Agency Law as Asset Partitioning

GABRIEL RAUTERBERG†

ABSTRACT. This article suggests a shift in how we think about agency. The essential function of agency law lies not only in enabling the delegation of authority, as is widely suggested, but as significantly in its effect on *creditors' rights* through asset partitioning. There is an increasing temptation in legal scholarship to treat agency law as a side-show confined to the first day of corporations class. This is because much of what agency law does in commerce could simply be accomplished through standard-form contracts, providing default terms for the relationships among firms, their managers, and third parties. Even agency's much-vaunted fiduciary duties can easily be altered or waived by contract – and often are. This article identifies the essential role of agency law, which parties could not contractually replicate, and the important efficiencies that flow from it.

This role is asset partitioning: Just as limited liability and organizational law partition off the assets of a firm's owners from the assets of the firm itself, agency law partitions off the assets of a firm's managers from the firm's own assets. Recognizing this function reframes the usual staging of contractual disputes in agency as a zero-sum balancing act between the interests of third parties and of principals. Whether owners or managers should be liable for a firm's unpaid contracts is not a win-lose distributional question – pitting the firm's creditors against insiders – but can be socially efficient. Through simplifying and specializing asset pools, asset partitioning lowers the cost of monitoring the firm's assets and thus the cost of credit.

Understanding agency's asset partitioning role has extensive implications for theory and practice. In addition to providing a unifying account of agency law, the analysis resolves current disputes in the interpretation of its doctrine. Most importantly, recognizing the essential role of agency demonstrates its ongoing significance to commercial and corporate law.

†AUTHOR. Post-Doctoral Research Scholar, Program in the Law & Economics of Capital Markets, Columbia Law School; J.D., Yale Law School 2009. For particularly helpful comments, I am grateful to John Armour, Anthony Casey, Tsilly Dagan, Zohar Goshen, Marcel Kahan, Peter Molk, John Morley, James Nelson, Joseph Raz, Sarath Sanga, Henry Smith, Richard Squire, Andrew Verstein, and participants at workshops at the 2014 Midwest Law and Economics Association Conference and Columbia Law School.

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INTRODUCTION

The agency relationship is a foundation of modern commerce. Every large firm manages its business activities through a dizzying array of agents who carry out the firm's affairs and bind it by the contracts they enter.[1] Directors, CEOs, managing partners – all are agents authorized to transact on some firm's behalf. As the Supreme Court noted last term in *Hobby Lobby*, "corporations, separate and apart from the human beings who run and are employed by them, cannot do anything at all."[2] Given the importance of agency law, the Supreme Court and federal circuit courts predictably remain preoccupied with disputes over the interpretation of its doctrine.[3]

Yet, scholarly understanding of agency law has not kept pace with its continuing significance to commercial and corporate activity. In fact, the most noticeable feature of scholarship addressing agency law is how little there is. Ever since Oliver Wendell Holmes, Jr. attacked agency doctrine a century ago as "the resultant of a conflict between logic and good sense," academics have almost universally neglected the topic in both law and economics.[4] While a sophisticated literature explored the economic concept of agency costs, the concepts of agency law itself have gone largely unanalyzed.[5] Though there has been a renewed theoretical focus on the functions of legal entities (such as partnerships, corporations, or LLCs), the agency relationships through which an entity controls its affairs have been overlooked.[6]

This article seeks to remedy that gap in scholarship, and develops a theory of the economic function of agency law in the context of business enterprise. Agency law's most important economic contribution lies not only in enabling the delegation of authority, as is widely suggested, but more significantly in its effect on *creditors' rights* through *asset partitioning*. Specifically, agency law empowers individuals to manage an

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[1] Many economists and legal scholars have noted the pervasive role played by agents in modern commercial life. *See, e.g.*, Kenneth Arrow, *The Economics of Moral Hazard: Further Comment*, 58 AM. ECON. REV. 537 (1968) ("The principal-agent relationship is very pervasive in all economies and specially in modern ones"); HAROLD GILL REUSCHLEIN & WILLIAM A. GREGORY, THE LAW OF AGENCY AND PARTNERSHIP 3 (2d ed. 1990) ("most of the world's work is performed by agents").

[2] *See Burwell v. Hobby Lobby Stores, Inc.*, 573 U.S. __, 134 S.Ct. 2751 (2014) (internal punctuation omitted); *St. Clair v. Cox*, 106 U.S. 530 (1882).

[3] For just the Supreme Court, this includes last year's decision in *Hobby Lobby*, and the recent decisions in *Vance v. Ball State University*, 570 U.S. __, 133 S.Ct. 2434 (2013), *Maples v. Thomas*, 565 U.S. __, 132 S.Ct. 912 (2012), and *Janus Capital Group, Inc. v. First Derivative Traders*, 564 U.S. __, 131 S.Ct. 2296 (2011), all of which grappled with important agency law issues.

[4] *See* Oliver Wendell Holmes, Jr., *Agency* (pts. 1 & 2), 4 HARV. L. REV. 345 (1891), 5 HARV. L. REV. 1, 14 (1891).

[5] Agency costs are "the sum of the costs of designing, implementing, and maintaining appropriate incentive and control systems [for agents] and the residual loss resulting from the difficulty of solving these problems completely." Michael C. Jensen & William H. Meckling, *Specific and General Knowledge, and Organization Structure*, in CONTRACT ECONOMICS 17 (Lars Werin & Hans Wijkander eds. 1992); *see also* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

[6] *See, e.g.*, Kenneth Ayotte & Henry Hansmann, *Legal Entities As Transferable Bundles of Contracts*, 111 MICH. L. REV. 715, 721 (2013); Anthony J. Casey, *The New Corporate Web*, 124 YALE L.J. __ (2015).

enterprise's affairs, while maintaining a separation between the personal assets and liabilities of those managers and the assets and liabilities of the enterprise itself.

Understanding agency's asset partitioning role illuminates where agency law serves a function that contract law alone could not achieve. Most of what is usually emphasized in agency law could simply be accomplished through standard-form contracts providing off-the-rack terms for the relationships among firms, their managers, and third parties.[8] In this sense, the doctrine of agency merely provides default terms around which parties can freely contract. Even agency's famous fiduciary duties can easily be altered or waived by contract – and often are.[9] This raises the question of whether the law of agency does something more – and more important – than merely provide ready default terms. This article shows that agency law does have an essential role – asset partitioning. Essential, both in the sense that parties could not replicate it through contracting and so it is a necessary contribution of law,[10] and because it makes a crucial contribution to business enterprise.[11]

Asset partitioning consists of legal rules that separate the personal assets of an organization's insiders from the assets of a business entity, which we can generically call a firm.[12] When a firm defaults on its obligations, there is a natural human tendency to want to hold the firm's controlling insiders – its owners and managers – responsible for its unpaid debts. So, if a firm stops repaying a debt, it will be tempting to reach into the pockets of the directors who approved the deal, the CEO who signed it, or the owners of the business in order to repay creditors. Asset partitioning rules prevent this by defining and limiting creditors' rights in an event of default.

The best-known asset partitioning arrangement consists of the rules that partition off the assets of a firm from the assets of its owners. The familiar rule of limited liability or "owner shielding" bars the creditors of a firm from seizing the personal assets of its owners.[13] Less familiar, but as important, "entity shielding" prevents the personal creditors of individual owners from seizing the assets of the firm they own.[14] Entity

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[8] *See* Thomas A. Simpson, *A Comment on an Inherently Flawed Concept: Why the Restatement (Third) of Agency Should Not Include the Doctrine of Inherent Agency Power*, 57 ALA. L. REV. 1163, 1164 (2006) ("Most rules governing principal-agent relations are simply a generic set of 'off the rack' rules that mimic what a reasonable principal and a reasonable agent would have agreed to if they sat down and entered into negotiations."); *see also infra* note 144.

[9] *See infra* notes 171-180 and 186-188 and accompanying text.

[10] I use the term "essential" in the sense first employed by Hansmann and Kraakman to denote a legal feature that could not feasibly be replicated through contract. *See* Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE L.J. 387, 416 (2000). This article's title is also, of course, an allusion to their seminal article.

[11] *See infra* Section II.C.

[12] Hansmann & Kraakman, *supra* note 10, at 416 (2000) (explaining the role of asset partitioning rules).

[13] *See* Henry Hansmann, Reinier Kraakman & Richard Squire, *Law and the Rise of the Firm*, 119 HARV. L. REV. 1335, 1336 (2006) (reconceptualizing limited liability as owner shielding).

[14] *See* Hansmann et al., *supra* note 13, at 1336; Henry Hansmann & Reinier Kraakman, *Organizational Law as Asset Partitioning*, 44 EUROPEAN ECON. REV. 807 (2000); Henry Hansmann & Ugo Mattei, *The Functions of Trust Law: A Comparative Legal and Economic Analysis*, 73 NYU L. REV. 434 (1998).

shielding has been called "the essential role of organizational law" – the body of law that governs the creation and form of legal entities.[15]

Yet, an equally important and unexplored set of partitions exist to keep the assets of a firm and its *managers* separate. This article identifies and explains how *agency law* serves this asset partitioning role through what I term agent and principal shielding. *Agent shielding* partitions off agents' personal assets from the assets of the firm on whose behalf they act. Typically, individuals are bound by the contracts they sign; they are parties to the transactions they negotiate and enter. Agency law, however, overturns this rule, exempting individuals from liability on the contracts they enter for a firm, provided they disclose the principal and the contract was authorized by the principal.

The inverse is also true. *Principal shielding* bars the creditors of agents from being able to seize the assets of the firm itself. Seeing how agency establishes an asset partitioning arrangement casts fresh light on the most important efficiency advantages implicated by the agency relationship.[18] This article also identifies equitable doctrines – analogous to piercing the corporate veil – which courts use to sometimes set aside agency's asset partitions, holding managers liable for the debts of a firm or a firm liable for the personal debts of its managers.[19]

This article contributes to three existing literatures. First, it extends the insights of the asset partitioning approach from corporate law to commercial and agency law.[20] Second, it opens new avenues for the nascent law-and-economics literature on agency.[21] Third, it identifies which aspects of agency law are its essential contribution to commercial enterprise.[22]

This account of agency law also has extensive implications for theory and policy. It illuminates the basic doctrinal architecture of agency, explaining why it adopts waivable default rules and mandatory rules in the pattern it does,[23] as well as explaining

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[15] Hansmann and Kraakman have noted that a firm's assets are partitioned off from its managers' assets, although they did not develop that particular observation. *See* Hansmann & Kraakman, *supra* note 14, at 809. This article provides that theory, identifying *agency law* as the body of law that partitions off the assets of managers from a firm's assets, showing how it accomplishes that role, and explaining the resulting and distinctive efficiencies.

[18] *See infra* Subsections II.B.1-2.

[19] *See infra* Subsections II.B.1-2.

[20] Asset partitioning's core insights have been applied to numerous other fields of law, demonstrating asset partitioning to play an important role in trust law, bankruptcy law, investment funds, and the corporate group. *See, e.g.*, Hansmann & Mattei, *supra* note 14; Douglas G. Baird & Anthony J. Casey, *No Exit: Withdrawal Rights and the Law of Corporate Reorganizations*, 113 COLUM. L. REV. 1 (2013) (arguing that the partitioning of legal entities effectively permits firms to circumvent a mandatory-seeming bankruptcy regime); Quinn Curtis & John Morley, *Taking Exit Rights Seriously: Why Governance and Fee Litigation Don't Work in Mutual Funds*, 120 YALE L.J. 84 (2014) (analyzing the functional impact of mutual fund exit rights on the conduct of fund investors); John Morley, *The Separation of Funds and Managers*, 123 YALE L.J. 1228 (2014) (analyzing economic consequences of the legal structure of investment funds); Richard Squire, *Strategic Liability in the Corporate Group*, 78 U. CHI. L. REV. 605 (2011).

[21] *See* Part II.A.

[22] *See infra* Section III.D.

[23] *See infra* Section IV.B.

why the basic attribution rules of agency differ in contract and tort.[24] It also suggests answers to controversial doctrinal disputes and identifies how the rules of agency affect business outcomes.[25]

The article proceeds in four parts. Part I briefly sketches current doctrine and shows how this account of agency departs from existing interpretations. Part II explains how agency law establishes an asset partitioning arrangement by separating a firm's assets from the assets of its agents, and identifies the important efficiencies created by that arrangement. Part III demonstrates that private parties could not feasibly replicate the role of agency law in establishing asset partitioning, and that this role is agency's sole essential contribution to commerce. Finally, Part IV outlines some implications of the account offered here.

I. RETHINKING THE CONVENTIONAL WISDOM

Section A of this Part sketches some necessary background concepts from agency law, while Section B challenges the conventional accounts of agency doctrine in legal scholarship, emphasizing the law-and-economics literature.

A. Background Concepts

An agency relationship[26] arises when one party (the 'principal') manifests consent to another (the 'agent') that the latter shall act on her behalf and subject to her control, and the other consents to do so.[27] The agency relationship imposes duties on both the agent and principal and alters both of their legal relationships with third parties. The relationship between the agent and the principal is a fiduciary one.[28] The agent owes the principal duties of loyalty,[29] care,[30] and obedience,[31] *inter alia*, while the principal owes the agent a duty to comply with his contract, including, most importantly, to pay the agent's wages.[32] As a result of the creation of the agency relationship, the agent is endowed with the capacity to alter the principal's legal rights and duties as to third

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[24] *See infra* Section IV.A.

[25] *See infra* Sections IV.C & IV.D.

[26] For convenience, although this article is about agency's role within business enterprise, it will usually refer to the principal as female, the agent as male, and use 'firm' to refer to a generic business enterprise conducted through a legal entity, such as a corporation, LLC, or LLP.

[27] RESTATEMENT (THIRD) OF AGENCY § 1.01 [hereinafter "RESTATEMENT"] ("Agency is the fiduciary relationship that arises when one person (a 'principal') manifests assent to another person (an 'agent') that the agent shall act on the principal's behalf and subject to the principal's control, and the agent manifests assent or otherwise consents so to act.").

