

Michigan Law Review

Volume 116 | Issue 2

2017

Enterprise Without Entities

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Recommended Citation

Andrew Verstein, *Enterprise Without Entities*, 116 MICH. L. REV. 247 (2017).

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ENTERPRISE WITHOUT ENTITIES

Andrew Verstein*

Scholars and practicing lawyers alike consider legal entities to be essential. Who can imagine running a large business without using a business organization, such as a corporation or partnership? This Article challenges conventional wisdom by showing that vast enterprises—with millions of customers paying trillions of dollars—often operate without any meaningful use of entities.

This Article introduces the reciprocal exchange, a type of insurance company that operates without any meaningful use of a legal entity. Instead of obtaining insurance from a common nexus of contract, customers directly insure one another through a dense web of bilateral agreements. While often overlooked or conflated with mutual insurance companies, reciprocal exchanges include some of America's largest and best-known insurance enterprises.

This Article explores how it is possible to run an international conglomerate with essentially no recourse to organizational law as it is normally conceived, and it then draws out the important implications of these findings. The viability of reciprocal exchanges stands as a powerful foil to the academic consensus that legal entities are somehow essential, while nevertheless validating the underlying logic that led scholars to elevate entities in the first place.

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INTRODUCTION

Scholars and practitioners generally agree that any large enterprise must be run through a legal entity such as a corporation. While a minority view questions whether business entities are really necessary,¹ the leading academic voices argue that use of a legal entity confers benefits that would be “effectively impossible” to obtain through other means.² For example, an entity reduces the transaction costs of coordinating an enterprise’s many

1. Business is conducted by human beings—workers, customers, suppliers—who can coordinate through contracts. So what is gained by positing a fictional person? The triviality of entities is emphasized in the main line of law-and-economics scholarship and, in particular, the contract theory of the firm. *E.g.*, FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 24–25 (1991); RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 396 (4th ed. 1992). The essentiality of entities is also intimately related to the question of whether organizational law (such as corporate law) is trivial in the sense of containing no important mandatory rules. *See* Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 *Nw. U. L. Rev.* 542 (1990). If entities are not themselves vital, and so it is feasible to do without them, then even mandatory rules on entities are trivial. On the nexus of contract theory of the firm, see Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 *Am. Econ. Rev.* 777 (1972), and Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 *J. Fin. Econ.* 305 (1976). *See also* William T. Allen, *Contracts and Communities in Corporation Law*, 50 *Wash. & Lee L. Rev.* 1395, 1400 (1993) (“The notion that corporations are ‘persons’ is seen as a weak and unimportant fiction.”).

2. Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 *Yale L.J.* 387, 406 (2000).

patrons,³ limits liability for shareholders,⁴ and protects a business from untimely dissolution.⁵ The widespread consensus is that legal entities are essential to economic life as we know it.

This Article challenges the regnant view by documenting and analyzing a domain of mass commerce in which legal entities are substantially absent. In this domain, millions of people exchange trillions of dollars, and they do so without meaningful recourse to legal entities.⁶ That domain is insurance, as conducted by reciprocal exchanges.

A “reciprocal exchange” is an insurance enterprise in which all insurance subscribers contract directly with one another, promising to pay a share of any losses the others suffer. A thick braid of contracts unites a circle of natural persons, each of whom participates as part of the enterprise, with no legal entity at the contractual core.

The theoretical significance of reciprocals has gone unnoticed because reciprocals themselves have gone unnoticed. Most scholars and insurance practitioners appear to be unaware that reciprocals exist,⁷ and some even deem them to be impossible.⁸ Yet reciprocals provide almost 10% of America’s property and casualty insurance,⁹ which totals to about 5% of all

3. See, e.g., Martin Hellwig, *Banks, Markets, and the Allocation of Risks in an Economy*, 154 J. INST. & THEORETICAL ECON. 328, 331 (1998). A related thought is that entities reduce the potential for exploitation when some or many contracts must be left incomplete.

4. Stephen M. Bainbridge, *Abolishing Veil Piercing*, 26 J. CORP. L. 479 (2001); Scott Baker & Kimberly D. Krawiec, *The Economics of Limited Liability: An Empirical Study of New York Law Firms*, 2005 U. ILL. L. REV. 107; *The Key to Industrial Capitalism: Limited Liability*, ECONOMIST (Dec. 23, 1999), <http://www.economist.com/node/347323> [<https://perma.cc/Z3EB-LLZE>].

5. See generally Hansmann & Kraakman, *supra* note 2, at 434–35.

6. Three large reciprocals alone insure some thirty million individuals. See *Corporate Overview: Financial Strength*, USAA, https://www.usaa.com/inet/pages/about_usaa_corporate_overview_financial_strength [<https://perma.cc/ST9M-5XED>] (11.4 million members); *About Farmers*, FARMERS INS., <https://www.farmers.com/about-us/> [<https://perma.cc/U9GT-CDAC>] (nineteen million policies); Jim Martin, *Erie Insurances Marks 90 Years*, GoERIE (Apr. 12, 2015, 12:01 AM), <http://www.goerie.com/news/20150412/erie-insurance-marks-90-years> [<https://perma.cc/FCA3-5P2M>] (five million policy holders).

7. Essentially the only research on reciprocal exchanges took place in the 1960s. Richard Norgaard, a longtime professor at the University of Connecticut, devoted his PhD dissertation and several articles to documenting the history and contemporary practices of reciprocals in the United States. Richard Lima Norgaard, *Reciprocals: A Study of the Evolution of an Insurance Institution* (1962) (unpublished Ph.D. dissertation, University of Minnesota). Dennis Reinmuth followed with a book focused on the law and public policy of reciprocal insurance. DENNIS F. REINMUTH, *REGULATION OF RECIPROCAL INSURANCE EXCHANGES* (1967); see also Michael A. Haskel, *The Legal Relationship Among a Reciprocal Insurer’s Subscribers, Advisory Committee and Attorney-in-Fact*, 6 N.Y. CITY L. REV. 35 (2003).

8. See Hellwig, *supra* note 3, at 331 (calling the very notion of such a structure “a bit ludicrous”).

9. See NAT’L ASS’N OF INS. COMM’RS, 2013 MARKET SHARE REPORTS FOR PROPERTY/CASUALTY GROUPS AND COMPANIES 11–12 (2014), http://www.naic.org/prod_serv/MSR-PB-14.pdf [<https://perma.cc/9DY8-KSSC>]. P&C insurance includes lines such as personal-automobile and home insurance, as well as flood and fire, and other business insurance.

the nation's insurance.¹⁰ Almost one in six doctors buy malpractice insurance from a reciprocal.¹¹ Moreover, some of America's best-known insurance enterprises are reciprocal exchanges. For example, USAA and Farmers Insurance, both among the ten largest insurers in the United States,¹² are reciprocals.¹³ Reciprocals are too important to ignore.

If reciprocals are forgotten, it may be because they are often confused with mutual insurance companies, or "mutuals."¹⁴ Although both enterprise forms emphasize cooperation among customers, they nevertheless differ in important ways. They are subject to different governing statutory provisions.¹⁵ Reciprocals present different risks of managerial expropriation because their compensation structures sometimes permit managers to extract substantial profits from the enterprise.¹⁶ They raise different tensions between present and future policyholders; in a reciprocal, the present policyholders are due a refund if the reciprocal pays out less than the premiums collected, whereas mutual policyholders may have no direct claim to such a surplus—and will never enjoy its fruit if they cancel their policy before the mutual opts to pay a dividend. Such structural differences lead to meaningful economic differences.¹⁷

Most crucially for present purposes, mutuals and reciprocals also differ in their use of legal entities. Like almost all business ventures, a mutual relies on a legal entity, often a corporation, to operate; a mutual is peculiar only in that the legal entity happens to be owned by its policyholders. Conversely, the reciprocal exchange is neither owned by policyholders nor anyone else,

10. The property and casualty market is about half of the total insurance market. *Industry Overview: Insurance Industry at a Glance*, INS. INFO. INST., <http://www.iii.org/fact-statistic/industry-overview> [<https://perma.cc/2GBF-RGWR>]. Reciprocals are prohibited from offering life insurance. See *infra* note 117 and accompanying text.

11. See NAT'L ASS'N OF INS. COMM'RS, *supra* note 9, at 185–86.

12. *Top 25 Insurance Companies*, INSWEB, <http://www.insweb.com/insurance-tools/insurance-companies.html> [<https://web.archive.org/web/20160320080747/http://www.insweb.com/insurance-tools/insurance-companies.html>].

13. *True v. Robles*, 571 F.3d 412, 413 (5th Cir. 2009) (stating that USAA is a reciprocal exchange); *About Farmers*, *supra* note 6 (stating that Farmers is a reciprocal exchange).

14. E.g., William M. Duffy, *The Ultra Vires Question as Applied to Corporation Subscribers at Reciprocal or Inter-Insurance Exchanges*, 5 KY. L.J. 52, 52 (1917) (defining reciprocal as "an unincorporated mutual"); Peter Molk, *The Puzzling Lack of Cooperatives*, 88 TUL. L. REV. 899, 921 (2014) (mistakenly calling USAA a mutual).

15. See, e.g., TEX. INS. CODE ANN. § 942.003 (West 2009) (exempting reciprocal exchanges from otherwise applicable insurance regulations); *id.* § 942 (imposing new obligations on reciprocals); *id.* §§ 882–883 (regulating mutuals).

16. While managers of a mutual may help themselves to perquisites or slacken their efforts, they cannot simply extract a slice of the premiums; this is part of the appeal of the mutual structure, which ensures a reasonable relationship between the cost of the insurance and the protection provided. The compensation structure of some reciprocals permits managers to extract substantial profits from the enterprise. See *infra* Section II.A.

17. Emilio C. Venezian, *Reciprocal Insurance: A Case of Supply Created by Demand*, 6 J. RISK FIN. 404, 412–13 (2005) (showing greater reciprocal insurance levels than mutual or stock insurance, even in the presence of management fees).

since there is no legal entity to own.¹⁸ Its members stand in direct contractual privity.

The viability of reciprocal insurance challenges the entity essentialism now dominant in the corporate law community and elsewhere. Without any entity, reciprocals have somehow been able to secure or forswear the supposedly essential functions that entities provide. It turns out that creative applications of contract law, agency law, and insurance law suffice to support broad coordination. How? An enterprise's many patrons can appoint a common person (the "attorney-in-fact") to act as their agent, authorized to quickly sign multifarious contracts in their names.¹⁹ Liability can be limited and prioritized within those contracts.²⁰ These limitations are binding on third parties because insurance regulation puts potential creditors on constructive notice of these agreements.²¹ Entity-like functions follow, but sans entity.

This Article therefore deflates the importance of *entities*, but it does not necessarily undermine all arguments of *entity theorists*. To the contrary, the fact that reciprocals seek and find many of the core functions provided by entities underscores the importance of those functions. Reciprocals have used agency law to overcome transaction costs, and they have alloyed contract law and insurance regulation to create the pattern of creditors' rights that scholars refer to as "asset partitioning."²² Though reciprocals do this without the state's helpful entities, public law is still important for establishing some of those entity-like benefits because insurance regulation gives the gift of constructive notice.²³ Entity essentialism is therefore honored in the breach. Entity theorists overstate the uniqueness of entities in achieving certain functions, but they are largely correct in highlighting those functions.

Indeed, even as reciprocals achieve those functions without entities, their circumnavigation traces the path of organizational law. Contractual limitations on liability or liquidation are usually binding only on those who have notice of them.²⁴ Organizational law avoids this problem by conjuring fictional *persons* entities. The reciprocal instead relies on insurance and agency law to construct fictional *networks* and fictional *notice*. Thus, reciprocals swap one set of legal fictions for another in the quest for certain key economic functions.

18. See, e.g., *General Revenue Revision: Hearing Before the H. Comm. on Ways and Means*, 85th Cong. 3342 (1958) (statement of Floyd E. Jacobs, General Counsel, American Reciprocal Insurance Association) ("Again, we reiterate, that the so-called exchange is a mere place at which the subscriber-policyholders exchange contracts of indemnity among themselves. Such exchange owns nothing and is legally, of course, incapable of owning anything, since it is not an entity.").

19. See *infra* Section III.A.

20. See *infra* Section III.C.

21. See *infra* Section III.B.

22. See *infra* Sections I.B, I.C; see also *infra* Section III.A.

23. See *infra* Section III.A.

24. Hansmann & Kraakman, *supra* note 2, at 420–22.

This Article gives reciprocals their first serious scholarly treatment, explains how they succeed without entities, and relates these findings to the most foundational questions in business law.²⁵ For example, the case for robust corporate social responsibility and corporate regulation rests most comfortably if entities are essential.²⁶ If the state grants irreplaceable benefits only through entities, then it may reasonably charge a quid pro quo, such as meaningful philanthropy or empowerment of workers.²⁷ This sort of “concession theory” argument is weakened if entities are just one path to enterprise.

The essentialism debate is not just a normative one, about what we should *do* in regards to the regulation of enterprise. It is equally a question of *what we can hope for*.²⁸ Entity essentialism is a crucial obstacle to unorthodox visions of commerce.²⁹ According to some techno-optimists, commercial life is bound to change radically in coming years. A series of terms (*person-to-person*, *the sharing economy*, *gig-economy*, *micro-work*, *disintermediation*, *decentralization*) suggest a world without traditional companies, hierarchies, or employment contracts.³⁰ In recent years, platforms have emerged to more directly link borrowers and lenders,³¹ buyers and sellers,³²

25. For another example, entity triviality plays an important role in arguing against mandatory rules in corporate law. See generally Lucian Arye Bebchuk, Foreword, *The Debate on Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395 (1989).

26. Cf. Morton J. Horwitz, *Santa Clara Revisited: The Development of Corporate Theory*, 88 W. VA. L. REV. 173 (1985) (describing the relationship between certain theories of corporate existence and the appropriateness of regulation).

27. E.g., KENT GREENFIELD, *THE FAILURE OF CORPORATE LAW* 35 (2006) (“Early in our nation’s history, a corporation was seen as a creation of the state rather than a product of private contract, and a corporate charter came with important conditions that protected the public interest. In exchange for receiving the special benefits of incorporation, including limited liability for shareholders, corporations were chartered for some public purpose.”). Conversely, if entities are trivial, then entities do little more for parties than they could do through contract alone. In that case, corporate regulation is perhaps only as legitimate as regulation of private contracts. See LARRY E. RIBSTEIN, *THE RISE OF THE UNCORPORATION* 2 (2009). We do regulate private contracts, but prudential and libertarian concerns make us reluctant to do so. See U.S. CONST. art. 1, § 10 (“No State shall . . . pass any . . . Law impairing the Obligation of Contracts . . .”).

28. Cf. IMMANUEL KANT, *CRITIQUE OF PURE REASON* 677 (Paul Guyer & Allen W. Wood eds., Cambridge Univ. Press 1998) (1781) (asserting that all of philosophy amounts to answering three questions: “What can I know? What should I do? What can I hope for?”).

29. Of course, this contemporary debate was foreshadowed by questions we associate with R.H. Coase, *The Nature of the Firm*, 4 *ECONOMICA* 386 (1937), inquiring into why we observe firms at all, given the availability of contracting in the market.

30. See, e.g., GILLIAN K. HADFIELD, *RULES FOR A FLAT WORLD: WHY HUMANS INVENTED LAW AND HOW TO REINVENT IT FOR A COMPLEX GLOBAL ECONOMY* (2016).

31. LendingClub and Prosper both provide this service, which is sometimes called “P2P lending.” See generally Andrew Verstein, *The Misregulation of Person-to-Person Lending*, 45 U.C. DAVIS L. REV. 445 (2011).

32. eBay and Craigslist both provide this service.

riders and drivers,³³ and renters and letters.³⁴ Business futurists emphasize technology as a liberator,³⁵ but the transformation can never be totally successful if entities are in fact essential.³⁶ By contrast, if entities are optional, then we are free to ask how technology might facilitate new models of commercial connection. And this, paradoxically, might bring benefits most quickly to those least enamored of modern commercial life, such as religious objectors to health insurance and those cynical about the contemporary banking system.³⁷ This Article will explore what reciprocals can teach us about life without entities and consider how removing entities might support health insurance and person-to-person lending.

Perhaps most provocatively, by positing that reciprocals are not entities, this Article questions what it means to be an “entity” and what role the concept plays in our legal system. Even if entities are not functionally necessary, might they be ontologically necessary? That is, are there reasons that we must talk in terms of entities (rather than just humans, tasks, and deals, for example), in the context of reciprocals or elsewhere?

The structure for this Article is as follows. Part I introduces theories about the status of entities in our society—are they trivial or essential, and why? Part II introduces reciprocal exchanges and discusses the ways in which they do and do not use legal entities. Part III synthesizes the major theoretical premises from the first part with the minor factual premises from the second part. The goal is to understand how reciprocals are able to function without meaningful use of entities. Alongside this is the converse question: Why aren’t reciprocals even more common than they are currently? Part IV then asks what this study of reciprocals may have to say about the essentiality of entities in general. Specifically, it explores the magnitude of entities’ functional contribution, their ontological priority, and their normative significance.

I. THE ESSENTIAL ROLE OF ENTITIES

Life is possible without legal entities. After all, there have been historical epochs when workable legal entities were largely unavailable.³⁸ In the present, unincorporated associations still do plenty of things in our world, like

33. Lyft and Uber both provide this service, which is sometimes called “ridesharing.”

34. Airbnb and VRBO both provide this service.

35. See Lynn M. LoPucki, *The Death of Liability*, 106 YALE L.J. 1, 64 (1996) (arguing that “given the computerization of contracting and recordkeeping, [the assumption that large firms would continue to exist] may be unwarranted”).

36. This Article is about the potential for commerce with people and without entities, but the inverse—commerce with entities and without people—is explored by others. See, e.g., Shawn Bayern, *The Implications of Modern Business-Entity Law for the Regulation of Autonomous Systems*, 19 STAN. TECH. L. REV. 93 (2015).

37. See *infra* Section IV.A.2.

38. Cf. *infra* note 60.

run little-league teams.³⁹ Some industries are able to coordinate many individuals through trust and contract.⁴⁰ And everyone recognizes that natural persons can do a lot of business using only property, contract, and agency law—just ask one of America’s twenty-three million sole proprietors.⁴¹ So life without entities has always been imaginable.

What has seemed *unimaginable* to many is commercial life on any appreciable scale without entities. Relatedly, it has seemed inconceivable that serious ventures would be attempted without a legal entity now that legal entities are widely available. The triumph of the entity, at least for large ventures, seems inevitable.

But why is this so? In the end, natural persons must do all the work that is to be done. They must make plans that are comprehensible, mutually agreeable, and collectively rational. Why can they not scaffold worthwhile projects onto a framework of bilateral and multilateral contracts? It is true that novice entrepreneurs might find it convenient to pattern their affairs from some off-the-rack defaults,⁴² just as novice chefs might want a formal recipe or sample menu.⁴³ But in no case is a formal recipe or menu itself part of or essential to the meal.

