm's debts – they did not during the period Blair discusses have an absolute right either to compel termination of the firm or to receive the value of their interests. The courts for centuries have enforced contracts providing for continuation of the firm after partner retirement or death and payment of amounts provided for in the partnership agreement.[34] Under such an agreement a member could dissociate himself from further obligations to the firm but would not necessarily be able to take any cash with him. Although a partner might opportunistically use his power to leave, as where the member had skills that were important to the firm, neither the corporate nor the partnership form bound partners' human capital to the firm. Deterring opportunism was left to contract, including non-competition agreements and agreements regarding payoff of exiting members.

Partners actually did effectively provide for continuity, including in some of the situations that Blair relies on to illustrate the instability of the partnership form. For example, although Blair offers Baldwin Locomotive as an example of how corporate continuity would have benefited the partners, the partnership agreement in that case

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[28] *See* Blair, *Locking in, supra* note 1 at 409-13.

[29] *Id* at 420-21.

[30] *Id* at 442-49.

[31] Arthur J. Jacobson, *The Private Use of Public Authority: Sovereignty and Associations in the Common Law*, 29 BUFF. L. REV. 599, 648-51 (1980) (discussing various aspects of partnership law's recognition of the ongoing character of business)

[32] *See* Alan R. Bromberg & Larry E. Ribstein, BROMBERG & RIBSTEIN ON PARTNERSHIP, § 7.03(a), n. 4; Joseph Story, COMMENTARIES ON THE LAW OF PARTNERSHIP § 273-76, at 410-420 (2d ed. 1846).

[33] *See* Bromberg & Ribstein, *supra* note 32, § 7.11(e).

[34] Niel Gow, A PRACTICAL TREATISE ON THE LAW OF PARTNERSHIP, at 341-42, 435 (1825) (discussing agreements for continuation after partner death or retirement); Story, *supra* note 32 § 199, at 306-07 (discussing clauses for continuation notwithstanding partner death in order to be sure that the business is "steadily carried on"); *id.* § 207, at 318-19 (discussing clause providing for purchase of other partner "at a valuation" if "express stipulation") (2d ed. 1846); Percy F. Wheeler, PARTNERSHIP AND COMPANIES : A MANUAL OF PRACTICAL LAW at 87 (1892) (discussing enforcement of buyout agreements under English partnership law).

provided for continuity through slow pay-off of the estate.[35] Andrew Carnegie's "iron clad" continuity provisions provided that partners could buy out a deceased or retired partner's share of the business at book value, payable by installments.[36] Blair notes that this arrangement worked so well that a locked-in partner caused trouble, thereby illustrating the trade-off between continuity and the need to give members a suitable exit route.

Blair makes much of the need for corporate-type continuity to protect firms from claims of partners' heirs.[37] However, partnership law gives partners' heirs no interest in partnership property.[38] Although the partnership dissolves by default on a partner's death, as with other partner dissociation the partners can agree to continue the firm and pay off the estate. The heirs might fight over equity shares in a partnership, as in a corporation,[39] but they cannot threaten either the firm's capital or the surviving partners' control over the assets. Warren's leading early treatise on choice of form confirms that, despite default dissolution of the partnership entity on dissociation of a member, partners can contractually avoid liquidation.[40]

Blair argues that the corporate form reinforces capital lock-in through other entity features, including those restricting partners from transferring specific partnership property or binding these assets to their personal creditors.[41] However, the partnership form had many entity characteristics by the time of the Industrial Revolution. Although there is authority that partners at one time could transfer specific partnership property without co-partner consent,[42] any such right always conflicted with partner's power to co-manage the firm and the ancient partnership principle of delectus personae, or choice of associates. At least by the 19th century, these principles had been accommodated in much the same way that they are in modern partnerships, and not much differently from modern corporations, by holding that a partner could not unilaterally transfer control over partnership property. Thus, the 1850 case of *Appeal of Horton*[43] held that a partner's attempted transfer of all of his right in partnership assets did not give the purchaser any

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[35] Blair, *Locking in, supra* note 1 at 452-54.

[36] *Id.* at 451-52.

[37] *Id.* at 446.

[38] *See* UPA § 25(2)(d); RUPA § 501.