[28] RESTATEMENT § 1.01; *General Building Contractors Assn., Inc. v. Pennsylvania*, 458 U.S. 375, 392 (1982).

[29] RESTATEMENT § 8.01.

[30] *Id*. at § 8.08.

[31] *Id*. at § 8.09.

[32] *Id*. at § 8.13.

parties. This article focuses on agency law in contract, but the agent has the ability to alter the principal's legal status in both contract and tort.

In contract, the doctrine of authority governs the agent's power to affect the principal. The details are complex, but at the most general level, the agent gains the ability to take legally binding action on the principal's behalf as to those matters to which the principal has manifested consent.[33] More specifically, a contract entered by an agent binds the principal when it has been actually authorized or apparently authorized. Actual authority can be express, which involves spoken or written manifestations by the principal that the agent is authorized; or implied, which involves non-verbal manifestations of authority.[34] Apparent authority binds a principal to a contract, which it did not authorize, when a third party reasonably believed the agent had authority based on the principal's conduct. In agency law, the term 'authority' thus denotes an agent's capacity to legally bind the principal when interacting with third parties.[35] Likewise, an agent, for purposes of contract, is an individual on whom the principal confers some measure of authority to bind it.[36] In tort, the doctrine of vicarious liability governs the effects of agency. A principal is strictly liable for any tortious harm to a third party resulting from an agent's conduct when the tort is committed within the scope of the agent's employment.[37]

B. *The Standard Account of Agency Law*

Scholarship on the law of agency is striking for its rarity. Agency may be the only important area of law where the majority of articles analyzing it is were published before 1920. This is testimony to the debilitating legacy of Oliver Wendell Holmes, Jr.'s savaging of the subject as an obsolete grab-bag of rules, which would make a "judge blush."[38]

Some themes do emerge from recent scholarship on agency law, however, and much of it casts fresh light on aspects of agency's doctrine. One theme is the analysis of

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[33] *Id*. at § 2.01; other *see infra* Section II.B for a more detailed discussion of the rules of authority doctrine.

[34] RESTATEMENT § 2.01 Actual Authority ("An agent acts with actual authority when, at the time of taking action that has legal consequences for the principal, the agent reasonably believes, in accordance with the principal's manifestations to the agent, that the principal wishes the agent so to act."); *id*. § 2.03 Apparent Authority ("Apparent authority is the power held by an agent or other actor to affect a principal's legal relations with third parties when a third party reasonably believes the actor has authority to act on behalf of the principal and that belief is traceable to the principal's manifestations."). Whether an agent is actually authorized is based on how a reasonable agent would perceive the conduct of the principal. *See, e.g.*, *id*. § 2.01; *Interocean Ship. Co. v. National Ship. & Trad. Corp.*, 523 F.2d 527, 537 (2d Cir. 1975); TERRENCE COGHLIN, ANDREW BAKER, JULIAN KENNY & JOHN KIMBALL, TIME CHARTERS § 2.100 (2014).

[35] *Id*.

[36] Note that agency law's usage of both 'authority' and 'agent' is considerably narrower than their usage among economists, where authority involves any relationship of hierarchy and an agent is any individual with the power to affect another party. *See, e.g.*, OLIVER WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM (1985); George Baker, Robert Gibbons, Kevin J. Murphy, *Informal Authority in Organizations*, 15 J.L. ECON. & ORG. 56 (1999).

[37] RESTATEMENT § 7.03.

[38] Holmes, *Agency II*, *supra* note 4, at 14.

elements from other areas of private law that motivate specific agency doctrines or cases. For instance, several scholars have noted the role of tort-like considerations in agency case law,[39] while others have assimilated agency to principles drawn from contract law. Thus, Randy Barnett has looked at agency through the lens of consent, while Gerard McMeel has emphasized reliance.[40] Other scholarship has helpfully analyzed particular doctrines or problems within the broader world of agency.[41] One doctrine, vicarious liability, has a vast literature devoted to its functional role and efficiency,[42] though this article will only touch upon it. As for agency in contract, the most prominent theme has been the fiduciary duties it imposes on agents to ameliorate agency costs.[43]

This article offers a different perspective on agency. While the legal literature has overwhelmingly emphasized agency's distinctive liability-*creating* features, such as apparent authority and vicarious liability, this article addresses agency law's vital liability-*limiting* function, which shields both a corporate principal and its human agents through partitioning off their assets from each other. While the agency literature has focused on agency's remedial, *ex post* aspects, such as ensuring that tort victims receive recompense for agents' wrongs,[44] this article emphasizes agency law's ultimately more important *ex ante* role in expanding the world of action for commercial firms. A comment by Professor Dalley is paradigmatic of the current literature's over-emphasis on agency's remedial aspects: "the purpose of agency law is to restore the status quo after a person chooses to use an agent."[45] This article contends that agency's most important role

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[39] John Armour & Michael J. Whincop, *The Proprietary Foundations of Corporate Law*, 27 OXFORD J. LEGAL STUD. 429, 445-46 (2007); Eric Rasmusen, *Agency Law and Contract Formation*, 6 AMER. REV. L. & ECON. 369 (2004); Note, *An Efficiency Analysis of Vicarious Liability Under the Law of Agency*, 91 YALE L.J. 168 (1981). The foundational analysis of the efficiency of allocating liability to the lowest-cost avoider in tort is of course, GUIDO CALABRESI, THE COSTS OF ACCIDENTS: A LEGAL AND ECONOMIC ANALYSIS (1970).

[40] Randy E. Barnett, *Squaring Undisclosed Agency Law with Contract Theory*, 75 CALIF. L. REV. 1969 (1987); Gerard McMeel, *Philosophical Foundations of Agency Law*, 116 L.Q. REV. 387, 402 (2000); RODERICK MUNDAY, AGENCY: LAW AND PRINCIPLES 10 ("Many would claim that consent lies at the heart of agency."); *see also* Michael J. Whincop, *Nexuses of Contracts, the Authority of Corporate Agents, and Doctrinal Indeterminacy: From Formalism to Law and Economics*, 20 U.N.S.W. L.J. 274 (1997) (arguing that the legal rules of authority doctrine should minimize the joint costs of unauthorized transactions).

[41] *See* George M. Cohen, *The Collusion Problem in Agency Law*, U. Va. L., Leg. Stud. Working Paper No. 00-2 (1999) (focusing on collusion problems as an explanation for agency doctrines); Deborah A. DeMott, *The First Restatement of Agency: What Was the Agenda?*, 32 S. Ill. U. L.J. 17, 29-30 (2007).

[42] *See, e.g.*, John Coffee, Jr., *"No Soul to Damn; No Body to Kick": An Unscandalized Inquiry Into the Problem of Corporate Punishment,* 79 MICH. L. REV. 386,401 (1981); Reinier Kraakman, *The Economic Functions of Corporate Liability*, in CORPORATE GOVERNANCE AND DIRECTORS' LIABILITIES 178, 194-97 (Klaus J. Hopt & Gunther Teubner eds., 1985); Reinier H. Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 J.L. ECON. & ORG. 53, 53-54 (1986).

[43] *See, e.g.*, Robert Cooter & Bradley J. Freedman, *The Fiduciary Relationship: Its Economic Character and Legal Consequences*, 66 NYU L. REV. 1045 (1991); Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J. L. & ECON. 425 (1993); Robert H. Sitkoff, *An Economic Theory of Fiduciary Law, in* PHILOSOPHICAL FOUNDATIONS OF FIDUCIARY LAW 197 (Andrew S. Gold & Paul B. Miller 2014).

[44] *See, e.g.*, Kraakman, *supra* note 42, at 53.

[45] Paula J. Dalley, *A Theory of Agency Law*, U. PITT. L. REV. 495, 497 (2011).

is how it *alters* the status quo, empowering and facilitating commercial activity in ways that private parties could not recreate through contract.

II. AGENCY LAW AS ASSET PARTITIONING

The doctrinal details of how agency law separates the assets pools of a firm and its managers are complex, so an initial summary of the idea may prove helpful. The main claim of this article is that just as organizational law partitions off the assets of a firm's owners from the assets of the firm itself, so agency law partitions off the assets of a firm's managers from the firm's own assets. Organizational law governs the various legal entities employed by business enterprises, such as corporations, LLCs, or LLPs. It typically establishes two features that unincorporated forms of business lack.[46] First is owner shielding (better known as limited liability), which shields the assets of a firm's owners from creditors of the firm. Second is entity shielding, which shields the firm's own assets from the creditors of its owners.[47]

Like organizational law, agency law implements an asset partitioning arrangement in the commercial firm. Agent shielding shields the assets of individual agents from the creditors of the firm, while principal shielding protects the firm's assets from its agents' creditors. These limits on creditors' rights arise because by making it easier for creditors to assess and monitor an asset pool, they reduce the costs of credit for a firm, thus increasing the wealth that can be shared among all those who contract with the firm.

The table below illustrates the relationships among owner and entity shielding, and agent and principal shielding:

FORMS OF ASSET PARTITIONING IN COMMERCIAL FIRMS

SOURCE OF LIABILITY	LEGAL PERSON WHOSE ASSETS ARE SHIELDED	FORM OF PARTITIONING
BUSINESS ENTITY	OWNER	OWNER SHIELDING
OWNER	BUSINESS ENTITY	ENTITY SHIELDING
AGENT (WITH AUTHORITY)	AGENT'S PERSONAL ASSETS	AGENT SHIELDING

[46] Hansmann et al., *supra* note 13, at 1336. A corporation is "[a]n artificial person or legal entity . . . . The corporation is distinct from the individuals who comprise it (shareholders) . . . [and] is regarded in law as having a personality and existence distinct from that of its several members." BLACK'S LAW DICTIONARY 340 (6th ed. 1990). *See also Harris v. Stony Clove Lake Acres Inc.*, 608 N.Y.S.2d 584, 586 (1994) ("A corporation, even when wholly owned by a single individual, has a separate legal existence from its shareholders"); *see also Dartmouth College v. Woodward*, 17 U.S. 518 (1819).

[47] Hansmann et al., *supra* note 13, at 1336.

AGENT (WITHOUT AUTHORITY)	BUSINESS ENTITY	PRINCIPAL SHIELDING

Let us turn now to fleshing these ideas out. I first consider the theory of asset partitioning, and then examine the doctrine through which agency partitions managers' assets from those of the firm. I then identify and explain the efficiency advantages generated by agency law as asset partitioning. While some of these advantages parallel organizational law, others are unique to agency.

A. *The Theory of Asset Partitioning*

The literature on the role of asset partitioning in different areas of law has grown enormously in size and sophistication.[48] This section offers a brief summary for those new to this literature. The aim is to give the necessary context for understanding the application of these ideas to agency law.

The essential idea of asset partitioning is that legal rules can reduce the costs creditors face in assessing the value of a firm's assets by partitioning the assets held in the firm's name from the assets of those involved in the firm. As Robert Sitkoff has put it, "[t]he core function of asset partitioning rules . . . is to separate the personal property and obligations of the organization's insiders from the property and obligations of the organization."[49] The theory begins with the observation that when a legal person enters a contract or incurs a tort liability, all of the resources that she owns – her "pool of assets" – are, as a default, available to recompense a counterparty or victim.[50] From the perspective of a creditor considering a contractual relationship with that person, that asset pool is the security that exists to "bond" or render credible her contractual commitments and to levy upon in the event of default. Yet, the law can partition off some of those assets and protect them from creditors' claims. For instance, in many states an individual's primary residence is protected from seizure by an unsatisfied tort claimant, unlike the remainder of her assets.[51] Such legal arrangements divide up assets, which the

[48] *See, e.g.*, Douglas G. Baird and Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L REV. 1209, 1230 (2006) (discussing the secured loan from an asset partitioning perspective); Marcus Cole, *Limiting Liability Through Bankruptcy*, 70 U. CIN. L. REV. 1245 (2002) (arguing that the distinguishing characteristic of bankruptcy law is temporal asset partitioning); Richard Squire, *Clearinghouses and the Rapid Resolution of Bankrupt Financial Firms*, 99 CORNELL L. REV. 857 (2014) (exploring the efficiency advantages of the faster payouts enabled by the asset partitioning role of clearinghouses's set-off rights); Richard Squire, *The Case for Symmetry in Creditors' Rights*, 118 YALE L.J. 806, 810 (2009) (contrasting the economic consequences of "symmetrical" and "asymmetrical" asset partitioning arrangement). In a short, but important essay, Robert Thompson observed that agency rules could alter the asset partitioning arrangement of a corporate group. *See* Robert B. Thompson, *Agency Law and Asset Partitioning*, 71 U. CIN. L. REV. 1321 (2003). Thompson does not discuss the general asset partitioning role of agency in commerce, confining his remarks to the corporate group.

[49] Robert H. Sitkoff, *Trust Law as Fiduciary Governance Plus Asset Partitioning*, *in* THE WORLDS OF THE TRUST 434 (Lionel Smith ed. 2013); *see also* Thomas W. Merrill & Henry E. Smith, *The Property/Contract Interface*, 101 COLUM. L. REV. 773, 849 (2001).

[50] Hansmann & Kraakman, *supra* note 14, at 810.

[51] *See, e.g.*, DEL. CODE ANN. TIT. 10 § 4914 (2010); MASS. ANN. LAWS CH. 235, § 34A (2010).

law could, in principle, treat as a single pool available to creditors. By doing so, the law creates winners and losers. For instance, a creditor may go unpaid because the debtor's bank balance is zero, even though the debtor owns a valuable home. It is natural to view such arrangements through a zero-sum lens in which creditors are the losers and debtors the winners.[52] What is so enlightening about asset partitioning is that it shows how a clear pattern of creditors' rights, which partitions off some assets, can actually be efficient for *the debtor and creditors*.

