ORGANIZATIONS AS INTERNAL CAPITAL MARKETS:  
THE LEGAL BOUNDARIES OF FIRMS, COLLATERAL, 
AND TRUSTS IN COMMERCIAL AND CHARITABLE ENTERPRISES

George G. Triantis

TABLE OF CONTENTS

INTRODUCTION ......................................................................................................................... 1103
I. SWITCHING OPTIONS, INFORMATION ASYMMETRIES, AND AGENCY PROBLEMS .......................................................... 1109
II. ORGANIZATIONAL BOUNDARIES OF INTERNAL CAPITAL MARKETS ................................................................. 1119
   A. Contractual Constraints ................................................................................................. 1119
      1. Hierarchies and Intermediaries ............................................................................... 1119
      2. Liquidity Controls .................................................................................................... 1123
   B. Legal Organisations: Corporate Boundaries ............................................................. 1124
      1. Corporate Law ......................................................................................................... 1125
      2. Tax Law .................................................................................................................. 1127
      3. Securities Law ........................................................................................................ 1127
      4. Debtor-Creditor Law ............................................................................................. 1131
      5. Example: Spinoffs and Carve-Outs vs. Tracking Stocks ........................................ 1133
   D. Legal Organisations: Security Interests in Collateral ................................................. 1138
      1. Secured Transactions and Bankruptcy Law ............................................................. 1138
      2. Structured Finance and Securitization .................................................................. 1141
   E. Legal Organisations: Trusts ....................................................................................... 1144
III. CHARITABLE ORGANIZATIONS ......................................................................................... 1145
   A. Switching Options in Charities ................................................................................... 1145
   B. Legal Constraints on Flexibility ................................................................................ 1150
      1. Allocation Among Charitable Purposes .................................................................... 1151
      2. Allocation Over Time Between Commercial and Charitable Ventures ............... 1155
   C. The Role of Intermediaries in Restoring Flexibility .................................................. 1157
      1. The Courts and Cy Pres ......................................................................................... 1157
      2. Charitable Intermediaries ....................................................................................... 1158
      3. For-Profit Intermediaries ....................................................................................... 1160
CONCLUSION ............................................................................................................................ 1162
ORGANIZATIONS AS INTERNAL CAPITAL MARKETS:
THE LEGAL BOUNDARIES OF FIRMS, COLLATERAL,
AND TRUSTS IN COMMERCIAL AND CHARITABLE
ENTERPRISES

George G. Triantis

This Article explains an important yet unexplored function of the legal boundaries of
various organizations, such as corporations, security interests, and trusts. These
boundaries define internal capital markets within which capital may be redeployed over
time by fiat and across which it may be moved only at greater cost and with greater
difficulty. The option to switch capital allocations among available projects is valuable,
and its value can be enhanced when management of the option is delegated to an
informed and loyal agent. However, if the switching option has low value, if agents have
little private information, or if agency costs are high, the principal should constrain the
ability of the agent to reallocate capital. The principal may accomplish this task by
shrinking the legal boundaries of the relevant internal capital market — that is, by
segregating projects into separate legal organizations. For example, a number of rules in
corporate, securities, tax, and debtor-creditor law make switching capital allocations
among affiliate corporations significantly more costly than switching such allocations
within a firm. Security interests and trusts also constrain capital budgeting flexibility.
Indeed, the law provides a menu of instruments that, to varying degrees, remove from
agents the discretion to adjust capital allocations among projects over time. This Article
also examines internal capital markets in the charitable sector: the prevailing
information conditions and tax rules in this sector differ in important respects from
those in the commercial sector, thus raising interesting internal capital market issues.
Capital budgeting flexibility in charities is also constrained by charitable trust law
principles. In both commercial and charitable sectors, intermediaries offer an attractive
alternative solution to the agency tradeoff problem.

INTRODUCTION

In recent scholarship, efforts to describe the optimal boundaries of
firms have evolved into a broader inquiry into the justification for le-
gal organizations.1 In this literature, the corporation is a form of or-

1 The comparison of firms versus contracts has commanded scholars’ attention for many de-
recent scholars have broadened the analysis of the boundaries of firms to a variety of issues, in-
cluding theories of the allocation of residual control in property ownership rights, see, e.g.,
OLIVER HART, FIRMS, CONTRACTS AND FINANCIAL STRUCTURE 29–34 (1995), and theories
organization, as are the partnership and the trust. Indeed, to some authors, hierarchical substructures within firms may also form organizations. Although the conception of organization varies among authors, many of them offer explanations for the choice of organizational boundaries. With very few exceptions, however, this literature pays no attention to the function of legal organizational boundaries.

A significant exception is the recent work of Henry Hansmann and Reinier Kraakman, who argue that the legal organizational boundaries of corporations, partnerships, trusts, and even marriages serve to dedicate pools of assets to specific creditors and thereby insulate those assets from the reach of other creditors. Hansmann and Kraakman suggest that the motivation for partitioning business assets among distinct organizations is to exploit the comparative monitoring advantages of heterogeneous creditors. They present an example of a business that includes two ventures — a chain of hotels, and oil fields and refineries — that are owned and managed by the same parties. If the business is structured as two corporate subsidiaries, and if courts enforce this partition, borrowing may be structured so that any given creditor may reach only the assets related to the business that the creditor has financed. The authors suggest that, given the differences in the nature of each firm, consequent specialization by creditors in monitoring the firms’ activities may lead to a lower aggregate cost of credit. As Hansmann and Kraakman note, security interests and trusts also partition assets and can yield similar monitoring efficiencies. Yet such specialization economies may be of little significance in the case of large institutional lenders or debenture holders. Moreover, of organizations in general, of which corporations are one subcategory, see, e.g., Henry Hansmann & Reinier Kraakman, The Essential Role of Organizational Law, 110 Yale L.J. 387 (2000); Raghuram G. Rajan & Luigi Zingales, The Firm as a Dedicated Hierarchy: A Theory of the Origins and Growth of Firms, 116 Q.J. Econ. 805 (2001) [hereinafter Rajan & Zingales, Dedicated Hierarchy]; Raghuram Rajan & Luigi Zingales, The Influence of the Financial Revolution on the Nature of Firms, 91 AM. ECON. REV. 206 (2001).

3 See Rajan & Zingales, Dedicated Hierarchy, supra note 1, at 842–43.
4 Some authors explicitly state that their organizational structures often do not coincide with legal boundaries. See id.
5 See Hansmann & Kraakman, supra note 1, at 390; see also Hansmann & Mattei, supra note 2, at 472.
6 See Hansmann & Kraakman, supra note 1, at 398–405. Although much of their article concerns partitioning business assets from the personal assets of owners and managers, Hansmann and Kraakman also present a theory of partitioning subsets of business assets. See id. at 399–401.
7 See id. at 399.
8 See id. at 400.
9 Although security interests are not “organizations” as defined by Hansmann and Kraakman, the authors note that security interests affect monitoring activity. See id. at 417–20.
these creditors often seek guarantees from related entities: the lender to the hotel firm receives a guarantee from the affiliated oil firm. The prominence of such surety relationships seems to limit the scope of the Hansmann-Kraakman hypothesis. The partitioning of assets into separate firms may be valuable instead because it limits the borrower’s prospective ability to increase the risk of default by shifting resources between the two ventures.

In this vein, this Article presents a distinct but complementary explanation of the legal boundaries of organizations. These boundaries define internal capital markets within which resources may be readily redeployed, but across which redeployment may occur only at some cost. Internal capital markets permit capital to move between projects; in the language of real options, they enhance the value of “switching options,” or the ability to delay a capital allocation decision until more information becomes available. The distinction between external and internal capital markets is that capital moves between projects by contract in the former case and by authority or fiat in the latter. A corporate manager might finance a new venture by contracting with outside investors (external) or by shifting resources from an existing project within the firm (internal). For example, capital is redeployed through external markets when one firm distributes some of its assets to investors and another firm sells securities to those investors, or when two separate firms contract with each other to move capital between projects managed by each firm. If instead the two projects were contained in an internal capital market, the new project might be financed by diverting cash flow from the existing project, by liquidating some of that project’s assets, or by borrowing against those assets.

Internal capital enables a firm to avoid the information asymmetry between a firm’s managers and outside investors, or between two firms, that may impede or may raise the cost of external finance. Internal capital thereby reduces the cost of switching capital allocations and increases investment flexibility. There is a tradeoff, however, between this gain and the agency costs of having this flexibility managed by an agent who can exploit her private information for her own benefit. A manager may reallocate capital within internal markets to maximize her private benefits rather than firm value, and she may use her informational advantage to conceal from investors the shift in resources or its impact on firm value. In light of this agency problem,
investors may choose to forego the flexibility of an internal capital market and to impede the movement of capital from one venture to another. Indeed, this concern may be felt not only by creditors, but by all classes of investors and even other constituencies.11

Internal capital markets are the subject of active investigation in financial economics, particularly in explaining the “diversification discount” applied by equity markets to the shares of conglomerates, and the benefits of corporate restructurings such as spinoffs and equity carve-outs.12 While finance scholars acknowledge that internal capital markets may be broken up by the formation of separate “entities” subject to the control of different management, this Article focuses on the role of legal rules in raising barriers to capital movements across the boundaries of such entities, even when they are subject to common control. In this respect, this Article shares the legal emphasis of the work of Hansmann and Kraakman.

This Article proceeds as follows. Part I describes three factors that determine whether investors should delegate flexibility to a manager in an internal capital market: the value of flexibility to adjust investment allocations among available projects over time, the value added by a competent and informed agent who manages that flexibility, and the incentive conflicts resulting from the agent’s control over that flexibility. In brief, switching options are valuable if the distributions of payoffs from the various projects are negatively correlated with each other. Managers are more likely to have an informational advantage that they can contribute to switching decisions when external capital markets are less developed. And agency conflicts are more problematic when there is a negative correlation between the private benefits and the aggregate value of a given project. Thus, the agency tradeoff yields the following prediction: a business enterprise is more likely to organize to partition assets and otherwise restrict internal capital markets when agency conflicts are large, when disciplining forces on managers are weak, when the value of switching options is low, and when the informational advantage of managers with respect to project payoffs is small.

11 Hansmann and Kraakman’s monitoring specialization thesis can extend beyond their example of creditors to include the monitoring activity of shareholders. When a conglomerate is partitioned into distinct firms, investors may specialize in the trading of each firm’s stock, thereby revealing public information specific to each line of business.

12 The conventional wisdom a decade ago was that the stock of diversified firms tends to trade at a discount compared to corresponding firms that focus on individual industries. Recently, several financial economists have raised doubts about the accuracy of this view. See Belen Villalonga, Research Roundtable Discussion: The Diversification Discount 1–8, http://ssrn.com/abstract=402220 (literature review); see also infra notes 19–22 and accompanying text (discussing the efficiencies of internal capital markets in conglomerates).
Part II presents the core of the internal capital markets hypothesis of legal organizations. It describes the contractual and organizational partitions of internal capital markets that constrain to varying degrees the switching discretion of business managers. Attempts to mandate efficient capital reallocations by contract (and to prevent inefficient reallocations) are unlikely to be effective because of the difficulty in observing and verifying the relevant factors in each set of circumstances. Therefore, investors must choose the extent to which they wish to impose restraints by contract on their managers’ ability to reallocate capital. In particular, they can decide whether to delegate reallocation authority at all and, if so, whether to delegate it to an intermediary. They may also seek to regulate the liquidity of the enterprise’s assets in order to reduce internal capital.

The separation of projects by legal organizations reinforces contractual constraints on investment flexibility. Part II examines the frictions that impede movement of capital between affiliate corporations but not between divisions of a single firm. Corporate law imposes much stricter substantive and procedural requirements on transactions between affiliates than on transactions within a firm. Securities regulation demands more detailed disclosure of related-party transactions across corporations than of transfers within a single firm. Tax authorities may review the terms of interaffiliate deals, but not those of transfers within an entity. Debtor-creditor law limits intercorporate distributions and transactions when either corporation is insolvent or undercapitalized, but it does not limit transfers within a firm, even if the firm is insolvent. The more an enterprise is fragmented into discrete firms, the more significant the legal constraints on capital budgeting flexibility.13

Part II then explains that security interests in collateral assets impede the reallocation of capital between projects within firms, thus allowing collateral to be viewed as an alternative form of organization. Security interests impede the conversion of nonliquid assets into liquid assets that could then be invested in other ventures. In addition, the broad priority right held by a secured creditor in project assets prevents these assets from being used to cross-finance other ventures. Security interests are valuable alternative mechanisms for breaking up

---

13 The internal capital market theory, however, is only a partial account of organizational boundaries. Casual observation suggests, for instance, that conglomerates may not bother to integrate acquired firms into a single corporation simply because, given the ability to consolidate financial statements, there are no benefits to justify the legal costs of doing so. In some cases, one of the merged entities may have a preexisting debt covenant, such as a debt ceiling, that prevents full integration and is costly to renegotiate.
internal capital markets because they fine-tune managerial flexibility over capital budgeting.

Part III of the Article turns to the agency tradeoff of internal capital markets in the charitable sector and the mechanisms for partitioning assets dedicated to charitable purposes. The tax concessions enjoyed by charities encourage donors to accelerate rather than stage over time their donations, which suggests that donors would want to give charitable managers discretion over the reallocation of capital over time. However, the potential for conflicting interests is greater in charities than in commercial organizations. In addition to the usual conflicts with managers and with creditors, donors also have heterogeneous preferences among themselves that make them more averse than for-profit investors to the flexibility of internal capital markets. Furthermore, switching options between projects tend to be less valuable in the charitable sector because the social payoffs of most charitable ventures tend to be positively correlated with each other as a result of being highly correlated with macroeconomic cycles. In such cases, donors can remove the discretion of managers to reallocate capital between charitable projects even within a single organization by restricting the purpose of their gift. Trust principles enforce such restrictions and break up the internal capital market, thereby preventing the cross-financing of charitable projects. A similar analysis applies to the optimal endowment policy — that is, the manager’s flexibility to reallocate capital between commercial and charitable uses over time. Part III concludes with a discussion of the important role of intermediaries, such as charitable foundations or commercial banks, in providing desirable flexibility in the face of changing conditions and information.

The internal capital markets explanation of organizational boundaries is a financial agency theory, and like other theories of this type, it is based on a premise that competition in external markets promotes the emergence of efficient financing and governance arrangements. In particular, investors and donors prefer to contribute to organizational structures that give managers the optimal amount of reallocation authority. This Article assumes that investors and donors select the structures of the enterprises they fund — an assumption that is analytically equivalent to the premise that managers are induced to establish efficient structures to lower their cost of capital. Even if this premise is accepted, however, these organizational structures may well be compromised by agency conflicts that arise after the outsiders have invested. Managers may fail to adjust the structures to accommodate changes in conditions, and more perniciously, they may even dismantle organizational constraints on their authority. Nonetheless, managers have at least some incentive to maintain efficient organizations in order to prevent takeovers of their enterprises and to bolster their
reputations. Thus, the market for corporate control and the market for managers may be two continuing checks on such midstream misbehavior.\footnote{See, e.g., Philip G. Berger et al., Managerial Entrenchment and Capital Structure Decisions, 52 J. FIN. 1411, 1413 (1997); Jeffrey Zwiebel, Dynamic Capital Structure Under Managerial Entrenchment, 86 AM. ECON. REV. 1197, 1198–99 (1996).}

I. SWITCHING OPTIONS, INFORMATION ASYMMETRIES, AND AGENCY PROBLEMS

An internal capital market permits the reallocation of capital between projects at a lower cost than through external capital markets because project managers possess expertise and private information that cannot be efficiently communicated to outside investors. Managers of internal capital markets are informed but self-interested agents. The internal capital markets thesis of organizational boundaries may be framed as addressing a balance between the benefits and the costs of leaving investment switching options in the hands of agents. Therefore, three factors define the optimal size (or boundaries) of an internal capital market: the value of the flexibility to adjust over time the allocation of capital among available projects, the value added by a competent and informed agent who manages that flexibility, and the incentive conflicts resulting from the agent’s control over that flexibility.

Investment flexibility can be framed in terms of real options.\footnote{See Alexander J. Triantis & James E. Hodder, Valuing Flexibility as a Complex Option, 45 J. FIN. 549, 549–50 (1990). Managerial agency problems associated with the management and exercise of real options have received relatively little attention since the seminal work of Stewart Myers that introduced the problem of underinvestment in growth options. See generally Stewart C. Myers, Determinants of Corporate Borrowing, 5 J. FIN. ECON. 147 (1977).} In this context, a real option is the ability to adjust an investment decision when better information is obtained. In the realm of capital budgeting, real options include the ability to defer, abandon, accelerate, or decelerate projects. The ability to reallocate capital between projects may be viewed as a switching option — that is, the abandonment or deceleration of one project and the initiation, continuation, or acceleration of another project. For example, suppose an investor initially funds two ventures, $V_1$ and $V_2$, based on incomplete information.\footnote{The “projects” discussed here are defined narrowly. In a sense, any decision involves an allocation between projects. The decision between using electricity or oil to power the manufacture of widgets, for example, may be thought of as a decision between two projects, even though...} When new information is subsequently revealed, the invest...
ment mix may be changed, albeit at some cost. This switching option — the ability to adjust the investment mix with the benefit of new information — is valuable because the option will be exercised only if the reallocation of capital between the two projects increases the aggregate return. One might similarly view the ability to divert cash flow from one project to another as a switching option by presuming that the cash flow is reinvested in the source project unless the option to switch is exercised.

Real options analysis offers several important insights. First, the value of the switching option is a function of the correlation between the payoff distributions of the two projects. The less positively correlated and the more negatively correlated the distributions, the more valuable the option to switch between projects.