The following Sections outline three of the main contenders for the essential contribution of entities: reduction in transaction costs, limited liability for shareholders, and shielding for the company from investors and their creditors.

A. *Transaction Costs*

Coordination is costly. Parties must either (1) specify their rights in clear and credible contracts, which creates a meaningful upfront cost, or (2) leave many rights unspecified, and thereby tempt costly opportunism or litigation concerning gaps in the contract.⁴⁴ Use of a legal entity is thought to

39. See, e.g., *King v. Little League Baseball, Inc.*, 505 F.2d 264, 265 (6th Cir. 1974) (noting that a member of an unincorporated little-league association is suing the incorporated little league).

40. See William A. Klein & Mitu Gulati, *Economic Organization in the Construction Industry: A Case Study of Collaborative Production Under High Uncertainty*, 1 BERKELEY BUS. L.J. 137 (2004) (explaining how coordination is possible between many patrons of a construction project). Professors Gilson, Sabel, and Scott deal obliquely with the same notion in other industries, such as pharmaceutical research. Ronald J. Gilson et al., *Braiding: The Interaction of Formal and Informal Contracting in Theory, Practice, and Doctrine*, 110 COLUM. L. REV. 1377 (2010). By emphasizing the power of informal sanctions and information sharing to support formal contracting, these projects implicitly deemphasize the salient alternative—ownership of the entire construction or research project by a single firm.

41. Scott A. Hodge, *The U.S. Has More Individually Owned Businesses than Corporations*, TAX FOUND. (Jan. 13, 2014), <http://taxfoundation.org/blog/us-has-more-individually-owned-businesses-corporations> [<https://perma.cc/W6LF-VVCS>].

42. See STEPHEN M. BAINBRIDGE, *CORPORATION LAW AND ECONOMICS* 29 (2002).

43. See Michael Klausner, *The Contractarian Theory of Corporate Law: A Generation Later*, 31 J. CORP. L. 779 (2006) (describing benefits of a corporate governance menu).

44. See Jody S. Kraus & Robert E. Scott, *Contract Design and the Structure of Contractual Intent*, 84 N.Y.U. L. REV. 1023 (2009).

reduce both the number of costly contracts and per-contract cost of opportunism for each individual linkage among business patrons.

1. Contracting

Bilateral agreements must be negotiated, considered, drafted, and sometimes updated. A complex enterprise with many interconnected patrons would pay such costs many times over. Conversely, the number of contracts is minimized if each patron need only coordinate with a single party. For some theorists, legal entities are largely justified by their ability to act as the common nexus of contract and reduce transaction costs.⁴⁵

Professor Martin Hellwig articulates this sort of reasoning in an influential paper about the role of financial intermediaries in the economy. As a thought experiment, he considers whether we could dispense with insurance companies if everyone just bought insurance from “the local greengrocer.”⁴⁶ Naturally enough, Hellwig doubts that such an arrangement could succeed and argues that the crucial problem “is one involving transaction costs savings rather than any inherent features of risk management.”⁴⁷

[T]he mere costs of writing all the requisite contracts would eat up a significant portion of the funds that the households provide. If there are, say, a thousand shopkeepers to be financed, the intervention of an intermediary issuing significantly larger life insurance policies to each of the one million households and using the proceeds to finance each of the one thousand shopkeepers would *reduce the number of requisite contracts* from one billion (one thousand times one million for each shopkeeper-household pair) to one million and one thousand (one for each household and one for each shopkeeper). Even if the costs of writing a single contract are no more than a few pennies, such a reduction in the number of requisite contracts would reduce costs significantly⁴⁸

The cost of contracting renders any nonentity insurance “a bit ludicrous.”⁴⁹

While Hellwig is concerned with financial institutions, the same logic applies to industrial companies. Consider an enterprise with five participants—a user of ball bearings, an ore miner, a factory worker, a foreman,

45. See REINIER KRAAKMAN ET AL., *THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH* 5 (3d ed. 2017) (describing a firm “as a ‘nexus for contracts’ in the sense that a firm serves, fundamentally, as the common counterparty in numerous contracts with suppliers, employees, and customers, coordinating the actions of these multiple persons through exercise of its contractual rights”); see also *supra* note 1.

46. Hellwig, *supra* note 3, at 331.

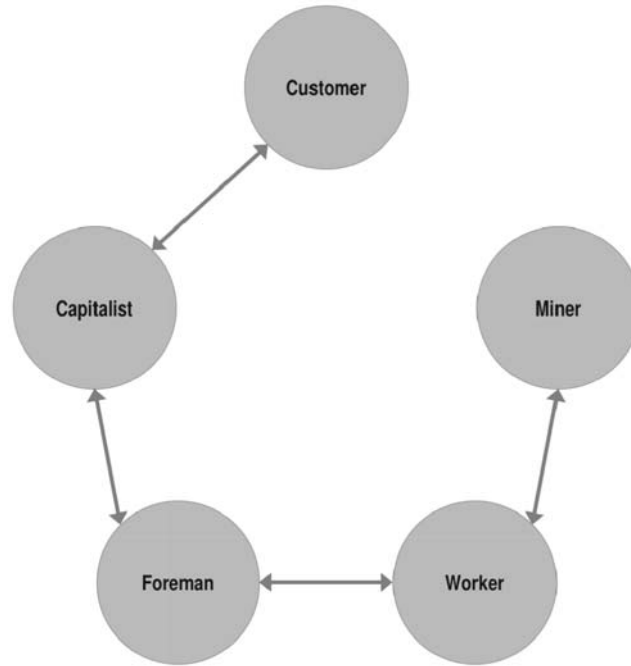
47. *Id.* Risk could be managed by splitting the customer’s insurance needs up into manageable slices and then doling them out to the various grocers. See *id.*

48. *Id.* In 1997, 1.74 DM equaled one USD. Harold Marcuse, *Historical Dollar-to-Marks Currency Conversion Page*, U.C. SANTA BARBARA (Aug. 19, 2005) (updated Feb. 9, 2013), <http://www.history.ucsb.edu/faculty/marcuse/projects/currency.htm> [https://perma.cc/TG94-KFBK]. So 100,000 DM was \$57,471.26.

49. *Id.*

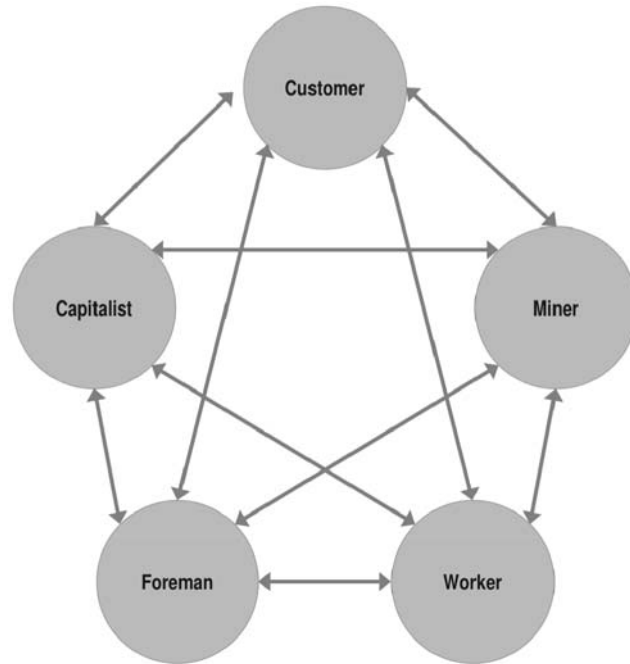
and a capitalist investor. These natural persons might be able to work together to their mutual benefit, but it could take a great deal of contracting. The customer will want to contract with the capitalist to gain possession of the final products, and the capitalist will want to hire a foreman to hire and motivate a worker, who will want an ore miner happily churning out inputs. Figure 1 illustrates these relationships.

FIGURE 1



Each will soon recognize, however, the utility of having some relationship to the others. The capitalist will not want to be hamstrung if the worker is unavailable some day and cannot issue orders to the ore miner. If the ball bearings are sufficiently important to the customer, she may want some contractual rights against the foreman in case the capitalist proves intransigent. Contractual relationships multiply as the enterprise achieves a more sophisticated contractual expression. Figure 2 depicts the increasingly complex network of relationships.

FIGURE 2

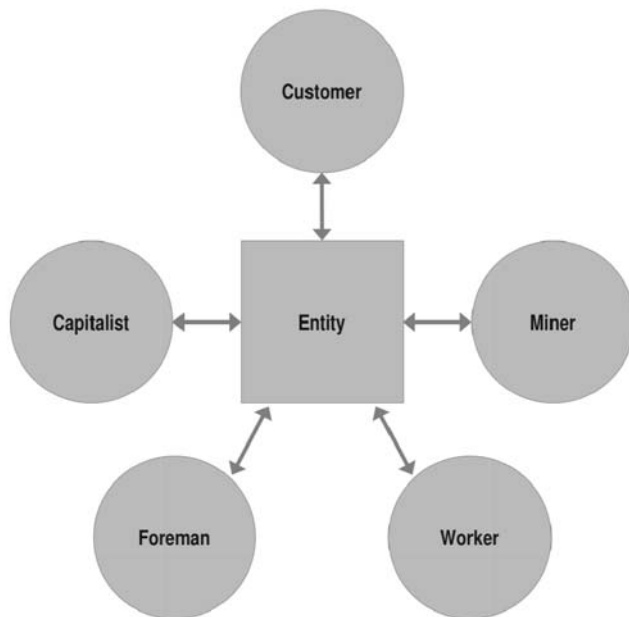


Each arrow is costly, and the costs of contracting multiply with the number of participants. Five participants generate ten arrows. Six participants yield fifteen arrows. An enterprise with ten thousand participants generates nearly fifty million contracts, one for each pair to evaluate and negotiate.⁵⁰ Such an arrangement is unsuitable for mass commerce.

The firm, as a common party to all contracts, greatly simplifies the endeavor. Figure 3 illustrates how a common party can simplify things.

50. See PROJECT MGMT. INST., *A GUIDE TO THE PROJECT MANAGEMENT BODY OF KNOWLEDGE* 292 (5th ed. 2013).

FIGURE 3



If each patron can contract with the firm, then the number of contracting problems never exceeds the number of participants. Each person must vet, dicker, and sign only one agreement. Scalable ventures become tractable again. The entity becomes essential as a matter of almost geometric proof.

2. Opportunism

Still, none of the forgoing contracts is perfect and complete.⁵¹ A second rationale for entities focuses on the potential risks of contractual exploitation.⁵² The life of a single bilateral contract affords great potential for opportunism, where one party might exploit the other by either invoking a needlessly strict contract term or shirk through a mistakenly lax one. These worries only multiply if a project requires many participants to coordinate,⁵³ since each one might have a chance to exploit the contracts' weaknesses.⁵⁴

51. See Jean Tirole, *Incomplete Contracts: Where Do We Stand?*, 67 *ECONOMETRICA* 741, 771–72 (1999) (explaining the existence of incomplete contracts partially in terms of unforeseen contingencies). See generally Charles J. Goetz & Robert E. Scott, *Principles of Relational Contracts*, 67 *VA. L. REV.* 1089, 1090–91 (1981) (discussing incomplete contracts).

52. See generally Oliver E. Williamson, *Transaction-Cost Economics: The Governance of Contractual Relations*, 22 *J.L. & ECON.* 233 (1979).

53. This is the hallmark of team production. See Alchian & Demsetz, *supra* note 1, at 779–81.

54. See Andrew Verstein, *Ex Tempore Contracting*, 55 *WM. & MARY L. REV.* 1869, 1893–94 (noting that multiparty projects face challenges to amicable coordination).

The problems inherent in contracting are reduced if a single individual is a common party to all contracts and reserves the right to update all contracts in the network.⁵⁵

Still, why must a legal entity be the common party, rather than a natural person? There is no answer inherent in a transaction costs view, and so such views must be supplemented by references to other organizational features. Some accounts emphasize the eternal life of legal entities, which minimizes the costly reassembly of the network upon the inevitable death of a human nexus.⁵⁶ Another account stresses the structured transferability of firms as bundles of assets.⁵⁷

Talk of structured bundles of assets leads naturally to limited shareholder liability and entity shielding, since all are part of an asset partitioning view. According to Henry Hansmann and Reiner Kraakman, legal entities are essential because they allow something important that would be “effectively impossible” without the creation of legal entities: asset partitioning.⁵⁸ Asset partitioning is composed of limited liability (owner shielding) and entity shielding, which collectively facilitate liquidation protection and prioritization of creditor claims.⁵⁹ According to asset-partitioning theorists, the

55. See Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 276–87 (1999); see also Coase, *supra* note 29, at 390–92. This would explain the prominence of the corporation, but it would not explain the pervasive use of limited life entities. Many partnerships and close corporations have liberal dissolution conditions, either by default or contract. UNIF. P'SHIP ACT §§ 601, 801 (NAT'L CONFERENCE OF COMM'RS ON UNIF. STATE LAWS 1997). Many investment vehicles, such as private equity funds, require liquidation every five or ten years. Ronald W. Masulis & Randall S. Thomas, *Does Private Equity Create Wealth? The Effects of Private Equity and Derivatives on Corporate Governance*, 76 U. CHI. L. REV. 219, 222 (2009).

56. E.g., Andrew A. Schwartz, *The Perpetual Corporation*, 80 GEO. WASH. L. REV. 764, 765–76 (2012).

57. Kenneth Ayotte & Henry Hansmann, *Legal Entities as Transferable Bundles of Contracts*, 111 MICH. L. REV. 715, 717–18 (2013) [hereinafter Ayotte & Hansmann, *Legal Entities*]; see also Kenneth Ayotte & Henry Hansmann, *A Nexus of Contracts Theory of Legal Entities*, 42 INT'L REV. L. & ECON. 1, 1–2 (2015). If a natural person individually holds all the contractual relations, she will face difficulty if she wishes to sell her enterprise to someone else. Her ability to novate the contracts can be limited, explicitly or by default, in order to protect her counterparties from opportunistic transfer to less desirable contractors. But those limitations allow her counterparties to ransom their consent even for good faith transfers. Vesting an alienable entity with all of the rights allows them to be transferred as, and often only as, a bundle. Such bundling may be more valuable ex ante for all participants. Unlimited transfer of a bundle removes holdup power from the nontransferor counterparty without allowing the transferor excessive and exploitative power to transfer to an inappropriate buyer.

58. Hansmann & Kraakman, *supra* note 2, at 406. For other entity-stressing views, see Edward M. Iacobucci & George G. Triantis, *Economic and Legal Boundaries of Firms*, 93 VA. L. REV. 515 (2007), which stresses legal decisions, such as capital structure, which must be made for an entire entity.

59. Although Hansmann and Kraakman consider limited liability to be an important form of asset partitioning, they are far from its most strident advocates. Instead, they emphasize entity shielding as the truly essential part of organizational law. See Hansmann & Kraakman, *supra* note 2, at 390.

utility of the entity lies in the ability to apportion assets into distinct pools for distinct creditors. Such accounts are explored in the next two Sections.

B. *Limited Liability*

Limited liability is the common term for the form of asset partitioning that protects the owners from the debts of the enterprise.⁶⁰ Limited liability is the most commonly cited benefit conferred by the use of legal entities.⁶¹ Praise for limited liability borders on the breathless.⁶² The *Economist* magazine called it “[t]he key to industrial capitalism,” a contribution on par with developments like the steam engine and the locomotive.⁶³ It has been argued that unlimited shareholder liability would frighten away small investors and small investments by large investors, who have little control over the liabilities that might eventually befall them.⁶⁴

Even beyond the impact on investors, the theory of asset partitioning stresses the importance of limited liability to creditors.⁶⁵ With unlimited liability, creditors would need to assess the solvency of enterprise shareholders before determining the total pool available to bond the firm’s commitments. The appropriate interest rate to charge a company would be higher if the company has mom-and-pop investors than if it is owned by Warren Buffett, and it is costly to run a credit check on dozens—or millions—of shareholders. Creditors would also demand restrictions on the free sale of stock, lest wealthy shareholders sell their shares to less wealthy ones just after the credit check is over. Limited liability for owners reduces these costs by taking

60. Hansmann and Kraakman refer to it as defensive asset partitioning. *Id.* at 394. Their work with Richard Squire endorses the new term “owner shielding.” Henry Hansmann et al., *Law and the Rise of the Firm*, 119 HARV. L. REV. 1335, 1336 (2005).

61. For example, one common version of the concession theory cites limited liability as a privilege awarded to corporations, for which taxation or corporate social responsibility can be justly extracted in exchange. See Jill E. Fisch, *Frankenstein’s Monster Hits the Campaign Trail: An Approach to Regulation of Corporate Political Expenditures*, 32 WM. & MARY L. REV. 587, 630 n.227 (1991) (“[T]he artificial entity theory . . . views the corporation as an artificial creation of the state subject to state-imposed limitations . . .”).

62. See, e.g., CURTIS GARDNER, *THE ADVANTAGES OF LIMITED LIABILITY AND COMPANY FORMATION* (1907); Melissa Horton, *Investopedia Stock Analysis: What Are the Advantages to Registering a Limited Liability Company (LLC) in Delaware?*, INVESTOPEDIA (Apr. 29, 2015, 4:11 PM), <http://www.investopedia.com/ask/answers/042915/what-are-advantages-registering-limited-liability-company-llc-delaware.asp> [<https://perma.cc/J7HZ-SLD5>].

63. *The Key to Industrial Capitalism: Limited Liability*, *supra* note 4. Stephensen was the Father of Railways, *Plaque Unveiled for ‘Father of Railways’ George Stephenson*, BBC NEWS (Dec. 9, 2015), <http://www.bbc.com/news/uk-england-leicestershire-35039893> [<https://perma.cc/B76S-7PGX>], and Watt was of course famous for making the steam engine viable, C.N. Trueman, *James Watt*, HIST. LEARNING SITE (Mar. 31, 2015), <http://www.historylearningsite.co.uk/britain-1700-to-1900/industrial-revolution/james-watt/> [<https://perma.cc/WB53-HCMX>].

64. See, e.g., Nina A. Mendelson, *A Control-Based Approach to Shareholder Liability for Corporate Torts*, 102 COLUM. L. REV. 1203, 1218 (2002).

65. See, e.g., Hansmann & Kraakman, *supra* note 2, at 390.

shareholder wealth off the table. Protecting shareholders thus increases liquidity, lowers firm creditor monitoring costs, and calms the nerves of risk averse investors.

C. Entity Shielding

The other side of asset partitioning involves protecting the enterprise's assets from the personal creditors of the owners. When entity shielding is strong, the creditors of Ford Motor Company need not fear that Henry Ford's personal bookie will force an untimely liquidation of company assets to repay Henry's personal gambling debts. Nor will those personal creditors stand on equal footing with business creditors upon insolvency. Enterprise creditors can focus their attention just on the pool of business assets that have been offered up to secure their contracts. Personal creditors can do no more than take Henry's shares in the firm—which does little to frustrate business creditors. Hansmann, Kraakman, and Squire call this function “entity shielding.”⁶⁶ Entity shielding operates through two crucial efficiency channels: liquidation protection and priority of claims.