The theory of asset partitioning argues that partitioning asset pools can be socially efficient, rather than solely redistributive, where the partitioning reduces information costs for creditors in appraising and monitoring an asset pool for its value. Richard Posner and Anthony Kronman recognized the initial fact that *simplifying* a set of resources by dividing it up into smaller pools could make monitoring easier and thus less costly for creditors.[53] Smaller pools reduce creditor information costs because they reduce the number of factors whose value must be assessed when determining the risk of default and the scope of a likely recovery if default occurs.[54]

Subsequent work identified a more important benefit of asset partitioning, which flows from shielding assets from creditors' claims in ways that permit creditors to *specialize* in monitoring a particular kind of asset pool. Hansmann and Kraakman provide the classic example of this benefit.[55] Consider an airline company about to purchase a car rental business. It can purchase the car rental and organize it as a legally separate but wholly-owned subsidiary, or operate it as a division within the airline company itself. In either case, the management of the newly combined business will be the same, but if the car rental business operates as a subsidiary then creditors who specialize in assessing the value of car rental assets and the riskiness of car rental liabilities can incur lower costs by solely lending to and more cheaply monitoring that specialized subsidiary, than if they must monitor the combined business as a whole.[56]

Creditors with specialized monitoring abilities are ubiquitous.[57] For instance, car manufacturers that lease cars to a rental business will likely have great expertise in cars'

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[52] *See, e.g.*, Paul Halpern, Michael Trebilcock & Stuart Turnbull, *An Economic Analysis of Limited Liability in Corporation Law*, 30 U. TORONTO L.J. 117, 148 (1980) ("a limited liability regime will, in many cases, create incentives for owners to exploit a moral hazard and transfer uncompensated business risks to creditors").

[53] Richard Posner, *The Rights of Creditors of Affiliated Corporations*, 43 U. CHI. L. REV. 499 (1976); Thomas H. Jackson & Anthony T. Kronman, *Secured Financing and Priorities Among Creditors*, 88 YALE L.J. 1143 (1979).

[54] Posner, *supra* note 53, at 516-17 (emphasizing the simplification benefit of subdividing asset pools).

[55] Hansmann & Kraakman, *supra* note 14, at 810.

[56] *Id*.

[57] *See* Jackson & Kronman, *supra* note 53, at 1159 ("the expected monitoring costs of some creditors are almost certain to be lower than the costs of others, even at comparable levels of risk, and to rise more slowly in response to increases in risk as well, because of the comparative advantage these creditors enjoy in obtaining and assessing information about the debtor's behavior"); *see also* David A. Skeel, Jr., *Corporate Anatomy Lessons*, 113 YALE L.J. 1519, 1566 (2004) (discussing specialized monitoring abilities of creditors); Mark B. Wessman, *Purchase Money Inventory Financing: The Case for Limited Cross-Collateralization*, 51 OHIO ST. L.J. 1283, 1301 n.167 (1990) (discussing creditors who have "specialized knowledge of particular kinds of assets").

value as collateral and the risks they face, but comparatively none in the value and risk of airlines. A combined business thus faces a higher interest rate than a creditor would need to charge if they already understood the business. By disaggregating asset pools along specialized lines, asset partitioning avoids this problem. It empowers creditors with differing evaluation skills to lend to asset pools suiting their comparative expertise by separating them off from other assets.

Hansmann and co-authors famously offered asset partitioning as the core efficiency benefit of the legal entity and of organizational law – the body of law that governs the formation and structure of legal entities.[58] A legal entity, they suggest, is defined by owner shielding, which insulates the assets of the *owners* of a firm from creditors' claims against the firm itself, and entity shielding, which insulates the *firm*'s asset pool from creditors of the firm's owners.[59] They refer to this asset partitioning function as "the essential role of all forms of organizational law."[60] Essential, both because parties could not replicate entity shielding through contract, but also because of its indispensable efficiency benefits for firms.[61]

For each of limited liability and entity shielding, there is also an equitable doctrine that courts sometimes use to "pierce" or disregard partitions among assets. For limited liability, this doctrine is the notorious "piercing of the corporate veil," which remains the most litigated[62] and one of the most controversial doctrines in corporate law.[63] Piercing the corporate veil involves disregarding limited liability and holding the owners of a firm liable for the firm's unpaid debts.[64] For entity shielding, the equitable remedy is the opposite, "reverse veil piercing," which involves "disregarding the corporate form to reach assets of a corporation for debts of a shareholder."[65] While far less analyzed in scholarship, reverse veil piercing is nonetheless a commonly applied doctrine.[66] We will

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58 Hansmann & Kraakman, *supra* note 12, at 416.

59 Hansmann & Kraakman, *supra* note 14, at 810.

60 Hansmann & Kraakman, *supra* note 12, at 390.

61 *Id*.

62 Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 CORNELL L. REV. 1036 (1991).

63 *See* Richmond McPherson & Nader Raja, *Corporate Justice: An Empirical Study of Piercing Rates and Factors Courts Consider When Piercing the Corporate Veil*, 45 WAKE FOREST L. REV. 931, 934 (2010) (recounting the "controversial history in American business law" of veil piercing).

64 *See Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co.*, 267 F.3d 340, 353 (3d Cir. 2001)

("'piercing the corporate veil' doctrine treats a corporation and its shareholders as identical for purposes of suit, thereby imposing personal liability on shareholders").

65 *Pacific Development, Inc. v. U.S.*, 79-1 U.S.T.C. ¶ 9138 (U.S.D.C. Col.1979). Interestingly, reverse veil piercing recently received attention due to its applicability to the Supreme Court case, *Burwell v. Hobby Lobby Stores, Inc.*, 573 U.S. __, 134 S.Ct. 2751 (2014). *See, e.g.*, Stephen Bainbridge, *Using Reverse Veil Piercing to Vindicate the Free Exercise Rights of Incorporated Employers*, 16 GREEN BAG 2D 235 (2013).

66 *See, e.g.*, *McCall Stock Farms, Inc. v. United States*, 14 F.3d 1562, 1568 (Fed.Cir.1993); *Towe Antique Ford Foundation v. I.R.S.*, 999 F.2d 1387, 1390-94 (9th Cir.1993); *Zahra Spiritual Trust v. United States*, 910 F.2d 240, 243-45 (5th Cir.1990); *Seghers v. El Bizri*, 513 F. Supp. 2d 694, 703 (N.D. Tex. 2007); *Select Creations, Inc. v. Paliafito Am., Inc.*, 852 F.Supp. 740, 773-74 (E.D.Wis. 1994); *In re Mid-West Metal Products, Inc.*, 13 BR 562, 566 (Bk.Ct. D.Kan. 1981); *Taylor v. Newton*, 117 Cal.App.2d 752, 257

see later that the form of asset partitioning established by agency law is similarly accompanied by equitable doctrines that license courts to sometimes disregard the separation between agents' assets and the firm's assets. Surprisingly, these doctrines, while important, have largely eluded notice, let alone examination, in the legal and economic literature.

B. How Agency Establishes Asset Partitioning

This section explains how agency law establishes an asset partitioning arrangement – one that partitions off the assets of a firm's agents from the assets of the firm itself. Agency law shields the firm's agents from joint liability with the firm for conduct they undertake on its behalf and the firm from the creditors of unauthorized claims against its agents. As will be explained below, it is the rules of agency law that enable, say, a corporation's board or its officers, to conduct a firm's commercial affairs without becoming personally liable for them, and agency's rules that decide exactly what is an "authorized" and an "unauthorized" contract entered by an agent, which will or will not bind a firm.

1. Agent and Principal Shielding

Typically, an individual who signs a contract is bound by it. This sentiment is famously captured in a leading New York case: "the signer of a deed or other instrument is conclusively bound thereby."[67] Not so if the individual is acting as an agent, however. An agent can avoid personal liability on a contract he enters if two conditions are met. First, the agent must disclose that he is acting on the principal's behalf and the principal's identity ("disclosed principal doctrine").[68] If an agent does not disclose that he is acting for a principal (an "undisclosed principal"), or discloses the principal but not her specific identity (a "partially disclosed principal"), then the agent remains jointly bound to the contract with the principal.[69] Second, the agent must have entered the contract with authority, which encompasses either actual or apparent authority.[70] If an agent enters a contract on a disclosed principal's behalf, but without authority, then the agent (and not the principal) is a party to and bound by that contract.[71] If the agent meets both of these conditions, however, then the law of agency inserts a new rule where the principal is

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P.2d 68, 72-73 (1953); *Cargill, Inc. v. Hedge*, 375 N.W.2d 477, 478-80 (Minn.1985). *See generally* Kathryn Hespe, *Preserving Entity Shielding: How Corporations Should Respond to Reverse Piercing of the Corporate Veil*, 14 J. BUS. & SEC. L. 69 (2013).

[67] *Cont'l Airlines, Inc. v. Lelakis*, 129 F.3d 113 (2d Cir. 1997) (internal punctuation omitted).

[68] *Id*. at § 6.01 ("When an agent acting with actual or apparent authority makes a contract on behalf of a disclosed principal, (1) the principal and the third party are parties to the contract; and (2) the agent is not a party to the contract unless the agent and third party agree otherwise.").

[69] RESTATEMENT § 2(b); *id*. at § 6.03(2). The undisclosed principal typically also remains a party to the contract. *Id*. at §§ 6.03(1),(3), 2.06.

[70] RESTATEMENT §§ 2.01, 2.02, 2.03 & 6.10.

[71] RESTATEMENT § 6.10

alone liable and no recourse can be had against the agent's assets.[72] These rules are summarized in the Table below.

PARTIES LIABLE IN CONTRACT

DISCLOSURE	AUTHORIZED	UNAUTHORIZED
DISCLOSED PRINCIPAL	PRINCIPAL	AGENT
UNIDENTIFIED PRINCIPAL	AGENT & PRINCIPAL	AGENT
UNDISCLOSED PRINCIPAL	AGENT & PRINCIPAL	AGENT

Thus, agency law permits an agent to act on behalf of a firm and attributes the contract he entered to the firm, while shielding the agent from the creditors of that contract.[73] So, while the directors of a corporation are responsible for ratifying many of its most important transactions, they are generally not themselves parties to those contracts, unless they specifically personally guarantee a contract.[74] I refer to this aspect of agency law, which insulates agents from joint contractual liability with firms as *agent shielding*.

Although agent shielding (via disclosed principal doctrine) is a bedrock principle of modern agency law,[84] it is frequently tested by litigants' desire to reach into the deep pockets of the corporate officers or directors of a defunct corporation. For instance, in *Mason Tenders*,[85] an out-of-business construction company, Thomsen, Inc., failed to make monetary contributions it had contractually promised to the labor organizations it employed. The corporation conceded it was liable.[86] The only issue in dispute was whether the company's president was also personally liable to the plaintiffs for breach of contract.[87] It was the president who had signed the contract with the funds in the first place. Although it meant that the funds might never be repaid, the court held that the president was "not personally liable under the contract" because on the contract's

[72] *Id*. "The agent for a disclosed principal . . . is not responsible under the contract." *Kientzler v. Sun Line Greece Special Shipping Co.*, 779 F. Supp. 342, 346 (S.D.N.Y. 1991).

[73] It may be objected that there is no magic to the asset partitioning arrangement established by agency law. After all, disclosed principal doctrine ensures a third party had *notice* of the principal's identity. This is no objection, however, as all asset partitioning arrangements impose notice requirements for their efficacy, such as labeling requirements for corporations ("Inc."), to ensure limited liability. KRAAKMAN ET AL., ANATOMY OF CORPORATE LAW, CH.1 (2d ed. 2009).

[74] *Keskal v. Modrakowski*, 249 N.Y. 406 (1928) ("When the agency is disclosed, and the contract relates to the matter of the agency, and is within the authority conferred, the agent will not be personally bound").

[84] In 1840, the year of the earliest case cited on WestLaw using the phrase "disclosed principal," a court could declare "[i]t is a well established rule of law, that when an agent names his principal, the principal is responsible, not the agent." *Roberts v. Austin*, 2 Miles 254 (Pa. 1840).

[85] *Mason Tenders Dist. Council Welfare Fund v. Thomasen Const. Co.*, 164 F.Supp.2d 379 (S.D.N.Y. 2001).

[86] *Id*. at 380.

[87] *Id*. at 380.

signature line he had indicated that he was signing only in his capacity as president of the company and the contract had been authorized.[88] Agency law thus generally shields an agent from being personally bound by authorized contracts he undertakes for a disclosed firm.

Agency law also shields the assets of a *firm* from the creditors of its *agents*, when an agent has engaged in a transaction that was not authorized by the firm. I refer to this feature of agency law as *principal shielding*.[99] For instance, case law is filled with opinions featuring good faith insureds entering a policy believing it to protect them. After an accident, the insured seeks to make use of the policy, only to have the insurer deny coverage because the insurance agent acted beyond the scope of his authority.[100] Courts then uphold the insurer's argument and shield the company from the insured's claim. In *Van Arsdale v. Metro. Title Guar. Co.*, the court summarized the general rule succinctly: "A principal will not be bound where, as here, the agent exceeds the scope of his authority."[101]

2. *The Necessary Role of Agency Law*

The assets and liabilities of a firm and its employees are typically separate. It is a more complicated question, however, as to whether *agency law* plays a necessary role in establishing that separation, or whether, say, the law of contract or the concept of legal personality, would be sufficient. In this section, I discuss why agency law plays a necessary role. The crucial point is that the use of an agent to *intermediate* the principal's legal personality fundamentally alters the basic situation of contract so as to raise a whole set of novel issues that require a distinct body of law—agency law—to resolve them.

Structurally, the basic relationship in contract is *dyadic*. One principal exchanges a set of promises with another principal. Contracts certainly can become more complicated, but in its primitive, idealized form, a contract is simply a bilateral exchange of goods, services, or money for consideration of some kind.

Agency, even in most primitive, idealized form, is *triadic*. If a contract entered by an agent with a third party is to bind the principal—that is, for it to function as an agency contract—then it must have been authorized by the principal. The fact of authority, which is extrinsic to the dyadic negotiation and exchange between agent and third party is determinative of who is bound by the contract the agent enters.

Authority doctrine is necessary for both principal shielding and agent shielding. Consider two simple cases involving disagreement between the agent and principal regarding whether the principal authorized a contract that the agent entered with a third party. Such a disagreement can arise from a variety of sources. It could be an innocent

[88] *Id*. at 382-83; *see also Mencher v. Weiss*, 306 N.Y. 1, 4 (1953) ("where there is a disclosed principal-agent relationship and the contract relates to a matter of the agency, the agent will not be personally bound unless there is clear and explicit evidence of the agent's intention to substitute or superadd his personal liability for, or to, that of his principal.").