Second, a switching option is valuable and often worth incurring some cost to create and preserve. Suppose that the return from \( V_1 \) is initially expected to exceed the return from \( V_2 \). It may nevertheless be advisable to invest enough in \( V_2 \) to keep alive the option of later engaging more fully in \( V_2 \) by moving capital from \( V_1 \), especially if the distributions of returns from the two projects are negatively correlated. The more valuable the option, the greater the return from investments to create and preserve it. Therefore, to the degree that internal capital markets increase the value of switching options, they also encourage the creation of such options.

Third, the value of an option depends on the proper timing of its exercise. Switching between projects is costly. Therefore, even when new information about the relative returns on the two projects justifies the partial liquidation of the first and the shifting of capital to the second, switching should be deferred until further information confirms the superior returns of the second project. As a general proposition, the costly exercise of an option should be deferred until the option matures; accordingly, the value of an option typically depends on the time until maturity. Several factors, however, may accelerate the optimal timing of the decision to switch: in particular, the costs of switching may increase over time if the salvage values of assets in the source project deteriorate, and the value of switching to the second project may be compromised by delay if competitors can enter the product market in the meantime.

If reallocation occurs through external capital markets, an organization must distribute capital from one project (perhaps from cash

the output is the same. This Article, however, looks at projects with respect to which the choice whether to delegate allocation decisions to an agent calls for a weighing of the factors described in this Article. Cf. Oliver Hart & Bengt Holmstrom, A Theory of Firm Scope 2 (Nov. 4, 2002) (unpublished manuscript, on file with the Harvard Law School Library) (defining a production unit as “an irreducible set of activities that it would be meaningless to break up further”).
flow or partial liquidation of the project) to investors, who must then finance a second project in another organization. Alternatively, capital may move directly between firms without passing through the hands of investors, such as through interfirm loans.

Reallocation through internal capital markets may occur by any of the following means. First, the cash flow from one project may be diverted to fund another. Second, assets of one project may be sold and the proceeds transferred to another project. Third, the firm may implicitly borrow against the assets of one project to finance another venture whenever liability is incurred by the organization as a whole, because all of its assets are available to satisfy the creditor. Indeed, the firm may enhance its cross-financing option by giving the new creditor a security interest — and therefore priority — in the assets of the first project, even though the loan proceeds fund the second project. Fourth, two projects may share common expenses, such as administrative overhead, and an organization can shift capital between projects by changing the portion of organizational overhead allocated to each project. Fifth, the projects may trade goods or services with each other at internally determined rates. As explained later in this Article, organizations are not required by law to use market or arm’s-length prices for such transfers, and managers can reallocate capital between projects by selecting exchange terms in favor of one or the other project.

The advantage of an internal capital market is that it facilitates the delegation of control over switching options from investors to managers, who have superior expertise and access to information regarding available projects. The value of a switching option depends on the competence of decisionmaking with respect to the creation, preservation, and exercise of the option. The competence of such decisionmaking in turn relies on the quality of information about factors that affect the distribution of the projects’ future payoffs — factors such as projected costs, revenues, technology, and competitors. A significant portion of this information may be unobservable or “soft,” in the sense of

17 Larry Lang, Annette Poulsen, and René Stulz argue that firms sell assets when alternative external sources of financing are too expensive (such as when the firm is highly leveraged or has poor performance), or when information asymmetries are less important with respect to the assets than to the firm as a whole. Their evidence also suggests that the stock-price reaction to successful asset sales is significantly positive when the firm uses the proceeds to pay down its debt, but that it is negative and insignificant when the firm is expected to keep the proceeds within the firm. See generally Larry Lang et al., Asset Sales, Firm Performance, and the Agency Costs of Managerial Discretion, 37 J. FIN. ECON. 3 (1995).

18 In contrast, both corporate and income tax law regulate transfer prices in transactions between separate entities that are controlled, but not wholly owned, by the same parent. See infra pp. 1125–27.
being difficult to communicate to investors. The decisions of investors initially to determine the distribution of capital and subsequently to reinvest it are impaired by their inferior information about the expected returns from each project and the obstacles to effective disclosure by project managers (for example, the cost of revealing information to competitors or even government regulators). The greater the asymmetry of information and expertise between managers and investors, the greater the potential contribution by managers and the more significant the potential gain from an internal capital market. A similar information asymmetry also impedes the direct movement of capital from one firm to another (without passing through the hands of investors). Indeed, such obstacles to contracting between firms are compounded by the agency problems existing between each firm and its investors. Options that are effectively managed in this respect are more valuable, and accordingly, investors are more willing to invest ex ante to create and preserve such options. Specifically, investors are more likely to create an option to switch from $V_1$ to $V_2$ by investing a small amount in $V_2$ if the option will be exercised subsequently by a competent manager.

A substantial body of finance scholarship documents the connection between the size of an internal capital market and the amount of project investment, particularly when external financing is constrained by information asymmetries.\(^{19}\) For example, several articles have provided empirical support for the sensitivity of investment in one project to cash flow generated by another.\(^{20}\) Internal capital markets play a greater role in capital reallocation when external capital markets are less developed and when significant information asymmetry impedes external finance.\(^{21}\) Over time, external markets improve their ability

\(^{19}\) R. Glenn Hubbard, *Capital-Market Imperfections and Investment*, 36 J. ECON. LITERATURE 193, 193 (1998) (reviewing empirical studies finding that investment is significantly correlated with proxies for changes in internal funds and that the correlation is most important for firms likely to face information-related capital market imperfections).


\(^{21}\) The information problems in external capital markets and the relative ease of capital redeployment in internal markets form the basis of the conventional explanation for diversified conglomerates in which a headquarters coordinates the operations of various divisions and has the
to gather and process information, thereby reducing the asymmetry between managers and investors. As this happens, a growing number of switching opportunities can be exercised through external capital markets; internal capital markets become correspondingly less valuable.22

The value of a switching option in the hands of an agent is impaired by incentive conflicts. In particular, an agent may switch (or abstain from switching) capital allocations in order to maximize her private benefits rather than the aggregate return to the enterprise. Managers enjoy private benefits that are not shared by other investors because of their control over decisionmaking. These benefits typically include opportunities to self-deal, build empires, entrench positions, enhance professional reputations, and consume perquisites.23 Whether managerial pursuit of private benefits conflicts with the interests of investors in the exercise of shifting options depends on the type of private benefit in question. Compare the following three examples. First, empire building is unlikely to skew switching incentives because, for any given firm size, a manager wants to maximize profitability. Second, private benefits from entrenchment or shirking may lead to suboptimal switching activity; some studies, for instance, find that managers are reluctant to abandon losing projects.24 Third, private benefits from social prestige or investment in portable human capital may respond to social fads and thereby induce excessive switching and overinvestment in the creation of options.


23 In financial economics, the term “private benefits” principally refers to the benefits enjoyed by controlling shareholders and not by other shareholders. Nonetheless, the phenomenon is a general one and is used here to cover any principal-agent or intra-investor conflict.

24 See, e.g., MAX H. BAZERMAN, JUDGMENT IN MANAGERIAL DECISION MAKING 75–85 (5th ed. 2002).
There is a range of well-known mechanisms that restrain the extraction of private benefits to some degree. If investors receive low payoffs at the end of one period, they will be reluctant to make new investments with the same manager in future periods. Therefore, managers may forego private benefits in the current period to raise the likelihood that the enterprise will continue. Tax authorities might also provide some discipline. Stockholders have legal rights to enforce the duties of loyalty owed by managers to the corporation. Shareholders can also vote to replace directors and thereby remove misbehaving managers, and in many cases, they can veto extraordinary decisions. Debtholders (and less frequently, stockholders) can seek to control by contract the appropriation of private benefits.

The ability of shareholders and debtholders to monitor managerial misbehavior is impaired by the fact that the information necessary to detect opportunistic switching is frequently not verifiable, even if observable. The suspect reallocation itself may be subtle and not apparent to the investor. For example, there may be little evidence that cash is commingled, that administrative burdens are shifted between projects, or that transfers occur between ventures at prices at odds with arm’s-length terms. Indeed, the very expertise and informational advantage that investors wish to exploit in assigning to their managers the task of reallocating capital over time also undermine the ability of investors to monitor and discipline their managers’ self-interested exercise of discretion. Incentive-based compensation such as stock ownership may align managerial incentives with those of their principals, but only at the cost of imposing risk on the managers and inducing risk-averse decisionmaking. Thus, even in the aggregate, these various constraints on the extraction of private benefits are not completely effective and leave residual agency conflicts. As such, internal capital

25 See generally Andrei Shleifer & Robert W. Vishny, A Survey of Corporate Governance, 52 J. FIN. 737 (1997) (surveying research on corporate governance, with special attention given to the importance of legal protection of investors and of ownership concentration in corporate governance systems).

26 Alexander Dyck and Luigi Zingales note that the activities of tax authorities also protect minority shareholders: “How tax authorities enforce their rules on transfer pricing affects the incentives to transfer profits to related companies. The stricter the enforcement, the less controlling shareholders will use transfer prices to siphon out value at the expense of minority shareholders.” Alexander Dyck & Luigi Zingales, Private Benefits of Control: An International Comparison, 59 J. FIN. (forthcoming Apr. 2004) (manuscript at 35), available at http://www.afajof.org/pdf/forthcoming/benefitscontrol.pdf.

27 For the same reason, it is difficult for financial economists to identify and measure the value of private benefits in any given firm. Any such measurements have been indirect, such as the difference between the price per share of a privately negotiated transfer of a control block and the market share price. See Michael J. Barclay & Clifford G. Holderness, Private Benefits from Control of Public Corporations, 25 J. FIN. ECON. 371, 374–75 (1989); Dyck & Zingales, supra note 26 (manuscript at 7–8).
markets may yield inefficient reallocation of capital and a consequent reduction in the value of investor interests. In these cases, investors may seek to control the switching authority of their managers. Investors are unlikely to be able to specify ex ante optimal switching strategies because information asymmetries prevent investors from observing or verifying the efficiency of reallocations. Therefore, investors may instead seek to control ex ante the ability of their managers to move capital among projects, whether or not switching would be efficient. If managerial bias is against switching, investors may wish to compel periodic review of the allocation of capital, and as discussed in Part II, they may delegate the review to intermediaries. For example, investors may fund projects in stages or through short-term debt contracts that must be refinanced periodically. Conversely, if managers are prone to make inefficient reallocations, investors may seek to encumber their managers’ discretion to switch by constraining the internal capital market. Part II describes a range of mechanisms, including legal organizations, that serve this purpose.

The foregoing discussion demonstrates that the decision to constrain an internal capital market is the product of a tradeoff between the gains from employing an informed agent and the attendant agency costs. The remaining discussion explores in a preliminary manner the conditions under which the costs are likely to outweigh the gains, thus warranting constraints on internal capital markets. Suppose that investors retain a manager to invest in two ventures ($V_1$ and $V_2$) at time $0$. The total value yielded by each venture ($i = 1, 2$) will be realized at time $2$ and will yield $S$ to the investors and $B$ in private benefits to the manager ($V_i = S_i + B_i$). The payoffs to the investors and the manager from each venture are risky. The manager’s information is superior to that of the investors in the following manner. At time $0$, the investors and the manager have symmetrical information about the individual distributions of $S_i$ and $B_i$ suggesting that $V_1$ will yield a higher return than $V_2$. On this basis, the investors direct their manager to invest in $V_1$. Assume, for the sake of simplicity, that the option to shift capital to $V_2$ may be preserved at no cost. At time $1$, the state of the world at time $2$ becomes observable to managers, but not to investors or third parties. For example, suppose that $V_1$ is a manufacturing plant for computer hardware and $V_2$ is a venture in drug research. At time $1$,
the manager may observe soft information suggesting a deterioration in the market conditions for hardware at time 2 or a successful pharmaceutical discovery related to V2. If the manager has the authority, she may then choose to reallocate the capital from V1 to V2. At time 2, the financial payoff from the active project is realized, verifiable, and paid to the investors. But because the investors cannot observe the state of the world, they cannot discern whether the foregone venture would have yielded a higher return.

If an informed manager is also a faithful agent, the investors will delegate to the manager the authority to reallocate capital from V1 to V2 when the new information is revealed. The gain from delegating the switching option to the informed manager is higher when the payoffs from the two projects are less positively correlated or, even more so, negatively correlated and when the manager has a large informational advantage over outside investors.29

More realistically, managers are self-interested and seek to maximize their private benefits. Private benefits themselves may fluctuate over time so that different projects may yield higher benefits as exogenous conditions change. If the pursuit of private benefits leads managers to engage in excessive switching, investors may wish to constrain the discretion of managers to switch by setting narrow boundaries for internal capital markets. An unconstrained agent effectively controls conflicting options on two sets of assets: the aggregate value of the firm and the agent’s private benefits. Therefore, upon observing the information revealed at time 1, the self-interested manager will switch from V1 to V2 if B2 is greater than B1, but not otherwise. The manager will exploit the switching option to maximize her private benefits, not the aggregate value of the investment. If B1 and B2 are correlated, the agency cost of permitting the manager to shift resources between ventures is small. This may be true, for example, if a manager’s private benefits depend on the size of the enterprise and the aggregate amount of capital under her control; in such a case, the manager is unlikely to reap much incremental private benefit from switching. Alternatively, if B1 and B2 are not correlated but the distributions of V1 and B1 are perfectly and positively correlated, then the manager’s interests will be aligned with those of the investors, and all parties will enjoy the gains reaped from flexibility. Some commentators believe that these distributions are in fact often positively correlated to a very significant degree.30 For example, a manager seeking the prestige of

29 As capital markets become more sophisticated, the information asymmetry shrinks, thereby increasing the availability of external financing and reducing the importance of internal markets in managing switching options. See supra note 22.

30 E.g., LUCIAN ARYE BEBCHUK, ASYMMETRIC INFORMATION AND THE CHOICE OF CORPORATE GOVERNANCE ARRANGEMENTS 26 (John M. Olin Ctr. for Law, Econ., and Bus.,
controlling a large organization would prefer to manage a large organization that is also profitable.\textsuperscript{31}

With respect to other types of private benefits, the correlation between $V_i$ and $B_i$ may be negative. For example, the personal prestige a manager derives from any given industry is likely to vary with the ebb and flow of social fads.\textsuperscript{32} Or a manager may prepare herself for the next stage in her career by developing human capital in an emerging industry flush with financial capital.\textsuperscript{33} If the distributions of $V_i$ and $B_i$ are negatively correlated, and the interests of the manager and the investors are thus opposed, the manager’s discretion to switch capital allocations increases agency costs and decreases the return to investors. For example, suppose that the manager owns a potential supplier to $V_2$. When the $V_2$ industry is thriving, there will likely be much demand for the manager’s supplies and therefore little incentive to self-deal. However, when the prospects for the $V_2$ industry dim, the manager has more to gain by switching capital from $V_1$ to $V_2$ and thereby increasing the demand for her firm’s product.

The interests of the investors and the manager may also diverge with respect to timing the exercise of the option. Even if $B_i$ and $V_i$ are positively correlated, the manager may face a different personal switching cost from the firm as a whole. For example, the manager may face damage to her reputation if she abandons or downscales a project and may defer switching beyond the optimal time. Or the manager may not internalize the financial costs of switching and may switch too soon or too often. Moreover, managers appear to have higher discount rates than investors and therefore may be prone to switch (or to abstain from switching) in order to pursue returns in the short term rather than in the long term.\textsuperscript{34} When the managerial bias

\textsuperscript{31} In particular, a CEO’s (empire building) interest in governing a large, profitable firm coincides with the investors’ interest in profits when it comes to resource allocation among divisions. See Jeremy C. Stein, \textit{Internal Capital Markets and the Competition for Corporate Resources}, 52 J. FIN. 111, 131 (1997).

\textsuperscript{32} For example, “[t]he extent to which managers care about their social status may change over time. Social status may follow fads, inducing managers to add lines of business in socially prominent industries — for example, Internet-related businesses in the 1990s.” Rajesh K. Aggarwal & Andrew A. Samwick, \textit{Why Do Managers Diversify Their Firms? Agency Reconsidered}, 58 J. FIN. 71, 75 (2003).

\textsuperscript{33} Paul Gompers and Josh Lerner note that venture capitalists derive private benefits from building professional reputations and experience in certain areas, such as leveraged buyouts and foreign investment. Overall, however, these projects are losing investments for their investors. See \textsc{Paul Gompers \& Josh Lerner, The Venture Capital Cycle} 42 (2000).

\textsuperscript{34} See, e.g., James M. Poterba \& Lawrence H. Summers, \textit{A CEO Survey of U.S. Companies’ Time Horizons and Hurdle Rates}, 37 \textsc{Sloan Mgmt. Rev.} 43, 52 (1995) (finding that average in-
tends toward inefficient switching, investors may wish to narrow the boundaries of, or otherwise constrain managerial discretion over, internal capital markets.

The conflicts between classes of investors, like those between investors and managers, may also call for restrictions on internal capital markets. In the capital structure of business enterprises, creditors have fixed claims against assets, and shareholders hold the residual claim. Creditors have governance rights specified by contract, including the right to accelerate and enforce their claims if the debtor violates any debt covenant. Common shareholders typically have the right to vote for the board of directors and to enforce fiduciary duties on behalf of the firm. Creditors and shareholders have largely convergent interests in reducing managerial agency costs, and much of the governance activity by each class of investors inures to the benefit of both classes.35 Though beneficial to the disciplining of managers, the presence of both fixed and residual claims adds a well-known axis of conflict and, consequently, a distinct reason for segregating assets. Equity investors enjoy the upside of their firm’s value, while they share the downside with creditors. Therefore, shareholders may exercise their control over managers to induce them to reallocate capital in order to increase the riskiness of the firm’s business. Shareholders may prefer to switch from \( V_1 \) to \( V_2 \) because \( V_2 \) has become riskier, even if \( V_2 \) is less profitable.36 Thus, creditors are worried not only about the usual private benefits motivating managers’ decisions, but also about the risk alteration effected on behalf of shareholders.