[39] *See* Mark Maremont, *Court Documents Present Insight Into Breakup of Pritzker Empire*, Wall St. J., Jan 11, 2006 at A3, available at http://online.wsj.com/public/article/SB113694882504643459-R_ykCMCvhDnxOGbLHWGxsDe4B7Q_20060118.html (discussing squabbling over estate among various factions of the Pritzker family).

[40] *See* Edward H. Warren, CORPORATE ADVANTAGES WITHOUT INCORPORATION at 33 (1929).

[41] *See* Blair, *Lock-in, supra* note 1; Blair, *Locking in, supra* note 1.

[42] *See* Bromberg & Ribstein, *supra* note 32, §3.04; Martin v. Crump, 2 Salkeld 444, 91 Eng. Rep. 385 (1698).

[43] Appeal of Horton, 13 Pa. 67, 1850 WL 5688 (Pa.), 1 Harris 67 (1850).

right over any of the firm's assets. Rather, it effected a dissociation of the selling partner and therefore dissolution of the firm, after which the remaining partner possessed the assets for purpose of winding up the business and paying off the debts.

By the 19th century partnership law both in the U.S. and Britain had similarly recognized, consistent with modern partnership and corporate law, that individual partners could not bind partnership assets on individual debts.[44] Thus, in 1810, *Pierce v. Jackson* held that

> At common law, a partnership stock belongs to the partnership, and one partner has no interest in it, but his share of what is remaining after all the partnership debts are paid, he also accounting for what he may owe to the firm. Consequently, all the debts due from the joint fund must first be discharged, before any partner can appropriate any part of it to his own use, or pay any of his private debts; and a creditor to one of the partners cannot claim any interest, but what belongs to his debtor, whether his claim be founded on any contract made with his debtor, or on a seizing of the goods on execution. There are several cases, by which these principles, so reasonable and equitable, are recognized and confirmed.

Pierce accordingly held that an attachment of partnership property by a creditor of one of the partners was not valid against a later attachment by a partnership creditor.

Blair also cites creditor-protection features such as the owners' commitment to maintain a capital investment in the firm through statutory legal capital provisions and the "trust fund" doctrine.[45] But these rules deal with a problem different from the opportunism that capital lock-in addresses – that is, agency costs and moral hazard between corporate shareholders and creditors. Limited liability shareholders with little invested in the firm have an incentive to commit the firm to risky actions because the shareholders get much of the benefit of success while creditors bear the brunt of failure.

While owners' perverse incentives may be reduced to some extent by requiring shareholders to commit substantial personal assets to the firm, such a requirement may significantly reduce firms' flexibility and may only minimally protect creditors over fraudulent conveyance statutes.[46] In any event, since shareholders alone can decide where to incorporate, creditors have little power to impose rules that shareholders do not want. Accordingly, minimum capital requirements and other creditor protection rules long have played only a vestigial role in corporate law.[47] Any such rules that still exist are an aspect of *limited liability* rather than specifically of the corporate form. Thus, virtually all limited liability partnership-type statutes have creditor protection provisions similar to those in corporate statutes.[48] In short, these rules cannot possibly help explain the

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[44] *See* Bromberg & Ribstein, *supra* note 32, §3.04; Fox v. Hanbury, 2 Cowp. 445, 98 Eng. Rep. 1179 (1776); Pierce v. Jackson, 6 Mass. 242 (1810).

[45] *See* Blair, *Neglected, supra* note 1 at __.

[46] *See* Larry E. Ribstein, *An Applied Theory of Limited Partnership*, 37 EMORY L. J. 837 (1988).

[47] *See* Bayless Manning & James Hanks, LEGAL CAPITAL (3d ed., 1990).

[48] See Uniform Limited Liability Company Act, §§406-407; Uniform Limited Partnership Act (2001), §§607-608 (2001).

dominance of the corporate form.

