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The Use of "Internal" Asset Partitioning in Business Law

L. Ventura

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INTRODUCTION

In the last two decades, business organizations' asset partitioning has been a highly debated topic in corporate scholarship belonging to several legal traditions.

As pointed out by Henry Hansmann and Reinier Kraakman in their seminal work *The Essential Role of Organizational Law* (published in the *Yale Law Journal* in 2000), asset partitioning, with its two opposite sides of defensive and affirmative asset partitioning, represents an essential feature of all organizational forms provided by legal systems for carrying out business activities. In particular, the authors highlighted the essential role of affirmative asset partitioning (or "entity shielding"), which represents the reverse of limited liability, emphasizing the importance of the partitioning effect between a firm's assets and the claims of the personal creditors of its owners and managers.

The introduction, in Western legal tradition systems, of several new forms of asset partitioning demonstrates how the entity shielding effect (or affirmative asset partitioning) can currently be achieved through the use of two distinct techniques: *i)* the creation of a new legal entity (the "external" asset partitioning) and *ii)* the internal segregation of assets belonging to a subject that are committed to a specific purpose and pledged only to a specified group of creditors (functional creditors) whose claims are connected to the specific purpose (which I will refer to in this study as "internal" asset partitioning).

Starting from the theoretical framework proposed by Hansmann and Kraakman, this study investigates, from a comparative perspective, the practical use of the "internal" asset partitioning.

The new models of internal asset partitioning (such as the Delaware series, protected cell companies, funds committed to a specific purpose and limited liability individual enterprises) adopted in different legal systems distinguish themselves (shifting from "entity shielding" to "internal shielding") in that the partitioning effect between a firm's segregated assets and the claims of both the firm's owners' personal creditors and the firm's general creditors is no longer linked to the existence of a legal entity.

Currently, according to a significant body of scholarship, both the external and the internal asset partitioning models (*i.e.*, entity shielding and internal shielding) are (*in theory*) perfectly equivalent legal devices from the perspective of the common pledge of the firm's creditors.

In other words, both entity shielding and internal shielding segregate a certain pool of assets from unsecured general creditors' claims.

Starting from this assumption, this study will analyze several legislations regulating these new forms of internal asset partitioning for entrepreneurs and will investigate their practical use in civil law and common law legal systems.

In light of the following comparative law analysis of these internal asset partitioning mechanisms, this study will suggest that the asserted functional equivalence between external and internal asset partitioning (or between entity shielding and internal shielding) is valid only from a theoretical point of view. The functional equivalence of these two different techniques seems to disappear in their practical use due to the existence of uncertainties in the application of tax and bankruptcy law to the internal asset partitioning mechanisms.

Consequently, because of the existence of these regulatory uncertainties, the use of the internal asset partitioning technique cannot fully replace the external asset partitioning. The existence of certain regulatory asymmetries between entity shielding and internal shielding has (*in practice*) caused a considerable inequality between them. This observation is apparently confirmed by the fact that most entrepreneurs continue to use organizational forms that are based on the external asset partitioning technique (*e.g.*, corporate groups with elaborate subsidiary structures) rather than forms of internal asset partitioning.

In other words, it is possible to conclude that the "legal entity" status is still essential to achieve a strong form of affirmative asset partitioning.

From a methodological perspective, this study has been conducted using the comparative law method.

The microcomparison (or rule-oriented comparison) offered in this study will increase the understanding of foreign laws regulating internal asset partitioning techniques and will help to shed light on the similarities and differences among legal systems.

Furthermore, the comparative methodology allows to verify the consistency between "law in books" and "law in action" and to measure, from a practical perspective, the alleged functional equivalence between entity shielding and internal shielding.

In this perspective, the study analyzes different forms of internal asset partitioning conceived for individual entrepreneurs (such as the limited liability individual enterprise of France and Portugal), and forms of internal segregation conceived for companies (such as the Delaware series, the protected cell companies of Guernsey and Luxembourg, and the Italian funds committed to a specific purpose).

The study is organized as follows.

The first two chapters serve the purpose of clarifying some essential concepts of the common and civil law traditions (such as the debtor's personal liability regime and the concepts of "patrimony" and juridical personality) and offer a brief analysis of the evolution of business organizational law, exploring its development until the present day.

In particular, Chapter One advances a descriptive analysis of the debtor's personal liability regime in the civil law and common law systems (paragraph 1).

Then, moving from the debtor's personal liability to the entrepreneur's liability, the focus shifts to the asset partitioning theory elaborated by H. Hansmann and R. Kraakman (paragraph 2).

Based on the authors' emphasis on the essential role of affirmative asset partitioning (*i.e.*, entity shielding), paragraph 3 focuses on the personality conception of legal entities in the civil law and common law traditions and on the differences between the concepts of "juridical person" and "legal entity" in order to identify the boundaries of the so-called "entity status" from a comparative perspective.