In sum, the flexibility to move resources between ventures is essentially the ability to defer the capital budgeting decision until uncertainty is resolved. This flexibility is a valuable real option — a switching option — on the difference between the payoffs of the two ventures. Different constituencies in an enterprise focus on different switching options that reflect their divergent interests. In the example above, there are effectively three options that correspond to three underlying assets: the value belonging to the investors (\( S_2 - S_1 \)), the private benefits to the agent (\( B_2 - B_1 \)), and the aggregate value produced by the investment (\( V_2 - V_1 \)). If there are two or more classes of investors, the option on \( S_i \) is accordingly split among them. The manager

ternal discount rates of firms were higher than average rates of return on equity and on debt, leading to shorter planning time horizons).


36 This incentive in favor of excessive risk is now well-known; its original exposition is usually attributed to Michael C. Jensen & William H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 J. FIN. ECON. 305 (1976).
seeks to maximize the option value associated with her private benefits (B). If, however, investors control the switching option, they will seek to maximize $S_i$ and pay insufficient attention to the private benefits of managers.

The parties cannot contract ex ante to ensure the optimal management of the global option on $V$, because much of the relevant information is not verifiable. Instead, they might restrict contractually the degree to which the agent has flexibility to reallocate. The following Part reviews a range of mechanisms for constraining flexibility when the value added by competent and informed managers to capital reallocation opportunities is outweighed by the associated agency costs.

II. ORGANIZATIONAL BOUNDARIES OF INTERNAL CAPITAL MARKETS

Part I described the three factors that determine the optimal boundaries for internal capital markets: the value of the flexibility to adjust capital allocation over time, the value added by a competent and informed manager of that flexibility, and the agency costs arising from the divergent incentives of manager and investors. This Part discusses the means by which an internal capital market can be constrained if agency costs outweigh the gains from delegating reallocation authority to a manager. This Part divides the various constraints into those established by contract between investors and their manager, and those arising from legal rules governing organizations such as corporations, security interests, and trusts. Accordingly, section II.A describes hierarchical decisionmaking structures, established by contract, that delegate separately the functions of operating projects and of reallocating capital between projects. For example, investors may give control over each project to a different manager, or they may delegate reallocation authority to an intermediary. Section II.A also describes a set of contractual constraints that seek to limit capital budgeting flexibility by reducing the liquidity of business assets.

The principal focus of this Article, however, is the role of organizations in constraining internal capital markets. Organizations economize on contracting costs by binding multiple parties, many of whom are not known to the investors or manager at the time their agency relationship is created. Thus, section II.B demonstrates how obstacles to the movement of capital between corporations are created by a wide range of legal rules in corporate, securities, tax, and debtor-creditor law. Section II.C examines the effect of security interests in dividing internal capital markets within firms. The discussion presents a menu of organizational constraints. It leaves to later work the intriguing task of comparing the efficiency of the various mechanisms and describing the conditions under which, for example, a project should be
financed by secured credit rather than as a separate corporate entity under project finance. Section II.D explains briefly that the use of trusts in corporate finance is not motivated by internal capital market concerns. (In contrast, Part III discusses the important asset-partitioning role played by the principles of trust law in the administration of charities.)

A. Contractual Constraints

1. Hierarchies and Intermediaries. — This section explores the extent to which the ability of managers to reallocate capital can be restricted by contract, particularly contracts that define the manager’s decisionmaking authority. At least conceptually, the authority to execute and operate projects can be distinguished from the authority to allocate capital between projects.\(^37\) As principals, investors might choose to delegate these functions in one of the following three ways. First, they may delegate both execution and allocation authority jointly to a single manager. Second, they may delegate project execution to a manager but reserve for themselves the discretion to reallocate capital between projects. Third, they may grant allocation authority separately to an agent who has no execution authority — for example, a financial intermediary or a chief executive officer overseeing divisional managers.

For the purposes of this Article, the important distinction among these hierarchical structures is the amount of soft information available to the person making the reallocation decision. The degree to which information is observable depends on the observer’s distance from the source: soft information about the prospects of a venture is most likely to be observable to a skilled manager operating a venture, less so to her boss or a financial intermediary, and least to the investors or a court.\(^38\)

Consider the example in Part I and suppose that investors instruct their manager to make a specified investment at time $t_0$ in each of $V_1$ and $V_2$. If the firm’s switching option is valuable, if the manager has expertise in managing the option, and if the manager’s option on private benefits is not significant, then the investors will seek to maximize flexibility and thus may appoint a single manager to execute both ventures and to reallocate capital between them at time $t_1$. In contrast, if the reallocation option is not particularly valuable for the firm, if the manager does not have privileged access to information relevant to the

\(^37\) For a discussion of what is meant by a “project” in this analysis, see supra note 16.

\(^38\) The possibility that a court may be better informed than outside investors is the premise underlying the authority of bankruptcy courts to loosen the constraints on capital reallocation in bankrupt debtors. See infra pp. 1140–41.
option, or if the agency costs of giving the manager discretion are too large, then the investors may decide to forego the benefits of reallocation and instead retain two managers: M₁ and M₂ will execute V₁ and V₂, respectively. Although M₁ and M₂ may each appropriate private benefits from their respective ventures, they cannot reap additional benefits by shifting resources at time t unless they collude. Each manager has private information concerning her own venture and particularly the value of private benefits from that venture. This information asymmetry will make contracting between the managers significantly more cumbersome than the single manager’s unilateral action in the first case.

Thus, information asymmetry provides both a case against and a case for splitting internal capital markets. In the former account, information asymmetry impedes the efficient movement of capital between firms. However, information asymmetries are indiscriminate in their effect on contracting. In the latter account, they serve to prevent inefficient contracts between managers who seek to shift capital between firms for selfish purposes. The transaction cost of incomplete contracting threatens to offset the private value obtained from shifting capital at time t and may thereby deter it. Nevertheless, if the private gains from switching exceed the transaction costs, the managers may still strike a deal, and the transaction costs will further aggravate the efficiency loss.

Of course, the choice between one manager and two managers is affected by other factors as well. For example, economies of specialization would favor two managers, while economies of scope would favor one manager. If these economies are significant, the investors might consider two other delegation structures.

First, suppose that specialization economies can be reaped if M₁ and M₂ execute their respective ventures. In order to exploit some of the flexibility at time t, the investors may appoint an intermediary to make the allocation decision. Oliver Williamson calls this hierarchical structure the M-form, in which headquarters is responsible for resource reallocation.39 This structure is also similar to a more recent model by Oliver Hart and John Moore that assigns authority to two types of decision makers: specialized managers who concentrate on specific assets, and coordinators who identify ways to exploit synergies between assets.40

40 See Oliver Hart & John Moore, On the Design of Hierarchies: Coordination Versus Specialization 1 (Nov. 1999) (unpublished manuscript, on file with the Harvard Law School Library). For other discussions of hierarchical efficiencies, see Philippe Aghion & Jean Tirole, Formal and
Second, suppose that economies of scope outweigh those of specialization in executing the two ventures. In this circumstance, investors might choose to retain a single manager for both ventures. At the same time, they may also wish to constrain the movement of capital by this manager if the conflict of interest over capital budgeting flexibility is sufficiently severe. The investors may therefore interpose an intermediary to police the manager and to make reallocation decisions.

The important characteristic of an intermediary in either type of hierarchy is that the intermediary is a moderately informed party (that is, less informed than the manager but more informed than the investors) who observes some, but not all, of the soft information and to whom the investors can entrust capital reallocation decisions. Because the intermediary is also an agent of the investors, this structure raises a two-tiered agency problem; however, this problem is arguably less threatening to investor welfare than a single-tiered relationship. For the intermediary to enjoy private benefits, she must often have the cooperation of the project manager. These two agents must therefore collude against the outside investors to share private benefits. However, as in the case of the two managers discussed above, transaction costs may deter such agreement unless an ongoing relationship between the two agents significantly reduces these costs. It also bears noting, though, that the two-tiered hierarchy introduces an additional source of efficiency loss: even in the absence of collusion, project managers will expend resources to influence the intermediary’s allocation

Real Authority in Organizations, 105 J. POL. ECON. 1 (1997); and Jean Tirole, Hierarchies and Bureaucracies: On the Role of Collusion in Organizations, 2 J.L. ECON. & ORG. 181 (1986).

Though the function of the coordinators refers specifically to the joint use of two or more assets, it might be extended to cover asset reallocations, such as the sale or mortgage of one asset to finance a project involving the other. Hart and Moore show that the decision to give seniority to the coordinator depends on the probability distribution for profitable coordination opportunities. See Hart & Moore, supra, at 13. Similarly, this Article proposes that if the initial allocation of capital between projects is likely to remain optimal, even in light of new future information, the reallocation decision should not be assigned to project managers but to an intermediary (to preserve some switching option value) or to the investors themselves. However, while the Hart-Moore model focuses on differences in the exogenous likelihood of profitable ideas coming to specialists and coordinators, this Article emphasizes the role of hierarchical structure in reducing agency problems in capital redeployment decisions.

Like the Hart-Moore model, but unlike other models of organizational hierarchies, see, e.g., Patrick Bolton & Mathias Dewatripont, The Firm as a Communication Network, 109 Q.J. ECON. 809, 809–39 (1994); Jeremy C. Stein, Information Production and Capital Allocation: Decentralized Versus Hierarchical Firms, 57 J. FIN. 1891 (2002), this Article treats the production of information as exogenous. Incorporating incentives to produce information, though significant, adds an additional layer of complexity that does not further illuminate the internal capital market explanation of legal organizations.

41 See Patrick Bolton & David S. Scharfstein, Corporate Finance, the Theory of the Firm and Organizations, J. ECON. PERSP., Fall 1998, at 95, 108.
decisions in each period.\textsuperscript{42} And, as noted above, the information used by the intermediary in making reallocation decisions is inferior to that of the project managers.\textsuperscript{43} The intermediary structure therefore surrenders the incremental informational advantage of the manager to achieve, in some cases, a reduction in the extraction of private benefits.

The intermediary in this discussion may be inside or outside the boundaries of a firm, and the various means by which she may exercise control over capital allocations differ more in form than in effect.\textsuperscript{44} A CEO allocates capital among divisions and ventures within the firm by virtue of her authority to overrule the decisions of division managers. A bank moves capital among its borrowers by making discretionary advances under lines of credit and by setting payment maturities and acceleration provisions that enable it to call in loans. A venture capitalist holds seats on the operating firm’s board of directors and stages its investments. Notwithstanding the formal position of each of these intermediaries inside or outside the firm, the most important difference among them may be the nature of each institution’s reward structure and other controls on incentives.\textsuperscript{45}

2. \textit{Liquidity Controls.} — The most common sources of internal capital are cash and liquid assets. A manager may divert cash flow from one project to another instead of reinvesting the cash in the source project or distributing it to investors. Alternatively, the manager may hold a pool of cash or other liquid assets and defer the allocation decision until future periods. The justifications for keeping cash reserves, even in low-interest-bearing instruments, are very similar to the reasons for allowing the movement of capital between ventures. Liquid funds provide the firm with the flexibility to exploit options as they become available without having to draw on external markets and face information asymmetries. As discussed above, however, managers themselves also may value this flexibility because it enhances their ability to extract private benefits from their positions. This potential agency problem is most acute for investors when the

\textsuperscript{42} Indeed, inefficient reallocation of capital between projects may occur because managers of weaker projects enjoy lower opportunity costs of lobbying than managers of profitable projects. \textit{See} David S. Scharfstein \& Jeremy C. Stein, \textit{The Dark Side of Internal Capital Markets: Divisional Rent-Seeking and Inefficient Investment}, 55 J. FIN. 2537, 2539 (2000).
\textsuperscript{43} \textit{See supra} p. 1120.
\textsuperscript{44} In the internal capital markets thesis, the boundaries of the firm are significant with respect to the manner in which they partition projects or assets rather than the matter of whether decisionmakers lie inside or outside the firm. \textit{See generally} Robert H. Gertner \textit{et al.}, \textit{Internal Versus External Capital Markets}, 109 Q.J. ECON. 1211 (1994).
\textsuperscript{45} For example, corporate headquarters owns and controls the assets of divisions, while the ownership and control rights of banks are contingent on default. \textit{See id.} at 1212.
firm lacks sufficient growth options to deploy its liquid assets profitably.46

   Investors — and particularly debtholders — can constrain the li-
   quidity available to their managers in several ways. Investors can re-
   move cash from the firm by compelling periodic distributions in the
   form of debt repayment, dividends, or share repurchases.47 The choice
   of debt financing over the sale of equity interests, for example, com-
   mits the firm to paying out cash flow.48 Indeed, some bank financing
   agreements contain excess cash flow sweep provisions that require the
   debtor to prepay a portion of its indebtedness as determined by an ex-
   cess cash formula. If a debtor fails to meet its payment obligations,
   the lender may accelerate the maturity of the entire debt and proceed
   to remove project assets from the control of the debtor’s managers.
   The required payout obligation, however, removes cash from the
   source project and thereby might also threaten the continuation of that
   project by compelling managers to raise capital anew from the external
   market.

   The investors’ concern with liquidity extends beyond cash reserves
   and cash flows from operations. Managers can fund new ventures by
   selling some of one project’s assets in order to fund another venture.49
   When agency costs are sufficiently high, though, debt contracts tend to
   constrain asset sales outside the ordinary course of the debtor’s busi-
   ness. Some debt covenants further require that the net proceeds from
   asset sales be reinvested in the same project or applied to reduce the
   debt outstanding. Covenants may also inhibit investments in new pro-
   jects by barring mergers or large asset acquisitions. As an alternative
   to selling project assets, however, managers can cross-subsidize pro-
   jects by selling new company stock or borrowing against existing as-
   sets, thereby diluting existing interests in an old venture in order to
   fund a new one. Accordingly, many debt contracts constrain the abil-
   ity of managers to raise new capital in this manner.

46 See Michael C. Jensen, Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers, 75 AM. ECON. REV. 323, 323–24 (1986); René M. Stulz, Managerial Discretion and Optimal Fi-
    nancing Policies, 26 J. FIN. ECON. 3, 3–4 (1990); George G. Triantis, Financial Slack Policy and

47 See Jensen, supra note 46, at 323 (“Payouts to shareholders reduce the resource under man-
    agers’ control, thereby reducing managers’ power . . . .”).

48 See Robert M. Townsend, Optimal Contracts and Competitive Markets with Costly State
   Verification, 21 J. ECON. THEORY 265, 265 (1979). When the initial capital structure has insuffi-
   cient debt to remove free cash flow, a leveraged buyout may rectify the shortfall by raising debt
   levels. See Jensen, supra note 46, at 325–26.

49 Cf. Harry DeAngelo et al., Asset Liquidity, Debt Covenants, and Managerial Discretion in
    Financial Distress: The Collapse of L.A. Gear, 64 J. FIN. ECON. 3, 5, 14–21 (2002) (showing that
    financially constrained debtors can sell current assets, including inventory, in order to continue
    unprofitable operations).
In addition to the contractual constraints described above, the initial choice of project assets also affects the liquidity available to managers. The more specialized the project assets and the greater the private information that managers hold with respect to those assets, the less liquid the assets. Thus, one mechanism for impeding capital reallocation is to require by contract that a project be pursued using assets of high specificity and low liquidity. Managers will find it correspondingly more costly to finance new projects by selling those assets, either directly or indirectly through the issue of new stock or debt claims. Of course, this loss of flexibility is desirable only if agency costs outweigh the foregone switching option.

B. Legal Organizations: Corporate Boundaries

If common control of multiple projects under unified management is desirable, and if contractual constraints on switching have limited effect because of asymmetric information, investors may choose to impede capital movements by placing projects in distinct legal organizations that share common management. The remainder of this Part describes three types of organizations: corporations, security interests (collateral), and trusts. In particular, this section describes how corporate, securities, and debtor-creditor law constrain the movement of capital between corporations, despite their common control by a single agent. Much of the friction caused by organizational boundaries, however, impedes capital movements only if the beneficial owners of each organization — that is, the shareholders of the two corporations or the creditors holding the two security interests — are different to at least some degree, either in identity or in shareholding. From a normative perspective, this requirement seems anomalous if a purpose of organizational boundaries is to constrain capital movements. Alternatively, the requirement may simply reflect a greater concern for conflict between controlling and noncontrolling investors than for managerial agency problems.

If there are economies to be gained from having the same or overlapping managers control two projects, and yet it is efficient to limit the managers’ discretion to reallocate capital over time, the investors may choose to place the projects in separate corporations. Corporate boundaries define a number of legal obligations that impede

50 There are a number of other justifications for the separation of business operations into discrete corporations, some of which may not be in the social interest. For example, many structures incorporate multiple firms in different jurisdictions in order to avoid taxes or regulations. Some commentators also believe that the strategy allows business enterprises to avoid liabilities, particularly to small or nonconsensual creditors. See, e.g., Lynn M. LoPucki, The Death of Liability, 106 YALE L.J. 1, 21 (1996) (“Most large companies consist of numerous corporate entities. Limiting liability — that is, defeating part of it — is the principal reason for creating those entities.”).
boundaries define a number of legal obligations that impede capital movements. This section explores the difference in legal obligations between two projects that are managed within a single firm and two projects that lie in distinct but affiliated corporations subject to common control (such as in a parent and a subsidiary or in two subsidiaries of the same parent).

1. Corporate Law. — Reallocation of capital between affiliates (between parent and subsidiary or between subsidiaries of the same parent) must satisfy procedural and substantive requirements that do not apply to reallocation within a single corporation. Capital movements between affiliates (for example, an interaffiliate loan) are typically related-party transactions because the firms may, for example, have overlapping directors or officers. The intrinsic fairness of the transaction may be challenged by shareholders of either company and reviewed by a court, unless the firms are wholly owned by the same shareholders or one firm is wholly owned by the other.51 Corporate law insulates the transaction from review to some degree if it is ratified by disinterested directors or by the shareholders. In Delaware, ratification shifts the burden of persuasion to the plaintiff shareholder.52 Corporate statutes require that the terms of a transaction between firms with common directors or officers be disclosed.53 In addition, because the interests of the two firms are probably directly adverse, the rules of professional responsibility may require that each corporation be represented by separate counsel.54

In contrast, no separate counsel, disclosure, ratification, or fairness oversight is required for transfers between divisions of a single corporation. Under the general fiduciary duty of care, directors’ decisions regarding such transactions are protected by the business judgment

see James J. White, Corporate Judgment Proofing: A Response to Lynn LoPucki’s The Death of Liability, 107 YALE L.J. 1365, 1391 (1998) (“There may also be organizational virtues in firmly segregating one business from an unrelated business and so more readily identifying and calculating its success and failure.”).