1. Liquidation Protection

The less common and perhaps less vital prop of entity shielding is called “liquidation protection,” which refers to the durability of enterprise investments.⁶⁷ Many enterprises have going-concern value—their parts are worth more as a bundle in the long term than the parts can be sold for individually and on a moment's notice. For example, a restaurant may be worth more than the sum value of its spoons and plates if it has loyal customers and a staff that knows exactly how to keep those customers happy. If sold instantly and piecemeal, it would be impossible to monetize that idiosyncratic loyalty and know-how. Likewise, a factory may be sold at a fraction of cost, and a sliver of future returns, if sold when only half-built or separate from a network of customers and intellectual property. Sudden sales can be forced if an investor withdraws her money from the venture; most nonentity schemes of investing include such a default right to withdraw one's investment capital.⁶⁸

66. Hansmann et al., *supra* note 60, at 1336. Hansmann and Kraakman separately refer to it as affirmative asset partitioning. Hansmann & Kraakman, *supra* note 2.

67. Liquidation protection has also been called “strong entity shielding” in order to emphasize that liquidation protection tends to occur only in some cases and only where claims priority—“weak entity shielding”—has been established. Hansmann et al., *supra* note 60, at 1337–38. Liquidation protection is also related to capital lock in. Margaret M. Blair, *Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century*, 51 *UCLA L. REV.* 387, 427–28 (2003). *But see* Larry E. Ribstein, *Should History Lock in Lock-in?*, 41 *TULSA L. REV.* 523, 523–26 (2006) (criticizing focus on lock in).

68. Hansmann & Kraakman, *supra* note 2, at 411–12 (explaining that tenancy in common gives each party the right to demand partition).

Given the harsh effects of hasty withdrawal of capital, it is reasonable for entrepreneurs to seek restrictions on investor withdrawal, and *some* restrictions are legally permissible. For example, coinvestors may contractually waive their right to partition the investment or withdraw from the enterprise; the law will respect such agreements among partners or tenants in common, at least over a reasonable duration.⁶⁹ Such agreements, however, are usually personal to the signatories and not binding on their personal creditors, who, upon default, come to stand in their shoes.⁷⁰ This loophole and others make it very difficult to lock capital into an investment for the long haul.

The use of a legal entity solves these problems by simply letting the entity own the assets. Because the entity does not owe the investor's personal creditor anything, it has no obligation to make early tender of the desired cash. The creditor can take whatever interest the debtor-investor had, but that interest will have included a waiver of withdrawal rights. Entities can make long-term projects safe from wasteful dissolution.

2. Priority of Claims

The second benefit of asset partitioning is prioritization of creditor claims. By allowing the creation of legally distinct pools of assets, cordoning off one set for only certain creditors, asset partitioning can lower the total cost of credit for the heterogeneous community of creditors.⁷¹

To see how, consider Hansmann and Kraakman's example of a travel-business conglomerate.⁷² Some people know quite a bit about airlines but not much about rental cars.⁷³ They may be able to vet an airline's prospects cheaply, but it would be costly for them to form useful opinions about the quality of a car-rental business. If they were forced to lend to a rental company, they would do so only at rates that incorporated their heightened risk

69. *Id.*

70. *Id.*

71. Henry Hansmann & Reinier Kraakman, *Organizational Law as Asset Partitioning*, 44 *EUR. ECON. REV.* 807, 811 (2000).

72. *Id.*

73. Many scholars have stressed the importance of specialized creditors. See, e.g., Anthony J. Casey, *The New Corporate Web: Tailored Entity Partitions and Creditors' Selective Enforcement*, 124 *YALE L.J.* 2680, 2685 (2015); Thomas H. Jackson & Anthony T. Kronman, *Secured Financing and Priorities Among Creditors*, 88 *YALE L.J.* 1143, 1159–60 (1979) (“[T]he 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.”); Richard A. Posner, *The Rights of Creditors of Affiliated Corporations*, 43 *U. CHI. L. REV.* 499, 522–23 (1976); 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 with “specialized knowledge of particular kinds of assets”); David A. Skeel, Jr., *Corporate Anatomy Lessons*, 113 *YALE L.J.* 1519, 1566 (2004) (reviewing REINIER KRAAKMAN ET AL., *THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH* (2004)) (discussing specialized monitoring abilities of creditors).

of error and the learning costs. When a single tycoon personally runs both an airline and rental business, she exposes all of her creditors to both sets of risks and forces everyone to monitor everything.⁷⁴

Worse yet, these business creditors must also assess the tycoon's personal assets and liabilities (since her own mansion may someday be sold to repay the business debts, they will want to know if it is already subject to a mortgage). By default, all of an investor's assets are available to all business and personal creditors on equal terms. Yet great savings can be enjoyed if the airline creditors get all and only the security of the airline assets and the rental creditors get all and only the security of the rental cars—and if personal creditors could ignore and be ignored by these business creditors.

Yet a contractual solution to the problem, simply promising only certain assets to certain creditors, is not credible. Such relative priority can be promised to them, but the promise will not bind any creditor who refuses to waive her default rights to recover against the entire pool. While the tycoon has strong incentives to *promise* to give each creditor a unique silo of recovery, she has a little incentive to actually secure such partitioning since early creditors are not able to scrutinize every later contract and since the later creditors will offer better terms in exchange for higher priority and wider recovery options.

Legal entities make it easy to dispense with this problem. By designating business assets as the property of a separate legal entity, organizational law bends the default bonding rule to recognize separate asset pools for separate creditors—in a way that is generally not available without organizational law.⁷⁵ This approach can be repeated to further divide the business assets into subsidiaries (e.g., Airline Co., Rental Co.) subject to the claims of distinct creditors.

It is now clear just how many problems contractual theories of the firm must confront, and how legal entities solve many of them especially well. It would be tempting to conclude that entities are therefore essential, but it is best to avoid any conclusion until after first considering large enterprises that somehow function without meaningful use of legal entities: the reciprocal exchanges common in insurance.

II. THE RECIPROCAL EXCHANGE

This Part introduces the reciprocal exchange. First, the basic structure of the reciprocal is described. Then, this structure is given historical context. Finally, the discussion turns to just what use reciprocals do and do not make of entities.

74. Hansmann et al., *supra* note 60, at 811.

75. *Id.* at 812–14.

A. Basic Structure

Reciprocal insurance exchanges, or interinsurance exchanges, are described many ways: an unincorporated association,⁷⁶ a “trust for a purpose,”⁷⁷ a quasi-corporation,⁷⁸ and “more than a partnership and something less than an insurance corporation.”⁷⁹ One court offered the near tautology, “This is what it is: it’s an interinsurance exchange defined by the Insurance Code.”⁸⁰

The Fifth Circuit recently reiterated the most conventional description: “[I]n its pure form, a reciprocal insurance exchange is a web of contractual relationships between subscribers who agree to insure one another, consummated through a common agent with power of attorney.”⁸¹ This description has been repeated, essentially unchanged, for more than one hundred years.⁸²

Thus, the core of the reciprocal exchange is (1) the direct linkage between insurance customers, (2) which is facilitated by a common agent. Nowhere in that definition is a legal entity contemplated.

In conventional insurance, the policyholder pays a fee to an entity that agrees to indemnify her against loss. For example, one thousand people might each pay in \$10 per year. After a fire, one individual might claim \$6,000 from the insurance company, leaving some \$4,000 remaining. That surplus can be retained from year to year or paid out to the owners of the company—usually investors but sometimes the policyholders themselves.

In reciprocal insurance, participants sign an agreement authorizing an agent to act as their attorney-in-fact for the purposes of insurance. That agent then does the rest, soliciting other customers and signing contracts among them to cross-indemnify for risk. The individual’s \$6,000 claim is a \$6 claim against each and every policyholder. Customers will usually prepay a sum (perhaps the very same \$10) at the start of the year intended to meet

76. *State ex rel. Auto. Club Inter-Ins. Exch. v. Gaertner*, 636 S.W.2d 68, 74 (Mo. 1982).

77. David Mayers & Clifford W. Smith, *On the Choice of Organizational Form: Theory and Evidence from the Insurance Industry*, in *HANDBOOK OF INSURANCE* 669, 674 (Georges Dionne ed., 2d ed. 2013).

78. REINMUTH, *supra* note 7, at 182.

79. *In re Minn. Ins. Underwriters*, 36 F.2d 371, 372 (D. Minn. 1929).

80. *Lee v. Interinsurance Exch. of the Auto. Club of S. Cal.*, 57 Cal. Rptr. 2d 798, 804 (Ct. App. 1996).

81. *True v. Robles*, 571 F.3d 412, 414 (5th Cir. 2009).

82. See Robert J. Brennen, *Inter-Insurance—Its Legal Aspects and Business Possibilities*, 58 *CENT. L.J.* 323, 323 (1904) (“By inter-insurance . . . is meant that system of insurance whereby several individuals, partnerships and corporations underwrite each other’s risks against loss by fire or other hazard, through an attorney in fact, common to all, under an agreement that each underwriter acts separately and severally, not jointly with any other.”). Most states have adopted a formulation similar to this. See, e.g., ALA. CODE § 27-31-1 (2014); DEL. CODE ANN. tit. 18, § 5701 (West 2015); MASS. GEN. LAWS ch. 175 § 94A (2014); TEX. INS. CODE ANN. § 942.001 (West 2009). This definition, however, is not universally accepted. See *Lee*, 57 Cal. Rptr. 2d at 804 (asserting that California law rejects the notion that the subscriber is an insurer to others).

the maturing claims. Any unused premiums may be returned to customers or retained to cover premiums for future years.⁸³ Owing to their dual role as both insured and insurer, the customers are usually called “subscribers.”⁸⁴ The term “exchange” is used to refer to the physical or conceptual space in which subscribers’ risks are swapped.⁸⁵

These cross-indemnities are arranged by the policyholders’ common agent, the attorney-in-fact. Her powers, which are set by individual contracts with the subscribers, usually include day-to-day authority and the right to sign policies of insurance.⁸⁶ The attorney-in-fact charges a portion (ordinarily 15–30%) of premiums. From that sum, she pays all expenses except for maturing insurance claims and reinsurance premiums.⁸⁷

In some reciprocals, the subscribers are represented by a committee, somewhat akin to a corporation’s board of directors.⁸⁸ The character of this body differs from state to state and company to company. In some cases, the advisory committee has few formal powers.⁸⁹ In others, it may have a meaningful ability to replace the attorney-in-fact.⁹⁰ The power to replace the attorney-in-fact is important for succession planning, especially since human attorneys-in-fact eventually retire or die. Regardless of formal powers, some committees are passive or controlled by the attorney-in-fact, while others are assertive in their rights.⁹¹

In good years, there may be a substantial refund of the subscribers’ annual fee.⁹² In bad years, however, subscribers could be called upon to make potentially unlimited capital contributions. In early reciprocals, subscribers were personally liable for additional payments if losses outstripped prepayments.⁹³ While this “assessment” feature was once more common in the reciprocal than other business structures, it was never unique to them. Mutual insurance companies have sometimes exposed their members to additional

83. Norgaard, *supra* note 7, at 31.

84. *E.g.*, TEX. INS. CODE ANN. § 942.001(4).

85. *E.g.*, *id.* § 942.001 (“‘Exchange’ means a reciprocal or interinsurance exchange and includes the office through which a reciprocal or interinsurance contract is exchanged.”).

86. *See, e.g.*, *Lumbermen’s Underwriting All. v. Corcoran*, 479 N.Y.S.2d 797, 798 (App. Div. 1984).

87. *See* 43 AM. JUR. 2D *Insurance* § 74 (2013).

88. *E.g.*, *True v. Robles*, 571 F.3d 412, 416 (5th Cir. 2009) (noting the reciprocal exchange had a board of directors which was protected by the business-judgment rule). *But see* *Angoff v. Cas. Indem. Exch.*, 963 S.W.2d 258, 262 (Mo. Ct. App. 1997) (“A reciprocal insurance exchange typically does not have a board of directors, and CIE was no exception.”).

89. *Lumbermen’s Underwriting*, 479 N.Y.S.2d at 799.

90. *See, e.g.*, *Propac-Mass, Inc. v. Comm’r of Ins.*, 648 N.E.2d 407, 408 (Mass. 1995).

91. *Id.* (noting that the attorney-in-fact and founder was terminated after four years of service by exchange’s board of advisors).

92. Early reciprocals tended to match the premiums charged by mutuals and stock companies, and then return the bulk of it when losses proved low. *E.g.*, Norgaard, *supra* note 7, at 58 (noting that early lumbermen’s reciprocals returned 50–70% of deposits each year).

93. *E.g.*, *Howell v. Knox*, 211 S.W.2d 324, 329 (Tex. Civ. App. 1948) (commissioner assessing for insolvent exchange).

liabilities.⁹⁴ Eighty percent of municipal insurance pools—related to reciprocals but not quite identical—also provide for assessment.⁹⁵ Early unincorporated insurance companies and insurance partnerships, like all partnerships, exposed their members to joint and several liability.⁹⁶

In any case, by the early 1930s, the right of reciprocals to limit their members' liability was firmly established.⁹⁷ By the 1960s, reciprocals ordinarily limited liability to one additional premium deposit or less.⁹⁸ Thus, while some have wrongly emphasized personal liability as a distinguishing feature of reciprocals, personal liability is neither a necessary nor sufficient characteristic of the reciprocal exchange.

B. History

Unincorporated insurance companies emerged in the eighteenth century in England,⁹⁹ but reciprocals are an American innovation.¹⁰⁰ The first reciprocal was a dry-goods warehouse insurer begun in 1881,¹⁰¹ and it typified the motivation for many early reciprocals. The subscribers were among the earliest adopters of fire-control sprinklers, yet insurance companies charged them the same rate as facilities with only obsolete loss-prevention measures.¹⁰² In other words, they felt that they were being improperly pooled and sought to skim their own cream at a time when insurance rates were neither competitive nor actuarially graduated.¹⁰³

94. 3 STEVEN PLITT ET AL., *COUCH ON INSURANCE* § 39:17 (rev. 3d ed. 2011); e.g., *People ex rel. Bolton v. Crossley*, 222 N.E.2d 488 (Ill. 1966).

95. Peter C. Young, *Risk Pools*, in 2 *ENCYCLOPEDIA OF PUBLIC ADMINISTRATION AND PUBLIC POLICY* 1065, 1069 (Jack Rabin ed., 2003).

96. Ron Harris, *The History of Team Production Theory*, 38 *SEATTLE U. L. REV.* 537, 545 (2015) (describing unlimited liability of syndicates and unincorporated insurance companies).

97. *Wysong v. Auto. Underwriters, Inc.*, 184 N.E. 783, 787 (Ind. 1933); see also *infra* Sections III.A., III.B.

98. *Lee v. Interinsurance Exch. of the Auto. Club of S. Cal.*, 57 Cal. Rptr. 2d 798, 803 (Ct. App. 1996) (citing *REINMUTH*, *supra* note 7, at 17–19). Oftentimes, limitations on assessment were permitted only if the exchange maintained a large capital surplus, effectively imposing on the reciprocal the same reserve requirement as an entity-based insurance company. *REINMUTH*, *supra* note 7, at 44–45.

99. Harris, *supra* note 96, at 545 (“Syndicates such as the Lloyds for marine insurance—in Lloyds Coffee Shop around 1730—and unincorporated insurance companies, such as Phoenix and Equitable Life Insurance (1756) and Phoenix Fire Insurance Company (1781), were formed. These were not corporate entities; they did not have the privilege of limitation of liability, and they did not create a separate pool of assets from those of their investors.” (footnote omitted)).

100. Norgaard, *supra* note 7, at 3; *REINMUTH*, *supra* note 7, at xi (“[T]he reciprocal is a distinctively American form of insurer.”). In fact, reciprocals also exist in Canada, but I am not aware of any that provide retail coverage.

101. *REINMUTH*, *supra* note 7, at 1.

102. *Id.*

103. Richard L. Norgaard, *What Is a Reciprocal?*, 31 *J. RISK & INS.* 51, 54–55 (1964) (“[T]he underlying purpose is the lower cost to the insured through reciprocal operations as compared to the operations of other types of insurance organizations. . . . Companies applied a

Escape from inferior risk pools remained a motivating factor for the other early reciprocals. Such early reciprocals included USAA, which was founded by military officers convinced that they were better drivers than civilians,¹⁰⁴ and Farmers, which supposed that rural drivers were on the whole safer than urban drivers.¹⁰⁵

In many cases, the reciprocal form appears to have been chosen because regulatory compliance was easy enough for noninsurance experts to navigate as a part-time business.¹⁰⁶ At first, no statutes specifically addressed reciprocals,¹⁰⁷ and early statutes—the first enacted in 1913¹⁰⁸—tended to impose different and lesser regulation than required of stock and mutual insurers.¹⁰⁹

If the earliest reciprocals were chosen because they were easy enough for nonprofessionals to begin, professionalized reciprocals retained that form in part because of favorable legal treatment. In the opinion of some observers, the growth of reciprocals was encouraged by favorable regulatory and litigation options.¹¹⁰ As recently as the 1940s and 1950s, favorable tax status gave reciprocals a competitive advantage.¹¹¹

broad brush in setting up classes of risks; they might, for example, combine in one classification all dwellings and all commercial buildings despite marked variations in construction and location. Desires of insurers to correct deficiencies were lacking because the field was unlimited and profits were high; furthermore, no studies had been made for the purpose of equating premium to risk.”)

104. PAUL T. RINGENBACH, *USAA: A TRADITION OF SERVICE 1922–1997*, at 20 (1997) (discussing an advertisement that read, “It is estimated that over one-half of the losses paid by civilian companies have been . . . due to moral turpitude, crookedness, and dishonesty. The recognized honesty of our policy holders is our safeguard against any but actual, honest, and unavoidable losses.” (alteration in original)).

105. *Farmers Insurance Group of Companies History*, FUNDING UNIVERSE, <http://www.fundinguniverse.com/company-histories/farmers-insurance-group-of-companies-history/> [<https://perma.cc/2LZE-FWK3>].

106. See *Long v. Sakleson*, 195 A. 416, 418 (Pa. 1937) (“[I]ts peculiar organization lent itself to wider development because it was beyond the scope of most regulatory and taxing statutes dealing with insurance.”); 3 PLITT ET AL., *supra* note 94, § 39:51 (“The interinsurance exchange was in its earlier years beyond the scope of most regulatory and taxing statutes dealing with insurance companies.”).

107. *In re Minn. Ins. Underwriters*, 36 F.2d 371, 372 (D. Minn. 1929) (“It is a well-known fact that reciprocal or interinsurance exchanges existed in this country prior to enactment of laws authorizing them.”).

108. 1913 Pa. Laws 634 (repealed 1921).