[99] This is subject to the important exceptions, discussed next, that a principal sometimes is liable for unauthorized contracts.

[100] *See, e.g.*, *N. Assur. Co. of Am. v. Summers*, 17 F.3d 956 (7th Cir. 1994); *Allegheny Mut. Cas. Co. v. Franklin*, 513 N.E.2d 658 (Ind. Ct. App. 1987).

[101] 103 Misc. 2d 104, 425 N.Y.S.2d 482 (Dist. Ct. 1980).

mistake on the agent's part in which he sincerely, but unreasonably misinterpreted the principal's conduct to be enjoining him to enter the contract on the principal's behalf. It could be the principal's good faith mistake. It could also be insincere opportunism by either the principal or agent.

Take first the case of agent opportunism. Seeking a lower cost of capital, the agent entered a contract for a loan, purporting to enter it at the principal's behest, when in fact the loan is meant to serve the agent's personal purposes. Here, principal shielding is at issue as the principal will wish to not be bound by the contract. What will determine whether the principal *is bound* depends on whether either the agent or third party reasonably believed based on the principal's manifestations that she desired the agent to enter the contract. The key question is not a matter of contract doctrine. It is a question to be resolved under authority doctrine as a matter of actual authority and apparent authority.

The same is true in the case of the principal's opportunism. Say the principal told the agent to enter a contract, but seeing that it is now of negative value, the principal seeks to renege, claiming that it is a personal contract of the agent that was not authorized. Here, agent shielding is at issue. The governing doctrine is the same, however. Again, authority doctrine will be called upon to resolve whether the law will find the agent or principal bound to the contract.

3. *Equitable Remedies for Piercing Agent and Principal Shielding*

Equitable doctrines allow courts to disregard the partition between agent and firm and to hold an agent personally liable under certain circumstances. I refer to this as *agent piercing*.[109] Agent piercing occurs where an agent disclosed the firm for whom he acted, but a court holds that it is inequitable to maintain "the separate existence" of the corporation from its managers. The case law abounds with examples of this equitable piercing.[110] For instance, in *LaFond v. Basham*,[111] plaintiffs sued a construction company for defaulting on its remodeling contract as well as the corporation's president in his personal capacity. The president was not a shareholder of the corporation, but "was a member of the board of directors" and "dictated all [the firm's] policy and activity."[112] The court held the corporation's president individually liable for the contractual default, stating that the "corporate entity may be disregarded" and "corporate directors may be held personally liable if equity so requires."[113]

[109] The allusion, of course, is to veil piercing, which sets aside limited liability in order to hold a firm's owners liable for its debts. *See infra* Section II.A.

[110] There are a large number of cases involving agent piercing based on equitable. *See, e.g.*, *Freeman v. Complex Computing Co.*, 119 F.3d 1044, 1051 (2d Cir. 1997); *In re MacDonald*, 114 B.R. 326, 332-33 (D.Mass. 1990); *McCallum Family L.L.C. v. Winger*, 221 P.3d 69, 76 (Colo. App. 2009); *Sheffield Servs. Co. v. Trowbridge*, 211 P.3d 714, 721 (Colo. App. 2009); *Lally v. Catskill Airways, Inc.*, 198 A.D.2d 643, 645, 603 N.Y.S.2d 619, 621 (3d Dep't 1993); *Ward v. Cooper*, 685 P.2d 1382, 1383-84 (Colo. App. 1984); *Macaluso v. Jenkins*, 95 Ill.App.3d 461 (1981); *Rosebud Corp. v. Boggio*, 39 Colo.App. 84 (1977); *Nix v. Miller*, 26 Colo. 203 (1899).

[111] 683 P.2d 367, 369 (Colo. App. 1984).

[112] *Id*.

[113] *Id*.

The analogy between agent piercing and veil piercing suggests a position that is advanced repeatedly in cases litigating agent piercing, but that to my knowledge scholarship has never considered.[114] Where an owner of a firm is also a manager of the firm, *veil piercing and agent piercing can act as competing or concurrent theories of liability*. Both aim to set aside the corporate personality of a firm in favor of personal liability for insiders.[115] The difference is that veil piercing sets aside organizational law in order to hold the owners liable by piercing the corporate veil, while agent piercing sets aside agency law in order to hold managers liable.

These are close to exactly the arguments made by the plaintiff, a manufacturing corporation, in *Keator*.[116] The plaintiff had agreed to manufacture coloreaders – devices designed to assist those with impaired sight – for Eyetronics Inc., but were not paid when the manufacturing was complete. The plaintiff claimed it was unaware that Eyetronics was a corporation and sued the business's controlling shareholder and president George Keator. The plaintiff advanced a veil piercing theory against Keator in his capacity as owner, and further advanced a theory against Keator as president, claiming that Keator had signed the agreement in his personal capacity and not just as president.[117] The court rejected both theories, finding that there was no equitable basis to pierce the corporate veil and that defendant had signed the contract solely as Eyetronics' president, rather than also in a personal capacity.[118]

As with agent piercing, there are also courts that have engaged in principal piercing based on equitable grounds. I refer to these doctrines, which enable the creditors of an agent who was acting without the principal's authorization to nonetheless seize the principal's assets for recompense, as *principal piercing*.

The equitable cases are especially illuminating. In *JSC Foreign*,[119] a corporation's sole officer had an outstanding debt to the plaintiff. The plaintiff sought to levy on the assets of the corporation for which the officer worked in order to pay the debt, and the court permitted the plaintiff to do so, finding that the officer dominated the corporation.[120] The court thereby permitted a creditor of an individual officer to seize the assets of the firm itself, although the officer was not an owner.[121] Similarly, in *LFC Marketing Group*

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[114] *See, e.g.*, *Rosebud Corp. v. Boggio*, 39 Colo. App. 84, 87 (1977).

[115] *See also* 585 F.Supp.2d at 473; *LucidRisk, LLC v. Ogden*, 615 F.Supp.2d 1 (D.Conn. 2009).

[116] *New York Ass'n for Retarded Children, Inc., Montgomery Cnty. Chapter v. Keator*, 199 A.D.2d 921 (1993).

[117] *Id*. at 922-23.

[118] *Id*. at 923 ("an agent of a disclosed principal does not, absent express agreement, become liable individually on a contract relating to the agency").

[119] *JSC Foreign, Econ. Ass'n Technostroyexport v. Int'l Dev. & Trade Servs., Inc.*, 306 F. Supp. 2d 482 (S.D.N.Y. 2004).

[120] *Id*. at 486.

[121] In *In re Destiny Enterprises, LLC*, No. 2-07-BK-00542, 2008 WL 5047808, at *1 (Bankr. D. Ariz. July 14, 2008), the plaintiff sought a "judgment . . . against the Debtor, its manager, and related entities whereby the obligations of the manager . . . would be deemed to be the liabilities of the Debtor." The court noted that, if "successful, the Debtor no longer exists as a separate entity. Therefore, all assets of the Debtor become the assets of the Debtor's manager." *Id*. at *3 n.14.

v. Loomis,[122] the court permitted a judgment creditor of a failed real estate transaction with William Lange to levy on the assets of the corporation Lange managed. The court noted that Lange did "not own a single share" of the corporation, but that Lange was the "ultimate authority" over the corporation's affairs.[123] There are a large number of other such cases featuring the equitable piercing of a corporate principal.[124]

This table depicts the equitable remedy of piercing the corporate personality that corresponds to each form of asset partitioning:

EQUITABLE FORMS OF DISREGARDING CORPORATE PERSONALITY

FORM OF PARTITIONING	**EQUITABLE REMEDY**
OWNER SHIELDING	VEIL PIERCING
ENTITY SHIELDING	REVERSE VEIL PIERCING
AGENT SHIELDING	AGENT PIERCING
PRINCIPAL SHIELDING	PRINCIPAL PIERCING

C. *Benefits of Agency as Asset Partitioning*

Agency law separates agents' assets from the assets of the firm on whose behalf they act. Its doctrine determines when an agent and when a principal will be bound by a given contract. Agency law thus establishes a pattern of creditors' rights. It defines the rights of creditors of the firm and its agents because it determines who is liable for which contracts and thus whose assets act as security for them. So, parties to a contract entered by an agent and authorized by his disclosed principal can look to the principal's assets to satisfy their claims, but not the agent's, while personal creditors of the agent can look only to the agent's assets. This asset partitioning function establishes barriers to legal claims among different pools of assets, each of which can now serve separately as security for a different group of creditors. This section identifies and explains the efficiency benefits of the asset partitioning arrangement created by agency. While some

[122] 8 P.3d 841, 846 (Nev. 2000).

[123] *Id*. at 905.

[124] *See, e.g.*, *Towe Antique Ford Foundation v. I.R.S.*, 999 F.2d 1387 (9th Cir. 1993); *U.S. v. Kitsos*, 770 F.Supp. 1230 (N.D.Ill. 1991), *aff'd* 968 F.2d 1219 (7th Cir. 1992); *Loving Saviour Church v. United States*, 556 F.Supp. 688 (D.S.D. 1983), *aff'd* 728 F.2d 1085 (8th Cir. 1984); *G.M. Leasing Corp. v. United States*, 514 F.2d 935 (10th Cir. 1975); *Fitzgerald v. Central Bank & Trust Company*, 257 F.2d 118 (10th Cir. 1958); *C.F. Trust, Inc. v. First Flight L.P.*, 580 S.E.2d 806 (Va. 2003); *Litchfield Asset Management Corp. v. Howell*, 799 A.2d 298 (Conn. App. Ct. 2002); *State v. Easton*, 647 N.Y.S.2d 904, 908-910 (App. Div.1995). Despite the extensive number of cases, both agent and principal piercing remain untheorized.

of these benefits will be familiar to scholars of law-and-economics, others are distinctive to agency.

1. Reducing Creditor Monitoring Costs

Asset partitioning's chief efficiency advantage is that it reduces the cost of credit because it empowers creditors with varying comparative advantages to evaluate and monitor different forms of credit risk, which exist among distinct asset pools.[125] Through agent and principal shielding, agency law frees the creditors of agents from worrying about the success of the firm on whose behalf they work, and frees the firm's creditors from concern for the assets and creditworthiness of the firm's many agents.

Agency law thus empowers specialized creditors with varied appraisal and monitoring abilities to focus on the types of assets and risks in which they specialize. Such differing monitoring expertise is pervasive.[126] Creditors of large public corporations will often specialize in analyzing public disclosures filed with the SEC, assessing ratings for corporate debt, or scrutinizing deal documents, while lacking any special skill in deciding whether a firm's agents are entering risky home mortgages or car leases.[127] Think of the many constituents of the firm, who rely upon its assets and in some way become its creditors: employees, suppliers of inputs, lenders of debt financing, long-term purchasers. These individuals, due to their lines of business, will often have natural expertise in the business of their contractual counterparty.[128] The associates of a law firm will have a keen knowledge of its business reputation, clients will have potentially litigated many cases with the firm, its debt creditors may have made the firm many loans, and the other law firms in its malpractice insurance cooperative will have had a longstanding relationship with it. None of these constituents will have any reason to have developed an expertise in consumer lending to a business's agents. Conversely, consumer credit lenders possess specialized skills for appraising individuals' assets and risks, while

[125] Hansmann & Kraakman, *supra* note 14, at 814 ("The basic efficiency advantage of asset partitioning – the fact that the aggregate cost of credit can be reduced by appropriately dividing up a fixed pool of assets for purposes of pledging those assets as security to diverse creditors – has long been familiar in the law and economics literature.").

[126] *See supra* notes 45-47 and accompanying text; *see also* Frederick Tung, *Leverage in the Board Room: The Unsung Influence of Private Lenders in Corporate Governance*, 57 UCLA L. REV. 115, 127 (2009) (discussing how a bank's "specialized monitoring abilities make it the low-cost monitor, and because the borrower and creditors, as a group, care about minimizing total monitoring costs, the borrower willingly grants covenant protections to the bank that it may not grant other creditors.").

[127] *Cf.* KRAAKMAN ET AL., ANATOMY OF CORPORATE LAW, CH.1 (2d ed. 2009) ("Creditors of the firm commonly have a comparative advantage in evaluating and monitoring the value of the firm's assets").

[128] *See* Laura Lin, *Shift of Fiduciary Duty Upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors*, 46 VAND. L. REV. 1485, 1502 (1993) ("commercial lenders usually specialize in providing funds to companies in certain industries. Their knowledge of the trends and developments in the corporate debtor's particular industry enables them to evaluate and monitor the firm's major decisions, such as opening new plants or manufacturing new product lines. Indeed, these lenders have ready access to information regarding a debtor corporation and its business associates . . . [T]hese creditors have the expertise to appraise both the firm-specific and industry-specific risks (such as the adequacy of the corporate borrower's financial ratios) and to negotiate tailor-made provisions to protect their own interests.").

finding themselves bewildered by a 10-K.[129] Principal and agent shielding empower the firms' and agents' creditors to specialize in the asset pools in which they are expert.[130] As a result, the cost of credit for both agents and firms is lower.

It might be objected that eliminating agent shielding could not possibly lower the cost of capital for a business enterprise. After all, when agents are jointly liable for a firm's debts, the asset pool of the corporation remains – more assets are simply added to it in the form of the agents' personal assets. Even in a worst case scenario, where the agents have difficult-to-appraise assets and risks, the firm's creditors still have the firm's pool of assets available to secure any contracts.