Even if a traditional standard-form partnership could be deemed to lack some corporate-like continuity or entity features, this is clearly not the case for joint stock companies and business trusts, forms that existed throughout the period Blair discusses. Warren demonstrates through a lengthy analysis that the joint stock company, which he refers to as a "species of partnership" to which partnership rules were generally applicable except as modified by agreement,[49] had all of the six "corporate" features Warren identifies except limited liability. Moreover, during this period the parties had available the "Massachusetts Business Trust," still widely used today for mutual funds, which had all of the features of a joint stock company plus limited liability and a greater potential for concentrating management power.[50]

Most importantly for present purposes, Warren emphasizes that a joint stock company did *not* have the partnership disadvantage of impermanence.[51] Warren discusses a case that demonstrated that the parties could agree to full continuation of the firm on partner death,[52] noting the court's reasoning that parties sought to "imitate a corporation."[53] The joint stock company also solves other of Blair's criticisms of the partnership form. Because of its combination with the trust device, property can be placed in a separate entity and therefore is not subject to the partnership's aggregate ownership features. Management power can be concentrated in trustees, who have powers comparable to those of corporate directors.[54] Blair herself notes that joint stock companies "became increasingly sophisticated" between 1760 and 1810 in the US and were a model for the earliest corporate laws.[55]

Given the availability of the joint stock company, what is left of Blair's argument that the corporate form was necessary to enable capital lock-in? She notes that joint stock companies were subject to partnership law other than in the respects that they adopted corporate features.[56] But "linkage" with existing forms may involve benefits as well as costs because of the valuable legal predictability that comes with the application of existing precedents.[57] Even if there was English authority denying entity treatment,[58] and

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[49] *See* Warren, *supra* note 40 at 327-28.

[50] *Id.* at 328. See also *id* at 352 (referring to the business trust as a "superior means" of obtaining corporate advantages as compared to the joint stock company).

[51] *Id.* at 334.

[52] *Id.* at 334-35 (discussing Phillips v. Blatchford, 137 Mass. 510).

[53] *Id.* at 336.

[54] *Id.* at 338-40.

[55] *See* Blair, *Locking In, supra* note 1 at 419.

[56] *Id* at 419-20, 422.

[57] *See* Larry E. Ribstein, *Linking Statutory Forms,* 58 J. LAW & CONTEMP. PROB. 187 (Spring, 1995).

even assuming that the Bubble Act denied transferability in England,[59] there is no evidence that these problems crossed the ocean.[60]

Finally, Blair supports her theory by attempting to refute the argument that it was limited liability rather than continuity that accounted for the rise of the corporation. This matters for Blair because she is less concerned with the corporation as such than with the lock-in feature of corporate law. As evidence that limited liability was not an important reason for incorporation, Blair quotes a joint stock company's stated rationale for incorporating, noting that it emphasized continuity rather than limited liability. But Blair also notes that these requests for incorporation were "controversial,"[61] so it is understandable that this public document would underplay a potentially unpopular reason for incorporation.

On the other side, Warren argues that

> limitation or elimination of liability of the shareholders is not merely the chief single advantage of a business corporation but it is the advantage which in the estimation of legislatures and also in the estimation of the public is of more importance than all the other advantages put together. It is the main thing.[62]

This makes sense in light of the above analysis. In contrast to lock-in and other corporate features, limited liability was the only feature that firms could not fully duplicate by contract alone without statutory assistance.[63] To be sure, limited liability alone might not have been particularly important to firms before enterprise liability and the demise of contractual privity rules at the end of the 19th and beginning of the 20th century. But it could account for the rise and persistence of the corporate form when combined with the corporation's default continuity feature.

Blair, along with other commentators,[64] may have missed the availability of

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[58] *See* Blair, *Locking In, supra* note 1 at 420, 422.

[59] This is not clear. *See* Warren, *supra* note 40 at 330-31 (discussing minimal enforcement of the Bubble Act, questions concerning whether it made transferable shares illegal).

[60] *See id.* at 333 (noting that the Bubble Act was not commonly regarded as feature of U.S. law, so transferable shares were clearly legal here).

[61] *See* Blair, *Locking In, supra* note 1 at 420.

[62] *See* Warren, *supra* note 40 at 399.

[63] *See* Larry E. Ribstein, *Limited Liability and Theories of the Corporation*, 50 Md. L. Rev. 80 (1991) (discussing importance of ability to contract to entity choice).