109. See 3 PLITT ET AL., *supra* note 94, § 39:51 (“[R]eciprocal insurance exchanges may be regulated in a manner different than mutual companies.”); Brennen, *supra* note 82, at 323 (“Insurance through incorporated companies is beset with destroying taxation and license fees in a multitude of states, with penalties, burdens and ill-advised legislation of all kinds . . .”).

110. *Long*, 195 A. at 418 (asserting that reciprocals grew because they were “beyond the scope of most regulatory and taxing statutes dealing with insurance”).

111. I.R.S. Priv. Ltr. Rul. 2007-01-014, at 3 (Jan. 5, 2007), <http://www.irs.gov/pub/irs-wd/0701014.pdf> [<https://perma.cc/A8JJ-QKG2>] (describing how 1962 tax legislation preserved for reciprocals favorable tax status, which was eventually removed by the Tax Reform Act of 1986.); see also Norgaard, *supra* note 7, at 111 (stating that the Transport Indemnity Exchange, which originated in California in 1945, was the first reciprocal organized to capitalize on tax advantages; its income paid as premiums was deductible, became surplus of the reciprocal, and

Statutory inaction or permissiveness was often secured on the basis of philosophically contractarian rationales: with no entity involved, reciprocals were private contracts without public significance, and not appropriately the subject of public regulation.¹¹² Reciprocals also deployed their nonentity status strategically. “It is the practice of reciprocal insurance exchanges, domestic or foreign, to contend, when sued in a court of law, that an exchange is not a juristic entity.”¹¹³ Therefore, plaintiffs would be required to bring suit against the various members of the exchange. Even if such widespread service were practical, those defendants might then contest personal jurisdiction¹¹⁴ or subject matter jurisdiction.¹¹⁵

Yet it would be wrong to conceive of reciprocals as being principally a tool of regulatory arbitrage. For one thing, their legal advantages were only temporary. Courts eventually bypassed philosophical questions about the existence of an entity to impose on reciprocals similar treatment to that due an insurance corporation.¹¹⁶ State legislatures likewise acted, because of both incumbent industry protectionism and genuine concern about the risks unsound and unscrupulous reciprocals might pose. The federal tax advantages for reciprocals have largely disappeared.¹¹⁷

Nor did reciprocals receive merely positive treatment. For example, many states restricted operation by out-of-state reciprocals.¹¹⁸ Reciprocals

then was converted to stock as the exchange became a stock company, converting the income to capital gains); *cf.* *Hardware Underwriters & Nat’l Hardware Serv. Corp. v. United States*, 65 Ct. Cl. 267 (1928) (ruling that, although reciprocals had been exempt from federal income tax in 1926, they had not been exempted from premium taxes).

112. *See, e.g.*, Brennen, *supra* note 82, at 324 (“[I]nasmuch as the business of inter-insurance is so nearly done by each policy-holder himself, there is no reason why advantage should ever be taken of him either in the matter of rates of premium or settlement of losses.”).

113. *Long*, 195 A. at 418.

114. *Barr v. Cockrill*, 275 S.W.2d 6 (Ark. 1955).

115. *See* REINMUTH, *supra* note 7, at 26. To this day, there is a split in authorities about whether an insurance exchange can ever practically be subject to diversity jurisdiction. *See Nev. Capital Ins. Co. v. Farmers Ins. Exch.*, No. 2:12-CV-02166-APG-CWH, 2014 WL 6882342, at *2 (D. Nev. Dec. 4, 2014); *Erie Ins. Exch. v. Potomac Elec. & Power Co.*, No. DKC 14-0435, 2014 WL 1757949, at *3 (D. Md. Apr. 29, 2014) (adopting majority position that exchange takes the citizenship of its many members, while crediting “[d]efendant’s concerns that a reciprocal insurance exchange like Erie is essentially shielded from ever being subject to diversity jurisdiction”).

116. *See infra* Section II.C.

117. *But see* Kevin Moriarty, *Twenty Things You’d Always Wanted to Know About Reciprocals (But May Not Have Thought to Ask)*, STAR & SHIELD INS. 2–3 (July 2003), <https://starandshield.com/app/uploads/2015/10/Reciprocal.pdf> [<https://perma.cc/6VKY-X9U2>] (asserting that reciprocal insurance companies are uniquely positioned to avoid federal income taxation). This benefit is particularly valued by non-profit subscribers, who are otherwise tax exempt, and who thereby avoid all federal taxes in connection with their insurance needs. Roberto Cenicerros, *Get Flexible with Reciprocals: Arrangements Benefit Tax-Exempt Organizations*, *Bus. Ins.*, Feb. 16, 1998, at 59; Moriarty, *supra*, at 1.

118. *Hoopston Canning Co. v. Cullen*, 318 U.S. 313, 322 (1943) (holding that New York regulations that restricted out-of-state reciprocals were not barred by the Constitution); *see also* RINGERBACH, *supra* note 104, at 190–91 (noting that the UK and several American states licensed only incorporated insurance companies to do business, thereby excluding reciprocals).

faced legal challenges when they attempted to expand into additional lines of insurance (e.g., a fire insurer moving into the flood insurance business) on the theory that the different risks undermined true reciprocity.¹¹⁹ Although municipalities and states now make up a substantial share of the reciprocal business, they were previously barred from joining reciprocal exchanges.¹²⁰ There was even uncertainty about whether corporations could join an exchange, or whether agreeing to indemnify other corporations constituted an ultra vires frolic beyond the corporate purpose as spelled out in their charters.¹²¹ Reciprocals were barred from writing life insurance policies, a restriction that remains to the present.¹²² As reciprocals' early freedoms receded, they were subsequently visited by harsher legal treatment than other forms faced.

In the 1920s and 1930s, two other factors reduced the prevalence of reciprocals. First, increased regulation reduced the role of reciprocals in the 1930s.¹²³ Second, the Great Depression put stress on badly run reciprocals in particular. The number of reciprocals halved from 1920 to 1930 and then again between 1930 and 1935.¹²⁴

From that low, reciprocals grew rapidly in the 1950s and 1960s, nearly doubling in number by the 1960s.¹²⁵ After another period of decline, many new reciprocals opened in the 1980s and early 2000s in response to a shortage of affordable medical malpractice insurance for doctors.¹²⁶ At the same time, reciprocal exchanges proved popular as the enterprise structure for captive risk retention.¹²⁷ In short, despite intermittent periods of decline,

119. See *Gentry v. Republic Underwriters*, 78 S.W.2d 382, 383 (Ark. 1935) (considering but rejecting this argument).

120. Such concerns have been eliminated by statute. See, e.g., TEX. INS. CODE ANN. § 942.002(b) (West 2009).

121. Duffy, *supra* note 14, at 52.

122. E.g., TEX. INS. CODE ANN. § 942.002(c) (“An exchange may not engage in the business of life insurance.”). Rationales for this restriction are hard to find. Norgaard writes cryptically that this was “possibly because of the problems of reciprocal surplus and organizational pattern.” Norgaard, *supra* note 7, at 3. Presumably, the notion is that life insurance requires the most stringent long-term protection of the insurance funds and reciprocals have historically had a bias towards easy subscriber withdrawal.

123. Frederick G. Crane, Book Review, 35 J. RISK & INS. 292, 292–93 (1968) (reviewing REINMUTH, *supra* note 7) (“[Reciprocals] reached their high water mark around 1925.”).

124. Norgaard, *supra* note 7, at 71; see also *Benham v. Pryke*, 744 P.2d 67, 71 (Colo. 1987) (reporting on the closure of reciprocals).

125. Norgaard, *supra* note 7, at 7, 71 (“On a comparative basis reciprocals are the industry’s fastest growing group.”).

126. See A. Gordon McAleer, *Out of Crisis, a Proven Course Is Found*, FRONTIERS HEALTH SERVICES MGMT., Fall 2003, at 17, 19–21. New Jersey’s largest medical malpractice insurer converted to a reciprocal (it was a mutual from 1977 until 1999). Cinda Becker, *A New Incarnation*, MODERN HEALTHCARE, May 13, 2002, at 28.

127. See U.S. GOV’T ACCOUNTABILITY OFFICE, GAO-05-536, RISK RETENTION GROUPS: COMMON REGULATORY STANDARDS AND GREATER MEMBER PROTECTIONS ARE NEEDED (2005), <http://www.gao.gov/new.items/d05536.pdf> [https://perma.cc/M34W-GXLK]. As of 2003, more than 1% of all commercial insurance was provided in this way. *Id.*

reciprocals were generally an important player in the insurance market throughout the twentieth century and early 2000s.

Currently, reciprocal exchanges play a major role in insuring Americans against fire, automobile liability, specialized business risks, and municipal liability.¹²⁸ USAA, a reciprocal insurer with a reputation for customer service and a focus on those with ties to the armed forces, has over ten million customers.¹²⁹ Farmers Insurance has even more customers and is one of America's 250 largest enterprises.¹³⁰ Both Farmers and USAA are among the nation's ten largest insurers (excluding life insurance),¹³¹ and Erie Insurance, another Fortune 500 reciprocal, is among the top twenty.¹³² The scale of reciprocal insurance makes it an important subject for inquiry, but inquiry has been scarce.

C. *Entities: Absent or Incidental*

It was once possible to claim that reciprocals operated without any hint of a legal entity. The exchange was deemed to be a place and not a person at

128. On municipality insurance, see THOMAS W. RYNARD, *INSURANCE AND RISK MANAGEMENT FOR STATE AND LOCAL GOVERNMENTS* (2009), which profiles government insurance options; Young, *supra* note 95, at 1065–66; and Jason E. Doucette, Note, *Wading in the Pool: Interlocal Cooperation in Municipal Insurance and the State Regulation of Public Entity Risk Sharing Pools—A Survey*, 8 *CONN. INS. L.J.* 533, 542 (2002), which describes organizational structures in government risk pooling.

129. *Report to Members 2016: Standing Together*, USAA, https://www.usaa.com/inet/wc/reporttomembers_main_landing [<https://perma.cc/CW4A-HZJA>].

130. *Farmers Insurance Exchange (FIE), Today Was Named Again to the List of Fortune Magazine's 500 Largest Companies Based in the United States*, FARMERS INS. (June 6, 2016), <https://www.farmers.com/news/2016/farmers-insurance-exchange-makes-2016-fortune-500-list/> [<https://perma.cc/R8J3-5WFQ>].

131. Caitlin Bronson, *These Are the Top 25 Property/Casualty Insurance Companies in the U.S.*, *INS. BUS.* (May 31, 2016), <http://www.insurancebusinessmag.com/us/news/breaking-news/these-are-the-top-25-propertycasualty-insurance-companies-in-the-us-32630.aspx> [<https://perma.cc/S4KS-ERP4>]. Both USAA and Farmers are unable to provide life insurance through their reciprocal exchanges, though both are affiliated with life insurance companies. The attorney-in-fact for Farmers, for example, is now owned by Zurich Insurance Group, which is the world's second largest insurance conglomerate and writes plenty of life insurance. Prableen Bajpai, *World's Top 10 Insurance Companies*, *INVESTOPEDIA* (Jan. 7, 2015) (updated Mar. 23, 2016, 5:02 PM), http://www.investopedia.com/articles/personal-finance/010715/worlds-top-10-insurance-companies.asp?header_alt=c [<https://perma.cc/X29L-GUDW>]; see also *Life Insurance*, USAA, https://www.usaa.com/inet/pages/insurance_life_main [<https://perma.cc/T2R5-7F6P>].

132. Bronson, *supra* note 131.

all.¹³³ It could not sue.¹³⁴ It did not pay taxes.¹³⁵ It was not entitled to voluntary bankruptcy proceedings available to “natural persons and artificial persons.”¹³⁶ Refusing such a petition for voluntary bankruptcy filed by an attorney-in-fact on behalf of a defunct exchange, one court explained its decision by stressing the inability of contract alone to create a legal person:

But not every association of natural persons is an artificial, conventional, or juristic person. (If A and B and C interchange among themselves contracts of mutual insurance, an association, in the broad sense of the word, may be said to have resulted, but certainly a new person—an artificial, conventional, or juristic person, has not thereby been created. If instead of three, three thousand interchange insurance contracts, still no artificial person has been created.) It is only if an association is of such a nature as that there results from it a new and distinct entity, recognized as such by law, that it may be said to be an artificial, a conventional, a juristic person. As the eminent jurist, Learned Hand, said, when he was a district judge (he was discussing this very section): “To the creation of a person vested with rights and bound by obligations, there is always necessary . . . some fiat of the state.”¹³⁷

Judicial temperament has since changed.¹³⁸ An exchange may now be taxed,¹³⁹ sued,¹⁴⁰ rate regulated,¹⁴¹ and liquidated.¹⁴² But have those incidents

133. *E.g.*, *General Revenue Revision: Hearing Before the H. Comm. on Ways and Means, supra* note 18, at 3342 (statement of Floyd E. Jacobs, General Counsel, American Reciprocal Insurance Association) (“Again, we reiterate, that the so-called exchange is a mere place at which the subscriber-policyholders exchange contracts of indemnity among themselves. Such exchange owns nothing and is legally, of course, incapable of owning anything, since it is not an entity.”); Norgaard, *supra* note 7, at 27 (“The point was that if the exchange was only a place and not a legal entity, then it could *not* be regulated, taxed, sued, or liquidated . . .”).

134. *Underwriters’ Exch. v. Indianapolis St. Ry. Co.*, 185 N.E. 504, 507 (Ind. 1933) (holding that subscribers, and not exchange, are the real party of interest with the power to sue); *Turner v. Henshaw*, 155 N.E. 222, 226 (Ind. App. 1927) (en banc).

135. *Pickering v. Alyea-Nichols Co.*, 21 F.2d 501, 507 (7th Cir. 1927).

136. *In re Mfg. Lumbermen’s Underwriters*, 18 F. Supp. 114, 124–25 (W.D. Mo. 1936).

137. *Id.* at 123 (omission in original) (quoting *In re Tidewater Coal Exch.*, 274 F. 1008, 1010 (S.D.N.Y. 1921)).

138. See David Millon, *Theories of the Corporation*, 1990 DUKE L.J. 201, 240–51 (arguing that there is no inevitable link between views of whether a firm is an entity and the subsequent treatment of the firm).

139. Compare *Alyea-Nichols*, 21 F.2d at 508 (noting that exchange could not be taxed), with *Ind. Dep’t of Revenue v. Am. Underwriters, Inc.*, 429 N.E.2d 306, 312 (Ind. Ct. App. 1981) (noting that exchange could be taxed).

140. *Long v. Sakleson*, 195 A. 416, 422 (Pa. 1937); *Griffith v. Associated Emp’r’s Reciprocal*, 10 S.W.2d 129 (Tex. Civ. App. 1928); see also *Highway Ins. Underwriters v. Reed*, 221 S.W.2d 925, 926–28 (Tex. Civ. App. 1949) (finding reciprocal an entity for venue purposes).

141. See *Indus. Indem. Co. v. Golden State Co.*, 256 P.2d 677, 680 (Cal. Dist. Ct. App. 1953) (noting that the insurance commissioner of California determined the premium to be excessive).

142. See *Angoff v. Cas. Indem. Exch.*, 963 S.W.2d 258, 262 (Mo. Ct. App. 1997).

of jural personhood convinced courts that there is indeed a legal person present to be taxed, sued, regulated, and liquidated?

It is hard to find any courts willing to conclude explicitly that exchanges actually are entities or persons.¹⁴³ It would be harder still to find such cases if reciprocals had not learned that entity characterization could help them in certain kinds of litigation, just as nonentity characterization helped in other disputes.¹⁴⁴ It is far more common for courts to express agnosticism as to whether an exchange is an entity but nevertheless opt to treat it as an entity for certain purposes.¹⁴⁵ This is true even where statutory language might seem to require entity characterization.¹⁴⁶ “At present,” Norgaard wrote in the 1960s, “the question of entity seems to be a moot one since it has become obvious that entity or not, the courts, government, and people are going to act as if it were.”¹⁴⁷ Legal personhood is not vital to any interesting legal question for a sufficiently deft court, and so courts have stopped searching for personhood—but generally they stop before they find one.

Just as with exchanges, the story for attorneys-in-fact has become more complicated in recent years. Early reciprocals appointed only human beings as their attorneys-in-fact. For example, the nation’s first reciprocal operated from 1882 to 1918 through a succession of human attorneys-in-fact.¹⁴⁸ Yet in the 1920s, many reciprocals began installing legal entities as their attorneys-

143. *E.g.*, *W.R. Roach & Co. v. Harding*, 181 N.E. 331, 336 (Ill. 1932) (finding that exchange has the attributes of a legal entity, in contrast to the features of an association); *State ex rel. Auto. Club Inter-Ins. Exch. v. Gaertner*, 636 S.W.2d 68, 71 (Mo. 1982) (en banc) (“Thus, Missouri has, in essence, afforded entity status to an exchange sued under § 379.680 and it is subject to suit as a jural person.”); *Highway Ins. Underwriters*, 221 S.W.2d at 927 (“[S]ince it is a legal entity it may be sued in the association name.”).

144. *Long v. Sakleson*, one of the cases that urges entity characterization, is now cited by reciprocals in order to frustrate derivative and class litigation. *See e.g.*, Memorandum of Law in Support of Defendants’ Motion to Dismiss the First Amended Complaint at 26 n.10, *Erie Ins. Exch. v. Stover*, No. 1:13-cv-37 (W.D. Pa. July 21, 2013). Interposing an entity between the plaintiff-subscriber and defendant-attorney-in-fact may strip the plaintiff of standing to sue or create procedural barriers of the sort familiar from corporate derivative litigation.

145. *E.g.*, *Mitchell v. Pac. Greyhound Lines*, 91 P.2d 176, 182 (Cal. Dist. Ct. App. 1939) (“We need not enter into an academic discussion as to whether a reciprocal exchange is or is not a legal entity for all purposes.”); *W.R. Roach*, 181 N.E. at 336.

146. It’s clear that reciprocals ought to be deemed unincorporated associations under California law. *See CAL. CORP. CODE* § 18035(a) (West 2014) (defining “[u]nincorporated association” as “two or more persons joined by mutual consent for a common lawful purpose, whether organized for profit or not”). This is a definition so broad that even bilateral contractual relations might seem to be swept in. Yet courts remain reluctant to call reciprocals entities or to hold them to the law of entities. The transitive property simply doesn’t always work in law. To wit, California prohibits an unincorporated association from asserting its own internal limitations (on property transfer, etc.) on third parties unless they were on notice. *Id.* § 18035(b). Reciprocals have plainly evaded this provision—whether by the constructive notice argument or preemption from the insurance code. *See infra* Section III.B.