To see why this appealing objection is mistaken, we need to recall how individuals respond to the imposition of risk: No one puts their assets at risk without demanding compensation.[131] Thus, if creditors of a bankrupt business could levy upon the assets of its agents, then those agents would demand compensation for these new (and potentially very significant) risks.[132] The firm would need to compensate the agents for their exposure.[133] In looking for new funds, the firm would turn to the creditors who benefit from the elimination of agent shielding seeking a lower cost of capital from them, which it could pass on to its agents. Firm creditors, though, will not be able to lower the price of the credit they lend to the firm by anything like the amount the agents demand because the firm's creditors will not have the requisite expertise to cost-effectively price the assets and risks of all of the individual agents of the firm.[134] The agents will likewise face a higher cost of credit from all their personal creditors given their exposure to business risks, and again, those personal creditors will lack expertise to properly assess the firm's assets.[135] The firm's creditors will not be able to deliver lower credit to match the increased cost of personal credit and vice versa because while each type of creditor previously could specialize in the asset pool in which it possessed an advantage, both of those advantages have now been hugely diluted. To put the point slightly differently, *ceteris paribus*, firms that partition assets will in the long-run outperform firms that do not because firms that separate their asset pools will enable specialized creditors to lend in a way that empowers them to utilize their comparative expertise.[136]

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[129] *See* William M. Clark, *An Economic Analysis of the Oklahoma Installment Loan Industry*, 60 CONSUMER FIN. L.Q. REP. 487, 488 (2006) (discussing specialization among consumer credit lenders).

[130] Empirical evidence suggests that the information costs associated with acquiring new monitoring expertise can be a significant burden on the cost of capital for a corporation. *See* Robert C. Merton, *A Simple Model of Capital Market Equilibrium with Incomplete Information*, 42 J. FIN. 483, 484-85 (1987) (Merton analyzes the consequences of the fixed costs creditors face in acquiring a baseline understanding of a firm on its cost of capital).

[131] Posner, *supra* note 53, at 501-07; Jackson & Kronman, *supra* note 53, at 1159 (1979).

[132] *Id*.

[133] As the Supreme Court has put it, "an objective economic analysis would suggest the debtor's interest payments will adequately compensate all such creditors for the time value of their money and the risk of default." *Till v. SCS Credit Corp.*, 541 U.S. 465, 477 (2004).

[134] *See supra* notes 45-47 & 95-97 and accompanying text.

[135] *See supra* notes 45-47 & 98.

[136] This parallels why Posner identified that limited liability benefits not only the creditors of individual shareholders, but also the creditors of the corporation. *See* Posner, *supra* note 53, at 516-17. Shareholders

2. *Economies of Risk Bearing and Decision-Making*

For a variety of reasons, agents are poorly suited to bear the risks associated with business enterprise. For instance, unlike the shareholders of a publicly traded firm, it is difficult, if not impossible for agents to be well-diversified as to the businesses of which they are agents.[139] This is both because an individual typically holds only one full-time position at a given moment, and also because agents are already over-invested in their employer firm because of the substantial human capital investment typically made in an employer.[140]

Consider some of the other difficulties resulting from the elimination of just agent shielding. Agents would be jointly bound by the contracts they enter. Joint liability for contracts would significantly alter the managerial environment. If agents were jointly bound by only the contracts they individually entered, then managers would jockey to avoid being the agent ordered to enter a given, significant contract. Even if all a firm's agents were jointly bound by the contracts the firm enters, inefficiencies would be introduced. Imagine that a firm's board of directors were all personally liable for the firm's contracts. The directors would undergo differing impacts based on their assets. For instance, those agents with an enormous amount at stake might be significantly less (or more) willing to enter a risky contract. Agent shielding homogenizes the interests of agents.[141] Thus, it facilitates management that is focused on a firm's economic prospects, rather than the potential impact of firm decisions on the net worth of agents as individuals.[142]

Agent and principal shielding also have the advantage of making the wealth of individual agents largely irrelevant to hiring decisions. If there were no principal

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of a corporation will not expose their personal wealth to the vagaries of the corporation's fortunes without extracting adequate compensation. A corporation's creditors, however, are ill-suited to provide that compensation. For, while they are likely to have a comparative advantage in assessing the value of corporate assets and the credit risks a business faces, they are unlikely to possess those same advantages for assessing the individual shareholders' assets. *See* Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 85, 100 (1985).

[139] Easterbrook & Fischel, *supra* note 136, at 107 ("Human capital . . . is notoriously difficult to diversify. Managers who have firm-specific investments of human capital cannot diversify the risk of business failure. . . . The possibility of bankruptcy also represents a real cost to those with firm-specific investments of human capital, and firms must compensate those who bear this risk."); Book Note, Margaret M. Blair, *Stakeholders As Shareholders Ownership and Control*, 109 HARV. L. REV. 1150, 1153 (1996) ("the human capital of employees is unique to the firm and is thus much more difficult to diversify.").

[140] Morey W. McDaniel, *Stockholders and Stakeholders*, 21 STETSON L. REV. 121, 124 (1991) ("Employees . . . have all their human capital invested in a single employer."); Rafael Gely and Leonard Bierman, *The Law and Economics of Employee Information Exchange in the Knowledge Economy*, 12 GEO. MASON L. REV. 651, 674 (2004) ("employees have a fairly limited ability to diversify their human capital portfolio. . . . [I]t is much more difficult to spread one's human capital among different projects or functions than it is for the owners of capital to diversify their wealth among a wide variety of investments.").

[141] The fear of bankruptcy and job loss alone likely is a major distraction to corporate managers. *See* Steven L. Schwarcz, *The Easy Case for the Priority of Secured Claims in Bankruptcy*, 47 DUKE L.J. 425, 454 (1997).

[142] Hansmann & Kraakman, *supra* note 12, at 424 (making the analogous point that decision-making by firm owners is greatly eased by limited liability).

shielding, then the owners and agents of a firm would seek wealthier agents as those agents' personal net worth would lower (or if poor, increase) the firm's cost of capital. Indeed, the firm's marginal likelihood of insolvency would decrease with the employment of wealthier agents. For instance, it might become desirable to hire a CEO whose competence was inferior to another candidate, but whose net worth was substantial because creditors would be willing to lend to the firm for less, given the increase in the pool of its assets.[143] Agency law compartmentalizes a manager's human capital off from their financial capital.

III. AGENCY LAW IS ESSENTIAL TO ASSET PARTITIONING

Much of agency law's contribution to commerce consists of simply providing default terms around which parties can freely contract.[144] Agency thus acts like a standard-form contract providing off-the-rack terms to govern the relationships among firms, their managers, and third parties. In serving this role, agency is haunted by the same charge that has confronted corporate law for decades – whether it is in fact "trivial."[145] Bernard Black most sharply posed this question, asking whether corporate law actually mattered, if it all it did was provide parties with an initial set of contract terms, which they could freely and cheaply circumvent.[146] The "conventional wisdom" became that "most of the provisions in business corporation statutes were just default rules," and as a result, inconsequential, because parties could alter or waive them at low cost.[147] This charge of triviality not only threatens the independent integrity of a body of law, by asking whether it is merely a form of contract, but also threatens its significance to commercial outcomes. If all a set of doctrines do is provide easily altered defaults, then they are unlikely to seriously affect the results that sophisticated parties reach. This Part argues that agency law is "essential" in a way that answers this charge of triviality.

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[143] This is similar to limited liability. If there were no limited liability, then owners of a firm would seek wealthier co-owners as their personal net worth would lower (of if poor, increase) the firm's cost of capital. *See* Larry E. Ribstein, *Limited Liability and Theories of the Corporation*, 50 MD. L. REV. 80, 106 (1991) (limited liability "serves important functions in closely held firms, including . . . reducing creditors' need to monitor shareholder wealth"); *see also* Easterbrook & Fischel, *supra* note 136; Hansmann & Kraakman, *supra* note 12.

[144] *See* Simpson, *supra* note 8, at 1163; Richard S. Gruner, *Intangible Inventions: Patentable Subject Matter for an Information Age*, 35 LOY. L.A. L. REV. 355, 428 (2002) ("Agency laws provide gap fillers where contractual definitions of agents' and principals' legal relationships are incomplete."); Douglas M. Nevin, *No Business Like Show Business: Copyright Law, the Theatre Industry, and the Dilemma of Rewarding Collaboration*, 53 EMORY L.J. 1533, 1566 n.204 (2004) ("in most contract and agency law, traditional solutions serve as default provisions that only take effect when the parties remain silent on the issue.").

[145] Bernard S. Black, *Is Corporate Law Trivial? A Political and Economic Analysis*, 84 NORTHWESTERN UNIV. L. REV. 542 (1990). Black's challenge spawned a significant literature in corporate law. *See, e.g.*, Ian Ayres, *Regulating Opt-Out: An Economic Theory of Altering Rules*, 121 Yale L.J. 2032, 2113 (2012) ("Bernie Black famously described corporate law defaults as 'trivial' because corporations could so easily opt out that the legal choice of default had in equilibrium no impact on the substantive choices of corporations."); Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757, 827 (1995) (discussing Black's thesis); Russell Korobkin, *The Status Quo Bias and Contract Default Rules*, 83 CORNELL L. REV. 608, 613 (1998).

[146] *Id*.

[147] Henry Hansmann, *Corporation and Contract*, 8 AM. L. & ECON. REV. 542, 557 (1990).

Agency law serves a function that parties could not feasibly attain through contract – a function that is profoundly important to the efficiency of commercial enterprise.[148]

There are a number of features to the asset partitioning arrangement established by agency law. They will be considered as individual components because while the law is essential to establishing some, others could be replicated through contract.

A. *Principal and Agent Shielding*

Principal and agent shielding could not be established by contract—agency law plays an essential role. There are two arguments for this conclusion. The first shows the infeasibility of a firm replicating principal shielding by contract in the face of a default rule that personal creditors of an agent could levy upon the assets of his firm.[149] The second argument leads to the conclusion that both agent and principal shielding require apparent authority.[150] It shows that some variant of apparent authority is necessary in order to avoid inefficiently burdening third parties, simply because if principals were shielded from any agent contract that they did not actually authorize, third parties would effectively have to verify every contract with the principal herself.

1. *Why Law is Essential*

The first argument is based on the transaction cost and moral hazard problems a firm would face in attempting to replicate principal shielding contractually.[151] Imagine a typical large corporation attempting to establish principal shielding in the face of a default rule that agents' personal creditors could levy on the firm's assets in the event an agent breached a contractual obligation. To establish principal shielding, the firm would have to require every agent to include relevant contractual language requiring the counterparty to waive recourse against the firm in every contract he entered with anyone. The firm could draft, at moderate expense, standard language providing for this, which could then be imparted to agents.[152] The agents themselves, however, would face substantial transaction costs in negotiating the inclusion of this term with every contractual counterparty they encountered.[153] The transaction costs of this alone might prove prohibitive. There is another and more severe problem involved, however, stemming from a firm's need to monitor whether its agents are including these waivers.

This is because if an agent can contractually bind the firm for which he works, a significant moral hazard is created. An agent can always lower his cost of credit by not including a nonrecourse waiver as to the firm, but instead implicitly pledging its assets as

[148] *See infra* Section II.C.

[149] *See infra* notes 152-155 and accompanying text.

[150] *See infra* notes 156-161 and accompanying text.

[151] The explanation offered here applies the insights of Hansmann and Kraakman on entity shielding, which principal shielding parallels in these respects. Hansmann & Kraakman, *supra* note 14, at 812.

[152] *See* Charles K. Whitehead, *Destructive Coordination*, 96 CORNELL L. REV. 323, 326 (2011) (discussing how "standard-form contracts . . . lower the expense of negotiating deals" for repeat players).

[153] *Id*.

well as his own.[154] The attempt to monitor every agent for such activity due to the constant threat of opportunism would be enormously costly for a firm. Monitoring each of the agents in a large commercial enterprise for every contract they personally entered would undo much of the benefit of deploying agents in the first place.[155] The combined costs of trying to circumvent both the transaction cost and moral hazard problems would almost certainly render this impracticable. Thus, the law of agency makes an essential contribution to commercial firms by establishing principal shielding.

There is a second argument for the necessary contribution of agency law to principal shielding, which focuses on the need for apparent authority and its provision through law. Assume principal shielding is in place. Unlike with entity shielding, the story cannot yet be at an end. For unlike with the owners of a firm, the point of having directors, CEOs, managers, and any agent is so that they can sometimes bind the firm.[156] Agency law must thus grapple with defining which and/or when agents can bind a firm.[157]

The problem necessitating law's role is that a firm must identify to third parties exactly who has the legal power to act on the firm's behalf, whether in buying and selling assets, entering contracts, or bringing and defending suit. This is because third parties will interact with agents who, whether from opportunism or simple error, will persuade a third party to contract with them, under the impression the principal authorized the contract, when their action is in fact unauthorized.[158] If actual authorization by the principal (say, the board) was necessary for a contract to be binding on a firm, then much of the value of deploying agents would be undone, as third parties would have to check with the ultimate authority of the firm as to a contract's authorization in every instance.

Third parties would incur prohibitive transaction costs if they had to inquire with the principal as to the agent's authority for every contract.[159] Imagine if, to rent a car at Hertz, you had to contact the board of directors or CEO because nothing short of their assurance was necessary for the contract you signed with a purported Hertz agent to be

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[154] Hansmann & Kraakman, *supra* note 14, at 812 (in the absence of entity shielding, the owners of a firm "have both the ability and the incentive to explicitly or implicitly pledge the firms' assets to support their individual activities (including their other business investments).").

[155] *Cf.* Hansmann & Kraakman, *supra* note 12, at 408 (discussing why a firm cannot monitor its owner's personal contracting, Hansmann and Kraakman note that "in order for the entrepreneur's business creditors to have faith in the entrepreneur's compliance with his promise to give them priority in his business assets, they would have to engage in continuous monitoring of the entrepreneur's contracts with all of his individual creditors—a task that generally would be infeasible.").

[156] "The underlying premise of agency law [is] that a principal has the power to appoint someone to act on his behalf." *LaCosta v. McCalla Raymer, LLC*, No. 110-CV-1171-RWS, 2011 WL 166902, at *4 (N.D. Ga. Jan. 18, 2011).

[157] This argument owes much to John Armour and Michael Whincop's work on apparent authority. *See* Armour & Whincop, *supra* note 39, 441-42 (2007); KRAAKMAN ET AL., ANATOMY OF CORPORATE LAW 7 & n.19, 13 & n.34 (2d ed. 2009).