[64] *See* Naomi R. Lamoreaux and Jean-Lorent Rosenthal, *Corporate Governance and the Plight of Minority Shareholders in the United States Before the Great Depression*, NBER Working Paper No. W10900 (November 2004) http://papers.ssrn.com/paper.taf?abstract_id=618582 (arguing that investors in the late-nineteenth and early twentieth century chose to incorporate because of the dissolvability of partnership, leading the courts to clarify the non-dissolvability of the corporation and thereby to facilitate majority oppression of minority shareholders); Henry Hansmann, Reinier H. Kraakman & Richard C. Squire, *Law and the Rise of the Firm* (January 2006). ECGI - Law Working Paper No. 57/2006 http://ssrn.com/abstract=873507 (arguing that partnerships did not attain corporate-type continuity until the

continuity through the partnership form by paying insufficient attention to the nuances of how business law can develop. To begin with, they erroneously assume that law evolves in discrete statutory leaps, ignoring the development that occurs through contracts and statutes between statutory changes. This is like assuming that all of evolution is in the fossil record. These authors have focused on the fact that continuity provisions were not adopted in formal US statutes until the UPA in 1914, and then further extended in the Revised Uniform Partnership Act in 1994. But the drafters of the original Uniform Partnership Act sought only to clarify and not radically alter partnership law. That was the reason, bolstered by detailed case law support, drafter William Draper Lewis, gave for adopting the "tenancy in partnership" in the UPA.[65] More recently, these features were well-recognized in Georgia prior to its adoption of the UPA in 1985.[66]

Hansmann, Kraakman & Squire carry this refusal to recognize the entity features of partnership law beyond the UPA and into the adoptin of the Revised Uniform Partnership Act in the late 20th century.[67] They claim that RUPA increased partnership's continuity by, for example, barring a wrongfully dissociating partner from being bought out until completion of an agreed term or undertaking unless he could show that immediate buyout would not cause "undo hardship to the business."[68] This would support their theory that stronger continuity had to await development of better valuation technology. But RUPA's changes cut both for and against continuity. For example, RUPA merely substituted a deferred payout of the wrongful partner[69] for the infrequently used UPA duty to post a bond to avoid immediate payment of an exiting partner's interest.[70] RUPA actually reduced continuity by eliminating the non-payment of goodwill that had discouraged departure under UPA.[71] On the other hand, RUPA, but not UPA, required payment of goodwill to wrongfully dissolving partners, a move that actually reduces the firm's continuity by requiring the members to come up with more cash for wrongfully departing members.[72]

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advent of the Revised Uniform Partnership Act in the late twentieth century, by which time the development of valuation mechanisms facilitated buyout as an alternative to liquidation). See also Ron Harris, *The Formation of the East India Company as a Deal between Entrepreneurs and Outside Investors*, http://papers.ssrn.com/paper.taf?abstract_id=567941 (discussing dissolvability of the partnership as a reason for the development of the specialized business form of the East India Company in the early 17th century).

65 See William Draper Lewis, *The Uniform Partnership Act –A Reply to Mr. Crane's Criticism,* 28 HARV. L. REV. 158 (1915).

66 *See* Larry E. Ribstein, *Analysis of Georgia's New Partnership Law,* 36 MERCER L. REV. 443 (1985) (showing the relationship of the charging order to Georgia's pre-U.P.A. law).

67 *See* Hansmann, et al, *supra* note 64.

68 *See id.* at __.

69 *See* RUPA §701(h).

70 *See* UPA §38(2)(b).

71 *Compare* RUPA §701 *with* UPA §38(2) (b).

72 *Compare* RUPA §701 *with* UPA §38(2)(b).

Blair and other commentators also make questionable assumptions about the importance of legal default rules. What corporate shareholders got by default partners were able to get by agreement, particularly including agreements restricting buyout of dissociating partners. The costs of making such agreements may have mattered for smaller firms whose costs of contracting around defaults are high per dollar of capitalization. But it is not clear why these costs would impede adoption by the larger firms that are the focus of Blair's analysis.