51 In the case of Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971), the parent company used its control over one subsidiary, which it did not wholly own, to cause that subsidiary to enter into an exclusive contract with another, wholly owned subsidiary. See id. at 722–23. The parent subsequently prevented the former subsidiary from suing to enforce the minimum quantity purchase obligation of the contract. The court found that the contract (and its enforcement) involved self-dealing and that the parent had failed to satisfy its burden of showing intrinsic fairness. See id. at 723.

52 See DEL. CODE ANN. tit. 8, § 144(a) (2001); Orman v. Cullman, 794 A.2d 5, 20 (Del. Ch. 2002) (describing shifts in the burden of persuasion presented by transactions involving interested directors); Lewis v. Vogelstein, 699 A.2d 327, 336 (Del. Ch. 1997) (“Delaware law treating shareholder ratification of corporate plans that authorize the granting of stock options to corporate officers . . . appears to hold that informed, non-coerced ratification validates any such plan or grant, unless the plan is wasteful . . . .”); see also N.Y. BUS. CORP. LAW § 713(a) (McKinney 2003).

53 See, e.g., DEL. CODE ANN. tit. 8, § 144(a)(1)–(2); N.Y. BUS. CORP. LAW § 713(1)–(2).

54 See MODEL RULES OF PROF’L CONDUCT R. 1.7(a) & cmt. 7 (1999).
rule. Thus, the cost of capital reallocation is significantly lower within a corporation than across its boundaries. To be sure, a subsidiary can avoid the frictions of a related-party transaction if it pays a dividend to its parent and the parent reinvests in another subsidiary. However, the dividend must be paid to all shareholders of that class, including minority shareholders, and this leakage of capital makes the reallocation more costly than if the transfer were effected between divisions.

The ultra vires doctrine might have reinforced the impediments to capital reallocation by constraining the ability of a corporation to pursue new projects even within its corporate boundaries. Historically, corporate charters were required to specify a corporate purpose, and contracts in pursuit of other purposes were unenforceable against the corporation. However, the current ultra vires doctrine no longer affects the enforcement rights of third parties, and corporate statutes have abandoned the limited-purpose requirement. The statement of a corporate purpose in a charter is therefore essentially a matter of contract between the firm and its shareholders. Shareholders can still enjoin ultra vires transactions or hold management liable for engaging in them. Modern corporations, however, generally draft liberal charter provisions that allow for any lawful purpose, and even if a firm adopts a restricted purpose, the provision can be amended by shareholder vote. Moreover, violations of purpose restrictions are often costly to verify, and investors may therefore forego them in favor of more effective deterrents to opportunistic capital reallocation within the firm, such as debt covenants and security interests.

2. Tax Law. — In some cases, there is an intriguing coincidence of interests between investors and tax authorities. Taxes are assessed on an entity basis, and consequently, tax authorities are not concerned with transfers within a tax entity. They do, however, monitor transfers between tax entities because such transfers may be used to reduce aggregate tax liabilities. As a general rule, a group of affiliates may file a consolidated return for all subsidiaries in which the parent holds at least eighty percent of the stock. If either this threshold is not met or the parent chooses not to consolidate, the prospect of tax review may

---

55 See Sinclair Oil, 280 A.2d at 721.
56 Some commentators argue that this liberalization is inefficient and reveals a race to the bottom in state regulatory competition. See, e.g., Kent Greenfield, Ultra Vires Lives! A Stakeholder Analysis of Corporate Illegality (with Notes on How Corporate Law Could Reinforce International Law Norms), 87 VA. L. REV. 1279, 1311 n.101 (2001) (citing cases that discuss the “race to the top” and the “race to the bottom”). A notable exception to this liberalization is corporations established to purchase assets in a structured finance arrangement, which tend to have a limited purpose specified in their charter. See infra pp. 1141–43.
58 See I.R.C. §§ 1501, 1504(a)(1)–(2) (West 2002).
discourage interaffiliate capital movements. For example, section 482 of the Internal Revenue Code authorizes the IRS to review the sale of assets between affiliates if such action is necessary to prevent the evasion of taxes or to reflect clearly the income of any such organization. If it appears that the sale terms were not made at arm’s length, the IRS may adjust the income of the selling firm and the basis of the buyer. Similarly, under this clear-reflection-of-income standard, the IRS is authorized to adjust the terms of an intercompany loan if those terms do not reflect arm’s-length rates. Therefore, by establishing ventures in separate corporate entities, investors can harness the policing efforts of the IRS to raise the cost of reallocating capital from one corporation to another.

3. Securities Law. — Disclosures mandated by securities laws are important complements to contractual and corporate law requirements because they help investors observe switching activity. Securities laws require public companies to make annual, quarterly, and other periodic filings that include financial information. The federal securities statutes of 1933 and 1934 each give the Securities Exchange Commission the authority to prescribe the accounting standards for financial statements filed under those statutes. The Commission relies on the Financial Accounting Standards Board (FASB) to establish accounting standards used in these financial reports. FASB largely disregards the legal boundaries of corporations in favor of a “reporting entity” approach, under which enterprises comprising majority-owned firms must prepare consolidated accounts. In contrast to separate reporting by distinct legal entities, consolidated statements obscure capital movements between ventures.

59 See id. § 482 (“[T]he Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among [related] organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.”).
60 See id.
64 Compare RELATED PARTY DISCLOSURES, Statement of Financial Accounting Standards No. 57, § 1 (“Transactions between related parties are considered to be related party transactions [and therefore must be disclosed] even though they may not be given accounting recognition. For example, an enterprise may receive services from a related party without charge and not record receipt of the services.”), with id. § 2 (“Disclosure of transactions that are eliminated in the preparation of consolidated or combined financial statements is not required in those statements.”).
FASB requires some disaggregated reporting, but only for significant operating segments. The enterprise must present financial results concerning revenue, expenses, profit, loss, and identifiable assets with respect to each such segment, including revenues from transactions between such segments and allocated portions of interest expenses incurred by the corporation.\textsuperscript{65} The definition of operating segment has qualitative and quantitative thresholds, but does not refer to legal entities.\textsuperscript{66} The FASB standards permit the reporting enterprise to aggregate the results of two segments carrying on similar types of business.\textsuperscript{67} Therefore, the disaggregated disclosure will reveal movements of capital between two significant and distinct project lines that meet the definition of operating segments, irrespective of whether the capital crosses a legal boundary.

Legal entities may nevertheless retain some of their salience in financial reporting in the following sense. The definition of operating segment, as well as the information that must be disclosed for each such entity, is based on the internal organization and reporting practices of each reporting enterprise.\textsuperscript{68} The relevant FASB statement provides:

The method the Board chose for determining what information to report is referred to as the management approach. The management approach is based on the way the management organizes the segments within the enterprise for making operating decisions and assessing performance. Consequently, the segments are evident from the structure of the enterprise’s internal organization, and financial statement preparers should be able to provide the required information in a cost-effective and timely manner.\textsuperscript{69}

The internal practices of corporate groups are likely to call for separate reporting by the executives of each subsidiary, so that this disaggregated information is somewhat more likely to appear in the segment reporting mandated by FASB than similar operations within a single firm.

In sum, overall-fairness review of related-party transactions under corporate law, coupled with the disclosure requirements for these transactions in securities law, improves the ability of investors to discipline and sanction inefficient reallocation of capital between corporate affiliates. Together with the prospect of tax review identified above, these legal rules increase the cost of switching and thereby indiscrimi-


\textsuperscript{66} See id. §§ 10–24.

\textsuperscript{67} See id. § 17.

\textsuperscript{68} See id. §§ 10–15.

\textsuperscript{69} Id. § 4.
nately discourage capital reallocation, whether it is in the manager’s interest alone or in the interest of the enterprise as a whole.

This combination of legal constraints does not always ensure effective policing of asset transfers. Recent corporate scandals have illuminated the ability of managers to move assets between related firms (indeed, even to their personal accounts) without detection. A well-publicized recent example involves the management of Adelphia Communications by the Rigas family, which controlled the company despite owning less than twenty percent of its equity.\footnote{See Robert Frank & Deborah Solomon, \textit{Adelphia and Rigas Family Had a Vast Network of Business Ties}, WALL ST. J., May 24, 2002, at A1. In 2002, several indictments were brought against members of the Rigas family.} The family moved significant amounts of capital among affiliated corporations without seeking the approval of outside directors and without meeting the disclosure requirements of securities laws.\footnote{When these transfers came to light, the board of directors appointed a special committee to investigate the relationship between Adelphia and companies related to the Rigas family. \textit{See Adelphia Communications Corp., Form 8-K: Current Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934} SEC File No. 000-16014, May 24, 2002) [hereinafter \textit{Adelphia 8-K}], \url{http://www.sec.gov/edgar.shtml}.} The Rigases accomplished some of this reallocation through a cash management system that involved many of Adelphia’s affiliates. Each of the system’s members deposited into the system all or some of the cash generated from that member’s operations or loans, and each member was entitled to withdraw funds from the pool for its own expenses, capital expenditures, and debt repayment. Adelphia’s board of directors never approved the structure or operation of the cash management system, and the company’s SEC filings did not fully disclose the system’s operation.\footnote{See id. sec. 5.} A substantial amount of capital — more than that revealed to the directors or to the public — was withdrawn from the system to finance the family-controlled Buffalo Sabres hockey team.\footnote{See Frank & Solomon, supra note 70 (“Cash advances went to the family-controlled Buffalo Sabres hockey team when it was short on cash . . . . The system allegedly worked both ways: If the Sabres made money, for instance, cash would come into Adelphia through [the cash management system].”); \textit{see also} \textit{Adelphia 8-K, supra note 71, sec. 10}.} Adelphia also guaranteed approximately $120 million of the hockey firm’s indebtedness but disclosed only a fraction of this contribution to its board of directors and in its filings with the SEC.\footnote{See Frank & Solomon, supra note 70 (“Adelphia guaranteed about $120 million in loans to recapitalize Niagara Frontier [the Rigases’ limited partnership that controlled the hockey team] and advance money to the team to help subsidize losses. The full extent of the relationship wasn’t disclosed in the company financial filings.”). Niagara Frontier filed a bankruptcy petition under Chapter 11 in January 2003 and listed Adelphia as its largest creditor. \textit{See Thomas Heath, Buffalo Sabres File in Court, WASH. POST, Jan. 14, 2003, at D6.}} In addition, various transactions between the hockey franchise and a cable sports net-
work controlled by Adelphia were neither presented to nor approved by the disinterested directors. 75

In response to Adelphia and other similar high-profile abuses, Congress passed the Sarbanes-Oxley Act of 2002. 76 Pursuant to the Act, the SEC adopted new rules requiring the disclosure of off-balance-sheet arrangements (such as a guarantee in favor of an entity unconsolidated with the registrant) that materially affect the financial condition of a registered issuer. 77 These rules will increase the transparency of cross-subsidization of projects across entity boundaries and, correspondingly, the contrast between inter- and intra-firm reallocations. Even these enhanced disclosure requirements, however, would not have prevented the egregious instances of abuse (such as Adelphia) that snubbed then-existing requirements.

4. Debtor-Creditor Law. — At the core of the Hansmann-Kraakman theory of organizations is the legal rule that limits claims of creditors to assets owned by the debtor. 78 With rare exceptions discussed below, 79 a creditor of corporation A cannot reach the assets in corporation B and is not compelled to share the assets of A with B’s creditors, even if A and B have common ownership and common management. A single entity encompassing projects A and B might diversify the risk of insolvency due to exogenous shocks and seem to thereby lower the default risk borne by creditors. Nevertheless, Hansmann and Kraakman appropriately address agency concerns and suggest that the diversification benefit from an integrated firm is outweighed in some cases by the specialization economies that creditors

75 In yet another example, Adelphia’s cable systems ran commercials at no cost for Eleni Interiors, a furniture firm owned by John Rigas, from which Adelphia also purchased much of its furniture. See Frank & Solomon, supra note 70.


77 The disclosure requirements call for companies to report material off-balance-sheet transactions in a separately captioned section of the management’s discussion of financial condition and results of operations. See 17 C.F.R. § 229.329(a)(4) (2003). Federal regulations define an off-balance-sheet transaction as “any transaction, agreement or other contractual arrangement to which an entity unconsolidated with the registrant is a party, under which the registrant has . . . [a]ny obligation under a guarantee contract . . . [], or [has a] contingent interest in assets transferred to an unconsolidated entity . . . [], or has [a]ny obligation, including a contingent obligation, arising out of a variable interest.” Id. § 229.329(a)(4)(ii)(A)-(D). The new FASB Interpretation No. 45 requires disclosure of liability for the fair value of guarantee obligations incurred by a company. See Guarantor’s Accounting & Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, FASB Interpretation No. 45 (Financial Accounting Standards Bd. 2002).

78 See Hansmann & Kraakman, supra note 1, at 390.

79 See infra p. 1132.
can exploit in monitoring two separate corporations with activity focused in distinct industries.80

Institutional creditors such as banks, however, usually acquire broad expertise in monitoring debtors that cuts across industries. Thus, the specialization economies emphasized by Hansmann and Kraakman are unlikely to play an important role with these lenders. The creditors with industry-specific expertise are more likely to be the smaller trade creditors.81 Yet the interest rate charged by trade creditors is typically invariant with respect to the condition of each borrower, particularly when compared to the pricing of institutional loans. In many cases, therefore, specialization gains in monitoring may not explain the partitioning of assets into separate corporations. Instead, the patterns of institutional debt financing are revealing in a slightly different manner, as highlighted in this Article. Banks often extend loans to finance projects or ventures that are pursued in discrete corporations rather than in integrated conglomerates. However, banks also typically seek guarantees from affiliates — a pattern that is inconsistent with the specialization economies hypothesis. Rather, the more compelling explanation of this pattern is that banks are concerned about the agency problems associated with switching and that corporate boundaries discourage capital reallocation. In many cases, the incentive benefits from removing switching options outweigh the increase in expected bankruptcy costs caused by the loss of diversification.82

In rare cases, a creditor of corporation A might reach the assets of corporation B under legal doctrines that permit courts to disregard corporate boundaries for the benefit of some creditors (such as the doctrines of enterprise liability, instrumentality or agency liability, and piercing the corporate veil). For the creditor of A to reach the assets of B under one of these doctrines, courts generally require that there be evidence of some abuse of the common control of the two corporations, that legal formalities have been ignored, and that corporation A was undercapitalized in light of its actual or expected liabilities.83 The case

80 In Hansmann and Kraakman’s example, some creditors specialize in monitoring an oil refining concern and other creditors specialize in monitoring a hotel operation. See supra p. 1104.

81 Hansmann and Kraakman make this observation when they state that their monitoring specialization thesis is particularly apt for suppliers, lessors, and customers. See Hansmann & Kraakman, supra note 1, at 399–400.

82 Moreover, as Michael Jensen and others have pointed out, a higher risk of insolvency may in fact reduce bankruptcy costs by inducing a more timely economic restructuring of the borrower’s affairs. See Michael C. Jensen, Eclipse of the Public Corporation, HARV. BUS. REV., Sept.–Oct. 1989, at 61, 72–73.

law suggests that courts set aside corporate boundaries to impose liability more frequently against individual shareholders than against affiliated corporations.\(^{84}\)

A bankruptcy court may exercise its general authority under section 105 of the Bankruptcy Code to order a substantive consolidation: it may combine the assets and liabilities of two debtor firms if the affairs of the two firms are so closely intertwined that they lack separate existence or are impracticable to separate.\(^{85}\) Like the corporate law doctrines identified above, however, substantive consolidation is rarely invoked. Because courts respect corporate boundaries in the vast majority of cases, creditors lending to corporation \(A\) would not rely on substantive consolidation in the hope of reaching the assets of corporation \(B\). Therefore, corporate boundaries remain effective in deterring the use of borrowing to cross-finance projects \(A\) and \(B\).

Debtor-creditor law raises another obstacle to interaffiliate capital reallocation in addition to the corporate law impediments discussed in section II.B.1. As noted earlier, the corporate law obstacles do not operate when affiliates have identical beneficial ownership (for example, the case of a parent and a wholly owned subsidiary). In contrast, debtor-creditor law impedes capital movements between entities with different creditors, even if they have the same owners. Under the law of fraudulent transfers in every state, if a firm makes a transfer or incurs an obligation without receiving reasonably equivalent value in exchange and is either insolvent or unreasonably undercapitalized, then the transfer or obligation is fraudulent and may be avoided by creditors of that firm.\(^{86}\) In addition, corporate statutes prohibit undercapitalized firms from paying dividends or making other distributions to shareholders, including intercorporate distributions.\(^{87}\) These laws have no bearing on integrated firms that move capital among divisions, even if the divisions are insolvent. If projects are executed in separate corporations, however, any reallocation at a time of financial distress may violate these rules. Moreover, the timing of these additional constraints on switching is appropriate because financial distress itself intensifies incentive conflicts and blunts many forces that restrain managerial misbehavior.

---


87 See, e.g., DEL. CODE ANN. tit. 8, § 170 (2001).
5. Example: Spinoffs and Carve-Outs vs. Tracking Stocks. — The effect of corporate boundaries on internal capital markets can be demonstrated by comparing three types of recapitalization transactions that create distinct investor interests in a given business operation or division: spinoffs, equity carve-outs, and tracking stocks. All three transactions entail the issuance of a new equity security and share some of the same motivations. But whereas spinoffs and carve-outs each begin with the incorporation of a new entity, tracking stocks track the performance of divisions within an existing corporation. The presence or absence of a separate organization in each case determines the ease with which capital may be reallocated.