[158] The opposite situation is also a danger, in which the principal does secretly authorize an agent, but when a deal goes sour, conspires with the agent to claim his action was unauthorized. *See, e.g.*, *PanAmerican Operating v. Maud Smith Estate*, 409 S.W.3d 168, 175 (Tex. App. 2013) ("This case, on the other hand, is about a principal who employs an agent to carry out its business but, regretting the outcome of the agent's actions, opportunistically denies the agent acted with authority.").

[159] Armour & Whincop, *supra* note 39.

binding. This is exactly what would be necessary if the allocation of a firm's authority were determined by the agreements among intra-firm parties. Principal shielding would be prohibitively costly for third parties if there were no principal piercing at all and principals were *only liable for those precise contracts they actually authorized*.[160] In other words, an essential way in which agency law sustains principal shielding is by defining some alternative to actual authority so third parties can rely on contracts they enter with agents binding the principal without having to verify the contract with the principal herself. Agency solves this problem by putting third parties on general notice that a principal will be bound by contracts that were actually unauthorized, under certain conditions (i.e., apparent authority).

2. How Doctrine Reflects Agency Law's Essential Role

The argument of the last section concluded that there are important commercial efficiencies that depend upon the law providing for when a principal will and will not be bound by the contracts entered by its agents. In particular, third parties benefit enormously from stable expectations concerning when a firm will be bound by unauthorized contracts entered by its agents. This theoretical argument leads to an expectation about how legal doctrine should look. Namely, that the law should provide *mandatory apparent authority rules*, rather than merely leaving it to firms to decide the body of law that will govern when they will be bound by unauthorized contracts. This is because if firms could decide what body of law governed authority, they would simply adopt the law of the state with the rules that bind the firm to the fewest (or no) unauthorized contracts. Moreover, whatever body of law an individual firm chose, enabling firms to freely choose the authority rules governing them would create enormous confusion for third parties.

Mandatory rules for authority are exactly what are observed in legal doctrine. While a firm is typically given enormous latitude over the body of law that governs the allocation of authority among its owners and managers, this is not true when it comes to the rules governing when a firm will be bound by an unauthorized contract entered by its agent with a third party. When decisions solely impact intra-firm matters, they are almost exclusively left to the firm to decide.[162] Not so when a firm's allocation of decision-making rights affects third parties, however.

The body of law governing the allocation of authority over internal firm matters is called "internal affairs doctrine." The "internal affairs doctrine" governs most of how a firm divides up control over its business. Internal affairs doctrine provides that the law of a corporation's state of incorporation governs the relationships among its managers, shareholders, and the firm itself.[163] Because firms can freely choose the state of their incorporation, the internal affairs doctrine leads to firms generally being free to choose

[160] An attempt to solve this problem through further representations by agents themselves simply creates a regress because in the absence of principal piercing third parties cannot rely on those representations to bind the principal.

[162] *See infra* notes 163-166 and accompanying text.

[163] RESTATEMENT (SECOND) OF CONFLICT OF LAWS §§ 304 and 307.

the body of law that regulates their internal operations and managerial hierarchy.[164] This led scholar Larry Ribstein to note that because of internal affairs doctrine, "firms can avoid organization law simply by choosing their state of organization. . . . [I]n such a system, organization law has less influence in shaping firms."[165] Ribstein took this to be "consistent with Bernard Black's thesis that even apparently mandatory business organization rules are trivial" because parties can avoid rules they dislike through simply contracting around them by choice of state of incorporation.[166]

This is certainly not true when it comes to how a firm allocates the authority to bind it among its agents. For whether an agent effectively exercises decision-rights over a firm's contracts and property is determined by the rules of agency law, such as apparent authority, and crucially, *firms cannot choose the body of agency law that governs them*.[167] Whether a principal is pierced does not lie in the power of the firm to decide. As one case put it, "'questions relating to the internal affairs of corporations are decided in accordance with the law of the place of incorporation,'" but the "issue of apparent authority is governed by the law where [the plaintiff] 'relied upon such apparent authority.'"[168] Regardless of what state a corporation chooses for its organizational law, whether contracts entered by an agent bind the firm, even if they are unauthorized, will be determined by the law of the state in which the firm's agents actually do their business. The bottom line is that a firm cannot opt out of apparent authority doctrine or choose which state's authority rules apply to it.

B. Does Agency Law Serve Other Essential Functions?

I have argued that agency's principal shielding role is the essential function of agency law. 'Essential' in the sense of an attribute that could not practicably be replicated by contract in the absence of agency law.[174] Parties, struggling to establish the benefits of principal shielding on their own would face enormous transaction cost and moral hazard problems in achieving that goal.[175] The question can be asked, then, as to whether there are other essential functions of agency outside of asset partitioning. After all, while

[164] Exceptions exist where federal law imposes substantive corporate governance requirements on firms, though even in light of Sarbanes-Oxley and Dodd-Frank, these remain relatively limited. *See* Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1524 (2005) (providing an overview of many of the controversial substantive provisions of the statute).

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

[166] *Id*.

[167] *See, e.g.*, *Trip Mate, Inc. v. Stonebridge Cas. Ins. Co.*, No. 10-0793-CV-W-ODS, 2013 WL 1628502, at *5 (W.D. Mo. Apr. 16, 2013), *case dismissed* (Nov. 5, 2013), *rev'd and remanded*, 768 F.3d 779 (8th Cir. 2014) ("Apparent authority and agency by estoppel depend on representations made to [the third party], so the [] choice of law provision [in the contract between principal and agent] should not govern.").

[168] *Lehman Bros. v. Tutelar CIA Financiera, S.A.*, No. 95 CIV. 3772 (DLC), 1997 WL 403463, at *3 (S.D.N.Y. July 17, 1997). *See also In re Total Containment, Inc.*, No. 04-13144BF, 2008 WL 250176, at *14 (Bankr. E.D. Pa. Jan. 29, 2008) ("The Restatement (Second) of Conflict of Laws, § 292 (1971), instructs that a principal will be bound by its agent's actions 'if he would so be bound under the local law of the state where the agent dealt with the third person.'"); *M. Lowenstein & Sons v. British-Am. Mfg. Co.*, 300 F. 853, 855 (D. Conn. 1924) *rev'd on other grounds*, 7 F.2d 51 (2d Cir. 1925).

[174] Hansmann & Kraakman, *supra* note 12, at 432.

[175] *See infra* Section IV.A.

agency scholarship has neglected asset partitioning, other aspects of agency law are subject to a vast literature, including the fiduciary obligations often treated as agency's core.[176] Are any of the other aspects of agency law features that parties could not replicate through contract?

To offer an answer to this question, I look at the three core sets of agency rules, which address the three major dynamics implicated by the agency relationship: the duties an agent owes the principal; the duties the principal owes the agent; and the relationship between principal and agent and third parties. I cannot offer an exhaustive analysis in the space here, but simply take the time to suggest that in the world of voluntary commercial activity, it is agency's asset partitioning role alone, which is essential.

1. The Duties of the Agent and Principal

The heart of agency law is often thought to lie in the fiduciary duties that agency law mandates agents owe their principals.[177] There are several such duties, including the core duties of loyalty,[178] care,[179] and obedience.[180] As has been widely observed of such duties, however, they could easily be replicated by contract.[181] These duties boil down to promises made by agents to act in the principal's interests – promises that can be put to paper with relative ease and for which standard-form contracts could be supplied. Indeed, the fiduciary duties that officers owe the firm are the subject of frequent contractual negotiation.[182] Likewise, the fiduciary duties of directors on a corporate board, which grow out of the law of agency, are often the subject of extensive contractual negotiation.[183]

The doctrine of agency underlines this fact. While agency law provides a rich array of fiduciary duties,[184] these rules are all and only default rules.[185] The Restatement

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[176] *See supra* note 43; *see also* Lyman Johnson & Robert Ricca, *Reality Check on Officer Liability*, 67 BUS. LAW. 75, 85 (2011); Douglas Zolkind, *The Case of the Missing Shareholders: A New Restriction on Honest Services Fraud in United States v. Brown*, 93 CORNELL L. REV. 437, 461 (2008).

[177] *See supra* note 129.

[178] RESTATEMENT § 8.01.

[179] *Id*. at § 8.08.

[180] *Id*. at § 8.09.

[181] EASTERBROOK & FISCHEL, *supra* note 138, at 24-25; *see also* Aaron D. Jones, *Corporate Officer Wrongdoing and the Fiduciary Duties of Corporate Officers Under Delaware Law*, 44 AM. BUS. L.J. 475, 478 (2007) (discussing that the rules governing the "principal-agent relationship are defined in the first instance by agreement, with agency law merely providing certain useful default provisions").

[182] Sandra K. Miller, *The Best of Both Worlds: Default Fiduciary Duties and Contractual Freedom in Alternative Business Entities*, 39 J. CORP. L. 295 (2014).

[183] *See, e.g.*, Frank H. Easterbrook, *Corporate Control Transactions*, 91 YALE L.J. 698, 700 (1982) (discussing the function of the fiduciary duties of managers and directors); Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 574 (2003) (discussing to whom directors' fiduciary duties are owed).

[184] REUSCHLEIN & GREGORY, *supra* note 1, at 309-319.

[185] RESTATEMENT (SECOND) OF AGENCY § 376 ("the existence and extent of the duties of the agent to the principal are determined by the terms of the agreement between the parties").

of Agency expressly renders each one of them waivable by contract.[186] As the Restatement puts it, "[c]onduct by an agent that would otherwise constitute a breach of duty . . . does not constitute a breach of duty if the principal consents to the conduct."[187] Thus, the principal and agent may modify or eliminate the agent's fiduciary duties simply by agreement between themselves.[188]

That the rules governing the agent's duties are almost all default rules does not make them unimportant. There is a huge literature devoted to analyzing the optimal default rules for contract law.[189] This is because optimizing default rules can make an important efficiency contribution. It does so by reducing transaction costs, and one important way in which it reduces those costs is through so-called "majoritarian" defaults that insert into contracts the terms that most or all parties would have wanted had they considered the matter.[190] The parties need not analyze, negotiate, and draft those terms, however, for the law has saved them the work of doing so by inserting them, unless contrary language is added. Default terms also force those who wish to change them to do the work of drafting and adding them, which a careful counterparty will notice.[191] The harder it is too waive a default, such as requiring the detailed and explicit waiver of a default term, the more protection the law gives the unsophisticated or unwary.[192] Default terms also have the benefit of enabling a body of rich interpretive precedent to develop, clarifying a provision's application in a variety of settings.[193]

A principal also owes duties to an agent, including, centrally, the duty to pay the agent's wages.[194] These duties, like that of the agent to the principal, can be altered by

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[186] In its discussion of the duties the principal and agent owe each other, the Restatement expressly provides that the principal and agent can agree to waive the agent's duties. *See* RESTATEMENT (THIRD) OF AGENCY § 8.06. This provision extends to waiving the duty of loyalty, § 8.01, the duty to not act adversely to the principal in a transaction connected with the agency relationship, § 8.03, and to not compete with the principal, § 8.04. *See also* KLEINBERGER, *supra* note 205, at 147. In the context of the corporation, corporate officers and directors sometimes have non-waivable fiduciary duties, although Delaware LLCs render even these duties mostly waivable. *See generally* Mohsen Manesh, *Delaware and the Market for LLC Law: A Theory of Contractibility and Legal Indeterminacy*, 52 B.C. L. REV. 189, 226 (2011) (mandatory "provisions that are imposed under Delaware corporate law -- including the judge-made law of fiduciary duties -- may be contractually waived, modified or clarified under Delaware LLC law"); Lyman Johnson, *Delaware's Non-Waivable Duties*, 91 B.U. L. REV. 701, 702 (2011).

[187] *Id*. at § 8.06.

[188] *Id*.

[189] *See* Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 89-91 (1989).

[190] Easterbrook & Fischel, *supra* note 183, at 701.

[191] *Id*.

[192] Robert Sitkoff, *An Agency Costs Theory of Trust Law*, 89 CORNELL L. REV. 621 (2004).

[193] *See, e.g.*, Arthur B. Laby, *Selling Advice and Creating Expectations: Why Brokers Should Be Fiduciaries*, 87 WASH. L. REV. 707, 775 (2012) (explaining how "default rules governing fiduciary relationships" benefit from having "developed through centuries of precedent in the common law").

[194] *See* KLEINBERGER, *supra* note 205, at 158-161; *see also supra* note 181, at 484 ("Nothing in agency law presents any limits on the parties' ability to alter the legal obligations that they owe each other."); Charles Silver, *Merging Roles: Mass Tort Lawyers As Agents and Trustees*, 31 PEPP. L. REV. 301, 321 (2003) ("Agency law gives principals and agents complete freedom to modify its default provisions.").

contract.[195] In fact, while the Restatement offers a lengthy list of duties owed a principal by an agent, a principal's duty to her agent is largely confined to "act[ing] in accordance with the express and implied terms of any contract between the principal and the agent."[196]

2. *The Liability of Principal and Agent to Third Parties*

There is an aspect of principal piercing that was not discussed above, and that is worth noting, which is principal piercing in tort. Tort rules cannot be established by contract because they involve the firm's impact on involuntary creditors, who are, almost by definition, strangers to the operations and contracts of a firm and its agents.[197] The vicarious liability rule whereby a firm is legally held strictly liable for torts committed by its agents could not be put in place through the contracting of private parties simply because the parties usually have no relationship prior to the tort.[198]

D. *Principal Shielding and Entity Shielding*

One complication of the asset partitioning role of agency law is the complex relationship between entity shielding and principal shielding. In a large public corporation, almost all shareholders are typically uninvolved in the corporation's affairs, generating the famous "separation of ownership and control" and distinct roles for owners and managers.[201] In many business forms, however, this is not the case, and owners also play a managerial role, acting as agents of the firm. This is the case with the partnership,[202] but also with many LLCs, closely-held corporations, and solely-owned corporations.[203] In these situations, where ownership and control are not separated and are sometimes vested in exactly the same persons, the relationships among the various forms of asset partitioning become complex.

Consider the partnership as an illustration. For centuries, the partnership was the principal multi-owner business form for commercial activity in the developed world.[204]

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195 *See also* KLEINBERGER, *supra* note 205, at 147.

196 RESTATEMENT § 8.13.

197 *See infra* Section IV.A.