Even if there is a persistent difference between the corporate and partnership forms regarding lock-in, the difference could be attributed to limited liability and not any inherent inability of the partnership form to accommodate lock-in. Indeed, William Draper Lewis indicated that he would have accepted his predecessor UPA-drafter Ames' decision to apply forthright entity characterization were it not for what he believed was the inconsistency between entity treatment and personal liability of the members.[73] This bolsters the argument that limited liability, and not lock-in, is the main corporate characteristic.[74]

Thus, even in the 19th century, there was no inherent inconsistency between the partnership and corporate forms regarding continuity. Whether or not the differences between the standard forms are significant, there was at least no impediment to developing corporate-type continuity through a partnership-type form rather than turning to the corporation. Even if there is a value to having distinct standard forms to serve distinct types of firms,[75] these distinct forms could be offshoots of partnership, such as the joint stock company. The long history of the close corporation indicates that the corporate form was not specific to the large publicly held firm that Blair focuses on. The costs of moving to a brand new form like the corporation are at least not clearly lower than evolving variations on the partnership.[76]

Finally, Blair appears to concede all this when she says in a footnote that she does not want to debate whether lock-in might have developed outside the corporate form.[77] This suggests that Blair is concerned only about the lock-in feature and not with particular business forms. But this concession is inconsistent with Blair's emphasis

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[73] See William Judson Lewis, *The Uniform Partnership Act – A Reply to Mr. Crane's Criticism,* 29 HARV. L. REV. 158 (1915).

[74] *See* Bromberg & Ribstein, *supra* note 32, §1.03 (discussing cases concerning the aggregate-entity distinction). Lewis' concern was based on the highly conceptual distinction between "aggregates" and "entities" rather than on practical considerations. The RUPA drafters opted for entity characterization 70 years later, as did several cases even under the UPA, even with the owners' personal liability. Even with personal liability entity features arguably predominate over aggregate in the partnership. *Id.* To be sure, personally liable members need to be able to sever their membership in the firm, and therefore their liability for future debts. But they can do this without being given a right to pull their investments out of the firm.

[75] *See supra* text accompanying note 3.

[76] *See* Bruce H. Kobayashi & Larry E. Ribstein, *Choice of Form and Network Externalities*, 43 WILLIAM & MARY LAW REVIEW 79 (2001) (discussing tradeoffs between these strategies).

[77] *See* Blair, *Locking In, supra* note 1 at 422, n. 128.

argument for the special role of the corporate form.[78] The importance of that claim is discussed in the next Part.

III. POLICY IMPLICATIONS OF THE HISTORICAL ACCOUNT

Blair's account of corporate history is questionable economics and history. Strong continuity has costs as well as benefits. And even if lock-in is as important as Blair asserts to the history of business, the partnership as well as the corporation could have provided it. The explanation for the mix of forms we observe today lies in a much richer set of business, regulatory and tax considerations than Blair's simplistic lock-in story.[79]

But why should Blair's story, and therefore the problems with the story, matter? Plainly lock-in *is* an important feature of modern business. Even if lock-in might have developed in the partnership form, it would still have been important in that form. What difference does it make whether lock-in was responsible for the development and persistence of the corporation?

First, Blair's story provides a defense of the corporate form. This is important because the contractually-based partnership is not well suited to Blair's purpose. If lock-in is essential to maintaining the mediating hierarchy, it should not be subject to contractual variation. The corporation brings with it the concession theory – that is, the theory that corporate power is derived from the state.[80] This supports a presumption favoring legal restrictions on contracts,[81] including contracts that could erode lock-in.

Second, Blair is concerned with defending lock-in against modern assaults and not simply with the development of the corporation. If lock-in is just another feature of the firm that evolved to meet business needs, it could just as easily fade into history. On the other hand, if lock-in is the essential core of the corporate form, as Blair suggests,[82] it obviously cannot be dealt with so lightly. This weightiness of lock-in matters to Blair's theory of the corporation because the power of her mediating hierarchy is depends on this rigid foundation.

Blair argues that an important implication of the central role of lock-in is that we should not tinker with the corporation in a way that threatens this feature. In particular, any reform proposal that threatens to weaken lock-in, such as one that would significantly weaken managers' ability to defend against takeovers, is unacceptable.[83] Blair supports this approach with a contractual argument: Given the contrast between the corporation

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[78] *See* Blair, *History supra* note 1.

[79] *See* Larry E. Ribstein, *Important Role of Non-Organization Law,* 40 WAKE FOREST L. REV. 751 (2005).