147. Norgaard, *supra* note 7, at 26.

148. *See id.* at 47–53.

in-fact.¹⁴⁹ By the 1960s, only 11% of reciprocals had a natural person serving as attorney-in-fact.¹⁵⁰

With the prevalence of entities as attorneys-in-fact, it can no longer be claimed that entities are entirely absent from reciprocal insurance. It is now truer to say that entities are common but only *incidentally* present. That is because entities perform only *some* enterprise functions and those functions *could be* performed by humans, *were* performed by humans for many decades, and were handed over to entities largely for *uninteresting* reasons.¹⁵¹

When asked why they opted for an entity, many reciprocal representatives cited limited liability and a desire to attract investors in the attorney-in-fact.¹⁵² Yet there was also a strong tendency to trivialize the transition to an entity or to convert for admittedly trivial reasons.¹⁵³ As Norgaard stated, “[T]he attorney-in-fact is a device to simplify and expedite transactions and only that. As a result, the organization of the attorney-in-fact is not overly important; he may be an individual, partnership, or corporation.”¹⁵⁴

For example, USAA operated until 1962 without a legal entity of any kind, and only created one to save a trivial sum of money incurred in insurance licensing.¹⁵⁵ The United Kingdom did not license USAA to sell insurance because it was a reciprocal.¹⁵⁶ USAA was spending \$70,000 annually for technical compliance by partnering with local U.K. firms, and it finally decided to incorporate an entity to save those fees.¹⁵⁷ Similar rules required local incorporation in Ohio, Delaware, Vermont, and New Hampshire.¹⁵⁸ It was only in response to these problems that USAA authorized the creation of wholly owned subsidiary corporations to obtain insurance licenses on their behalf.¹⁵⁹ By that point, USAA was serving many hundreds of

149. *Id.* at 86. By 1918, even the very oldest reciprocal (Individual Underwriters) had selected a juridical person, a corporation, as its third attorney-in-fact. *Id.* at 53–54. It is perhaps worth noting that the rise of the entity coincided with a period of sharp decline for the reciprocal form. The number of reciprocals halved in the 1920s and halved again in the first five years of the 1930s. *Id.* at 71.

150. *Id.* at 176. The rest were corporations (80%) or partnerships (9%). *Id.*

151. Specific statutes confirm the right of corporations to act as attorney-in-fact. *E.g.*, TEX. INS. CODE ANN. § 942.051(b) (West 2009).

152. Norgaard, *supra* note 7, at 176. These are familiar arguments for the use of a legal entity. *See supra* Part I. The ability to sell interests in the attorney-in-fact provides some confirmation of Ayotte and Hansmann’s transferable-bundle theory, at least with respect to the managing agent. *See Ayotte & Hansmann, Legal Entities, supra* note 57. Though, interestingly, the ability of the organizational attorney-in-fact to find new owners was interpreted by Reinmuth as a hallmark of exploitation, contrary to Ayotte and Hansmann’s suggestion that bundled novation serves to limit exploitation. *See REINMUTH, supra* note 7, at 183.

153. *See* Norgaard, *supra* note 103, at 59.

154. *Id.*

155. RINGERBACH, *supra* note 104, at 189–90.

156. *Id.* at 190.

157. *Id.*

158. *Id.* at 190.

159. *Id.* at 190–91.

thousands of customers, was handling millions in premiums, and had operated internationally for twenty years.¹⁶⁰ Reciprocal, therefore, operated on a large scale before they utilized entities in any way.

So here is what can be said: entities are now a common part of the operation of reciprocal insurance exchanges, just like the rest of the advanced economy. But they are not a meaningful part of reciprocals, insofar as reciprocals can operate and have operated without entities and insofar as entities still only encompass just a portion of the enterprise. The best way to think of reciprocals may be as case studies, like Hansmann, Kraakman, and Squire's investigation of premodern enterprise forms, except from our very recent past.¹⁶¹ Parts III and IV will examine what such case studies may teach.

III. ENTERPRISE THROUGH EXCHANGES

Somehow, reciprocals can operate with little or no recourse to legal entities. Such reciprocal exchanges must therefore do without the benefits entities provide or else obtain them by other means. The exact path by which this is achieved is the subject of Section III.A. Section III.B reviews the economic and legal props on which that analysis rests. The short answer is that most of the benefits of entities can be secured through agency, contract, and insurance law, which lower transaction costs and impose a pattern of creditors' rights binding on third parties. There are economic features of reciprocal insurance that make it an easier domain to substitute legal techniques, such as the ease of conceptually distinguishing between liquid portfolio assets and illiquid management assets, but the case is not fully explained by simply noting that reciprocals are insurance enterprises.

A. *Transaction Costs: Agent as Nexus*

Reciprocals overcome the transaction costs of coordinating numerous individuals by using a common attorney-in-fact who can handle all the intermember contracting.¹⁶² While the fictive quantity of contracts remains high, since each customer must somehow contract with each other, the quantity of real contracting is not high, since each customer need only scrutinize and physically sign one contract. This one contract is inked between the subscriber and the agent-in-fact, who is then authorized to execute the millions of other contracts on the subscriber's behalf. With only one meaningful contract per subscriber, reciprocals have roughly the same contracting cost as is made possible by entity-based insurance.

To see this, compare Figure 4, which depicts the number and nature of contracts necessary for entity-based insurance, with Figure 5, which depicts

160. *History*, USAA, https://www.usaa.com/inet/pages/about_usaa_corporate_overview_history [<https://perma.cc/W65A-DDFK>].

161. Hansmann et al., *supra* note 60.

162. Norgaard, *supra* note 103, at 59 (“[T]he attorney-in-fact is a device to simplify and expedite transaction.”); accord REINMUTH, *supra* note 7, at 11.

the contractual structure for a reciprocal insurance company. Solid lines represent meaningful contracts, which must be considered and signed. Dashed lines represent legal contracts where a common agent represents both parties and signs for them both. Those contracts can be executed and updated effortlessly.

FIGURE 4

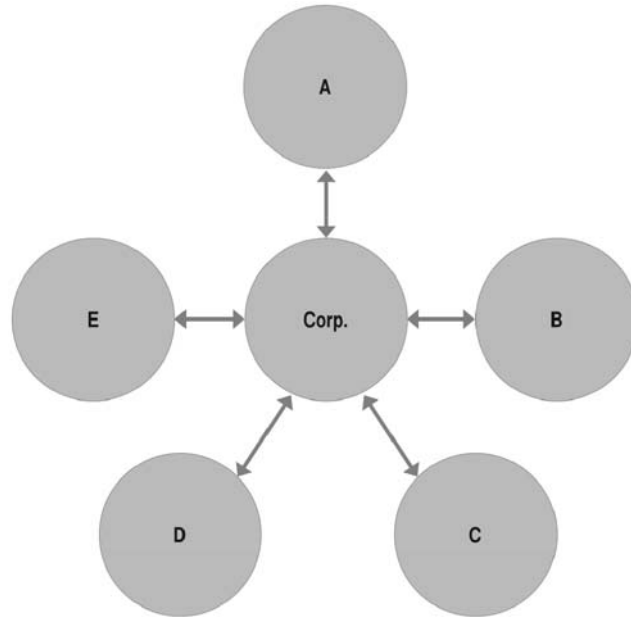
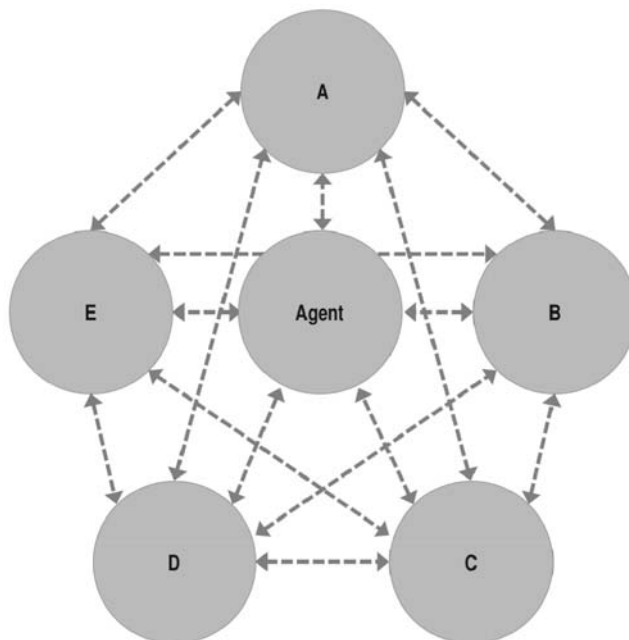


FIGURE 5



The number of solid lines is five for both entity and reciprocal insurance. The reciprocal in Figure 5 includes many more lines, but they are mostly costless dashed lines. The attorney-in-fact represents both parties to the transaction and can consummate the transaction without their involvement. That means that the real contracting costs are the same under each structure.

It should not be surprising that agency can serve to lower the cost of multiple contracts. Hansmann and Kraakman anticipated that such a structure could solve many problems of coordination and mass contracting:

It would not, in fact, be difficult to establish the basic nexus of contracts structure, either under the civil law systems of continental Europe or under the Anglo-American common law systems. The firm's prospective owners could simply appoint one or more persons to act as the owners' common agent in managing the firm'[s] affairs, with full authority to contract on the owners' behalf with respect to matters involving the firm'[s] business.¹⁶³

163. Hansmann & Kraakman, *supra* note 71, at 812. This insight has been imbedded in other observations. As Hansmann and Kraakman write:

There are, broadly speaking, two ways to coordinate the economic activity of two or more individuals. The first is by having those individuals contract directly with each other on their own account. The second is by having each of those individuals enter into a contract with a third party who undertakes the coordination through design of the separate contracts and—most importantly—through exercise of the discretion given the

This same agent, being the common party to all contracts, is in a good position to update incomplete contracts on behalf of the common patrons, solving the intragroup opportunism problems. The attorney-in-fact is perfectly able to reduce the contracting or transaction costs of coordinating a large enterprise.

Thus, the central problem with using an agent sans entity is not the functional one of making the business work—it is the challenge of operationalizing an efficient pattern of creditors' rights, commonly including limited liability and entity shielding, to be discussed in the next Sections.¹⁶⁴

B. *Limited Liability: Constructive Notice When It Matters*

Early reciprocals operated for decades without the strict limitations on liability now commonly associated with legal entities. The explanation is in part that economic features of insurance made limited liability less important than it is in other business contexts, and in part that the importance of owner shielding may be overstated. Nevertheless, later reciprocals were able to achieve limited liability by bootstrapping insurance law in various ways.

1. Operating Without Limited Liability

Unlike patrons of most entity-based insurance companies, subscribers of early reciprocals could be charged additional premiums in order to pay higher-than-expected claims.¹⁶⁵ Subscribers in such arrangements were foregoing the limited liability available from other insurance enterprises, taking a risk that they could be billed far more than their stated premiums if losses

third party by those contracts. A third party that serves this coordination function is what is commonly called a firm.

Id. at 808–09. In fact, these two ways of coordination are not mutually exclusive. It is possible for two or more individuals to directly contract with each other through a third party authorized to execute those mutual covenants.

164. Human agents do die or quit, leading to succession problems. Norgaard, *supra* note 7, at 178 (“Where an individual is the attorney, his removal entails the cancellation of everyone’s contract.”). But the vital contracts, among the policyholders, are personal to them and not the attorney-in-fact, and so remain binding if the attorney-in-fact should perish. 3 PLITT ET AL., *supra* note 94, § 44:69. As for the attorney-in-fact’s responsibilities to the exchange, a succession plan can be approved for the follow-up agent, just as would be required to plan for the potential passage of a large number of executives. *Id.* The plan might either specify the individual to succeed the attorney-in-fact or authorize the subscribers’ committee to promptly select a replacement. *Id.*

165. *Id.* § 39:56.

grew larger than expected.¹⁶⁶ Yet reciprocals grew unabated during this period.¹⁶⁷ For a large reciprocal able to spread the coverage broadly, an individual's share of any shortfall would likely be small, so that even risk-averse customers might rationally accept the risk.¹⁶⁸ Moreover, while such additional assessments might be inconvenient *ex post*, they may be desirable *ex ante* because they virtually guarantee payment for an insurance claimant. If customers can be charged more later so that the claimants can get the payments they expect, customers are very likely to be paid in the event that they ever make a claim. A rational customer might willingly risk an occasionally higher insurance bill to altogether avoid the risk that his insurer collapses at the same time as his warehouse. In insurance, unlimited or multiple liability can be a feature, not a bug.¹⁶⁹

Another circumstance made limited liability less than essential: the dearth of nonpolicyholder creditors.¹⁷⁰ Reciprocal exchanges conduct almost all business through their attorneys-in-fact. Typically, the only transactions conducted through the exchange were the receipt of payments, the disbursement of claims money, and the purchase of reinsurance. Myriad other expenses, such as paying clerks or securing company real estate, would be the responsibility of the attorney-in-fact, and only the attorney-in-fact would be liable if things went badly. Thus, the subscribers had little to fear from errant liabilities to nonsubscriber creditors. The separation of management assets from insurance assets made unlimited liability a bounded and salutary phenomenon.

166. See SAMUEL P. BLACK & JOHN PAUL ROSSI, *ENTREPRENEURSHIP AND INNOVATION IN AUTOMOBILE INSURANCE* 172 (2001) (describing this difference as a factor affecting competition between reciprocals and incorporated insurance companies).

167. See Norgaard, *supra* note 7, at 71 (noting that the number of reciprocals quadrupled between 1910 and 1920). This may be unsurprising to scholars who believe that the importance of limited liability has been overstated. Peter Z. Grossman, *The Market for Shares of Companies with Unlimited Liability: The Case of American Express*, 24 J. LEGAL STUD. 63, 63 (1995); Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879, 1890 (1991); Mark I. Weinstein, *Don't Buy Shares Without It: Limited Liability Comes to American Express*, 37 J. LEGAL STUD. 189, 189 (2008) [hereinafter Weinstein, *American Express*]; Mark I. Weinstein, *Share Price Changes the Arrival of Limited Liability in California*, 32 J. LEGAL STUD. 1, 1 (2003).

168. Furthermore, the risk of any shortfall could be reduced by simply maintaining a generous capital buffer.

169. Early reciprocals sometimes capped assessments as some multiple of premiums, rather than allowing unlimited liability. 3 PLITT ET AL., *supra* note 94, § 39:57.

170. Cf. Weinstein, *American Express*, *supra* note 167, at 194 (explaining American Express's long operation without limited liability in part by the fact that—like any reciprocal—AMEX operated a financial services firm with few involuntary creditors, and noting that “[g]iven the nature of its business, in the mid-1960's American Express would not have faced significant tort liability”).

2. Obtaining Limited Liability

Notwithstanding the viability of enterprise without owner shielding, the long-term trend was toward limited liability for policyholders.¹⁷¹ Subscriber agreements would authorize the attorney-in-fact only to enter into insurance contracts up to some maximum amount, usually equal to the prepaid annual premiums plus one additional payment.¹⁷² If claims exceeded that sum, subscribers could rightly say that no authorized contract requires additional payment and that their agent lacked actual authority to incur additional obligations.¹⁷³ Any governing documents for the exchange filed with the insurance commissioner would list the same limitations.¹⁷⁴

Courts unsurprisingly recognized the right of subscribers to set the terms of their own obligations to one another.¹⁷⁵ With a common agent among them, it posed no great contracting problem for each subscriber to waive claims above a certain point.

The more interesting transformation concerned third parties. Suppose, for example, the attorney-in-fact should buy supplies, not in his own name, but in the name of the exchange. The exchange subscribers may not have authorized such behavior, but the suppliers are ignorant of both the express limits on the agent's actual authority and the internal limits in the subscriber contracts. They may have reasonably assumed that the exchange vested its managers with the same authority as every other type of insurance enterprise. Can the subscribers limit their liability to such suppliers?

With legal entities the answer would be easy—managers cannot create obligations for the shareholders, regardless of what suppliers believe or agree to. Without legal entities, liability would be limited only if suppliers agreed to, or at least knew of, such a limitation. It should be difficult or impossible for intragroup agreements to impair the rights of third parties unaware of the terms of those agreements. While actual authority may have been limited, the doctrine of apparent authority gives agents the power to bind the principal “when a third party reasonably believes the actor has authority to

171. Lloyd's of London, the most famous of the general category of Lloyd's insurance schemes, operated for hundreds of years without limited liability for its participants. They were liable “down to their cufflinks” on any policyholder claims. Despite the relative rarity of large losses and the comfort this system may have given to policyholders, Lloyd's of London has mostly switched to limited liability over the last fifteen years. See *Freed from the Cufflinks*, ECONOMIST (Apr. 7, 2004), <http://www.economist.com/node/2577615> [<https://perma.cc/J7KP-GWFD>].

172. See, e.g., *Taggart v. Wachter, Hoskins & Russell, Inc.*, 21 A.2d 141, 144 (Md. 1941) (describing policies with such a clause).

173. *Wysong v. Auto. Underwriters, Inc.*, 184 N.E. 783, 788 (Ind. 1933).

174. 3 PLITT ET AL., *supra* note 94, § 39:57.

175. *In re Int'l Underwriters, Inc.*, 157 F. Supp. 367, 371 (W.D. Mo. 1957). But see Commonwealth *ex rel. Schnader v. Keystone Indem. Exch.*, 34 Pa. D. & C. 505, 520 (1938) (finding where statute required assessments, assessments limitation not valid). Eventually, assessment limitations were permissible in accordance with an authorizing statute. See, e.g., CAL. INS. CODE § 1401.5 (West 2009).

act on behalf of the principal and that belief is traceable to the principal's manifestations."¹⁷⁶

Consistent with this reasoning, early courts indeed vindicated suppliers, disregarded subscriber contracts and express limits on attorney-in-fact authority, and imposed joint and several liability upon subscribers.¹⁷⁷ The longer-term trend, however, has been to allow limited liability even against nonconsensual or unknowing third parties. This result has been achieved through an alchemical combination of actual-authority doctrine and insurance regulation: the aforementioned limits on policy assessments (and limits on the agent's authority to enter any other sort of contract in the principal's name) are to be recorded in subscriber policy agreements and attorney-in-fact agreements. These agreements are filed with state insurance commissioners. Because the agreements are part of the public record, any creditor could have consulted them to ascertain the relevant authority and limits on liability. It is therefore possible to treat the creditor as having been on constructive notice of the limitations.

Perhaps surprisingly, courts accepted this theory, under which creditors were authors of their own ignorance, and therefore not worthy of judicial protection.¹⁷⁸ One clear statement of this rule, though by no means unique,¹⁷⁹ is as follows:

[W]e are of the opinion that third parties are held to have had notice of and bound by the terms of the power of attorney executed by the subscribers and on file in the office of the state auditor, and that the attorney in fact has no authority to create a liability against the subscribers beyond the limitations of the power of attorney.¹⁸⁰

While contractual limitations on liability and actual authority are private and bilateral matters, they are publicly available by way of the insurance commissioner. Insurance regulation thus provides constructive notice to all creditors—contract and tort, alike—of the subscribers' limited liability.

Of course, it is ridiculous to think that reasonable creditors would have consulted these insurance records before conducting ordinary business or before putting themselves in a position to incur a tortious injury. And yet,

176. RESTATEMENT (THIRD) OF AGENCY § 2.03 (AM. LAW INST. 2005).

177. *E.g.*, *Sergeant v. Goldsmith Dry Goods Co.*, 221 S.W. 259, 261 (Tex. 1920).