198 Vicarious liability will be discussed in more detail in Part V.A.

201 ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 119 (1933); Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 312, 317-18 (1983).

202 *See supra* notes 118-19.

203 *See* Andrew A. Lewis, *Small Business Toolkit for Probate and Estate Planning Attorneys*, 6 EST. PLAN. & COMMUNITY PROP. L.J. 279, 297-98 (2014) ("It is most common for limited partnerships to be managed by a general partner who is an owner of the partnership; for LLCs to be managed by either managers or members who are owners of the LLC; and for small corporations to have a board of directors and officers who are also owners of the corporation.").

204 Warren H. Johnson, *Limited Liability Companies (LLC): Is the LLC Liability Shield Holding Up Under Judicial Scrutiny?*, 35 NEW ENG. L. REV. 177, 182 (2000) ("The privately-owned, for-profit business corporation came into existence only within the last few centuries and until the mid-1800s most business was conducted by proprietorships and partnerships."); Myron T. Steele, *The Moral Underpinnings of Delaware's Modern Corporate Fiduciary Duties*, 26 NOTRE DAME J.L. ETHICS & PUB. POL'Y 3, 17

But in the partnership, *entity shielding and principal shielding overlap* because the partners of a partnership are owner-agents. A general partnership exists where two or more persons join together to carry on a business for profit as co-owners.[205] Each partner has a right to co-manage the partnership's affairs and each partner has the power to bind the partnership through acts that are in its usual course of business.[206] Each partner is thus also an agent of the partnership.[207] A partner is consequently both an owner and a manager of a partnership with a right both to the partnership's profits and to bind it as its agent.[208] As one treatise puts it, "ownership and control are identical in the common law partnership."[209] In such a situation, entity shielding and principal shielding overlap because a personal creditor of a partner is by definition a personal creditor both of an owner and of an agent of the partnership. A legal system that attempted to accomplish entity shielding in the partnership without principal shielding would quickly collapse for the personal creditors of the partnership's owners are also the personal creditors of its managers.

A historical note is in order here. It may be intuitive to view principal shielding as an extension of entity shielding, but as a historical and conceptual matter, the opposite is true. Entity shielding grew out of principal shielding. Entity shielding first developed in the industrialized West in the partnership, and then continued on as an attribute of the corporation.[210] But in the partnership, entity shielding was born out of the logic of principal shielding – the logic that bars a personal creditor of an agent from seizing the assets of his principal.

The easiest way to see this is to look at the early U.S. cases first adopting entity shielding and to examine their justification for doing so. The leading case is an opinion of the United States Supreme Court written by Justice Story.[211] Story was the early court's keenest student of agency and partnership law, and having written the seminal treatises on the subject was the likeliest Justice to offer an in-depth explanation of the Court's

(2012) ("For centuries, partnerships were favored forms of business, and people generally organized corporations only for public or charitable purposes."); Hansmann & Kraakman, *supra* note 12, at 439 ("Prior to the advent of the investor-owned business corporation, which is largely a creature of the past two centuries, partnership was the form commonly used for jointly owned businesses.").

[205] *See* DANIEL S. KLEINBERGER, AGENCY, PARTNERSHIP, AND LLCS 215, 220 (2008). Many of partnership's most basic principles stretch back for more than half a millennium to the Middle Ages. *See* WILLIAM A. GREGORY & THOMAS R. HURST, AGENCY AND PARTNERSHIP AND OTHER FORMS OF BUSINESS ASSOCIATIONS 363 (1994).

[206] *See* KLEINBERGER, *supra* note 205, at 215, 220; GREGORY & HURST, *supra* note 205, at 363 ("Each partner is the agent of the partnership and has the power to bind the partnership in the ordinary conduct of its affairs.").

[207] *Id*.

[208] *Id*.

[209] *See* GREGORY & HURST, *supra* note 205, at 363. Economists have carefully studied the efficiencies, in certain contexts, of putting ownership claims in the hands of those managing the firm. *See* Eugene F. Fama & Michael C. Jensen, *Agency Problems and Residual Claims*, 26 J.L. & ECON. 327, 333 (1983).

[210] *See* Hansmann & Kraakman, *supra* note 13.

[211] N. *Rogers & Sons v. Batchelor*, 37 U.S. 221, 229-30 (1838).

reasoning in endorsing entity shielding.[213] Story was confronted with a case that squarely raised the central question of entity shielding – "whether the funds of a partnership could be rightfully applied" to pay the "separate pre-existing debt" of an individual partner.[214] Story provided the crucial answer, but his explanation was especially illuminating:

> We are of opinion in the negative on [this] question. The *implied authority* of each partner to dispose of the partnership funds strictly and rightfully extends only to the business and transactions of the partnership itself; and any disposition of those funds, by any partner, beyond such purposes, is *an excess of his authority* as partner.[215]

The reasoning here is clearly an application of principal shielding to a situation in which an agent is also an owner, as in the partnership. A partner cannot pay an individual debt with partnership funds, nor can his creditor levy on the partnership's assets, as "the separate creditor can have no better title to the funds than the partner himself had."[216] In justifying entity shielding, the logic of the court was that of principal shielding. Individual creditors of partners have no right to the assets of the partnership itself because each partner only has *an agent's rights to the assets of the partnership.* An unauthorized agent cannot bind the principal –the partnership here – even if that agent happens to be an owner. More specifically, it is beyond the authority conferred on a partner by the rules of agency law that a partner be able to use partnership assets as security for his personal contracts. Entity shielding, which bars partners' personal creditors from being able to seize partnership assets is thus founded in the logic of principal shielding, at least in the United States.[217]

IV. IMPLICATIONS

The account of agency law offered here has far-reaching normative and doctrinal implications. It explains the powerful efficiency advantages of agency law for third

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[213] JOSEPH STORY, COMMENTARIES ON EQUITY JURISPRUDENCE (1839); COMMENTARIES ON THE LAW OF PARTNERSHIP (1846).

[214] *Rogers*, 7 U.S. at 229.

[215] *Id*. at 229-30 (emphases added).

[216] *Id*. at 230.

[217] There is ample case law elaborating on the agency logic exemplified in Story's opinion from the early days of U.S. partnership law. *See, e.g. Babcock v. Standish*, 53 N.J. Eq. 376, 383-84 (1895) ("a partner could not apply partnership property to the payment of his individual debt . . . . The reasoning is that the implied agency of one partner to dispose of partnership property extends only to its disposition for partnership purposes, and not to its application to the purposes of one of the partners."); *Dob & Dob v. Halsey*, 16 John. Rep. 34, 1819 WL 1526 (N.Y. Sup. Ct. 1819) (entity shielding is rooted in "the want of authority, either express or implied, in the debtor partner, to give the security of the firm for his separate debt"); *Williams v. Barnett*, 10 Kan. 455, 461 (1872) (a partner "may not pledge the partnership credit, or use the partnership assets, for the satisfaction of his individual indebtedness . . . . 'The implied authority of each partner to dispose of the partnership funds strictly and rightfully extends only to the business and transactions of the partnership itself'"); *Bowen v. Clark*, 3 F. Cas. 1049, 1050 (D. Wis. 1856); *Evernghim v. Ensworth*, 7 Wend. Rep. 326, 1831 WL 3105 (N.Y. Sup. Ct. 1831).

parties, illuminates the basic purposes and contours of agency doctrine, and provides several ways in which we can usefully reform that doctrine.

A. *Contract versus Tort*

One basic insight suggested by an asset partitioning account is how to make sense of the difference between the attribution rules governing the application of agency in contract and in tort. Contract and tort are agency law's two principal tributaries. Even a superficial reading of the Restatements of Agency indicates that these are the two bodies of private law in which agency principles are most consequential.[225] In many respects, agency treats them identically. For instance, the doctrines governing the creation of the agency relationship,[226] the scope of authority an agent possesses,[227] or the attribution of knowledge from agent to principal[228] all apply in the same ways in contract and tort.

Yet, this symmetry produces a puzzle because while many of agency's principles apply uniformly across contract and tort, an agent's personal liability in contract and tort is strikingly different. In tort, an agent is jointly and severally liable with the principal for any tort the agent commits within the scope of his employment.[229] Personal liability for tortious conduct is inescapable for agents.[230] In contract, however, an agent exempts himself from personal liability on the contracts he signs simply by identifying the principal on whose behalf he acts.[231] The common law goes further, actually, and imposes a strong presumption that an agent entering a contract for a disclosed principal is not personally liable.[232] Conventional accounts of agency fail to even address this basic structural discrepancy, let alone offer a cogent explanation for it. Asset partitioning, however, provides precisely such an explanation. It does so by identifying the factors that motivate the attribution rules of agency in contract (authority doctrine), clarifying their absence in tort.

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[225] *See* RESTATEMENT §§ 2.01-2.07; 3.01-3.02; 3.05-3.06; 4.01-4.08; 6.01-6.11 (addressing agency law's role in governing contracting); §§ 7.01-7.08 (addressing agency law's role in governing tort liability). There are only eight chapters in the Restatement.

[226] *Id*. at § 3.01.

[227] *Id*. at § 7.03-7.04.

[228] *Id*. at §§ 2.01-2.07.

[229] *Id*. at §§ 7.03, 7.07-7.08; *see also Granquist v. Crystal Springs Lumber Co.*, 190 Miss. 572 (1941) ("whence the liability of the principal . . . has its sole basis in the doctrine of respondeat superior and in nothing else, the liability is joint and several [between principal and agent]").

[230] *Musgrove v. Hickory Inn, Inc.*, 168 W. Va. 65, 69 (1981) ("the doctrine of respondeat superior does not relieve the servant of his tort liability"); *Wrigley v. Nottingham*, 111 Ga. App. 404, 406, *rev'd on other grounds*, 221 Ga. 386, 144 S.E.2d 749 (1965) ("One who is sued in his personal capacity, whether the alter ego, an officer or agent of a corporation, may not escape personal liability for his tortious misconduct damaging employees or third persons by hiding behind the corporate veil even in those situations where the corporation might also be a proper party to the action.").

[231] *Id*. at §§ 1.04, 6.01.

[232] *Mason Tenders Dist. Council Welfare Fund v. Thomasen Const. Co.*, 164 F.Supp.2d 379, 381 (S.D.N.Y. 2001) ("an agent signing an agreement on his principal's behalf, will not be found personally liable under the terms of the agreement 'unless there is clear and explicit evidence of the agent's intention to substitute or superadd his personal liability for, or to, that of his principal.'"); *id*. ("personal liability is found 'only in rare cases.'").

Specifically, the asset partitioning account explains the principal efficiency of the separation of the firm's assets from those of its managers as arising from the monitoring behavior of creditors. Contract creditors who enter into contractual relationships with a principal do so voluntarily, fixing the cost of credit (or other compensation) they demand based on the value of the principal's assets and their associated risks, given the creditors' expertise in assessing them.[233] Such creditors benefit enormously from asset pools that are specialized so as to permit the creditor to utilize her comparative advantages in assessing those assets.[234] Hence, the important reduction in creditor monitoring costs that can arise as a result of asset partitioning. Tort creditors, however, are involuntary creditors – they suffer some harm without their foreknowledge or consent and do not benefit from assessing the assets of the tortfeasor.[235] Tort creditors typically not only lack a contractual relationship with a firm and its agents, but are unsuspecting and involuntary victims who could gain nothing from the partitioning of assets, which they do not know of or monitor.[236] So, in the tort situation, agent shielding would lessen a victim's recovery from culpable players without the efficiency benefit of reducing information costs for those victims, while in contract, creditor monitoring costs would be significantly increased by the imposition of joint liability. The optimal level of joint liability between principal and agent will differ based on whether *creditors are voluntary or involuntary* because that will shape when monitoring costs are reduced by partitioning.

To put this point less technically, the difference between an agent's liability in contract and tort boils down to the fact that the advantages of asset partitioning derive from *adjusting creditors* who alter the cost of credit they demand based on the ease with which they can monitor assets' quality and risk. The monitoring economies that make asset partitioning socially efficient in contract, rather than merely redistributive, disappear in tort, removing the main justification for the asset partitioning arrangement.[237]

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[233] J. Stephen Gilbert, *Substantive Consolidation in Bankruptcy: A Primer*, 43 VAND. L. REV. 207, 218 (1990) ("voluntary creditors assess the risks of lending to a particular debtor and adjust the terms of the credit agreement accordingly.").

[234] *See infra* Subsection II.C.1.

[235] Steve Knippenberg, *The Unsecured Creditor's Bargain: An Essay in Reply, Reprisal, or Support?*, 80 VA. L. REV. 1967, 1969-70 (1994) ("The most striking examples of involuntary creditors are tort victims . . . they are unwilling creditors from the outset"); *see also* Charles A. Beckham, Jr., *It's All an Unsecured Claim to Me: The Tortious Interference of Bankruptcy Law with Liability Insurance Proceeds*, 22 TEX. TECH L. REV. 779, 793 (1991) ("the trade creditor has had an opportunity to estimate risk, the tort claimant has not. . . . The tort claimant . . . is an involuntary creditor who has no opportunity to bargain with its debtor; the tort claimant cannot choose a tortfeasor.").

[236] *See* Andrew Price, *Tort Creditor Superpriority and Other Proposed Solutions to Corporate Limited Liability and the Problem of Externalities,* 2 GEO. MASON U. L. REV. 439, 464 (1995) ("involuntary creditors can not negotiate for protections with the firm ex ante because they do not know that they will be creditors until after the tort").

[237] *Cf.* 1 WILLIAM M. FLETCHER, FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 41.85 at 712 (1990) ("the party seeking relief in a contract case is presumed to have voluntarily and knowingly entered into an agreement with a corporate entity, and is expected to suffer the consequences of the limited liability associated with the corporate business form, while this is not the situation in tort cases.").