In a spinoff, the shares of the new corporation are typically distributed pro rata to the shareholders of the original firm. These shareholders often sell some portion of their stock; when they do, the managers of the original firm are unlikely to retain control of the spun-off firm for long. Without common management, a transfer of capital between the two entities is likely to occur through the external capital market — that is, through a distribution of cash by one firm to its shareholders followed by an offering made by the other firm, or through an arm’s-length transaction between the entities (such as an intercompany loan). Therefore, a spinoff breaks up the internal capital market and divides it into two organizations under separate control. Recent empirical work indicates that spinoffs improve the efficiency of investment by both the spun-off division and the remainder of the original firm. These findings suggest that the removal of switching options may motivate spinoffs.

For example, the new security may attract greater market or analyst attention to an undervalued operation and thereby increase the operation’s market value. Or, as part of a compensation package, the new security may provide more tailored incentives to divisional employees.

There are other motivations that the transactions typically do not share. For example, equity carve-outs are more likely than spinoffs to be used to raise new capital from external markets. Tracking stocks sometimes enjoy tax advantages over spinoffs and sometimes may serve as consideration in the acquisition of a new division when information about the division’s value is asymmetrical. For example, General Motors’ acquisition of EDS in 1984 is said to be the first use of a tracking stock.

Daines and Klausner, however, find that the charters of spinoffs frequently include anti-takeover provisions that entrench the managers appointed by the parent. See Robert Daines & Michael Klausner, Agents Watching Agents: The Governance Structure of Spinoffs 7–11 (n.d.) (unpublished manuscript, on file with the Harvard Law School Library).
In an equity carve-out, the enterprise sells a minority stake in the new corporation in a public offering. Unlike the spinoff, a carve-out permits the managers of the original firm to retain their control over the project in the new entity; both the board of directors and the executives of the two entities typically overlap. This contrast suggests that the carve-out may not yield the improvement in investment efficiency that is observed in spinoffs. Moreover, in a carve-out, the sale of the minority interest creates a pool of cash that may be transferred to a different project. However, the carve-out transaction itself is a public act that draws the attention of investors and may intensify their monitoring activity. The capitalization of the prospective cash flow generated by the carved-out project simplifies the monitoring task; investors can compel the original firm to pay out the proceeds rather than invest them in a different project.

In addition, a carve-out achieves some prospective segregation of capital because the corporate boundaries that divide the two projects impede the flow of capital after the carve-out, although not to the degree effected by separate management (as in a spinoff). Any transaction between the two firms is a related-party transaction and therefore subject to the procedural and substantive restrictions identified earlier: shareholder and independent director ratification, fairness review, and disclosure requirements. As noted above, moreover, corporate and debtor-creditor laws prohibit the carved-out subsidiary from distributing capital to the parent if the subsidiary would be undercapitalized thereafter. The fiduciary obligations of the controlling parent require that a pro rata distribution also be made to the minority shareholders of the subsidiary. This requirement acts as a tax that might deter capital reallocation.

91 Enterprises typically sell no more than twenty percent of their shares in the carve-out in order to preserve the ability to file consolidated tax returns. See id. at 2504.

92 See, e.g., Katherine Schipper & Abbie Smith, A Comparison of Equity Carve-Outs and Seasoned Equity Offerings: Share Price Effects and Corporate Restructuring, 15 J. FIN. ECON. 153, 179 (1986) (finding that in 34 of 48 cases, the president or CEO of the subsidiary was also a manager of the parent and that in 56 of 57 cases, the two firms had at least one overlapping director).

93 This argument also applies to other transactions that break up internal capital markets, notably the granting of collateral to a new secured lender and the securitization of a subset of firm assets. See infra p. 1144.

94 Conversely, an enterprise may facilitate an internal capital market by freezing out minority shareholders and thereby removing the related-party requirements.

95 See Sinclair Oil Corp. v. Levien, 280 A.2d 717, 721–22 (Del. 1971).
When an enterprise issues tracking stock to cover a division, the original management maintains control over the enterprise and its cash flow. Unlike a carve-out or spinoff, the issuance of tracking stock creates no distinct legal entity. Rather, a single board of directors continues to control all divisions, and the tracking stocks carry rights (typically minority rights) to vote for all directors. The liquidation rights of a tracking stock are not limited to the tracked division, but lie against the assets of the entire corporation. The tracking feature is achieved in one or both of the following ways. First, the tracking stock’s share of the entire firm’s liquidation value at dissolution is often a function of the value of the tracked division’s assets or the market value of the tracking stock relative to the firm’s aggregate common stock capitalization. Second, the payment of dividends to holders of tracking stock, while within the discretion of directors, is often capped by the accumulated earnings of the tracked business. Thus, upon the issuance of tracking stock, each class of shareholders is concerned about not only the private benefits extracted by managers, but also the removal of capital from the tracked division. This conflict of interest between classes of shareholders motivates closer monitoring of intracompany transfers (as well as allocations of common assets, liabilities, and expenses) than in a similar company with a single class of common stock. The monitoring task is supported by the SEC requirement that filing corporations present financial data for the tracked division along with the consolidated data.

Corporate law offers little protection to tracking stockholders against opportunistic reallocation of capital between divisions because such movements do not cross legal organizational boundaries. In several recent decisions, Delaware courts have declined to invoke the fiduciary duties necessary to apply a fairness scrutiny to transactions that have disparate impacts on different tracked divisions. Issuers,

---

96 Relative voting rights per share are either fixed at the time of tracking stock issuance or floating based on market capitalization.

97 The SEC staff, however, is concerned that too much segregated data may give a false impression of the degree to which the value of the tracking stock depends on the performance of the tracked division: “While the staff encourages robust disclosure about the registrant’s operating segments, presenting information about the referenced businesses as if distinct from the registrant may confuse investors about the nature of the security.” Accounting Staff Members, Division of Corporate Finance, SEC, Current Accounting and Disclosure Issues (June 30, 2000), at http://www.sec.gov/divisions/corpfin/acctdisc_old.htm.

98 See In re Staples, Inc. S’holders Litig., 792 A.2d 934, 937 (Del. Ch. 2001) (refusing to review the substantive fairness of a reclassification scheme designed to eliminate the company’s tracking stock); Solomon v. Armstrong, 747 A.2d 1098, 1124–29 (Del. Ch. 1999) (dismissing the plaintiffs’ fiduciary duty claims on the grounds that a director’s committee tried to approximate an arm’s-length transaction and that the shareholders ratified the transaction); In re Gen. Motors Class H S’holders Litig., 734 A.2d 611, 616–19 (Del. Ch. 1999) (rejecting duty of care and duty of loyalty claims on the grounds that the shareholders ratified the disputed transactions and that the direc-
however, are aware of the resulting concern among investors in tracking stocks, and they adopt board policies or bylaws that provide for arm’s-length terms in interdivision transactions and in the allocations of general expenses, including interest. Typically, the registration statement filed in connection with the tracking stock offering discloses these policies, and issuers often appoint board committees to monitor compliance. Although the directors and officers might be liable if they violate the policy, tracking stockholders are unlikely to have a remedy under either corporate or securities law if the corporation sub-

99 For example, Sprint has separate tracking stock for its traditional business (FON Group) and its wireless business (PCS Group). Both stocks are listed on the New York Stock Exchange. The registration statement and prospectus filed with respect to the tracking stock offering provides that intersegment transactions must be at arm’s-length terms. For example:

Loans from Sprint or any member of the FON Group to any member of the PCS Group will be made at interest rates and on terms and conditions substantially equivalent to the interest rates and terms and conditions that the PCS Group would be able to obtain from third parties (including the public markets) as a direct or indirect wholly-owned subsidiary of Sprint, but without the benefit of any guaranty by Sprint or any member of the FON Group.


Nevertheless, “some analysts say Sprint’s intracompany transactions and allocation decisions have had the effect of bolstering FON, where revenue is on the decline . . . . [For example,] Sprint says PCS paid FON $672 million last year for various services, including long distance, making it one of FON’s biggest long-distance customers.” Jesse Drucker, Sprint Shows Pitfalls of Investing in Tracking Stocks, WALL ST. J., March 7, 2003, at C1.

100 For example, General Motors’ Class H common stock tracks the performance of its Hughes Electronics business:

The GM by-laws currently provide that the capital stock committee of the GM board is responsible for reviewing the policies and practices of GM with respect to matters in which the two classes of stockholders may have divergent interests, particularly as they relate to . . . the business and financial relationships between GM and any of its units and Hughes . . . .


102 For example, they (as well as the underwriter) might be liable under section 11(a) of the Securities Act of 1933, see 15 U.S.C. § 77k(a) (2000) (imposing liability for a false statement of a material fact in the registration statement), or the issuer might be liable under section 12(a)(2) of the Act, see id. § 77l(a)(2) (imposing liability for a false statement of material fact in the prospectus).
sequently changes its policy and makes the appropriate amendments to its bylaws.103

Part I described the fundamental tradeoff in the assignment of switching options to agents in an internal capital market. It also defined conditions under which investors would be more or less willing to leave capital reallocation decisions in the hands of managers. The goal of this Part is to describe a range of legal instruments that can restrict internal capital markets to varying degrees. Investors can choose among the recapitalizations effected under spinoffs, equity carve-outs, and tracking stocks, each of which provides a decreasing degree of constraint on switching.104 The availability of such a menu of choices highlights the fact that investors prefer different degrees of constraint on managers in different contexts.

D. Legal Organizations: Security Interests in Collateral

1. Secured Transactions and Bankruptcy Law. — Security interests divide internal capital markets within firms. They fall under the category of legal organizations for the purposes of this Article because they impede capital reallocation without the contracting costs that would otherwise be incurred to bind multiple parties. Like corporations, security interests dedicate groups of assets to specific creditors and thereby can achieve the monitoring-specialization economies highlighted in the Hansmann-Kraakman hypothesis.105 Indeed, these monitoring efficiencies served for some time as the leading academic justification for the priority rights of secured credit.106 However, as this section demonstrates, the boundaries of collateral, like those of

103 For example, GM’s registration statement states explicitly that its board policies relating to the dual common stock can be modified or rescinded at any time by the GM Board. GM FORM S-4, supra note 101, at 105. In the very rare case, it is possible that aggrieved tracking shareholders might persuade a court that the initial representation was fraudulent and thereby violated SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (2003).

104 Tracking stocks are sometimes preferred to spinoffs because they preserve internal markets. See Matthew T. Billett & David C. Mauer, Diversification and the Value of Internal Capital Markets: The Case of Tracking Stock, 24 J. BANKING & FIN. 1457, 1464 (2000). Billett and Mauer found a strong positive correlation between tracking stock announcement effects and certain proxies for the value of the firm’s internal capital market. Id. at 1483–85; see also Julia D’Souza & John Jacob, Why Firms Issue Targeted Stock, 56 J. FIN. ECON. 459, 471 (2000) (finding that when tracked divisions are compared to independent firms in the same industries, they show significant dependence on the other divisions of their firms).

105 See Hansmann & Kraakman, supra note 1, at 399–405.

corporations, also serve the significant function of deterring opportunist-ic capital reallocation.107
A firm can shift capital between two projects by liquidating part of one project and reinvesting the proceeds in the other ("cross-subsidization") or by borrowing against the assets of the source project to finance the other ("cross-financing"). Security interests impede both forms of capital reallocation. First, a security interest is a contingent property right in collateral that, as a general rule, follows the asset into the hands of transferees.108 Moreover, the collateral may continue to secure the outstanding debt of the debtor-transferor to the secured party, even to the extent that the indebtedness grows after the transfer. This feature impedes the sale or other disposition of collateral, thereby preventing liquidation of one project and reinvestment in another.109
Sales of inventory collateral are exempt from the general rule, and inventory can be sold free of the security interest in the ordinary course of business.110 Therefore, to restrain the diversion of cash flow in the ordinary course of business, creditors must enforce debt covenants that, for example, compel the segregation or payout of proceeds.111

Second, security interests impede future borrowing against the collateral assets and thereby prevent cross-financing.112 A security interest generally gives the secured creditor a priority claim against the value of the collateral based on a first-in-time, first-in-right principle.113 Therefore, once a firm has granted a security interest in the assets of a project, it can thereafter sell only claims of lower priority against those assets. Moreover, the senior secured claim may extend to indebtedness incurred by the debtor to the secured creditor even after the new junior debt is issued.114 Thus, cross-financing in the face of a prior security interest is costly and often unavailable.115

109 As described earlier, unsecured creditors rely simply on debt covenants to prevent asset sales: their interests do not follow firm assets that are transferred. See supra pp. 1124–25.
110 See U.C.C. § 9-320(a) & cmt. 3 (2000).
111 Various priority provisions in article 9 of the U.C.C. help to coordinate creditor monitoring of cash flow. For example, a secured creditor holds a security interest in proceeds from the sale of collateral, but only if the proceeds are identifiable. See U.C.C. § 9-315(a) (2000); see also Triantis, supra note 107, at 59.
112 Triantis, supra note 107, at 43.
113 See U.C.C. § 9-322 (2000). The security interest generally must be perfected by filing. See id.
114 See U.C.C. §§ 9-204(c), 9-323(a) & cmt. 3 (2000).
115 The constraint imposed by a broad security interest is more effective than a negative pledge covenant prohibiting future secured debt financing because such a covenant is not effective against third parties. A perfected security interest, in contrast, is binding on future creditors.
Security interests and separate corporate entities are alternative organizations that break up internal capital markets. The choice between them is an intriguing and unexplored topic. Suppose a firm has invested in project V1 and seeks a loan to finance a new project V2. The firm wishes to employ an organizational structure that reassures the lender that the managers will not subsequently reallocate capital from V2 to V1. One such structure is project finance: the managers can establish a new firm to hold project V2. The obstacles described in section II.A impede the movement of capital between projects, even if firm V1 controls firm V2. An alternative is for the lender to take a security interest over all assets in project V2, so that the property and priority right associated with that security interest will impede capital reallocation. If project V1 is also financed by secured credit, the movement of capital in the opposite direction will be similarly constrained.

As emphasized in Part I, the decision to impede capital reallocation by separating diverse projects into legal organizations has a disadvantage: it compromises switching options. The creation of a legal organization entails transaction costs, and so does its dismantling. As a result, there is a stickiness in the decision to discourage capital movements between projects. Bankruptcy law plays an interesting

116 Drafters of negative pledge clauses in debt contracts recognize that priority may be effectively given to a new creditor or even a preferred shareholder by transferring firm assets to a subsidiary that then issues new debt or preferred stock. See AM. BAR FOUND., COMMENTARIES ON INDENTURES 357, 387–89 (1971).
117 Some borrowers give their principal institutional lender a broad first-in-time security interest over classes of assets (such as inventory, receivables, and equipment) that cut across their various projects. The priority of the security interest also typically attaches to new assets in these classes as they are acquired subsequently by the debtor. See U.C.C. §§ 9-324(a), 9-322(1) & cmt. 5 (2000). This blanket security yields important screening and monitoring efficiencies. See generally Robert E. Scott, A Relational Theory of Secured Financing, 86 COLUM. L. REV. 901 (1986) (advancing a prospect theory of blanket security interests). A disadvantage of this blanket security, however, is that it not only prevents cross-financing, but also impedes the financing of new projects even through fresh outside financing (the “overhang” problem). A new investor who finances the acquisition of new project assets is subordinate to the holder of the earlier after-acquired property interest.

The law of secured transactions, however, has a well-known exception to the first-in-time priority rule for purchase money secured credit. See U.C.C. § 9-324 & cmt. 2 (2000). This purchase money security priority extends only to the acquired asset. It is junior to earlier secured claims in other assets and therefore does not enable cross-financing of the new asset. See id. §§ 9-324(a), 9-322(1). The purchase money security priority provision has two principal weaknesses. First, it is too narrowly specified to enable the financing of operating expenses such as wages or utility bills. Second, the purchase money creditor has a claim against the other assets, albeit subordinate to earlier security interests in those assets. The first weakness is somewhat mitigated by the discretion of the bankruptcy court to loosen the constraints on internal and external financing. See Triantis, supra note 107, at 55–59.

118 This problem is distinct from the underinvestment or debt overhang obstacle to financing, which is an obstacle to external finance and can exist even in a single-project firm. See generally Myers, supra note 15 (explaining corporate debt policy); George G. Triantis, A Theory of the Regu-
role in loosening the constraints of security interests once the bankruptcy court assumes a role in policing managerial decisions.\textsuperscript{119} During bankruptcy, for example, the debtor can authorize the sale of a collateral asset free of its security interest if the sale price is higher than the amount of the secured indebtedness at that time.\textsuperscript{120} Thus, the firm can cross-subsidize by liquidating collateral when the security interest in question is oversecured.

Outside bankruptcy, moreover, the priority of a secured creditor extends to identifiable cash and to noncash proceeds from the disposition of collateral, whether or not the disposition is a sale in the ordinary course of business.\textsuperscript{121} The secured creditor thereby has the leverage to prevent the reallocation of proceeds to a different project. In bankruptcy, however, the court can authorize the use of cash collateral from one project to finance capital investment in another project.\textsuperscript{122}

As noted above, the first-in-time priority of security interests impedes the debtor’s ability to cross-finance one project by borrowing against the assets of another project. In bankruptcy, however, the court can authorize new financing (“debtor-in-possession financing”) with priority in existing assets that is senior to prebankruptcy security interests, provided that the “primed” prebankruptcy interests are adequately protected.\textsuperscript{123} Adequate protection can be provided by a replacement lien in assets used in another project operated by the firm, as long as the court is satisfied that the value of the replacement lien is equivalent to the loss inflicted on the primed secured party by the new priority financing.\textsuperscript{124} Bankruptcy courts also find adequate protection when the proposed venture will add sufficient value to the collateral assets so that the primed creditor is no worse off, despite being subor-

\textsuperscript{119} The effect of bankruptcy on the rights of secured creditors has been summarized, analyzed, and criticized in many fora. A number of significant changes to these rights are unrelated to the internal capital market thesis: during a bankruptcy case, for example, the enforcement rights of secured creditors are subject to the automatic stay, and interest does not accrue on secured debt unless there is equity in the collateral. See 11 U.S.C. §§ 362, 506(b) (2000); United Sav. Ass’n of Tex. v. Timbers of Inwood Forest Assocs., 484 U.S. 365 (1988) (holding that an undersecured creditor is not entitled to interest on its collateral during the automatic stay). This Article focuses instead on the subset of these changes that loosen restrictions on capital reallocation within the debtor enterprise.