[80] *See* Larry E. Ribstein, *The Constitutional Conception of the Corporation*, 4 SUPREME COURT ECONOMIC REVIEW 95 (1995)

[81] *See* Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 WASH. L. REV. 1 (1990)

[82] *See* Blair, *History, supra* note 1.

[83] *Id.* at 32-42.

and the partnership regarding lock-in, the parties to the corporation necessarily have indicated a preference for lock-in by incorporating.[84] Thus, Blair says,

> If equity investors in corporations had wanted the same rights of control over corporate assets as partners in a partnership have over partnership assets, then they should have invested in partnership-type organizations rather than in corporations.[85]

Even if Blair were right about the significance of lock-in in the corporate form, she would be wrong about the implications. To be sure, investors' ability to choose among partnership and corporate forms may be valuable for investors because it enables them to escape the form of capital lock-in that currently exists in the corporate form.[86] Moreover, the ability to escape through choice of form arguably supports the existence of alternative rules. However, contrary to Blair's argument, the availability of choice of form does not support any particular menu of choices. More importantly, the fact that parties can choose among different forms does not mean that particular rules in a given form should be mandatory.[87]

If lock-in does not account for the rise of the corporation, what does? In other words, if lock-in could just as easily have been accommodated within the partnership form, why did corporations become so important? Limited liability is at least part of the answer.[88] Capital lock-in also played a role, but not, as Blair supposes, because it is inherent in and essential to the corporation. Rather, lock-in was backed by politically influential corporate managers because of its role in underpinning of managers' power. Empowering owners to cash out of the firm would have the significant effect of loosening managers' control over the corporate cash. Thus, lock-in matters not as a business necessity but as a regulatory objective. Corporate managers have reason to like the control over corporate cash that lock-in enables. They would accordingly favor laws that maintain this control, including laws associated with the corporate form. For example, the corporate tax has the effect of reducing owners' incentives to insist on a right to distributions.[89]

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[84] *Id.* at 19-26.

[85] *Id.* at 38.

[86] *See* Ribstein, *supra* note 23; Ribstein, *supra* note 26. Blair oddly disputes this argument on the basis that "passive investors in limited partnerships may have even less ability to withdraw their contribution or influence management to make distributions than shareholders have, especially if the limited partnership shares are publicly traded." Blair, *History, supra* note 1 at 38, n. 142. This seems to suggest that limited partners are more like corporate shareholders than corporate shareholders are, thereby undercutting her claim that lock-in is an essential difference between the forms.

[87] Indeed, Blair stresses the *default* rules of business entities, thereby implying that the parties ought to be able to opt out of those rules.

[88] *See* Ribstein, *supra* note 80 (showing how corporate entity provided the conceptual basis for limited liability).

[89] *See* Steven A. Bank, *A Capital Lock-In Theory of the Corporate Income Tax*, 94 GEO. L. J. __ (2006); Ribstein, *supra* note 26.

Although Blair purports to embrace choice of form,[90] her theory implies that firms should be compelled to accept capital lock-in. If lock-in is as important as Blair suggests, it follows that courts and regulators should suspect contracts and business associations that purport to reject it. Legal pressures toward lock-in will become more significant as the business and political stories diverge. Business considerations increasingly favors a different sort of firm – one that relies on contracts and markets rather than ownership of far-flung assets.[91] As Douglas Baird has observed, "no longer are the entities providing the goods or services long-lived, atomistic firms with a readily identifiable governance structure."[92] Thus, rules that favor the traditional corporate entity can be expected to get increasingly out of step with business reality.

IV. CONCLUDING REMARKS

Margaret Blair theorizes that capital lock-in is both the essential nature of the corporation and the reason why corporations dominate the business landscape today. This confers stature on capital lock-in that it does not deserve, given the varying costs and benefits of lock-in depending on the particular context and firm. Moreover, lock-in has never been unique to the corporate form and did not make the rise of the corporation inevitable. Thus, the lock-in feature should not be frozen in place by this dubious historical account. Rather, the business forms should be free to evolve to meet changing business needs.

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[90] *See supra* text accompanying note 84.

[91] *See* Ribstein, *supra* ntœ 23 at __.

[92] *See* Baird, *supra* note 20