B. *The Pattern of Agency Doctrine*

In Part III, we looked at where agency law did and did not play an essential role by providing an economic benefit that parties could not have achieved through contract.[238] There is a straightforward, but fundamental implication of that analysis: The common law doctrine of agency seems to have generally arrived at the efficient level of "contractibility" for its rules.[239] Contractibility involves where a rule of private law falls on the spectrum between default rules, which parties can easily alter or waive through contract, and mandatory rules, which parties cannot alter or waive.[240] We saw in Part III that the rules governing the duties owed by an agent to a principal and by a principal to an agent were exclusively default rules.[241] This makes sense given the ease with which parties can – and do – carefully alter and craft these terms so as to maximize the economic benefit of their relationship.[242] We also saw that there were significant economic benefits to certain rules, which parties could not feasibly replicate through private ordering and where the law alone could deliver those benefits. In these circumstances, the law of agency indeed adopted mandatory rules.[243] This was the case with vicarious liability in tort and apparent authority in contract. The account of agency law offered in this paper thus generates a positive claim, which is that agency's doctrine conforms to an efficient approach to the contractibility of its rules.

This might seem trivial to point out, but it is actually quite important. After all, Holmes' claim that the doctrine of agency is irrational remains, more than a century later, the most prominent statement on this once proud area of law.[244] The account of agency as asset partitioning refutes this claim by revealing the essential rationality of agency's doctrine.

C. *Assessing Inherent Authority*

Another implication of this account is that authority doctrine should promote, rather than undo the basic benefits of asset partitioning. This section contrast the two most important alternative forms of authority, besides actual authority, from this perspective, and shows how while one promotes the efficiencies of asset partitioning, the other thwarts them.[245] These two alternatives are apparent authority and inherent authority.

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[238] *See infra* Sections III.A-C.

[239] *See generally* Ian Ayres, *Valuing Modern Contract Scholarship*, 112 YALE L.J. 881, 886 (2003) (discussing the meaning and importance of contractibility).

[240] *Id*.

[241] *See infra* Subsection III.C.1.

[242] *See supra* notes 177-188 & 194-196 and accompanying text.

[243] *See supra* Section III.A and Subsection III.C.2.

[244] *See* Holmes, *supra* note 4.

[245] I do not consider in detail two other bases for principal piercing – estoppel and ratification – because first, they play a significantly less important role in the case law, and second, they ultimately pivot on conduct by the principal and thus follow the same basic logic as apparent authority, which I consider above. *See* REUSCHLEIN & GREGORY, *supra* note 1, at 65-69 (estoppel) and 72-84 (ratification).

The law of agency sometimes binds a principal to an unauthorized contract entered by an agent, if the counterparty had a reasonable belief that the agent had authority to enter the contract. It does so through two distinct bases of liability. Apparent authority doctrine provides that a principal is bound by a contract entered by an agent, which the principal did not authorize, if a third party reasonably believed the agent had authority to act on the principal's behalf based on *the principal's manifestations*.[246] Inherent authority doctrine, on the other hand, provides that a principal is bound by a contract entered by an agent, which the principal did not authorize, when the third party reasonably believed the agent had authority not based on the principal's conduct, but based on the *agent's conduct or status*.[247]

The desirability of inherent authority doctrine is enormously controversial.[248] For instance, one scholar has not only endorsed it, but argued that the concept of inherent authority should be expanded in order to bring a principal's liability for unauthorized contracts close to that of her liability for unauthorized torts.[249] His main reason for taking this position was the "belief that the employer who creates, controls and benefits from the agency relationship should stand to lose rather than someone who deals in good faith with his agent."[250] Other scholars have criticized inherent authority as an extension of agency law that was never actually required by the cases thought to underwrite the doctrine.[251]

The account of agency as asset partitioning makes out a decisive case against inherent authority. To understand how inherent authority undermines the key efficiency

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[246] *See, e.g.*, RESTATEMENT (SECOND) OF AGENCY §§ 8, 27; *Hallock v. State of New York*, 64 N.Y.2d 224, 231 (1984) ("Essential to the creation of apparent authority are words or conduct of the principal, communicated to a third party, that give rise to the appearance and belief that the agent possesses authority to enter into a transaction. The agent cannot by his own acts imbue himself with apparent authority."); KLEINBERGER, *supra* note 205, at 33-45.

[247] *See* Simpson, *supra* note 8, at 1163 ("[I]nherent agency power . . . maintains that a principal will be liable for an unauthorized contract entered into by its agent if the other party to the contract reasonably relies on the unauthorized agent's claims of authority."); *see also* RESTATEMENT (SECOND) OF AGENCY § 8A ("Inherent agency power is a term used . . . to indicate the power of an agent which is derived not from authority, apparent authority or estoppel, but solely from the agency relation and exists for the protection of persons harmed by or dealing with a servant or other agent."); *Butler v. Maples*, 76 U.S. (9 Wall) 766 (1869); *Bank of Am., N.A. v. Terra Nova Ins. Co.*, No. 01 CIV. 0646 (LMM), 2005 WL 1560577, at *7 (S.D.N.Y. June 30, 2005) ("The distinction between the Restatement's descriptions of apparent authority and inherent authority is that, under an inherent authority theory, the agent's title or position is enough to indicate authority to a third party, without further information from the principal."); *Kidd v. Thomas A. Edison, Inc.*, 239 F. 405 (S.D.N.Y. 1917), *aff'd*, 242 F. 923 (2d Cir. 1917).

[248] *See, e.g.*, Kornelia Dormire, *Inherent Agency Power: A Modest Proposal for the Restatement (Third) of Agency*, 5 J. SMALL & EMERGING BUS. L. 243, 263 (2001); Bart Mckay, *Inherent Agency Powers: Does Celtic Life Insurance Co. v. Coats Open the Door to A New Theory of Vicarious Liability in Texas?*, 46 BAYLOR L. REV. 449, 460 (1994).

[249] Edward Mearns, Jr., Comment, *Vicarious Liability for Agency Contracts*, 48 VA. L. REV. 50 (1962); *see also* David A. Westbrook, *A Shallow Harbor and A Cold Horizon: The Deceptive Promise of Modern Agency Law for the Theory of the Firm*, 35 SEATTLE U. L. REV. 1369, 1391 (2012).

[250] Mearns, *supra* note 250, at 57.

[251] *See* Deborah A. DeMott, *The Contours and Composition of Agency Doctrine: Perspectives from History and Theory on Inherent Agency Power*, 201 U. ILL. L. REV. 101 (2014). "Inherent authority" has been removed from the current Restatement of Agency. *Id*.

advantages of agency law as asset partitioning consider how actual authority and apparent authority promotes those efficiencies. Actual authority facilitates the establishment of an asset partitioning arrangement, where third parties can look to a firm's assets in the event the firm defaults on a contract it authorized, but that they cannot do so if the contract is with an agent in his personal capacity.

Apparent authority dilutes asset partitioning to the minimal extent because it directs the third party's gaze to the conduct of the principal. Knowing this, a principal can take care to ensure that she provides third parties accurate guidance as to the status of her agents and the scope of their authority.[252] Apparent authority – although it provides some protection to third parties by validating their principal-based beliefs – is actually beneficial for both principal and third party. After all, if principals were not bound by agent action when it seemed authorized based on their own manifestations, third parties would need to exercise significantly more care in verifying with the principal that the precise contract in question was specifically authorized. This would impose direct costs on the principal in the form of opportunity costs: time and effort spent validating agents' authority as to every contract. As importantly, it would also increase costs for third parties due to the increased diligence they would have to conduct, which would partly be passed on to the principal in a competitive market. Apparent authority also reduces agent costs by conscripting third parties into verifying agent conduct with the principal through reliance on her manifestations. To obtain the aid of the doctrine, and thus assurance that a contract – even if unauthorized by the principal – will bind the principal, the third party must look to the principal's own manifestations, which can be expected to serve the principal's interests, rather than the agent's, controlling agency costs.[253]

Neither of these benefits is true of inherent authority, which, if widely applied, would largely undo the benefits of asset partitioning. Inherent authority undermines the asset partitioning arrangement by easing the ability of an agent to pass on his own contractual commitments to the principal. To the degree that this becomes possible, third party creditors of a business will need to become concerned with the personal lives of the agents, rather than being able to exclusively concern themselves with the business itself. Consider also the benefit of controlling agency costs. Inherent authority loosens the necessity of relying upon the principal's manifestations in order to bind the principal. Instead, the third party can look to other circumstances unrelated to the principal's conduct, such as the manifestations of the agent himself. This dilutes reliance on the principal's conduct. Beyond merely diluting that incentive, it exacerbates agency costs by potentially permitting agents to bootstrap into their own authority.

D. Agency and Business Outcomes

The law of agency will also shape the hiring decisions of employers through how easily it applies apparent authority and other forms of principal piercing. In particular, the

[252] "It is the principal who has selected and delegated responsibility to those agents; accordingly, [apparent and actual authority] doctrine creates incentives for the principal to do so carefully and responsibly." *Official Comm. of Unsecured Creditors of Allegheny Health Educ. & Research Found. v. PriceWaterhouseCoopers, LLP*, 605 Pa. 269, 302, 989 A.2d 313, 333 (2010)

[253] *See supra* Part II.C.3. The connection between apparent authority doctrine and controlling agency costs seems never to have been drawn in scholarship.

balance that agency law adopts – between permitting flexibility to principals and agents in precisely tailoring agents' authority, and the costs to third parties in confusion and investigation of whether an agent is authorized – will be important. The greater the restrictions that the law places on private ordering for the sake of third parties (i.e., the less latitude the law gives principals in defining the scope of agents' authority), the more principals will have to carefully choose and standardize their agents. For instance, if the law applied apparent authority based on a presumption that agents generally have substantial authority, then principals would generally designate fewer agents, each of whom would have to be more competent and trustworthy.[254] At the extreme, if the law imposed a mandatory rule of plenary authority on agents with any actual contracting authority, you would expect corporate entities to only designate a handful of authorized agents. The relative flexibility that the law provides firms in defining the authority of agents thus shapes the employment decisions of managers.

This point is illustrated by the partnership. In a partnership, merely because of her role, a partner has the inherent power to bind the partnership for the purposes of its ordinary affairs. As the Uniform Partnership Act puts it, "[e]very partner is an agent of the partnership for the purpose of its business, and 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."[255] What this means is that whenever a partnership chooses a new partner they automatically confer on that individual a substantial amount of authority over their shared business and wealth. The consequence is well-known, which is that this "forces principals to select their agents with care to avoid losses attributable to dishonest agents."[256] There are reasons to believe that such an arrangement will sometimes be efficient,[257] but the ubiquitous use of business forms in which the authority of agents is placed more flexibly in management's control suggests that firms also find substantial value in being able to more precisely tailor and vary the authority they confer on agents.

E. Agency and the Role of Law in Commerce

A final implication of understanding agency law as asset partitioning is at the level of theory. It has been two decades since Bernard Black's seminal article asked whether corporate law is trivial because its mandatory rules could easily be established

[254] The apparent authority case law struggles with exactly this concern when deciding what reasonable expectations a third party should have given particular pieces of evidence of an employee's authority. *See, e.g.*, CSX Transp., Inc. v. Recovery Express, Inc., 415 F. Supp. 2d 6, 11 (D. Mass. 2006) ("Granting an e-mail domain name [to an employee], by itself, does not cloak the recipient with carte blanche authority to act on behalf the grantee. Were this so, every subordinate employee with a company e-mail address-down to the night watchman-could bind a company to the same contracts as the president."); *Muscletech Research & Dev., Inc. v. East Coast Ingredients, LLC*, No. 00-CV-0753A(F), 2004 WL 941815, at *32 (W.D.N.Y. Mar. 25, 2004) (holding that possession of business cards with a company's logo and a company credit card as well as appearing in company advertisements were insufficient to create apparent authority).

[255] UNIF. PARTNERSHIP ACT § 9(1).

[256] Don L. Kristinik, III, *Transferring Title to Partnership Real Property Under the UPA and Proposed RUPA*, 27 REAL PROP. PROB. & TR. J. 143, 161 (1992).

[257] Fama & Jensen, *supra* note 209, at 333.

(or circumvented) through private ordering.[258] Asset partitioning has provided perhaps the most compelling rejoinder to the claim that corporate law is trivial in this way.[259] The capacity of firms to maintain separate asset pools from their owners and agents can be enormously efficient and could not be feasibly achieved through private ordering. It turns out to be the dimensions of corporate law that limit the ability of owners and managers to exercise the legal personality of the firm (i.e., to contractually bind it) that provide the firm with economic advantages that contracting could not achieve. The firm, as an efficient method of organizing business transactions, only exists *net* of these asset partitioning devices: owner shielding and agent shielding, and more importantly, entity shielding and principal shielding. Far from being merely a nexus of contracts, the firm is also a nexus of imputation and partitions.

CONCLUSION

Agency law has largely been forgotten by law-and-economics and by legal scholarship more generally. When scholars consider agency's contribution to commerce, they focus on elements of agency law that parties can and do freely alter or dispense with contractually. In contrast, the essential contribution of agency law is asset partitioning. Where organizational law partitions off the assets of a firm from the assets of its individual owners, agency law partitions off the assets of a firm from the assets of its individual agents. The establishment of a commercial firm whose assets are shielded from the personal creditors of its insiders thus requires both organizational law and agency law. Even more surprisingly, organizational law may owe much of its historical and conceptual genesis to the law of agency.

Recognizing how agency separates the assets of firms and their managers makes three additional contributions. First, it allows the identification of the most important efficiencies that agency law alone can provide to business enterprise. Appreciating these efficiencies enables a more sophisticated analysis of whether given doctrines, like inherent authority, serve the basic goals of agency law. Second, it facilitates an analysis of agency's doctrine that explains why it assumes the form it does. This allows not only for the rationalization of the contractibility of agency's rules, and of the differences in doctrine between contract and tort, but also for the identification of unappreciated strains in agency's case law, such as the equitable doctrines that pierce the shield between the firm and agents' assets. It also suggests a research agenda for further economic analysis of agency law, including the distinct justifications for agent and principal piercing as opposed to traditional veil piercing. Lastly, this asset partitioning account constitutes a justification of agency law. Far from an arcane body of unnecessary rules, the law of agency is essential to commerce.

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[258] Black, *supra* note 146; *see also* Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 289 ("The firm is viewed as a set of contracts").

[259] Hansmann & Kraakman, *supra* note 12, at 416.