178. 46A C.J.S. *Insurance* § 2359 (1993).

179. *See, e.g.*, *Underwriters' Exch. v. Indianapolis St. Ry. Co.*, 185 N.E. 504 (Ind. 1933); *Griffith v. Associated Emp'r's Reciprocal*, 10 S.W.2d 129 (Tex. Civ. App. 1928).

180. *Wysong v. Auto. Underwriters, Inc.*, 184 N.E. 783, 788 (Ind. 1933); *see also Hill v. Blanco Nat. Bank*, 179 S.W.2d 999, 1004 (Tex. Civ. App. 1944) (“[I]t seems reasonably clear to this court that the subscribers at Republic Underwriters had no liability to an assessment for any character of claim, including the so-called third party claims.”). It is not just courts that accepted this reasoning. *See, e.g.*, Ohio Att’y Gen., Opinion Letter (June 11, 1952), <http://www.ohioattorneygeneral.gov/getattachment/e10ad5ea-f3f1-4c4a-abeb-3d659c482789/1952-1499.aspx> [<https://perma.cc/J8E2-7XMN>] (discussing *Wysong* and concluding “[t]his principle of agency appears to me to be sound and fully supported by the authorities”).

legal fictions exist precisely to connect desirable legal conclusions with otherwise unsuitable facts. Courts in fact accepted public filing to be sufficient to create constructive notice of limitations on liability, presumably out of special solicitude for the viability of these insurance enterprises.¹⁸¹

Of course, limited liability by way of notice is not unique to reciprocals. It was used to mixed effect by English manufacturing companies prior to general incorporation statutes: “[I]nserting the ‘Limited’ after the company’s name, putting an indication of limited liability in the company’s stationery, and including limited liability clauses in the company’s contracts.”¹⁸² We can think of both organizational law and insurance law as regimes of constructive notice as to the limits of agents’ actual authority.

Thus, it is not obvious that limited liability is either necessary for enterprise or hard to construct without entities.¹⁸³

C. Entity Shielding: Lock In and Priority by Other Means

Recall that entity shielding consists of two parts: creditor priority and liquidation protection. The former means that an enterprise’s creditors stand higher in priority than the personal creditors of the patrons, and higher than the business creditors of the debtor’s other enterprises. The latter, liquidation protection, means that investors in the firm—and any creditors who may come to stand in their shoes—cannot readily withdraw their funds from the enterprise.¹⁸⁴ Because creditor priority is thought to exist through all entities, but only some entities exhibit liquidation protection, Hansmann, Kraakman, and Squire refer to creditor priority as “weak entity shielding” and liquidation protection as “strong entity shielding.”¹⁸⁵

This Section explains how reciprocals achieved both substantial creditor prioritization and liquidation protection by way of agency law and insurance law. Insofar as this means reciprocals enjoy strong-form entity shielding, it would suggest that some nonentities (reciprocals) outshine some entities (e.g., general partnerships, which enjoy only weak-form entity shielding) in terms of benefits that only entities are supposed to exhibit.

Yet reciprocals do not identically track the entity shielding of organizational law. For one thing, reciprocals may permit a higher degree of liquidation than do durable entities, such as the corporation. Where reciprocals do not perfectly match entities, certain economic features of insurance help to make the enterprise viable anyway.

181. See *supra* note 178 and accompanying text.

182. Hansmann & Kraakman, *supra* note 2, at 430.

183. Nor is there anything in the forgoing to indicate whether limited liability is socially optimal. *Cf. id.*

184. See *supra* Section I.C.

185. Hansmann et al., *supra* note 60, at 1337–38.

1. Liquidation Protection

Reciprocal exchanges obtain a measure of liquidation protection without recourse to traditional organizational law or entities. They also operate in a manner that minimizes disruption owing to liquidation.

Partial liquidation occurs if a subscriber receives a return of her premium payments not yet expended by claims. Early reciprocals allowed members to readily withdraw in just this fashion.¹⁸⁶ Many lauded this feature of reciprocals as useful for constraining managerial excesses.¹⁸⁷

Nevertheless, concerns grew that excessive withdrawal could leave remaining members, creditors, and the public in the lurch.¹⁸⁸ Insurance regulation proved accommodating for exchanges that wished to limit liquidation rights, tolerating or imposing limitations on subscribers and their assigns. By the 1960s, there were “no major reciprocals in which withdrawing members take with them all or a substantial part of their contributed surplus.”¹⁸⁹ Most retained some portion of premiums permanently as surplus for the benefit and protection of all members.¹⁹⁰ Subscribers may not withdraw any surplus if it would take the exchange below the statutory minimum surplus, or once liquidation is ordered.¹⁹¹ Withdrawal before that point may be permitted subject to contractually stated penalty or delay.¹⁹²

186. Norgaard, *supra* note 7, at 32–33.

187. REINMUTH, *supra* note 7, at 190–92; *see also* Joseph A. Fields & Dogan Tirtiroglu, *Agency-Theory Implications for the Insurance Industry: A Review of the Theoretical and Empirical Research*, Q.J. BUS. & ECON., Winter 1991, at 40, 47 (identifying withdrawal of capital as one of three discipline mechanisms); Mayers & Smith, *supra* note 77, at 674 (suggesting that ease of dissolution may support control of management).

188. Norgaard, *supra* note 7, at 32; *see also* 3 PLITT ET AL., *supra* note 94, § 5:5 (“Impairment of an insurer’s finances is of great concern to both the public and to the remainder of the insurance industry, which will bear the adverse effects of any public suspicion as to the health of insurers.”). Claim prioritization exists in part to prevent one set of creditors from externalizing risks on to another, Hansmann & Kraakman, *supra* note 2, at 408, and liquidation protection prevents withdrawing investors from externalizing the cost of withdrawal. Insurance regulation likewise seeks to control externalities—with both other policyholders and the public as the beneficiary.

189. Norgaard, *supra* note 7, at 32.

190. *Tex. Emp’rs Ins. Ass’n v. Humble Oil & Ref. Co.*, 103 S.W.2d 818, 820 (Tex. Civ. App. 1937); Norgaard, *supra* note 7, at 32. Others retained surplus until a designated time, such as the death of the policyholder. Norgaard, *supra* note 7, at 98 (USAA policy).

191. *E.g.*, CAL. INS. CODE § 1374.1(b) (West 2013) (excluding reciprocal surplus claims from priority hierarchy); *accord id.* § 1374.1 (“No subscriber shall have a secured or preferred claim against any of the assets of the reciprocal or interinsurance exchange arising out of surplus deposits. All assets, including the surplus deposits, shall be held by the reciprocal or interinsurance exchange and made available for payment of claims of policyholders and creditors of the reciprocal or interinsurance exchange in preference to any claim for withdrawal by a subscriber.”). A related issue is the allocation of surplus among continuing members. While reciprocals often return unused premiums as premiums, subscribers have no right to compel allocations. *Lee v. Interinsurance Exch. of the Auto. Club of S. Cal.*, 57 Cal. Rptr. 2d 798, 802 (Ct. App. 1997).

192. *E.g.*, CAL. INS. CODE § 1374.1(a).

Complete liquidation is also constrained by insurance regulation. In many states, only the commissioner of insurance can appoint a receiver to settle the claims of a troubled insurance company.¹⁹³ In those states, creditors have no private right to liquidate even an insolvent reciprocal.¹⁹⁴ Here again, insurance-specific rules help to secure liquidation protection in lieu of organizational law.

Yet reciprocals were able to operate without meaningful liquidation protection for some decades, and even now enjoy less protection than provided through many entities. This is possible because three features—two economic and one legal—reduce the need for liquidation protection.

The first is the individual irrationality of liquidation in many cases. A customer (or customer's personal creditor) seeking partial liquidation is effectively asking for early termination of the insurance and a refund of the policy member's unused premium payment. But the insurance is often worth the money. An insolvent policyholder may be stripped of her warehouse by the bankruptcy court, but the new owner will probably want insurance. Even if cheaper or better insurance is available, it will rarely pay to terminate the agreement early. (Indeed, it may be more likely that the reciprocal will want to terminate early once a new creditor arrives, because of adverse selection concerns.) If liquidation is rarely rational, then little effort need be expended in protecting it. In this respect, insurance policies are somewhat like shares in widely traded companies. If a creditor can take a debtor's shares and then promptly resell them, it would be irrational to expend efforts seeking liquidation. The character of the asset reduces the creditor's incentive to seek liquidation.

Second, the assets held by an insurance company tend to have little "going concern" value. The cash paid as premiums and the securities purchased with it tend to be liquid. For even appreciable redemption requests, an insurance company can honor the requests without destroying surplus by selling those securities and refunding the cash.

There are, of course, limits. If nearly all policyholders withdraw, the remaining few will be exposed to undiversified risks. But even this problem can be rectified by again growing the pool through new customer acquisition. This is not a case involving multiyear projects with limited redeployment value, like the restaurant or factory described in Section I.C. With little going-concern value to protect, less effort was required to protect it.¹⁹⁵ For

193. *E.g.*, TEX. INS. CODE ANN. § 443.005 (West 2009).

194. *Frontier Inv. Corp. v. Belleville Nat'l Sav. Bank*, 254 N.E.2d 295 (Ill. App. Ct. 1969); *State ex rel. Tomlinson v. Jeffrey*, 107 N.E.2d 1, 2 (Ind. 1952); *Whalen v. Keystone Mut. Cas. Co.*, 258 S.W.2d 450, 451 (Ky. 1953); *Okla. Benefit Life Ass'n v. Bird*, 135 P.2d 994, 996 (Okla. 1943). See generally 1 PLITT ET AL., COUCH ON INSURANCE § 5.9 (rev. 3d ed. 2009).

195. Of course, Norgaard was writing at a particularly stable moment for American securities markets. It is easier now to see that volatile markets can reduce an insurance enterprise's assets to below its expected liabilities, or for uncertain liabilities to spike above actuarial levels. Furthermore, insurance companies do invest in illiquid assets such as real estate. Thus, it is certainly possible that a reciprocal insurer could be vulnerable to a "run" by withdrawing subscribers, and that the run could be wasteful. See Daniel Schwarcz & Steven L. Schwarcz,

this reason, Norgaard was not troubled to describe some reciprocals as “perpetually liquidating” in response to payouts of surplus.¹⁹⁶

Third, one reason that reciprocal assets tend to be liquid is that the illiquid assets—leases, employment contracts, human capital—are owned by the attorney-in-fact. As the agent’s property, such assets are unavailable to the exchange’s policyholders and creditors.¹⁹⁷

Of course, in the hands of a human attorney-in-fact, liquidation risk remains. This residual risk is usually addressed at present by use of legal entities. But even full liquidation risk at the attorney-in-fact is of only limited relevance to the reciprocal, which can just replace the attorney-in-fact when insolvency makes it hard for them to perform.¹⁹⁸ Just as a homeowner cares little whether her handyman might lose his tools and truck because of personal debts—since if he does, the homeowner can just get a different handyman—reciprocal exchanges can and do replace troubled attorneys-in-fact.¹⁹⁹

2. Priority of Claims

Priority of claims means protecting the business enterprise’s creditors from (1) the personal creditors of the patrons and (2) the business creditors

Regulating Systemic Risk in Insurance, 81 U. CHI. L. REV. 1569, 1611, 1622 (2014) (disputing the characterization of insurance companies as inherently stable). Still, orthodox wisdom has been that insurance companies are more stable than other financial firms. *See, e.g.*, Scott E. Harrington, *Capital Adequacy in Insurance and Reinsurance*, in *CAPITAL ADEQUACY BEYOND BASEL: BANKING, SECURITIES, AND INSURANCE* 87, 93 (Hal S. Scott ed., 2005). A well-run reciprocal can do even more to protect itself by, for example, avoiding investments like real estate that are a more appropriate investment for life insurance insurers with an expected lag between premiums and liabilities. Reciprocals focused on property and casualty insurance would rightly err on the side of liquid assets. At the margin, the risk of lost going-concern value seems lower at reciprocals than other types of enterprises.

196. Norgaard, *supra* note 7, at 31.

197. Gabriel Rauterberg, *Agency Law as Asset Partitioning*, SSRN (Aug. 10, 2015), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2641646 [<https://perma.cc/H6HR-NNJQ>]; *cf.* Robert H. Sitkoff, *Trust Law as Fiduciary Governance Plus Asset Partitioning*, in *THE WORLDS OF THE TRUST* 428, 434, 439 (Lionel Smith ed., 2013) (“The 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.”). Not all courts recognize the full separation of assets for reciprocals. *See, e.g.*, *Troyk v. Farmers Grp.*, 90 Cal. Rptr. 3d 589, 615–16 (Ct. App. 2009) (holding attorney-in-fact liable for debts of exchange on the theory that the former was the latter’s agent). To the degree courts ignore the separation of exchange and attorney-in-fact, asset partitioning is undermined. But cases like *Troyk* are not yet the normal result, and even those cases tend to undermine asset partitioning in only one direction—holding the attorney-in-fact liable for the exchange’s debts, but not vice versa.

198. Recall that some kind of subscriber committee generally retains the right to cancel the contract of the attorney-in-fact and hire a new one. *Mass. Emp’r’s Ins. Exch. v. Propac-Mass, Inc.*, No. CA934987G, 1993 WL 818825, at *6 (Mass. Super. Ct. Dec. 30, 1993). Of course, transitions are not always easy. *Propac-Mass, Inc. v. Comm’r of Ins.*, 648 N.E.2d 407 (Mass. 1995) (affirming the revocation of license from outgoing attorney-in-fact in recognition of the obstruction it mounted to frustrate its replacement).

199. *Mass. Emp’r’s Ins. Exch.*, 1993 WL 818825, at *3.

of other enterprises.²⁰⁰ Absent entities, claimant-customers of an insurance company might fear that their claims will not be paid in full. In their role as creditors of the reciprocal, continuing policyholders would fear that withdrawing policyholders (or personal creditors of the company's insolvent investors) would vie for some of surplus and premiums needed to satisfy their claims. Entities allow flexible, durable property-based priority schemes by creating distinct pools accessible only to designated creditor groups. Yet reciprocals are able to largely reproduce a scheme of creditors' rights without entities.

In some sense, this achievement is implied by the foregoing discussion of liquidation protection. Recall that courts have enforced restrictions on withdrawal of premiums and surplus by policyholders and their creditors, both out of their own desire to protect the enterprise and because of prudential insurance regulation rules. Strong-form entity shielding is on display so, a fortiori, weak-form entity shielding (priority of claims) should follow. Yet there is still more to say.

As a general matter, insurance law automatically establishes a pattern of creditors' rights, privileging policyholders with valid claims over essentially everyone else.²⁰¹ New York's insurance statute is typical:

No subscriber shall have a secured or preferred claim against any assets of the reciprocal insurer arising out of such operating reserve, but all assets held by such insurer shall be available for the payment of claims of policyholders and creditors of such reciprocal insurer in preference to any claim for withdrawal by a subscriber as such.²⁰²

So withdrawing subscribers—the investor equivalent—are last in line behind claimant policyholders and other business creditors.

Creditors of the attorney-in-fact are also generally unable to proceed against the customer premiums held by the attorney-in-fact. This is not a function of organizational law, because not even trust law is required to protect policyholder premiums from the attorney-in-fact's creditors. First, insurance law likely already privileges policyholders' interest in that money.²⁰³ Second, agency law and property law are likely sufficient as well. The assets owned by the attorney-in-fact (the trademarks, leases, trucks) are the property of the attorney-in-fact and available for its creditors, but the insurance premiums are not its property. Asset partitioning is achieved without creating a new person to own the cash because the policyholders

200. Recall that if we incorporate a company to hold, say, rental car assets, creditors of a rental car enterprise need not worry about any shareholders' personal creditors, nor the creditworthiness of an airline subsidiary that happens to be part of the same corporate family.

201. See *State ex rel. Grimes v. Okla. Prop. & Cas. Ins. Guar. Ass'n*, 796 P.2d 352 (Okla. Civ. App. 1990) (noting that policyholders receive priority over secured creditors); 1 PLITT ET AL., *supra* note 194, § 6:8.

202. N.Y. INS. LAW § 6109(c)(1) (McKinney 2016).

203. There is also a duty to transmit premiums. See 4 PLITT ET AL., *supra* note 94, § 54:5.

don't cease to own their cash (even once paid in) until claims are made on it.²⁰⁴

Agency law recognizes the separation of principal and agent. Under systems of agency law less amenable to asset partitioning, such an arrangement would not be possible.²⁰⁵ Insurance clarifies the subordinate interest the attorney-in-fact has in the exchange's assets—even assets loaned to it by the attorney-in-fact²⁰⁶—and the inability of agent creditors to seize prepaid premiums which happen to be held by the attorney-in-fact.

Such in personam partitioning also has two independent salutary effects. First, it allows creditors of the exchange—namely, the subscribers—to disregard risk attendant to the management of the enterprise and vice versa. A customer of the exchange may be moderately good at evaluating the exchange's policy of collecting premiums and paying claims, just as lenders to the attorney-in-fact can focus on the efficiency and propriety of the management offices. But a customer may not be able to determine whether the attorney-in-fact is properly paying payroll taxes or rent, just as lenders do not worry about overall trends in insurance claims. Second, the illiquid assets held by the attorney-in-fact are often of the sort that can be used to run more than one insurance pool. By housing them in an independent management pool, the attorney-in-fact is able to redeploy them efficiently without either endangering one pool at the expense of another or crafting complex interpool contracts. Thus, Farmers operates separate exchanges for automobile insurance, commercial-trucking insurance, and fire insurance.²⁰⁷ The same mainframe can process claims for all three, without one of the pools worrying about the creditworthiness of another and without paying interpool usage fees. Crucial to such resource sharing is the fact that the attorney-in-fact is generally not liable for the debts of the pools it oversees.²⁰⁸

This separation has benefits for both insurance customers and managers. By exempting the management assets from any losses associated with the

204. If some other theory is necessary, it is natural to think of the attorney-in-fact as a bailee, rather than a trustee. An agent dispatched by a principal to spend a wallet of money in some particular way does not take title, legal or beneficial, to the money. *See id.* § 54:5 (“[A]gent does not ordinarily hold the premiums received by him or her as a trustee nor as trust funds, but merely as a debtor who owes the insurer as creditor the amount of the premiums for which the agent must account.”); *see also* *Clay v. Eagle Reciprocal Exch.*, 368 S.W.2d 344, 351–53 (Mo. 1963) (explaining the fiduciary requirements in the context of a reciprocal exchange); *United Benefit Fire Ins. Co. v. Earl*, 181 N.W.2d 841, 843 (Neb. 1970) (“Unearned premiums and unearned commissions held by an insurance agent are held a fiduciary capacity.”); *Rauterberg*, *supra* note 197 (describing agency relationship as a form of asset partitioning).

205. *See Rauterberg*, *supra* note 197, at 20–29.

206. *See infra* note 216.

207. Other examples abound. *See, e.g.*, *Hoopeston Canning Co. v. Pink*, 43 N.E.2d 49 (N.Y. 1940) (showing that Lansing Warner, Inc. served as attorney-in-fact for several exchanges (one grocery; one canners)).