\textsuperscript{120} See 11 U.S.C. § 363(f)(3).

\textsuperscript{121} See U.C.C. § 9-315(a)(2), (d)(2) & cmts. 3, 7 (2000).

\textsuperscript{122} See id. § 363(b)(1), (b)(2)(B).

\textsuperscript{123} See id. § 364(d)(11). Bankruptcy law also facilitates new debt financing by preventing after-acquired property clauses from reaching assets acquired after the initiation of bankruptcy, and by authorizing courts to prevent such clauses from extending to value added to prebankruptcy assets during bankruptcy. See id. § 552.

\textsuperscript{124} See id. § 361(2).
This adequate-protection requirement essentially vests in the court the authority to determine whether the proposed new financing is likely to increase the value of the debtor. If the court concludes that a new project is profitable, debtor-in-possession financing facilitates the cross-financing of projects. Thus, the bankruptcy provisions for cash-collateral use and for debtor-in-possession financing loosen the constraint of security interests on internal capital markets. They leave reallocation discretion largely in the hands of the bankruptcy court rather than with the firm’s managers. The bankruptcy court occupies a position analogous to the intermediaries described in section II.A: it is not as well-informed as the managers but is better informed than the external investors. In addition, the court is arguably less susceptible to pursuing private benefits than are the agents of those intermediaries.

2. Structured Finance and Securitization. — Structured finance evolved primarily to address the dilution of secured creditor rights in bankruptcy. The core of a structured finance transaction is the sale of rights to future cash flows (typically in the form of receivables) by a firm (the originator) to a new entity (a special purpose entity, or SPE). The SPE is set up to be “bankruptcy remote”—that is, un-

---

125 If the court is concerned about the adequacy of its information, it may prefer to authorize project financing alone and thereby limit cross-subsidization. See Triantis, supra note 46, at 67–68.

126 Legal scholars and practitioners do not view the bankruptcy treatment of security interests through the lens of the internal capital markets thesis. The automatic stay on secured credit enforcement rights and the denial of interest accrual on undersecured claims during bankruptcy alter significantly the prebankruptcy rights of secured creditors. Proponents of these provisions argue that they promote the rehabilitation of the debtor or that they spread the debtor’s losses somewhat more evenly among creditors. In contrast, the focus of this Article is not the impact of bankruptcy on the value of a security interest, but rather its effect on capital movement among projects within the debtor. The provisions for automatic stay and denial of interest accrual on undersecured claims are less relevant in this respect than provisions governing the use of cash collateral and debtor-in-possession financing.

127 In structured finance practice, the term “future cash flows” often refers to the securitization of accounts expected from future performance. Two prominent examples are the securitization of future flow receivables by Pemex, Mexico’s state-owned oil and gas company, and by Telmex, Mexico’s telephone company. See Suhas Ketkar & Dilip Ratha, Securitization of Future Flow Receivables: A Useful Tool for Developing Countries, FIN. & DEV., Mar. 2001, at 46, available at http://www.imf.org/external/pubs/ft/fandd/2001/03/ketkar.htm. This Article uses the term expansively to include any set of future cash flows.

128 One example of such a transaction is the securitization of automobile receivables. The receivables are typically sold by the finance subsidiary of the automobile manufacturer to a corporate SPE, and then resold to a trust that issues securities to the public. The finance subsidiary retains a part of the residual interest in the trust and often enters into an agreement with the trust to service the receivables. For a recent example, see HONDA AUTO RECEIVABLES 2003-1 OWNER TRUST, PROSPECTUS SUPPLEMENT PURSUANT TO RULE 424(B)(5) (SEC File No. 333-71022, Feb. 24, 2003), http://www.sec.gov/edgar.shtml. Less frequently, firms securitize their inventory; for example, Marne & Champagne SA (the world’s second largest producer of champagne) recently securitized its inventory of champagne at various stages of production. See Silvia Ascarielli & Michael R. Sese, Europe’s Boom in Securitized Debt Goes Far Beyond Mortgages and
able to file for bankruptcy and unaffected by any bankruptcy proceeding involving the originator. Typically, the SPE resells the assets to a trust (usually a common law trust) that in turn issues securities to public investors. The originator often holds a residual interest in the trust in order to provide credit support for the public offering. The second sale is not relevant to achieving bankruptcy remoteness, but rather it is intended to exploit the tax and governance advantages of the trust form.

Bankruptcy remoteness hinges on the integrity of the transfer from the originator to the SPE; in particular, the originating firm must not retain an interest in or control rights over the asset. In many cases, however, the originator holds an interest in the SPE because, for example, it can thereby vouch for the quality of the assets. It is important, therefore, that the SPE be a distinct legal entity so that, as a matter of law, the originator’s interest lies in the entity rather than in the transferred assets. To this end, the SPE is usually a corporation, but it might also be a limited liability company or a statutory business trust. A common law trust is unlikely to achieve this goal because bankruptcy courts traditionally have not recognized trusts as separate legal entities when debtors retain interests in them. In addition, the

Credit Cards, WALL ST. J., Jan. 18, 2000, at A23. Other examples include the securitization of buildings and power plants. Lynn LoPucki quotes practitioners who suggest that any income-producing asset is open to being securitized. See LoPucki, supra note 50, at 25.

129 The securities issued by the common law trust ("trust certificates") are essentially fixed claims, even though they are treated as equity for corporate purposes.

130 The originator also typically enters into a contract to service the securitized assets (for example, to monitor the payment of receivables and to report to the trustee).

131 The trust enables investors to avoid entity-level taxes. See Steven L. Schwarz, Commercial Trusts as Business Organizations: Unraveling the Mystery, 58 BUS. LAW. 559, 581 & n.148 (2003). In addition, the trust can sidestep certain corporate governance requirements, such as elections for directors. Schwarz explains another advantage of the trust:

[D]irectors of a corporate-SPE] would owe their primary fiduciary duty to residual claimants (shareholders) and not to the creditors who invest in the [SPE]. Where the [SPE] is a trust, however, the trustee cannot (under the duty of impartiality) favor the residual claimant (settlor) over investors, absent explicit agreement to that effect.

Id. at 583 (emphasis omitted) (footnote omitted).


133 For a definition of statutory trust under Delaware law, see DEL. CODE ANN. tit. 12, § 3801 (1997).

134 Steven Schwarz expresses some doubt that bankruptcy courts will uphold state statutes that treat statutory trusts as separate legal entities. See Schwarz, supra note 131, at 582 n.150. Schwarz writes:

Even in states such as Delaware that have legislation specifically permitting a settlor to retain a residual interest without undermining the integrity of the trust, there is little authority — given that federal bankruptcy law policy disfavors bankruptcy remoteness
originator and SPE must observe the formalities of two separate entities to avoid substantive consolidation in bankruptcy. The sale agreement and the securities issued by SPEs commonly include covenants barring the commingling of assets with the original firm, prohibiting guarantees, and requiring that all transactions between the entities be at arm’s length, in order to minimize the risk of consolidation.\footnote{Moreover, the provisions of the SPE charter themselves set conditions that make bankruptcy filing unlikely.}

The primary motivation of structured finance is to capitalize future cash flows in order to distribute cash to the originator’s creditors or shareholders (for example, to retire outstanding debt) or to finance new investments.\footnote{Other motivations include improving the debt-to-equity ratio of the principal company’s balance sheet.} As noted above, structured finance is preferable to secured lending because bankruptcy law interferes with security interests but respects transfers to separate legal entities. In addition, the Hansmann-Kraakman theory suggests that segregating the securitized assets from the operating assets retained by the originator may result in efficiency gains from specialized screening or monitoring.\footnote{See supra p. 1104.} Hansmann and Kraakman might also argue that bankruptcy remoteness shields the investors in the new securities from the business risks of the originator and thereby permits them to focus their screening and monitoring expertise on the securitized assets. In contrast, the internal capital markets theory focuses on the efficiencies of impeding the movement of capital between the SPE and the principal company. Structured finance uses a distinct legal entity to neutralize the reallocation discretion of bankruptcy courts. It therefore bears a stronger resemblance to a spinoff than to secured lending. Whereas spinoffs involve the transfer of entire projects to new firms, structured finance entails the sale of a subset of a project’s assets to the new SPE.

Of course, the structured finance transaction itself may facilitate the reallocation of capital if the proceeds from the sale of securitized assets from one project are invested in a different venture. The originator, however, may have previously committed in a debt covenant to distribute the proceeds to creditors. Moreover, as noted earlier in the case of an equity carve-out, the structured finance transaction is a public act that triggers closer scrutiny of the use of proceeds — that is, whether they are distributed to investors, applied to refinance outstanding obligations, or invested in new projects.\footnote{See supra p. 1134.} Structured finance effectively replaces the project manager’s control over a stream

\[\text{id. at 582 (footnote omitted).}\]
of proceeds with a single lump sum received at the time of the securitization transaction, thereby simplifying the investors’ task of monitoring the use of such proceeds.\footnote{Edward M. Iacobucci & Ralph A. Winter, Asset Securitization and Asymmetric Information 34–37 (Feb. 2003) (unpublished manuscript, on file with the Harvard Law School Library), available at http://www.law.northwestern.edu/mainpages/curriculum/colloquium/Iacobucci.pdf.}

E. Legal Organizations: Trusts

Until recently, the duty of loyalty of trustees was significantly more strict than the corresponding duty of corporate directors; as such, trusts could have served as more effective barriers to capital movements than corporations. If the assets of V\textsubscript{1} were held by its manager in trust and the same manager controlled V\textsubscript{2} outside the trust (for example, in a corporation), the duty of loyalty would have prohibited transactions between the two organizations, including sales of assets or loans.\footnote{See UNIF. TRUSTS ACT § 6, 7 U.L.A. 777 (1985) (“No trustee shall as trustee of one trust sell property to itself as trustee of another trust.”); RESTATEMENT (SECOND) OF TRUSTS § 170 (1959); G. B. BOGERT & G. T. BOGERT, THE LAW OF TRUSTS AND TRUSTEES § 543 (2d ed. 1993); A. W. SCOTT & W. F. FRATCHER, THE LAW OF TRUSTS §§ 170.10–170.16 (1987). In addition, the trustee’s duty of loyalty required that the assets of the two entities be kept strictly separate. See id. § 179.2. As part of the general relaxation of the duty of trustees, the Uniform Trust Code provides that “[i]f the trustee maintains records clearly indicating the respective interests, a trustee may invest as a whole the property of two or more separate trusts.” UNIF. TRUST CODE § 810(d), 7C U.L.A. 208 (Supp. 2000).} The beneficiaries of the trust could have rescinded such transactions and recovered any transferred property, as well as any profits earned by the transferee from the property.\footnote{See BOGERT & BOGERT, supra note 140, §§ 543, 543(J); SCOTT & FRATCHER, supra note 140, § 206.} Trust law, however, has followed corporate law in softening the duty of loyalty, and the trustee’s duty no longer seems to prohibit related-party transactions. The recently drafted Uniform Trust Code, for example, provides that a transaction between a trust and an affiliate of its trustee is presumptively voidable, rather than void per se. The presumption may be rebutted by proof that the transaction was fair and on terms that approximate those that would have been present in an arm’s-length transaction.\footnote{See UNIF. TRUST CODE § 802(a), (c) & cmt., 7C U.L.A. 201 (Supp. 2000). Moreover, the transaction can be ratified by the beneficiaries. See id. § 802(a)(4).} Thus, although trusts are not uncommon in corporate finance transactions such as structured finance,\footnote{See generally John Langbein, The Secret Life of the Trust: The Trust as an Instrument of Commerce, 107 YALE L.J. 165 (1997).} they currently provide no asset-partitioning advantage over corporations. Moreover, as noted in the previous section, their boundaries may be further compromised by the risk that their separate existence will not be fully vindicated in bankruptcy.
III. CHARITABLE ORGANIZATIONS

A. Switching Options in Charities

Like the commercial sector, the charitable sector faces a tradeoff between realizing the value of switching options and incurring the agency costs of managerial control over those options.144 Whereas an investor in the commercial sector seeks a financial return, the charitable donor often pursues a philanthropic return in the improved welfare of others.145 This idiosyncratic philanthropic return may be enhanced by the ability to reallocate funds among charitable ventures as conditions change. Given that financial returns also fluctuate, there may also be valuable opportunities to shift capital between charitable and commercial projects. Like investors, donors must decide how much flexibility to delegate to their agents, the charitable managers. Several unique features characterize charitable enterprises and lead to new insights about the role of legal organizations in defining the boundaries of internal capital markets.

Two defining features of a charitable organization are tax-based: donors may generally claim a deduction for their charitable contributions to the entity,146 and the entity is exempt from federal income tax on income from passive financial investments.147 These tax concessions encourage accelerated contributions to charitable organizations instead of a steady stream of staged funding because accelerated contributions increase the donor’s eventual post-tax charitable bang for her buck.148 Moreover, the timing of urgent charitable needs and of charitable contributions often do not coincide: donations vary with factors unrelated to, and even negatively correlated with, charitable need. During economic recessions, for example, the needs of the poor for

144 This Part generally addresses charitable organizations that qualify for exemption from federal income tax under I.R.C. § 501(c)(3)—that is, they are organized and operated exclusively for one or more charitable purposes, and none of their earnings may inure to private shareholders or other designated individuals. See Treas. Reg. § 1.501(c)(3)-1 (2003). An organization pursuing other specified purposes, including religious, educational, and literary purposes, may also qualify for this exemption. See, e.g., id. § 1.501(d)-1 (exempting religious or apostolic organizations that meet certain specified conditions). However, this discussion is limited to organizations pursuing charitable or educational purposes.

145 There are clearly selfish motivations for charitable contributions. See, e.g., Amihai Glazer & Kai A. Konrad, A Signaling Explanation for Charity, 86 AM. ECON. REV. 1019, 1019 (1996) (considering the “desire to demonstrate wealth” as an additional motive for charitable giving). This Article, however, uses the general notion of a philanthropic return to keep the ensuing discussion simple.


147 See I.R.C. § 501(a), (c)(3) (West 2002); cf. id. § 501(b).

148 As discussed below, several types of institutions (notably charitable foundations) serve the valuable function of intermediaries that take lump-sum donations from donors and provide staged financing to operating charities. See infra section III.C.2, pp. 1158–60.
food, shelter, and health care intensify. At the same time, however, the supply of charitable contributions falls with the wealth, income, and tax brackets of prospective donors. In light of this tendency for donations to come in lump sums, at times of relatively low charitable need, and in the face of substantial private information held by charitable managers, donors might be tempted to delegate substantial reallocation authority to those managers.

The means for moving capital within a charitable organization are more limited than in a commercial (that is, for-profit) corporation because charitable assets typically do not generate significant cash flows that can be diverted. Nevertheless, a charitable organization might finance a new venture internally by redeploying user fees or donations, liquidating assets, or borrowing against charitable assets or anticipated future donations. Subject to the restrictions described below, charities may place donated funds in financial securities (loosely referred to as an “endowment”\footnote{FASB rules divide charities’ liquid assets into three categories: pure endowment (restricted by the donors), quasi-endowment (restricted by the charity’s nonbinding dedication), and current funds (unrestricted). Evelyn Brody, \textit{Charitable Endowments and the Democratization of Dynasty}, 39 \textit{Ariz. L. Rev.} 873, 885 (1997); \textit{see also id. at} 884 n. 56, 885 n. 59.} to preserve their flexibility to defer the allocation of charitable investment to a later time when additional information becomes available. The management of the size of a charity’s endowment may be thought of as the timing of charitable investment or, more fittingly for this Article, the dynamic allocation of capital between the charitable and commercial sectors. At least in theory, a charitable manager might keep some capital in commercial investments indefinitely.

Internal capital markets facilitate switching capital allocations in charitable organizations for the same reason that they do in the commercial sector: internal markets exploit the private information and expertise of their managers. Indeed, information concerning the social benefits of charitable work tends to be softer and less observable than commercial values or profits. Therefore, information asymmetry is a greater obstacle to external finance in the charitable sector than it is in the commercial sector — that is, it is more difficult for charitable agents than for commercial managers to share information about their opportunities with potential donors or investors. A pressing charitable need sometimes arises too quickly or is too complex to communicate to prospective donors in a timely fashion. Although the need might eventually generate large donative support, the fact that the relevant information is unobservable in the immediate term may prevent the charity from receiving donations at the time when they are most valuable.
Like commercial investors, however, donors should be cautious in granting discretion over capital allocation to managers. The donors’ interests in switching among charitable and commercial alternatives may diverge from those of their agents, who may exercise investment flexibility in order to maximize their private benefits, including their own philanthropic returns. The same private information held by charitable managers that leads donors to think about delegating allocation authority to them also makes agency problems less tractable in the charitable sector than in the commercial sector because the information asymmetry impedes attempts to monitor performance and to structure appropriate compensation incentives. Although a manager’s desire to attract future donations provides some incentive for her to avoid any action that would tarnish her reputation, information asymmetry limits the impact of this external discipline as well.