Paragraph 4 will analyze the alleged functional equivalence between the two techniques of "internal" and "external" asset partitioning, bearing in mind that the rise of new forms of asset segregation available to the entrepreneur has reduced the use of the juridical personality as a device to limit the debtor's personal liability regime and that the same results usually achieved through the creation of a legal entity (*i.e.*, a new juridical person) can be now reached through the use of the "internal" asset partitioning technique. Paragraph 5 will then provide a cost-benefit analysis of these two techniques with particular attention to the efficiency advantages of the internal asset partitioning model.

Consistent with the famous words of Maitland and Gorla, "history involves comparison" and "comparison involves history"[1], Chapter Two offers a historical and comparative law analysis of the development and use of internal asset partitioning in civil law and common law legal systems.

While Paragraph 1 offers a short introduction, Paragraph 2 explains the concept of "patrimony" and the different theories of this concept elaborated in civil law countries. The analysis starts with the "singleness of patrimony" doctrine elaborated by Charles Aubry and Charles Rau in the eighteenth century and then moves to the "asset separateness doctrine" (*Zweckvermögen* theory) developed in the nineteenth century by Alois Brinz and Ernst Immanuel Bekker to justify the existence of different pools of assets segregated from the general patrimony of a subject.

After this clarification, the study focuses on the evolution of organizational law in European countries. In particular, the study highlights the development of organizational forms characterized by asset partitioning from the birth of the first form of general partnership until the introduction of the XII European Directive (89/667 CEE) of 1989 on single-member private limited liability companies.

Similarly, Paragraph 3 analyzes the concept of "patrimony" in common law tradition, the birth and use of the common law trust from the asset partitioning theory perspective, and the evolution of organizational forms characterized by asset partitioning in the Anglo-Saxon countries, from the birth of the partnership and the joint stock company in the seventeenth and eighteenth centuries until the present day.

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[1] See F.W. MAITLAND, *Why the History of English Law is Not Written*, in *The Collected Papers of Frederic William Maitland*, H.A.L. Fisher ed., vol. 1, Cambridge 1911, at 488; and G. GORLA, *"Diritto comparato"*, in *Enc. diritto*, vol. XII, Milano, 1964, at 930, nt. 5.

Through this historical and comparative law analysis, it is possible to observe that in common law countries, the segregation of assets within the boundaries of the same subject (a natural person or a legal person) has been accepted for a long time exclusively through the creation of a new legal entity. Nonetheless, in both civil law and common law systems, it is currently possible to find several examples of "internal" asset segregation.

Chapter Three is dedicated to the description of the existing forms of internal asset partitioning introduced in the Western legal tradition countries.

With regard to the individual entrepreneur (as addressed in Paragraph 2), the analysis starts with the "*peculio*" introduced in Roman law (Paragraph 2.1) and then focuses on forms of limited liability individual enterprise used in Portugal (Paragraph 2.2) and France (Paragraph 2.3). On the other side, as for company law, the study analyzes the use of "protected cell companies" in Guernsey (Paragraph 3.1.) and Luxembourg (Paragraph 3.2.), the Delaware "series law" (Paragraph 3.3.) and the Italian "funds committed to a specific purpose" (Paragraph 3.4.).

In particular, the comparison will be conducted between the provisions of the Delaware series law and the Italian funds committed to a specific purpose as general internal shielding mechanisms for the conduct of business activity.

Through the comparison of the specific provisions of these two legal devices, the chapter shows that common law and civil law countries have developed similar legal solutions.

After the analysis of the laws regulating the existing internal shielding mechanisms, Chapter Four argues that the alleged functional equivalence between external and internal asset partitioning (or between entity shielding and internal shielding) is only *theoretical* because of the existence of regulatory asymmetries causing inequality in the *practical* use of the internal asset partitioning models.

Indeed, based on the analysis of the different legislations regulating the new forms of internal asset partitioning, it is possible to demonstrate that all these internal shielding models produce the same practical problems (generally related to the lack of legal personality) in different countries, in particular with regard to the application of bankruptcy and tax law.

Moreover, due to the limitation of the debtor's liability determined by the use of internal asset partitioning, creditors' protection become an issue of paramount importance.

Thus, at Paragraph 2, the analysis focuses on the appropriate forms of disclosure and procedural safeguards required to protect creditors when a debtor is achieving asset partitioning through the internal technique.

Then in Paragraphs 3 and 4, the analysis addresses the application of tax and bankruptcy law to internal shielding mechanisms.

As shown through a comparative law analysis, in both civil and common law systems, the internal asset partitioning technique is characterized by all the typical features of an organizational form, but, in the absence of statutory or court intervention, it cannot replace the recourse to the creation of a legal entity. This is due

to the failure of other fields of law, such as tax and bankruptcy law, to clarify how the internal shielding mechanisms will be treated.

As a tentative conclusion, this study suggests that both Italy and the United States should adopt a more detailed legislative and judicial approach in the regulation of internal shielding mechanisms to ensure the efficiency of this legal device and to overcome the asymmsetries between the asset partitioning rules provided by corporate law and the rules provided by bankruptcy and tax law.