208. *Auto. Underwriters, Inc. v. Comm’r*, 19 B.T.A. 1160, 1161 (1930) (“The petitioner [attorney-in-fact] is not an insurance company. It does not carry the insurance, does not issue policies, and is not liable for losses on the policies.”).

pool, managers may be more willing to oversee insurance to high-risk populations.²⁰⁹

Insofar as there is a clear distinction between management assets (which can be deployed across multiple projects) and nonmanagement assets (which tend to be liquid and without going-concern value), insurance companies are like investment funds. So it is unsurprising that insights from Professor John Morley's work on investment funds—which also stresses asset partitioning—might be informative here.²¹⁰ For one thing, Morley defends the current practice of mutual funds owning no shares in their own management companies.²¹¹ Far from being an exploitative and inefficient practice, Morley shows that it allows redeployment of management assets across funds, and it simplifies work and lowers risks for both fund and manager creditors.²¹² It also allows funds to avoid functionally investing in their own management company, rather than whatever asset class is properly the focus of the fund.

If this separation between management assets and insurance assets serves an asset-partitioning purpose akin to those of investment funds, it helps to redeem one feature about reciprocals that has bothered their critics: that the attorney-in-fact, when an entity, is rarely owned by the exchange and its subscribers.²¹³ While it is possible for a reciprocal to mimic a mutual in the hermetic closure of the system, with all premiums going to support actual costs and the balance returning to the insureds, many reciprocals instead allow revenues to flow to an attorney-in-fact, which then keeps the money or passes it along to its investors. This has been deemed a defect.²¹⁴ But it is expected and desirable on an asset-partitioning theory. If the attorney-in-fact were owned by the insureds, the insureds would essentially be insuring their agent. A bad year for the attorney-in-fact—higher-than-expected advertising costs or rent—would be a financial drag for the customers, which could potentially endanger the pool's solvency. Whereas, under the typical reciprocal arrangement, a reciprocal's insureds need not worry about the financial health of their attorney-in-fact, thus eliminating a peculiar fish from the risk pool.

Can reciprocals establish a pattern of creditors' rights without recourse to organizational law? At some level, the answer is clearly yes. Insurance law also creates a priority scheme favoring claimant policyholders over many

209. See *Ind. Dep't of Revenue v. Am. Underwriters, Inc.*, 429 N.E.2d 306, 312 (Ind. Ct. App. 1981) (“It was conceded in oral argument . . . that the principal advantage to writing insurance in this manner is the insulation of liability to [the attorney-in-fact] in an area of high-risk, substandard insurance.”).

210. John Morley, *The Separation of Funds and Managers: A Theory of Investment Fund Structure and Regulation*, 123 *YALE L.J.* 1228 (2014).

211. See *id.*

212. *Id.* at 1243–68. A prominent exception is Vanguard, about which Morley urges skepticism. *Id.* at 1276–79.

213. E.g., Dennis F. Reinmuth, *Managerial Control of the Reciprocal: A Regulatory Void*, 34 *J. RISK & INS.* 69 (1967).

214. E.g., REINMUTH, *supra* note 7, at 77–80.

other business creditors. Consider an example in which a creditor loaned \$25,000 to an exchange in order to establish a guarantee fund, intending to support the exchange in the event that claims exceeded assets.²¹⁵ Such a fund would provide little guarantee to policyholders if all creditors of the exchange had equal claim to it, since upon insolvency a portion of the fund would then go right back into the hands of the creditor. This problem would not arise if the creditor agreed to lower priority, but here, quite the opposite promise was made. The exchange—managed, it turns out, by the creditor in question—promised the creditor an absolute right to withdraw the money in full.²¹⁶ Absent some pattern of creditors' rights, ordinary contract and bankruptcy principles would have awarded the creditor a lion's share of the guarantee fund, to the detriment of the insureds.

Despite the terms of the agreement, and the absence of an entity to help divide pools, the court had no difficulty in prioritizing the policyholders' rights to the money.²¹⁷ The role of the money, the structure of insurance regulation, and the special solicitude of judges toward insurance customers all push toward a durable priority scheme.

Although insurance regulation establishes a pattern of creditors' rights in favor of claimant policyholders over other creditors, it may appear less flexible than the malleability of entity-based asset partitioning. It is a simple matter for business conglomerates to create new subsidiaries or cross-guarantee existing ones to expand or restrict the domain of a particular creditor's recovery. Can insurance law and agency law achieve a complex and customizable scheme of creditor priorities? There is some suggestion that they can, by using the same bootstrapping constructive notice system discussed in Section III.B in connection with limited liability.

To see this, consider one of the more common litigation fact patterns, where later policyholders are promised more attractive priority than early policyholders. In reciprocals, this commonly arises when customers assert that the attorney-in-fact issued them a nonstandard policy and that the terms of their policy exempted them from ever contributing extra payments. Assessment of additional payments is essentially a negative priority position, requiring the assessed patron to contribute (rather than recover) unless general unsecured creditors are made whole.

Courts are generally hostile to such claims, invalidating them as "secret arrangement[s]."²¹⁸ Yet courts also give attention to constructive-notice arguments.²¹⁹ Each subscriber agrees to "identically the same character of contracts and powers of attorney," which is on file with the insurance commissioner.²²⁰ If that document includes assessment risk, later creditors

215. *Turner v. Henshaw*, 155 N.E. 222 (Ind. App. 1927).

216. *Id.* at 224.

217. *Id.* at 227.

218. *E.g.*, *S. Ornamental Iron Works v. Morrow*, 101 S.W.2d 336, 344 (Tex. Civ. App. 1937).

219. *See supra* Section III.B.

220. *S. Ornamental Iron Works*, 101 S.W.2d at 338–39.

are held to that priority scheme. Could an approved plan of business and creditor priority, properly filed with a public figure, establish a novel pattern of creditors' rights (such as solicitude to later policyholders) in circumstances where the competitive landscape compels such accommodations? It seems plausible, since not all policies currently issued through one exchange are identical, and since attorneys-in-fact can operate multiple insurance enterprises with different terms. If this is right, then agency law and insurance law are capable of responsive and supple priority modification akin to the result gained by filing incorporation documents with the secretary of state or corporations department.

Insurance law alone establishes a plan of creditors' rights, both through the rigid scheme of insurance solicitude to policyholders and the potentially flexible notice-through-filing method. Agency law further provides a measure of asset partitioning, and insurance-specific liquidation rules help to achieve their requisite level of capital lock in.

* * *

As demonstrated above, certain economic and legal facts make reciprocals viable without meaningful use of legal entities. While some of these features are not unusual, others are peculiar economic features of insurance companies (or peculiar legal treatment rarely observed outside of insurance). Those features can be summarized as follows:

TABLE 1

		Essential Function		
		Transactions Costs	Limited Liability (Owner Shielding)	Entity Shielding
Strategy for Achieving Function Without Entity	Go Without the Essential Function		Liability increases certitude of payment on claims.	(a) Most insurance assets have no going concern value; (b) Most insurance customers will not want to withdraw early.
	Agency Law	Attorney-in-fact can sign contracts.	Separation and conferral of most liability-creating operations onto the attorney-in-fact.	Management assets are owned by attorney-in-fact, an agent whose assets are not available to policyholder creditors.
	Insurance Law		Filings suffice for constructive notice of contractual limitations.	(a) Limits liquidation and withdrawal; (b) Statutory pattern of creditors' rights; (c) Filings suffice for constructive notice of further modifications to priority scheme.

In some sense, it is unsurprising that the need for entities is weaker where unusual economic conditions reign. These economic features (clear

divisions between liquid assets and multiply-deployable illiquid management assets) and legal structures (the legal separateness of management through agency law, the notification function afforded insurance filings, and its protective channeling of claims) are not universal features of all enterprises. But they are not unique to insurance, and a careful study of reciprocals may bear fruit. The following Part goes on to develop possible further implications.

IV. QUESTIONING THE ESSENTIALITY OF ENTITIES

Orthodox corporate law scholarship has understood organizational law as creating entities that are uniquely capable of fulfilling certain essential functions, but reciprocals largely obtain those functions without availing themselves of organizational law. Logically, this allows only two possibilities: either entities are not essential to obtain key functional benefits, or entities are essential but reciprocals should be reimagined as entities.

Section IV.A takes the former possibility. If reciprocals show life without entities is possible, what does that tell us about the relative contribution of entities to commercial life, and where else might we find enterprise without entities?

Section IV.B then takes the other horn and asks what we might learn if we are drawn to cast reciprocals as entities, even despite the practical and analytical problems with this recasting. Would we conclude that entity status is ontologically essential? That is, would we learn that entities are so foundationally a part of legal analysis that we cannot stray far without them?

Section IV.C then connects this discussion to one of corporate law's longest standing normative debates: the corporation's role in society. Many believe that the fact that the state grants certain privileges through the corporation entails a substantial ethical and legal responsibility to society. Is this view threatened if those privileges can be obtained without any entity?

A. *Functional Essentiality*

One possible conclusion from the study of reciprocals is that organizational law is not essential to providing key economic functions. Organizational law is the law that creates legal entities.²²¹ It clearly includes corporate law, partnership law, LLC law, and trust law.²²² And it is clearly meant to exclude some bodies of law, such as contract and agency to which it is often contrasted; no one has so far suggested that insurance law is a branch of organizational law.

221. Hansmann & Kraakman, *supra* note 71, at 808 (“[W]e use the term & ‘legal entities’ to refer to organizational forms—such as the business corporation, the general partnership, and the trust—that are established by law, and we refer to the law that creates and regulates legal entities as ‘organizational law.’”).

222. Hansmann & Kraakman, *supra* note 2, at 416 (“While it is sometimes said that the common-law trust lacks legal personality, in our view it is, on the contrary, quite clearly a legal entity, and trust law is consequently a form of organizational law.”).

Yet agency, contract, and insurance are plainly capable of substituting for organizational law at least some of the time. Thus, we might conclude that the contributions of organizational law, while real, are far from unique. Entities would be denied their functional essentiality. The question would then remain how much entities nevertheless contribute and just how much commerce is possible without them.

1. The Scale of Functional Contribution of Entities

The fact that reciprocals existed without entities for some time is not just a demonstration that such a thing is possible. It is an argument that the costs of operating an entity—whether regulatory, legal, or bureaucratic—however small, sometimes eclipse the benefits an entity provides. It is a rough measure of the net contribution of entities if entrepreneurs forgo them to the degree an alternative is available and salient. That they do so may suggest that legal entities may bring greater costs or fewer benefits than commonly thought.

Alternative interpretations are possible, of course. Recall that use of entities by reciprocals has become common.²²³ Even if entities are not essential for every task, they are surely helpful for many tasks. Recall also that reciprocals have sometimes been favored with strategic advantages in litigation, and with preferential tax and regulatory status.²²⁴ It is possible that these legal subsidies account for the creation of reciprocals, and that path dependence accounts for their persistence even now that these subsidies have been eliminated, such that it is unnecessary to claim that reciprocals are able to replicate or do without entity-benefits.

Yet past subsidy or path dependence will not explain the many reciprocals founded in recent years.²²⁵ It is primarily new reciprocals that make such important contributions to insuring doctors, municipalities, and specialized business risks. Moreover, reciprocals' past legal advantages were always modest, and they were periodically overshadowed by hostile or discriminatory legal treatment.²²⁶ Reciprocals have been restricted from entering certain lines of business in a given state or nation.²²⁷ Any legal advantages must be tallied in light of these restrictions. If the law has conferred an overall benefit upon reciprocals, it has surely been a modest one.

223. See *supra* Section III.C.

224. See *supra* Section II.B.

225. See, e.g., *PURE Group of Insurance Companies*, PURE, https://www.pureinsurance.com/about/pure_group [<https://perma.cc/5UNU-FMBH>] (major property & casualty reciprocal founded in 2006); Michael J. Moody, *25 Years of Stability in Medical Malpractice*, ROUGH NOTES COMPANY, <http://www.roughnotes.com/rnmagazine/2008/february08/02p068.htm> [<https://perma.cc/EN2J-PKZK>] (noting that New York's second largest medical insurer is Physicians Reciprocal Insurers, a reciprocal founded in 1981).

226. See *supra* notes 99–117 and accompanying text.

227. See *supra* notes 118–122.

And with a modest benefit, the overall point remains valid. The unique benefits available through legal entities, far from being essential and compelling, are sometimes small enough that even the tiniest regulatory nudge will make entity formation undesirable. This urges caution against the most strident claims of entity essentialism.

It also opens the door to discuss other possible channels for life without entities, where reciprocals might be used to solve problems. Consider two channels, one within insurance and one without, where reciprocals have not yet had any impact but might be considered.

2. Removing Entities to Accommodate Values: Health Care Sharing Ministries

Insurance policymakers have struggled to accommodate conscientious objectors to the Affordable Care Act. One compromise has been the integration of “health care sharing ministries” (HCSM).²²⁸ Covering almost one million people, HCSMs are networks of individuals who contribute to a common pool for healthcare costs, and when that pool is exhausted may directly fund one another’s claims.²²⁹ HCSMs are controversial for their uncertain and values-laden coverage. HCSMs impose belief-specific rules upon members²³⁰ and withhold coverage from disapproved medical claims.²³¹ Furthermore, the amount of contribution is partially voluntary, and there is consequently no assurance that individual claims will be paid in full.²³²

While users of HCSMs are obviously motivated to avoid traditional insurance, they may differ in the feature of insurance to which they object. In particular, some participants may only reluctantly accept some part of the package—perhaps the uncertainty of reimbursement for their valid claims—

228. See Benjamin Boyd, *Health Care Sharing Ministries: Scam or Solution?*, 26 J.L. & HEALTH 219 (2013); Samuel T. Grover, *Religious Exemptions to the PPACA’s Health Insurance Mandate*, 37 AM. J.L. & MED. 624, 644–50 (2011); Timothy Stoltzfus Jost, *Loopholes in the Affordable Care Act: Regulatory Gaps and Border Crossing Techniques and How to Address Them*, 5 ST. LOUIS U. J. HEALTH L. & POL’Y 27, 41–44 (2011).

229. *Data and Statistics*, ALLIANCE HEALTH CARE SHARING MINISTRIES, <http://www.healthcaresharing.org/about-us/data-and-statistics/> [https://perma.cc/W64K-NN7U]. Other estimates, from the recent past, are lower. Holly Johnson, *Health Care Sharing Ministries: An Alternative to Obamacare*, PERS. CAP. (Aug. 25, 2014), <https://blog.personalcapital.com/financial-planning-2/health-care-sharing-ministries-alternative-obamacare/> [https://perma.cc/CAX4-XQYQ].

230. See *Guidelines for Health Care Sharing*, CHRISTIAN HEALTH CARE NEWSL. (Samaritan Ministries, Peoria, Ill.), Feb. 2017, at 10 (requiring members to “abstain from sinful practices such as drug abuse and sexual immorality”).

231. *Id.* at 31–32 (explaining that expenses related to abortion, riot-related injuries, and ADD treatment not subject to reimbursement).

232. See *Issues*, ALLIANCE HEALTH CARE SHARING MINISTRIES, <http://www.healthcaresharing.org/issues/> [https://perma.cc/7Y4U-77GN] (stating that HCSMs “engage in voluntary sharing and not a contractual transfer of risk”).

because of their enthusiasm for some other feature of the exchange.²³³ One motivation for joining an HCSM might be a desire to be the payer for one another's medical needs—to support one's neighbors in fortune or folly—rather than rely on handouts from a governmental or private entity. If so, then a reciprocal form might hold promise as satisfying philosophical objections to traditional insurance without neglecting its benefits.²³⁴ This motivation is plausible for many objectors. For example, the Amish have traditionally resisted insurance, opting instead for the direct aid of their neighbors.

In a reciprocal, participants can think of themselves as actually helping and being helped by their neighbors, yet on terms of quality, fairness, and security similar to other insurance ventures. Reciprocals therefore promise a new combination of moral and nonmoral product characteristics geared to satisfy inframarginal users of the HCSM system, potentially expanding choice and coverage. They might also be able to draw into the fold other groups, like the Amish, that have long opted out of insurance coverage.²³⁵

It may seem that the use of a reciprocal structure here is a fig leaf: if Obamacare abstainers dislike traditional insurance, they should dislike an economically equivalent transaction in which they are merely encouraged to regard their role as more direct and relational. Still, a key role for lawyers is finding ways to fit important economic activity into normatively acceptable formats without excessively altering the economic activity.²³⁶

Insuring healthcare objectors through reciprocals is consonant with the substantial energy devoted in recent years to Sharia-compatible financial

233. Reluctant acceptance is particularly likely given the small number of HCSM options. Only four HCSMs appear to comply with state and federal law. With only four options available, it is unlikely that all users are satisfied with the current bundle of options.

234. See Robert L. Kidder & John A. Hostetler, *Managing Ideologies: Harmony as Ideology in Amish and Japanese Societies*, 24 *LAW & SOC'Y REV.* 895, 904 (1990); Glen O. Robinson, *Communities*, 83 *VA. L. REV.* 269, 329 (1997).

235. Daniel Kelly, *As U.S. Struggles with Health Reform, the Amish Go Their Own Way*, *NBC NEWS* (Oct. 6, 2013), <http://www.nbcnews.com/health/u-s-struggles-health-reform-amish-go-their-own-way-8C11345954> [<https://perma.cc/25KR-UGAN>] (describing “Amish Exemption” from Obamacare).

236. See Brian J. Glenn, *God and the Red Umbrella: The Place of Values in the Creation of Institutions of Mutual Assistance*, 10 *CONN. INS. L.J.* 277, 302 (2004) (“[W]hen the Amish explained to the Internal Revenue Service (IRS) that their religious beliefs forbade them from engaging in insurance programs, IRS agents stated that the Social Security payments were not insurance contributions but rather a tax.”).

products.²³⁷ Many Muslims feel that aspects of western finance—from ordinary bank savings deposits,²³⁸ to life insurance policies,²³⁹ to more complex financial instruments²⁴⁰—violate religious law. Ingenious lawyers have sought to reimagine finance, from retail banking²⁴¹ to project finance,²⁴² in order to satisfy both economic objectives and spiritual commitments. It is no superficial contribution to offer people a product that suits both their commercial needs and their consciences.²⁴³

3. Removing Entities to Reduce Risk: Person-to-Person Lending

Reciprocals might also serve as a foundation for non-insurance businesses. It is common now to laude as disruptive and innovative those companies (e.g., Airbnb, Uber, eBay) that promise to disintermediate a realm of commerce. For example, Prosper and LendingClub allow individuals to lend to and borrow from one another without a need for a bank.²⁴⁴ Most of these enterprises, however, really just introduce new intermediaries.²⁴⁵ In the case

237. It is also related to efforts to refashion insurance products to accommodate another group that has distinct values and beliefs: the young. As Professors Tom Baker and Peter Siegelman point out, adults ages 19–29 often avoid insurance because they feel that it is wasteful to buy protection they believe that they are unlikely to use. Tom Baker & Peter Siegelman, *Tontines for the Invincibles: Enticing Low Risks into the Health-Insurance Pool with an Idea from Insurance History and Behavioral Economics*, 2010 WIS. L. REV. 79. Baker and Siegelman propose (re)introducing insurance products that seem to reward healthy and prudent policy members: tontines, which pay a large dividend to the healthiest members of the insurance pool. *Id.* at 82. This is a reasonable effort to square the core insurance product with the distinctive non-economic outlook (rather than risk characteristics) of some under-served group.