Agency conflicts vary depending on the size of the organization and the scope of the philanthropic goal. Small charities are financed primarily by a few donors who sit on the board and exercise control by threatening to withhold future donations. Agency conflicts are relatively mild in these cases. Larger organizations achieve economies of scale and pool funds from donors seeking to diversify their charitable portfolios. A large number of donors, however, may raise either of two coordination problems. On the one hand, donors with small stakes are likely to exhibit the same passivity in governance as their counterparts in commercial corporations. On the other hand, unlike the homogeneous interests of stockholders, the philanthropic motives of donors differ somewhat from each other, and this heterogeneity multiplies the axes of agency conflict. Thus, any given donor should be concerned about whether other donors will exercise any effort to discipline the charitable managers and, if so, whether that effort will promote a charitable objective at odds with her own philanthropic goals.

150 One study found that 40% of 700,000 public charities have annual budgets of less than $100,000. See John A. Byrne, The New Face of Philanthropy, BUS. WK., Dec. 2, 2002, at 82, 92.

151 To the degree they are motivated by philanthropic goals, donors might perceive diminishing philanthropic returns from contributing to a single charitable cause. See, e.g., BEN WHITAKER, THE FOUNDATIONS: AN ANATOMY OF PHILANTHROPY AND SOCIETY 170 (1974) (quoting a Ford Foundation manager as saying that “an additional dollar plowed into an undercultivated field of second importance may have greater yield than the same dollar applied to an overcultivated field of first importance”). For the perception to be accurate, however, the charity must be operating in the vicinity of diminishing marginal social returns. To the degree the donor is instead pursuing nonphilanthropic objectives (for example, social recognition), the strategy of giving to a range of charities seems appropriate.

charity will seek new capital exacerbates the donor’s concern about drift in the charity’s mission.

Not surprisingly, donors to charitable organizations enjoy virtually none of the formal governance rights afforded commercial investors. Shareholders have the right to vote for a board of directors and to enforce the fiduciary duties the directors owe the firm, and creditors have the right to remove assets from the firm upon default. Charitable corporations, however, rarely assign voting rights to their donors because voting is a poor method for aggregating donor preferences. Instead, a small number of donors are appointed to the boards of these organizations. Although these board members are often the largest donors, their interests are more likely to diverge from those of other donors than are the interests of corporate directors representing shareholders of commercial firms. Moreover, charitable managers can develop close relationships with their board members because, unlike the board members of commercial firms, the board members of charitable organizations are not disciplined by the risk of being voted off the board or by the threat of hostile takeover. Donors who are not on the board lack standing to enforce the fiduciary duties of board trustees; standing is instead confined by law to the state’s attorney general.

Public resource constraints, however, have limited the enforcement activity of attorneys general to the most egregious and most publicized cases of misbehavior. The resulting weakness in governance is the subject of considerable academic concern.

The argument for constraining reallocations of capital is stronger in the charitable sector than in the commercial sector. Part I suggested that investors should constrain their agent’s discretion over switching options when the payoff distributions of the different projects are posi-

---

153 *Cf. Henry Hansmann, The Ownership of Enterprise* 289 (1996) (noting that when interests are heterogeneous in a firm, “it is common to encounter devices designed to attenuate rather than increase the refinement and force with which electoral mechanisms convey the interests of the individual owners”).

154 In many charities, a small subset of donors contributes the bulk of donated capital. For example, Shulman and Bowen found that five percent of the alumni of any given graduating class gave between one-half and three-quarters of the total unrestricted contributions to universities in their sample (with the concentration depending on the number of years since graduation). *See James L. Shulman & William G. Bowen, The Game of Life: College Sports and Educational Values* 216 (2001).

155 This restriction, founded in the law of charitable trusts, applies to charities organized as nonprofit corporations under the legislation of most states. *See Bogert & Bogert, supra* note 140, §§ 411, 414. As noted below, donors may lack standing to enforce even the conditions of their own gifts. *See infra* note 162.

tively correlated with each other (that is, when the value of the switching option is low) and when investor returns and private benefits to the agent are negatively correlated (that is, when agency costs are high). The social payoffs of different charitable projects are more likely to be positively correlated with each other than are the financial payoffs of different commercial investments because the social payoffs of charitable ventures tend to track macroeconomic cycles. At the same time, large information asymmetries and the heterogeneity of donor preferences hinder the disciplining of managers. Therefore, agency costs tend to be higher in charities than in commercial organizations and are more likely to outweigh the limited value of charitable switching options.

Given these conditions, one would expect the obstacles to capital reallocation to be greater in the charitable sector than in the commercial sector. Part II catalogues a range of impediments to capital reallocation, from contractual prohibitions to external intermediaries to organizational boundaries. The legal organizations typically used in the commercial sphere — notably, corporations and security interests — hinder reallocation but nevertheless allow some capital movement. Charities rely on trust principles to partition assets more severely.

Charities may be established as charitable trusts or as nonprofit corporations. Nonprofit corporate statutes bear a strong resemblance to for-profit corporate statutes, notwithstanding the historical roots of charity regulation in trust law. For example, the self-dealing provisions for nonprofits are generally those of corporate law rather than traditional trust law: they permit such transactions but subject them to a fairness review. And like commercial corporations, charitable corporations may have broad statements of purpose in their charters. Indeed, there may be good reasons for the existence of organizations that pursue multiple charitable purposes. A broad organization may be justified by economies of scope in pursuing related charitable projects that are not readily realized by contracts between corporations. A charity may have specific information about a community that enables it to provide food, clothing, education, and health care efficiently to the same beneficiaries. This information may not be as effectively transmitted between even well-meaning separate organizations. Similarly, there may be organizational or administrative economies in multipurpose charities. Therefore, it may be desirable to partition projects within a charitable organization, rather than between separate charitable corporations.

Trust principles operate within the organization to impede reallocation between projects. If a donor restricts the use of her contribution

157 HANSMANN, supra note 153, at 567.
to a specific purpose, the charity may not reallocate the funds to a different purpose. Moreover, the charity cannot borrow against assets acquired with restricted funds in order to finance a different project. A donor may also impose a restriction on the timing of the charitable investment by requiring, for example, that the charity spend the funds in the current period or defer a specified portion to subsequent periods.

The next two sections examine in greater detail these restrictions on managerial discretion over the allocation of capital among charitable causes, as well as between the commercial and charitable sectors.

In sum, charitable donors and commercial investors face a similar agency tradeoff. Donors can either stage their contributions and defer the tax benefits to be gained from charitable contributions, or they can donate all of their capital up front and surrender flexibility by making a restricted donation or by delegating discretion to the charity manager. The recent emergence and growth of private foundations offer an attractive alternative: an immediate tax benefit and the delegation of discretion to an intermediary (the foundation). The analogue in the for-profit sector, of course, is the financial intermediary, such as a bank or venture capital fund. The last section of this Part discusses the important role of intermediaries in the charitable sector.

B. Legal Constraints on Flexibility

As noted above, a charitable manager might have investment discretion across two dimensions: allocations among charitable projects and allocations between commercial and charitable projects (or the allocation of charitable investment over time). The donor determines the scope of the manager’s discretion in each respect. For example, a donor may condition her contribution on the immediate investment of the donated funds in a specific charitable cause. Or she may specify the maximum amount that can be spent each year on the cause, leaving the remainder in endowment until the following year. In either case, the manager’s allocation discretion is severely limited. Alternatively, the donor may make an unrestricted gift to an organization. In this case, the manager has the discretion to keep the capital invested in the commercial sector (in the endowment) and to hold an option to switch the capital to a charitable cause of her choosing at the time of her choosing.

The controversy over the Red Cross’s allocation of the Red Cross Liberty Fund for victims of the 9/11 attack on the World Trade Center provides a useful illustration. The solicitation drive for the Liberty Fund was much more fruitful than anticipated, and the Red Cross attempted to place some of the funds into a reserve for future crises.
Public outrage forced the organization’s president to resign and the agency to retract its plan.\textsuperscript{158} A year after the attack, a poll found that twenty-nine percent of Americans surveyed were less likely to donate to any charity because of the attempted diversion of donations dedicated to 9/11 relief efforts.\textsuperscript{159} Although the losses inflicted by the World Trade Center attack were public information, it is plausible that some donors would have given to other causes if they had known how much the Red Cross Liberty Fund and other similar funds would raise. Yet because the decisions of donors to large charities are typically uncoordinated, donors do not know how much other donors will contribute to the same purpose. Thus, the Red Cross may well have had benign motivations to help coordinate donations, to hold funds in financial securities yielding tax-free returns, and to build reserves that could be used for future needs, particularly those less transparent to the public than 9/11. Although reserves provide charities with flexibility to avoid the informational problem of external funding, they raise significant agency concerns when they lie within the discretion of charitable managers. One commentator described the Red Cross controversy as follows: “What the [Red Cross] had forgotten . . . was American charity’s ‘just-in-time’ tradition: Keep a very low inventory; go with all the resources you have right now; when the next emergency hits, call upon the American people once again.”\textsuperscript{160}

1. Allocation Among Charitable Purposes. — A donor can restrict her gift to a single purpose within the range of purposes authorized by the charter of the charitable corporation. The courts of various states differ in their formal categorization of such restricted gifts. Some identify them as transfers with a condition subsequent to the corporation, while others identify them as separate charitable trusts of which the corporation acts as trustee. Both forms draw on charitable trust principles to impose on the charity’s board a fiduciary duty of loyalty to use the gift for the purpose specified by the donor. The Reporter’s comment to section 348 of the Second Restatement of Trusts states: “Where property is given to a charitable corporation and it is directed by the terms of the gift to devote the property to a particular one of its purposes, it is under a duty, enforceable at the suit of the Attorney General, to devote the property to that purpose.”\textsuperscript{161}

\textsuperscript{158} See Reynold Levy, It's Hard To Be Charitable About This Breach of Trust, WASH. POST, Dec. 9, 2001, at B2.
\textsuperscript{159} The poll was conducted by Harris Interactive for The Chronicle of Philanthropy. See Thomas A. Fogarty & Sandra Block, Climate for Giving Has Been Chilly This Year, USA TODAY, Dec. 23, 2002, at 1A.
\textsuperscript{160} Marvin Olasky, Charity Doesn't Have To Mean Bureaucracy, WALL ST. J., Nov. 21, 2001, at A14.
\textsuperscript{161} RESTATEMENT (SECOND) OF TRUSTS, supra note 140, § 348 cmt. f. The Restatement also states:
Unless donors are on the board of the charity, however, they may not sue to enforce the restrictions attached to their donation and must rely on the state attorney general’s initiative.\textsuperscript{162} A donor, therefore, may be tempted to mimic commercial debt acceleration rights by specifying a right of reversion that is triggered by the violation of a condition of the gift. However, such a provision would jeopardize the tax deductibility of the charitable contribution if the IRS were to find a greater than negligible probability of reversion.\textsuperscript{163} Despite the low probability of legal enforcement, charitable trustees and directors take restrictions seriously, perhaps because of the severity of the legal\textsuperscript{164} and extralegal (principally reputational) sanctions for breach.

Thus, trust principles impose relatively tight boundaries within the charitable corporation that prevent the manager from diverting restricted funds to a different purpose. The same partitioning also prevents the charity from borrowing against the assets of one project to finance another. Bankruptcy law provides that assets held by a debtor in trust are excluded from the debtor’s estate, belong to the trust beneficiaries, and are therefore beyond the reach of the debtor’s general creditors.\textsuperscript{165} Applying the same trust principles to restricted gifts,

Where property is given to a charitable corporation, particularly where restrictions are imposed by the donor, it is sometimes said by the courts that a charitable trust is created and that the corporation is a trustee. It is sometimes said, however, that a charitable trust is not created. This is a mere matter of terminology. The important question is whether and to what extent the principles and rules applicable to charitable trusts are applicable to charitable corporations.

Ordinarily the principles and rules applicable to charitable trusts are applicable to charitable corporations.

\textit{Id.}\textsuperscript{162} Even if the charity reneges on a promise to devote funds to a certain purpose, the donor lacks standing to enforce the charity’s promise or receive restitution. \textit{See, e.g.}, Carl J. Herzog Found., Inc. v. Univ. of Bridgeport, 699 A.2d 995, 997 (Conn. 1997) (finding no standing at common law). The donor may be able to enforce the terms if she is on the board of trustees or directors. \textit{See RESTATEMENT (SECOND) OF TRUSTS, supra} note 140, § 391. Such a suit would be difficult to maintain if the majority directors had considered the investment options carefully, although it would be an easier case to make if the restriction were in the charter of the charitable corporation.

\textsuperscript{163} \textit{See} Treas. Reg. § 1.170A-1(e) (2003); \textit{see also} Briggs v. Comm’r, 72 T.C. 646, 657–59 (1979) (finding that a taxpayer’s contribution was conditioned on the establishment of a center that was unlikely to materialize). The donor might provide, however, that the funds go to another named charity in the event the original conditions cannot be satisfied. \textit{See Priv. Ltr. Rul. 8,012,033} (Dec. 27, 1979) (“In this case, the donations are to or for the use of an organization described in section 170 of the Code and not for the benefit of X or for an individual recipient. The contribution is irrevocable and the contribution can never be returned to X. If Z ceases to function as a four-year accredited college, the funds will go to another 170(c) organization. . . . [W]e conclude that the cash contribution by X to Y is deductible . . . .”).

\textsuperscript{164} On the books, at least, a trustee that participates in the decision to use restricted funds for an unauthorized purpose will be personally liable to restore the diverted money to the trust and might also be dismissed as trustee. \textit{See SCOTT & FRATCHER, supra} note 140, §§ 386, 387.

bankruptcy courts allow only creditors who have loaned capital for the specific charitable purpose of the restricted gift (as opposed to the broader purposes in the corporate charter) to reach the donated funds or the assets purchased with those funds.\textsuperscript{166} Therefore, if all of a charity’s assets are bound by donor restrictions, the charity can fund new ventures only with new capital contributions.

With two important differences, this doctrine is similar in effect to the impediment to cross-financing raised by security interests in the commercial sector. First, junior secured creditors and even general creditors of a commercial firm are entitled to claims against the residual collateral assets once the secured claims are satisfied, while charity creditors have no right to restricted assets in projects other than the one to which they contributed. Second, bankruptcy courts have drawn on trust principles to limit the claims of charity creditors even further: creditors who contribute to one venture may not recover even from unrestricted capital if the charity previously dedicated those assets to a specific restricted purpose,\textsuperscript{167} unless the creditors can demonstrate that the allocation was made with the intent to hinder their collection efforts.\textsuperscript{168}

Thus, the partitioning of assets created by donors’ restricted gifts or by managers’ designation of funds to specific purposes induces lenders to make project-specific loans. A lender providing bridge financing for a new charitable purpose can rely for repayment only on donations restricted to the furtherance of that purpose and on unrestricted funds and property that have not been dedicated by the charity to another purpose. The lender should be aware, conversely, that creditors providing financing for other ventures will not be able to reach assets dedicated to the new purpose. This system gives each creditor the incentive to screen carefully and to monitor distinct charitable projects, thereby yielding the specialized monitoring efficiencies described by Hansmann and Kraakman.\textsuperscript{169} It also prevents opportunistic capital movements by managers. If a new opportunity arises, managers must persuade a sophisticated lender that the project will attract sufficient funding over time. Given that charities tend to be characterized by low-value switching options and high agency costs,

\textsuperscript{166} See, e.g., In re Joliet-Will County Cnty. Action Agency, 847 F.2d 430, 432–33 (7th Cir. 1988) (holding that unpaid trade creditors could not satisfy their claim out of funds or assets restricted to a different purpose by the terms of a federal grant); Hobbs v. Bd. of Educ., 253 N.W. 627, 630–31, 634, 640 (Neb. 1934); Crane v. Morristown Sch. Found., 187 A. 632, 636 (N.J. 1936).

\textsuperscript{167} See In re Parkview Hosp., 211 B.R. 619, 634–36 (Bankr. N.D. Ohio 1997) (holding that, when the hospital regularly allocated unrestricted donations to a research fund, all the amounts in the fund were subject to a charitable trust and unavailable to satisfy the claim of a bank lender).

\textsuperscript{168} Cf. id. at 636 n.8 (suggesting the court would have ruled differently if there had been evidence of a deliberate attempt to shield assets from some or all creditors).

\textsuperscript{169} See supra p. 1104.
the constraint on cross-financing seems desirable in many cases. The last section of this Part argues that the efficiency of project financing can be enhanced by encouraging intermediaries to lend to charities with the expectation of repayment from future donations.

Many charities receive a mix of restricted and unrestricted contributions, plus user fees (such as tuition) in some cases. If unrestricted funds form a substantial portion of the total assets, restrictions on the remainder are unlikely to hamper the investment flexibility of the manager. For example, suppose a charity receives restricted funds of $10 for project $V_1$ and $20 for project $V_2$, as well as $10 in unrestricted funds. Suppose that the $10–$20 split in restricted funds available for $V_1$ and $V_2$, respectively, reflects the desirable allocation given current information. The ability to shift resources in response to new information in the future is valuable. The unrestricted amount gives the manager the ability to increase the funding of $V_1$ by one hundred percent or the funding of $V_2$ by fifty percent. If the option of switching between $V_1$ and $V_2$ is valuable, much of the value can be captured by exercising the limited discretion afforded by the unrestricted funds. Indeed, if there are diminishing marginal returns or increasing switching costs in either project, any more switching may be undesirable even if all capital were unrestricted. Thus, as with security interests in the commercial sector, the investment flexibility within an organization may be fine-tuned by varying the proportion of assets that are subject to restriction (whether under charitable trust principles or commercial secured credit rules). The socially optimal mix of restricted and unrestricted gifts in a charitable corporation depends on the volatility of the charitable environment, the private information of charitable managers, and the severity of agency costs. Unfortunately, a collective action problem may impede the realization of this optimal mix. Each donor has the incentive to restrict her own gift in order to protect her own priorities and to rely on others to provide the unrestricted funds that may be shifted to other valuable opportunities in the future. For this reason, too many donations may be restricted, and charities may consequently suffer from excessive partitioning of projects.

2. Allocation Over Time Between Commercial and Charitable Ventures. — This Part began with the suggestion that donors are encouraged to accelerate their charitable contributions by the tax deductibility of charitable donations and the ability of charities to reap tax-free returns from financial investments. Therefore, it often seems socially desirable for the charity itself to postpone the investment of capital in the charitable venture and to hold the funds in a reserve composed of financial securities. As noted earlier, once funds are allocated by either donor or manager to a specific charitable venture, the charity may not use them to cross-finance another project. Therefore, holding unre-
stricted capital in reserve also preserves the option to allocate funds to charitable projects in the future when better information becomes available. In addition, if the relevant charitable activities have diminishing marginal returns, the charity may be able to achieve a higher long-term return by investing temporarily in financial securities and allocating the funds to charity in future years when, for example, donations ebb. In this vein, many charities assert that their endowments provide buffers against adverse economic conditions that might decrease support for their causes in the future.\textsuperscript{170}

The amount that a charity should allocate to current expenditures in any given period is the result of a complex calculation involving the rate of return from charitable investment, the rate of return from financial investment, the appropriate rate of discount for future charitable work, and the value of options to defer the choice among charitable projects. For example, suppose that a manager must decide how to deploy a $100 contribution in a two-period world. She can spend the sum on charity in the current period, or she can invest in financial securities in the current period and make the charitable investment in the next period. Suppose that the financial return is five percent per year. If charitable needs do not change from period to period, the manager should begin by noting that if she defers the charitable use of the funds, she will have $105 to invest next period. Some commentators, however, believe that future charitable returns should be discounted, as future financial returns are, on the premise that charitable relief today is worth more than the same relief tomorrow.\textsuperscript{171} These commentators favor charitable investment in the current period unless the discounted charitable returns in the next period are expected to be higher. Others argue that it is inappropriate to discount future charitable values.\textsuperscript{172} In either case, deferral preserves the flexibility to select charitable projects in light of new information.

Although the charitable manager holds private information about charitable needs and returns, she does not have an informational advantage over the donors with respect to commercial rates of return or the appropriate discount rate. Thus, the information asymmetry in

\textsuperscript{170} Henry Hansmann explains that charities (and nonprofits in general) suffer from capitalization that tends to be sticky and unresponsive to changes in economic conditions. \textit{See} Henry B. Hansmann, \textit{The Role of Nonprofit Enterprise}, 89 \textit{YALE L.J.} 835, 877 (1980); Hansmann, \textit{supra} note 152, at 19–26.


charities is less significant than in commercial entities, and the switching option in charities is correspondingly less valuable. At the same time, the charitable manager, like the commercial manager, has the incentive to time investments in order to maximize her private benefits rather than the philanthropic return of the donors. These private benefits may result from the influence of other constituencies, such as the charity’s workers or other donors. On the one hand, the charity’s workers may reward their manager for increasing current spending on their projects and their compensation. On the other hand, the board of directors or trustees of the organization, who tend to have a longer time horizon than managers, may pressure the manager to feed the endowment in order to increase their own social prestige or influence. Like commercial firms, charities face a tradeoff between the benefits of delegating the option to defer or accelerate investment and the attending agency costs. And as in the commercial sector, holding a reserve of financial assets may be valuable when future needs are likely to be significant and external financing is difficult, but it is inefficient when opportunities are likely to be limited, new information is unlikely to be significant, and the checks on managerial misbehavior are weak.

As noted earlier, if the donor is to retain discretion by making staged donations, she forfeits the tax benefits derived from the charitable deduction and the charity’s exemption from income tax. Therefore, the donor might look to other means to regulate the allocation of her gift over time. If she wishes to correct a managerial bias in favor of accelerated investment, she may require her donated funds to be held in an endowment over a period of time or even indefinitely. The

---

173 As a charity grows in size, its workers may gain greater influence over governance. They enjoy better information than their superiors, and given incomplete employment contracting, they can also punish managers by withholding cooperation. EDWARD L. GLAESER, THE GOVERNANCE OF NOT-FOR-PROFIT FIRMS 4 (Harvard Inst. of Econ. Research, Discussion Paper No. 1954, Apr. 2, 2002), http://post.economics.harvard.edu/hier/2002papers/2002list.html (“The weak incentives in non-profit firms mean] that workers will have more influence within non-profits.”). Among his examples, Glaeser cites private universities that were initially controlled by their founding donors and subsequently by their faculty. See id. at 27–33. Through their influence (lobbying), workers can skew capital allocations in charities for the same reasons discussed earlier in the context of multidivision corporations. See supra p. 1122.

174 If the focus is fundraising prowess and not endowment, the manager may have high discount rates, particularly given pressure from her workers. The board, however, has an independent interest in building up the endowment to increase its power relative to the manager and to enhance its own prestige. Moreover, if the terms of the board members are longer than those of the charitable manager, the board members are more likely to be around when the capital is ultimately used.

175 This free-cash-flow concern is akin to the capital “lock-in” problem that Hansmann describes. He argues that a charity is overcapitalized when its needs subside because the organization has no residual claimants pressing for distribution of free cash and is not subject to a market for corporate control. HANSCHMANN, supra note 153, at 25–27, 240–41.
charity would thereby be constrained to spend no more than the yearly return from that principal.176 Yet unlike the purpose restrictions discussed above, an endowment imposed by a donor can be circumvented if the charity borrows against the capital.177 If instead a donor wishes to counteract the opposite managerial bias in favor of deferring investment, she might condition her gift on its current use or, alternatively, remove the option of deferral from the managers by making gifts in kind rather than in cash.178

C. The Role of Intermediaries in Restoring Flexibility

1. The Courts and Cy Pres. — Managers who face constraints in their charter or in a restricted gift may argue for an expansive interpretation of the restricted purposes. Alternatively, they may petition a court to loosen the restriction attached to a gift under the doctrine of cy pres.179 The doctrine, however, offers little flexibility because it is bound by strict conditions. The courts require that the designated purpose be fulfilled or frustrated (that is, illegal, impossible, or at least impracticable) and that the settlor had a general and not restrictive charitable intent.180 Therefore, a mere decline in the social value of one project or an increase in its opportunity cost is unlikely to lead a court to release the charity from the restriction. Moreover, courts are confined to authorizing a substitute purpose based on similarity to the original purpose rather than on social value. The limited flexibility permitted by the cy pres doctrine contrasts with the broad authority of

176 See Restatement (Second) of Trusts, supra note 140, § 348 cmt. f ("Where property is given to a charitable corporation and it is provided by the terms of the gift that it shall retain the principal and devote the income only to the accomplishment of its purposes or one of its purposes, the corporation is under a duty, enforceable at the suit of the Attorney General, to retain the principal and to use the income for the designated purposes."). The calculation of the return is a matter of some debate. See Unif. Mgmt. of Inst. Funds Act § 2, 7A U.L.A. 491 (1999).

177 Indeed, a charity can finance some projects through tax-exempt bonds issued on its behalf by a state or local government body. See I.R.C. §§ 103(a)–(b), 145 (West 2002). A number of conditions must be satisfied, including a provision concerning arbitrage bonds. Interest is not exempt if the charity fails to rebate the arbitrage profits earned from investing bond proceeds in higher-yielding financial investments. See id. § 148(f).

178 Glaeser gives the example of donating art rather than cash to a museum, which compels the museum to return to the market for charitable contributions to fund future projects. See Glaeser, supra note 173, at 8–9, 37–40.

179 Restatement (Second) of Trusts, supra note 140, § 399. Here, as elsewhere, standing is confined to the state attorney general.

180 The Uniform Trust Code states:

[If a particular charitable purpose becomes unlawful, impracticable, impossible to achieve, or wasteful . . . the court may apply cy pres to modify or terminate the trust by directing that the trust property be applied or distributed, in whole or in part, in a manner consistent with the settlor’s charitable purposes.

Unif. Trust Code § 415(a), 7C U.L.A. 168 (Supp. 2000); see also Restatement (Third) of Trusts § 67 (Tentative Draft No. 3, 2001) (stating that a judge may order the administration of the trust for a “charitable purpose that reasonably approximates the designated purpose”).]
bankruptcy courts to release debtors from the restrictions imposed by security interests. As discussed earlier, the bankruptcy court can authorize a debtor to sell collateral or grant a senior security interest in collateral assets in order to finance a more profitable project.  

2. Charitable Intermediaries. — Part II observed that hierarchical structures mitigate the agency problem associated with the delegation of reallocation decisions. Separating the allocation and execution functions may effectively harness transaction costs to reach a balance between maintaining flexibility to adjust to changed circumstances and reducing the threat of inefficient switching by agents in pursuit of private benefits. The same function is served in the charitable sector by intermediaries such as foundations. Charitable foundations may be divided into three categories: single-donor foundations, donor-advised charitable funds managed by investment companies, and multiple-donor public foundations that pool contributions. These intermediaries provide flexibility by allowing the donor to take a current tax deduction, defer the allocation of funds, and separate the delegation of allocation and execution functions.

Subject to the Internal Revenue Code’s minimum annual payout requirement of five percent, a foundation may distribute its funds over time as new social needs and information arise. Foundation

181 See supra pp. 1140–41.
182 One example of a single-donor foundation is the Bill & Melinda Gates Foundation. See http://www.gatesfoundation.org/Aboutus (last visited Jan. 11, 2004). The number and capital of private foundations have increased markedly in the past fifteen years. See Byrne, supra note 150, at 86 (reporting that the number of private foundations has more than doubled since 1987, to more than 56,000).
184 Examples include United Way, as well as corporate and community foundations such as JP Morgan Chase’s Community Development Group, see http://www.jpmorganchase.com/pages/jpmc/community/cdg (last visited Jan. 11, 2004), Microsoft’s Giving Program, see http://microsoft.com/giving (last visited Jan. 11, 2004), and Boeing’s Employees Community Fund, see http://www.boeing.com/companyoffices/aboutus/community/ecf.html (last visited Jan. 11, 2004).
185 In some but not all cases, the donor delegates the allocation discretion to a professional agent. Compare Charles Schwab’s Charitable Gift Account with its Philanthropy Fund at http://www.schwabccharitable.org (last visited Jan. 11, 2004).
186 See I.R.C. § 4942 (West 2002). If the foundation does not pay out the distributions, it must pay an excise tax of fifteen percent of the amount it should have distributed, and then an additional one hundred percent of that amount if the error is not corrected. See id. § 4942 (a)–(b).
187 A Treasury Department report on private foundations expressed the advantage of a foundation as follows: “because their funds are frequently free of commitment to specific operating programs, they can shift the focus of their interest and their financial support from one charitable area to another." Senate Comm. on Fin., 89th Cong., Treasury Department Report on Private Foundations § 1 (1965) [hereinafter Treasury Report].
managers have information about philanthropic returns that may be superior to the donor’s but inferior to that of the manager of the operating charity. Therefore, like intermediaries in the commercial sector, foundations can be a second-best solution to the twin problems of information asymmetry and agency costs. By leaving allocation authority one step removed from the information source, the principal reduces to some degree the ability of her agents to switch capital allocations in pursuit of private benefits.

Nevertheless, significant agency problems remain. Foundation managers may still extract private benefits from their choice of charities and have a notorious tendency to accumulate capital rather than release it to operating charities. In multiple-donor foundations, the conflicts among heterogeneous donor preferences may exacerbate the agency problem. This concern appears to have led an increasing number of donors to designate specific charities when giving to the United Way, for example.

In the commercial sector, intermediaries such as banks and venture capitalists play especially prominent roles in financing firms with very significant private information. Information about future profitability is more easily communicated to these intermediaries than to capital markets at large. Later in the firm’s life cycle, once information becomes more widely disseminated, the firm substitutes public for private financing through, for example, an IPO of common stock. This pattern is becoming more common in financing new charitable projects. Foundations are devoting an increasing portion of their capital to seed funding when the level of information asymmetry with individual donors is high. As the cause and work of the charity be-

188 See, e.g., Byrne, supra note 150, at 92 (“[M]ost foundations dole out only the required minimum of 5% of their assets annually, preferring to perpetuate their own organizations rather than put more muscle behind their stated cause.”). Klausner provides examples, including the Rockefeller Foundation, the John D. and Catherine T. MacArthur Foundation, and Pew Charitable Trusts. Klausner, supra note 172, at 58. The Treasury Report noted that “[i]t has been contended that the interposition of the foundation between the donor and active charitable pursuits entails undue delay in the transmission of the benefits which society should derive from charitable contributions.” TREASURY REPORT, supra note 187, at 5. The Report was also concerned by the resulting concentration of economic and social power in foundations. See id. Currently notable in law-and-economics circles is the limited term and high payout rate of the John M. Olin Foundation. Evidence of the foundation’s limited term can be found at http://www.jmof.org/history_purposes.html (last visited Jan. 11, 2004).

189 See Fogarty & Block, supra note 159.


191 See Christine W. Letts et al., Virtuous Capital: What Foundations Can Learn from Venture Capitalists, HARV. BUS. REV., Mar.–Apr. 1997, at 36, 40 (“Many foundations simply state that they will not fund any program for more than two or three years.”). For example, the New York Foun-
comes more widely known, the charity is expected to raise funds di-
rectly from the public, thereby avoiding the administrative costs of an
intermediary.

3. For-Profit Intermediaries. — Foundations sometimes provide
loans rather than grants, particularly to finance the construction of a
building or the performance of a contract that is expected to generate a
receivable.192 There is no compelling reason for the intermediary be-
tween the donor and the operating charity to be a nonprofit. Indeed,
for-profits offer an important advantage: their managers are easier to
incentivize through compensation packages and periodic monitoring of
outcomes. Banks do lend to nonprofit borrowers, but only to those
with strong balance sheets and demonstrated operating surpluses, be-
cause they are loathe to incur the public relations costs of foreclosing
on charity assets.193

A social opportunity is missed, however, when banks do not lend
against future donations to a charity. Bank debts can be satisfied out
of future donations, much like receivables financing of a commercial
debtor. Indeed, the creditors may even be able to garnish charitable
pledges that are enforceable by the charity.194 If the anticipated dona-
tions do not materialize, the creditors may also reach the assets of the
trust to which they contributed.195 The benefits should be clear from
this Article’s thesis. Institutional bridge financing resolves the prob-
lems of uncorrelated donations and information asymmetry; it creates
flexibility while containing agency costs. Information about new or
complex charitable needs may be conveyed to a sophisticated lender
more quickly than to a large number of donors. The lender provides
the bridge financing until donors can appreciate the merits of the
cause. A bank has the appropriate incentive to screen the proposed
project to ensure that it will be later marketable to donors, just as
banks evaluate the marketability of the commercial products of their
borrowers. The bank also has the incentive to ensure that the charity

Foundation limits funding to three years, and in limited categories, five years. See
http://www.nyf.org/
Guidelines.asp (last visited Jan. 11, 2004).
192 See Caroline Williams, Financing Techniques for Non-Profit Organizations, Report to
Presidential Committee on Arts and Humanities 10 (1998) (noting that the Ford and MacArthur
Foundations commonly make such loans).
193 See Hansmann, supra note 170, at 877.
195 Although nonprofit corporations may not be petitioned involuntarily into bankruptcy, they
may file a voluntary petition under either Chapter 7 or Chapter 11 of the Bankruptcy Code. See
11 U.S.C. § 303(a) (2000) (“An involuntary case may [not] be commenced . . . against . . . a corpo-
ration that is not a moneyed, business, or commercial corporation. . . .”). A creditor cannot con-
vert a nonprofit’s Chapter 11 case into a Chapter 7 case, but it may move to appoint a Chapter 11
trustee. Id. § 1104(a).
is diligent and efficient in performing its services and in publicizing its cause. Such institutional bridge financing against future donations has precedent in the funding of political campaigns and referenda.

This proposal faces a significant nonlegal obstacle, however. Although donors may be generally aware of the problems posed by information asymmetry, they nevertheless tend to prefer funding prospective social benefits over refinancing benefits that have already been achieved. Therefore, donors are more willing to contribute directly to a charitable cause or even to an endowment than to the repayment of debt associated with that cause. This phenomenon undermines the feasibility of receivables lending to charities. Even if philanthropists can be persuaded of the systemic benefits of refinancing institutional debt, they may still fall into a prisoner’s dilemma in which each donor prefers to fund charitable projects directly and relies on others to contribute to debt retirement. However, there may be regulatory solutions to this problem. For example, the tax code could be adjusted to favor debt retirement in its provision for charitable contribution deductions. Or Congress might extend the current provision for tax-exempt bonds to also exempt from tax assessment the interest income derived from institutional loans against future donations.

The goal of such policy prescriptions would be to allow the donors effectively to leverage their philanthropic investment and harness the monitoring expertise of financial institutions in a way they could not replicate by borrowing themselves.

CONCLUSION

The legal boundaries and constraints imposed on internal capital markets prevent, to varying degrees, the exploitation of valuable flexibility in capital budgeting. They remove discretion over capital reallocation from operating managers and place it in the hands of less informed principals or agents; they also threaten to impose significant transaction costs. Yet they may lead to a second-best outcome that avoids costly agency problems stemming from a manager’s discretion to reallocate capital over time. In this respect, corporate entities and security interests play an important role in commercial enterprises. In the charitable sector, principles of trust law segregate internal capital markets within charitable corporations. To motivate the analysis of

196 Lenders may be justifiably concerned about the subsequent incentives of managers to collect donations dedicated to the funded project to repay the loan. It may therefore be useful for the lender to take a security interest in an important asset of the debtor. Even if the asset has no value on resale, its idiosyncratic significance to the charity managers may reduce the moral hazard threat.

197 See supra note 177.
the full range of these legal instruments, this Article assumes that investors and donors seek to limit their agent’s authority. To the extent that principals wish instead to broaden the internal capital markets within which their agents operate, this Article illuminates the organizational boundaries that they should seek to break down. Thus, this Article provides a general framework for examining in each context whether the appropriate balance has been reached in preserving flexibility and for assessing the effectiveness of legal mechanisms employed to this end.