238. See Mahmoud A. El-Gamal, “Interest” and the Paradox of Contemporary Islamic Law and Finance, 27 *FORDHAM INT’L L.J.* 108 (2003).

239. See Hania Masud, Comment, *Takaful: An Innovative Approach to Insurance and Islamic Finance*, 32 *U. PA. J. INT’L L.* 1133, 1144 (2011).

240. See Bashar H. Malkawi, *Financial Derivatives in the West and in Islamic Finance: A Comparative Approach*, 128 *BANKING L.J.* 50 (2011).

241. See Haider Ala Hamoudi, *The Impossible, Highly Desired Islamic Bank*, 5 *WM. & MARY BUS. L. REV.* 105, 107, 136–50 (2014) (“[R]etail Islamic banking in the United States is impossible, and yet it remains highly desired.”).

242. See Alan J. Alexander, Note, *Shifting Title and Risk: Islamic Project Finance with Western Partners*, 32 *MICH. J. INT’L L.* 571 (2011).

243. Nor is values-based insurance limited to health insurance. Lemonade, a new insurance venture focused on homeowners and renters insurance, organizes its insurance customers according to their charitable ambitions—and then donates all unclaimed premiums to the designated charity. See LEMONADE, <http://www.lemonade.com> [<https://perma.cc/H862-UFNF>]. The venture’s founders hope that insurance linked to a common cause will attract customers and discourage frivolous or excessive claims. Lemonade considered organizing as a reciprocal but declined to do so because of the regulatory burden of forming a new exchange for each customer-chosen charity.

244. Verstein, *supra* note 31.

245. Tom C.W. Lin, *Infinite Financial Intermediation*, 50 *WAKE FOREST L. REV.* 643, 657–58 (2015).

of person-to-person (P2P) lending, the intermediary actually loans its own money and then stands in as creditor for the debt.²⁴⁶

Yet it remains impractical, notwithstanding technological improvement, for individuals to meet and contract directly. It is not efficient for millions of microcreditors and borrowers to negotiate, document, and service small loans. Intermediaries remain for reasons such as economies of scale. In so doing, they continue to multiply counterparty risk and systemic complexity because all payments pass through the intermediary. Competition ossifies as a few intermediaries solidify their position as the solitary common party to all contracts. Disintermediation has fallen short of its revolutionary ambitions.

Reciprocals prove, however, that the gains from intermediaries do not require the intermediary to interpose itself as the entity at the nexus of contracts. It need not contract as a principal. The intermediary can act as attorney-in-fact for multiple parties. For example, the P2P platform might act as an agent for all borrowers and lenders, subject to a power of attorney, which they use to sign and service many tiny credit agreements. Economically, things would operate similarly. But legally, the intermediary's secondary role would be clear and they would not interpose credit risk, opacity, or complexity. Even those uninspired by the rhetoric of technological disintermediation should be impressed by the asset partitioning achieved by fully separating the intermediary's assets from those of its patrons.²⁴⁷ This realization also helps to bolster the prospects for upstart P2P lending services that actually link the lender and borrower directly, without any intermediary credit risk.²⁴⁸

It also foreshadows the possibility of meaningful disintermediation for myriad other businesses. While many praise companies like Airbnb or Uber for their ability to link users and providers of services, it may seem to others that these companies have merely substituted themselves for existing hotel- and car-booking services.²⁴⁹ This view is unsurprising, and perhaps inevitable, if entities are essential. But if entities are not essential, then we are free to imagine greater disruption in housing and transportation and other industries in coming years.

246. Verstein, *supra* note 31, at 489.

247. See Kathryn Judge, *The Future of Direct Finance: The Diverging Paths of Peer-to-Peer Lending and Kickstarter*, 50 WAKE FOREST L. REV. 603, 611–12 (2015) (expressing skepticism that technology is enough to make disintermediation feasible for P2P lending).

248. See, e.g., *WeFinance Terms of Service*, WEFINANCE, <https://www.wefinance.co/terms> [<https://perma.cc/KW4F-JXVS>] (“WeFinance is a platform that helps organize and operate loans between individuals. It is not a lending service or a licensed lender . . .”).

249. See, e.g., Izabella Kaminska, *Sharing Economy Disruption, Maybe Not So Disruptive?*, FIN. TIMES: ALPHAVILLE (July 10, 2015), <https://ftalphaville.ft.com/2015/07/10/2134174/sharing-economy-disruption-maybe-not-so-disruptive/> [<https://perma.cc/DF9C-CTJS>].

B. *Ontological Essentiality*

The previous Section explored consequences of questioning the functional essentiality of entities in light of reciprocals. Another possibility is to insist that reciprocals are entities, and so they pose no argument against the status of entities. A consequence would be that “entities” are more abundant than commonly thought, and thus “organizational law” covers more than is commonly thought.²⁵⁰

There is much to recommend this approach. Organizational law fits hand in glove with bodies of law that are not obviously “organizational,” yet which support or supplant organizational law’s efforts, so that the analytic distinction is far from clear. Professor Gabriel Rauterberg recently argued that agency law’s essential contribution is organizational, establishing a pattern of creditors’ rights for enterprise workers akin to what corporate law does for investors.²⁵¹ If correct, the line between organizational law and agency cannot be so neatly drawn.

Hansmann and Kraakman contemplate that a sufficiently supple system of security interests could allow nonentities to establish priority of claims, and so accept that UCC Article 9 could potentially become a branch of organizational law.²⁵² But Article 9 is not our only law for creating security interests. The UCC carves out numerous exceptions from its scope, leaving tax liens, automobile loans, purchase money security interests, and countless others.²⁵³ Presumably each of these interests is governed by some law that borders on organizational law.

Interestingly for our purposes, one of the largest carve-outs by dollar value concerns security interests in insurance policies.²⁵⁴ State law establishes the pattern of creditors’ rights when creditors seek to foreclose on a life insurance policy, drawing on a mix of debtor–creditor law and insurance law.²⁵⁵ Priority of interest may be established under this regime, even against

250. Hansmann, Kraakman, and Squire define “legal entity” as “legally distinct pools of assets that provide security to a fluctuating group of creditors and thus can be used to bond an individual’s or business firm’s contracts.” Hansmann et al., *supra* note 60, at 1337. Nothing in this definition limits “legal entity” to the traditional structures (e.g., LLC, partnership) produced through their associated body of law. If insurance law partitions assets into pools, usable to bond contracts to fluctuating group of creditors, then insurance law can be said to create entities on this account.

251. Rauterberg, *supra* note 197, at 7.

252. Hansmann & Kraakman, *supra* note 2, at 417–23. Security interests can serve at most as an alternative to organizational law in forming weak-form legal entities such as partnerships; they cannot suffice for the construction of strong-form entities such as corporations. Moreover, even with respect to priority of claims, security interests do not today offer an effective substitute for organizational law.

253. Gerald T. McLaughlin, “*Seek But You May Not Find*”: *Non-UCC Recorded, Unrecorded and Hidden Security Interests Under Article 9 of the Uniform Commercial Code*, 53 *FORDHAM L. REV.* 953, 954, 957, 961–62 (1985).

254. Andrew Verstein, *Bad Policy for Good Policies: Article 9’s Insurance Exclusion*, 17 *CONN. INS. L.J.* 287, 289 (2010) (borrowing in the hundreds of billions of dollars).

255. *Id.* at 321–26.

later creditors who did not know about prior promises of priority, if proper notice is given to the issuing insurance company.²⁵⁶ Constructive notice to other creditors is assumed, even if notice was in fact impossible,²⁵⁷ establishing an alternative pattern of creditors rights. This non–Article 9 security regime also provides liquidation protection. Life insurance policies have going-concern value. They can be surrendered to the insurance company for immediate payment, but only at a severe discount.²⁵⁸ State law on insurance interests limits the ability of individual creditors to liquidate policies, thus affording a measure of liquidation protection.²⁵⁹

If insurance law and agency law have long been in the business of establishing patterns of creditors rights, then it should not surprise us that both serve a similar organizational approach to supporting reciprocals. It is important for reciprocals that policyholder assets held by an agent do not become the property of the agent, and that the personal liabilities of the agent do not become the liabilities of the principal. It is likewise important for reciprocals that insurance law require ample bonding capital, allow exchanges to limit withdrawal of surplus, and prioritize the claims of insurance beneficiaries over others. Reciprocals provide further support for the notion that organizational law extends into further territory than commonly supposed.

For many, pointing out that insurance law establishes important functions like asset partitioning is just to say that insurance law creates *de facto* entities.²⁶⁰ A similar conclusion may be spurred upon hearing that they possess common incidents of entity status, such as the ability to sue or be sued.

Does it matter whether we decide reciprocals are entities or instead allow that they function as entities? Is there any reason to allow ourselves the noun or nominalization of “entity” rather than the various verbs and adjectives attributed to reciprocals’ customers, agents, and regulators? We could discuss insurance and insurance regulation as well as business and the regulation of business, if we wished, by simply mentioning human beings, the activities they pursue, and the rules that govern them, rather than the legal persons to whom they attribute the acts. Would anything be gained or lost?

There may be prudential reasons for caution before deciding that reciprocals “are” entities. Deeming something an “entity” carries baggage that might not be obvious at the time the label is conferred. For example, legal entities sometimes command constitutional rights in our society.²⁶¹ It

256. *Id.* at 310–11.

257. *Id.* at 315–17 (describing how insurance companies are not required to provide ready access to encumbrance information, but that creditors are still constrictively charged with knowledge of encumbrances).

258. *Id.* at 296–301, 296 n.42.

259. *See id.* at 304, 335–37 (discussing the argument that limitations on policy liquidations protect consumers).

260. For this comment, I am grateful to Professor Mark Roe.

261. *See Citizens United v. FEC*, 558 U.S. 310, 365 (2010).

might be prudent to reserve the term “entity” for the more robust applications of the term in order to avoid unanticipated consequences.²⁶² If we can. Yet many readers may find it conceptually challenging to conceive of reciprocals except as entities, which is itself a revealing glimpse into the epistemic structures embedded in the law and legal analysis.

It may be significant if we instinctively find entities without thinking through the consequences. It may reveal as much about how the legal system and legal scholars conceptualize as it does about the proper categorization of reciprocals. Our struggle to show that entities are practically essential may actually show them to be *ontologically* essential, in that we may find the concept of “entity” to be inescapable in our analysis of legal relationships.

Ontological entity centrism means fixation with entities as the object of regulation and legal analysis. As Professors Andrew Gold and Henry Smith argue, private law is coordinated through “modular” structures.²⁶³ Rather than trying to maximize some desired end (such as utility or justice), the legal system proceeds by constructing and sustaining psychologically and morally tractable concepts, which generally conduce to the underlying features to be maximized.²⁶⁴ Smith gives examples such as the economic-loss rule in torts—which limits recovery to property but not contracts—which make sense in many cases and are at the same time sufficiently intuitive to people to make them workable.²⁶⁵ Could the entity be such a midlevel structure?

Taking a more skeptical stance, Professor Anita Krug has argued that financial regulation has unduly focused on the entity rather than broader group, affiliate, and contractual relations.²⁶⁶ For Krug, the entity is too small a unit of analysis. This study of reciprocals spurs us to ask about the inverse question—whether the entity may be too large a unit of analysis. We could instead describe, study, and regulate the insurance transaction without taking a stand on the ontological status of the insuring actor.

Is it strange to describe commerce without recourse to entities? After all, nonlawyers are not drawn to think in terms of boxes and triangles of entity contracting and ownership. How many policyholders of Farmers or USAA understand or care about the difference between their insurer and traditional entities? How much clarity does any consumer have about the legal structure of corporate groups?²⁶⁷ How many business people think about

262. In another working paper, I develop the eponymous question, *What is an Entity?*.

263. Andrew S. Gold & Henry E. Smith, *Sizing Up Private Law*, SSRN 7–8, 47 (Aug. 12, 2016), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2821354 [<https://perma.cc/2AQZ-K68P>]; see also Henry E. Smith, *Modularity and Morality in the Law of Torts*, 4 J. TORT L., Oct. 2011, art. 5.

264. Gold & Smith, *supra* note 263, at 33–35.

265. Smith, *supra* note 263, at 25–28.

266. Anita K. Krug, *Escaping the Entity-Centrism in Financial Services Regulation*, 113 COLUM. L. REV. 2039, 2041–43 (2013).

267. See generally Virginia Harper Ho, *Theories of Corporate Groups: Corporate Identity Reconceived*, 42 SETON HALL L. REV. 879 (2012).

unincorporated divisions any differently from wholly owned subsidiaries?²⁶⁸ The whole notion of a legal entity is likely to seem strained in some contexts. Much of ordinary human life is about relationships and transactions rather than entities.

While there are many occasions for which entities are an appropriate unit of regulation and analysis, they are not always the best option, and they are rarely the only option. Yet, there is something about lawyers that makes us wish to look at the entity first and foremost. There is something that draws us to say of reciprocals that if they can sue and be sued then they must be entities, even if the definition of an entity is contested and if popular definitions make no reference to that feature.²⁶⁹

C. Normative Essentiality

For many, the normative and practical case for corporate regulation and responsibility draws heavily upon the notion that the state empowers corporations with special privileges for which it may legitimately charge.²⁷⁰ For example, if the corporation is a concession of state power, robust social responsibility may seem like a fair quid pro quo.

This position is complicated by the possibility of reciprocal insurance enterprises without entities. Reciprocals contradict the thesis that parties require legal entities to secure certain key advantages. Insofar as state provision of advantages serves as a predicate for public oversight of corporations, reciprocals present a challenge for concession theories of corporate and organizational law.

On the other hand, reciprocals vindicate the underlying logic of entity essentialism by finding common foundations across all large enterprises, and noticing that those foundations require a measure of state solicitude—for reciprocals, in asset partitioning by way of the public law of insurance regulation. Concession theorists who seek an Archimedean point at which enterprise leverages public law can take solace.

Yet again, worries remain for essentialist-concession theorists, even after noting that insurance law is public law. For one, small and early reciprocals did not rely on insurance law. The law of agency seemed like enough. While agency law requires public enforcement too, it is a quintessential form of private law. If use of agency law is enough to normatively and practically ground regulation, then it is not clear what wouldn't justify regulation.

Moreover, while insurance law provides benefits to reciprocals that help to substitute for those embedded in entities, insurance regulation comes with many restrictions too. It is far from obvious that insurance regulation is

268. See Iacobucci & Triantis, *supra* note 58, at 560–64.

269. E.g., Hansmann et al., *supra* note 60 (defining legal entity as “a term we use to refer to legally distinct pools of assets that provide security to a fluctuating group of creditors and thus can be used to bond an individual’s or business firm’s contracts”).

270. GREENFIELD, *supra* note 27, at 35.

an all-things-considered benefit, rather than a burden with a few silver linings. Usually, insurance law's regulations would be considered the price of privileges, but here we conceived of insurance regulation as the privilege itself. If the state can claim to have conferred a valuable benefit merely by regulating, then concession theories of regulation approach tautology.²⁷¹

CONCLUSION

Monoculture reigns. The shareholder-owned company towers over rival forms of enterprise.²⁷² The exception is in insurance, the Amazon rainforest of business environments. More than anywhere else, diverse forms of life flourish in insurance. Stockholder firms, mutuals, Lloyd's, risk pools, securitized and contractual risk claims, government provision, and reciprocals all compete for attention and support. If the strangest entity of all, the nonentity, proves elusive even there, we can hope that it is worth the chase. After all, we know that many of the most important medicinal compounds are discovered in the crush of diversity, so we should heed the possibility that insurance enterprises like reciprocals have something to teach. Among other lessons, they suggest that legal entities are not always essential to mass commerce given the elastic powers of insurance and agency law, though a measure of legal fiction—here, constructive notice—may still be essential.

Regardless of whether we define insurance law as *part of* or *alternative to* organizational law, it is clear that reciprocals still seek out the desiderata of organizational law, suggesting that the underlying insights of entity essentialists remain largely valid. Transaction costs are sufficiently daunting that a common agent is required. Limited liability—while perhaps not “essential”—is attractive enough that reciprocals almost always pursued it. Entity shielding did strike courts and legislatures as vital to the viability of these insurance plans. Thus, entities permit something essential and irreducible to

271. The elastic borders of the concession theory have led many to worry about its viability. Some reject it in favor of a contractarian approach. See, e.g., William A. Klein, *The Modern Business Organization: Bargaining Under Constraints*, 91 YALE L.J. 1521, 1525 (1982); Larry E. Ribstein, *Limited Liability and Theories of the Corporation*, 50 MD. L. REV. 80, 82–83 (1991) (rejecting the notion that the state is conferring privileges warranting responsibilities). Others simply oppose or endorse regulation of firms on instrumental grounds, rather than some sort of state-corporate contract. See, e.g., Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 441 n.5 (2001) (“In our view the traditional debate between concession and contract theorists is simply confused. . . . [C]orporations—whether concessions or contracts—should be regulated when it is the public interest to do so.”). Yet even that approach depends on a theory of essentialism because the practicability of corporate regulation is also closely related to one's position in the essentialism debate. If entities give what cannot be otherwise had, then the state has substantial bargaining power to demand what it wishes. Conversely, if all entity functions could be feasibly accomplished through contract alone, then sufficiently burdensome corporate regulation may only spur a flight from the corporate form back into contract.

272. Hansmann & Kraakman, *supra* note 271; Henry Hansmann & Reinier Kraakman, *Reflections on the End of History for Corporate Law*, in *THE CONVERGENCE OF CORPORATE GOVERNANCE: PROMISE AND PROSPECTS* 32, 33–37 (Abdul A. Rasheed & Toru Yoshikawa eds., 2012).

contract law, even if entities are not the only way to claim the benefits. The fact that insurance regulation serves as a substitute for organizational law as a sui generis regime of constructive notice does not obviate the claim that public, property-like law is essential to mass commerce.²⁷³ The entity, however, proves a more contested subject—functionally, ontologically, and normatively—than previously thought.

273. See Henry Hansmann & Reinier Kraakman, *Property, Contract, and Verification: The Numerus Clausus Problem and the Divisibility of Rights*, 31 J. LEGAL STUD. S373 (2002) (discussing the central role of notice in establishing the contours of property regimes and the efficiency considerations relevant to those determinations); cf. Benito Arruñada, *Institutional Support of the Firm: A Theory of Business Registries*, 2 J. LEGAL ANALYSIS 525 (2010) (arguing for the importance of public business contracts registries to improve the tradeoff between secure property and ready trade).