Organizations as Internal Capital Markets:
The Legal Boundaries of Firms, Collateral and Trusts
in Commercial and Charitable Enterprises

George G. Triantis
University of Virginia

I. Introduction

In recent scholarship, the efforts to describe the optimal boundaries of firms have evolved into the broader inquiry into the justification for legal organizations.¹ A corporation is an organization, but so are partnerships and trusts.² Indeed, to some academics, hierarchical substructures within firms may also form organizations.³ Although the conception of organization varies among authors, many have offered explanations for their boundaries. Some relate to the vertical integration of two entities into a single firm (for example, a merger of supplier and customer). Others concern horizontal integration (such as a multidivisional corporation operating in several discrete industries). Particularly in connection with the latter form, this paper suggests a complementary justification for organizational boundaries: they define internal capital markets within which resources may be readily redeployed. The distinction

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³ E.g. Rajan and Zingales, supra note –.
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, for example, may finance a new venture by contracting with outside investors or by shifting resources from another venture within the firm. The reallocation of capital within an internal market occurs most commonly by diverting cash flow or borrowing against the other venture’s assets. Internal capital markets fund some profitable projects that would not be financed externally for any of several reasons, some efficient and others not. Internal capital enables a firm to avoid the information asymmetry between the firm’s managers and outside investors. However, managers may also reallocate capital within internal markets to maximize their private benefits rather than firm value. Moreover, they may use their information advantage to conceal from their 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 by impeding the movement of capital from one venture to another. This paper identifies and explores these constraints on internal finance and thereby provides a new perspective on familiar legal issues concerning corporate boundaries, trusts and security interests. I will refer to is as the internal capital markets (or ICM) theory of legal organizations.

The property rights theory of Grossman-Hart-Moore views the firm as a collection of assets that are owned by a common owner, who thereby holds the residual control rights over them. The parties thereby avoid the incentive problems arising in incomplete contracts and the threat of hold-up. However, the theory concerns vertical rather than horizontal integration and it does not explain why the

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4 Owen Lamont, Cash Flow and Investment Evidence from internal Capital Markets, 52 J. Fin. 83-110 (1997)(evidence that the cash flow from one venture affects the investment in another venture within the same firm); Hyan-Han Shin and Rene M. Stulz, Are Internal Capital Markets Efficient? Qu. J. Econ. 531-52 (1998)(same)

5 [Indeed, four-fifths of corporate projects are financed by internal capital.] [cite].

same owners may hold assets in different legal entities: for example, a spin-off of a division as a subsidiary corporation or of a commercial trust holding securitized receivables. Rajan and Zingales focus on hierarchical structures that regulate access to technology and thereby impede the expropriation of non-physical assets by mid-level managers of organizations. As they point out, however, their organizational structures often do not coincide with legal boundaries. The internal capital markets thesis, in contrast, emphasizes the legal boundaries and unites the justification of a variety of legal organizations.

In this sense, the ICM explanation is similar to and complements the work of Hansmann and Kraakman, who argue that organizational boundaries -- of corporations, partnerships, trusts and even marriage -- serve to dedicate pools of assets to specific creditors and thereby insulate those assets from the reach of other creditors. They suggest that the motivation for asset partitioning through organizations is to exploit the comparative monitoring advantages of heterogeneous creditors. They present an example of a business that includes two ventures which are owned and managed by the same parties: (i) a chain of hotels and (ii) oil fields and refineries. 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 only reach the assets related to the business that the creditor has financed. Given the differences in the nature of each firm, the authors suggest that consequent specialization by creditors in monitoring activities may lead to lower aggregate cost of credit. This partitioning gain may also be

7 Rajan and Zingales, supra note –.
8 Rajan and Zingales, Dedicated Hierarchy, supra note–, at 842-3.
10 They also point to the advantage of preserving the integrity of the governance rights of equityholders. Shareholders do not hold the right to seize firm assets, nor individually to force the liquidation of the firm. If their personal creditors were able to do so, this would undermine the governance limitation on shareholders.
achieved to some degree within a single corporation through the use of security interests or trusts.\textsuperscript{11} This paper describes a distinct motivation for asset partitioning: it restricts the internal capital market and the reallocation of capital among ventures by fiat. Although there may be benefits to diversifying insolvency risk by combining the two operations in a single organization, the creditors may wish to limit the borrower’s prospective ability to increase that risk by shifting resources between the two ventures. The benefits and costs of such restriction must be weighed in determining the appropriate mechanisms and boundaries for asset partitioning.

Internal capital markets permit capital to move between projects and therefore may be examined as creates a switching option: the ability to delay a portion of capital allocation decision until more information becomes available. Financial economics have explored the value of real options in capital budgeting, as well as their strategic management.\textsuperscript{12} In contrast, the managerial agency problems associated with the management and exercise of real options has received relatively little attention.\textsuperscript{13} As this paper explains more fully later, the ICM thesis may be framed as addressing a balance between the benefits and costs of leaving these switching options in the hands of agents. In effect, the agent controls potentially conflicting options on two sets of assets: the aggregate value of the firm and the agent’s private benefits.

The paper is related to several other strands of scholarship in the economics of contracts, finance and law. Oliver Williamson discusses the benefits and costs of M-form corporate structure in which a headquarters coordinates the operations of various divisions and has the authority to reallocate

\begin{itemize}
\item See also Thomas H. Jackson and Anthony T. Kronman, Secured Financing and Priorities among Creditors, 88 Yale L.J. 1143 (1979); Saul Levmore, Monitors and Freeriders in Commercial and Corporate Settings, 92 Yale L.J. 49 (1982); Hansmann and Mattei, supra note –.
\item Alexander Triantis and James Hodder, Valuing Flexibility as a complex option, 45 J. Fin. 549-565 (1990);
\item The seminal work by Stewart Myers, however, began with consideration of the financial agency problems of underinvestment in growth opportunities. Stewart C. Myers, Determinants of Corporate Borrowing, 5 J. Fin. Econ. 147-76 (1977).
\end{itemize}
capital among them. Financial economists have demonstrated the value of internal capital markets, and therefore diversified firms, by identifying information problems in external capital markets and the relative ease with which capital may be redeployed within an internal market.\textsuperscript{14} Other work, however, suggests offsetting inefficiencies in the operation of internal markets. For example, division managers within a firm will lobby their headquarters for resources and this may lead to inefficient allocation of capital (or cross-subsidization) when weaker divisions enjoy lower opportunity costs of lobbying.\textsuperscript{15} This paper focuses on a different tension. The very expertise that investors wish to exploit in assigning to their manager the task of reallocating capital over time also exacerbates the agency costs associated with the manager’s self-interested exercise of this discretion. Jensen and Meckling observe a more general version of this tradeoff that may lead to a choice to move decision rights away from the party with lowest information costs to the party with better incentives.\textsuperscript{16}

A similar tension has also been identified with respect to liquid assets: they facilitate investment in profitable growth opportunities, but also may be used for the private benefit of managers.\textsuperscript{17} The problem is most acute when the firm lacks sufficient growth options to profitably deploy its liquid assets, thereby creating free cash flow that managers can use for their private benefit.\textsuperscript{18} In the charitable

\begin{footnotesize}
\textsuperscript{14} E.g. Oliver Williamson, Markets and hierarchies (1975); Robert H. Gertner, David S. Scharfstein, and Jeremy C. Stein, Internal versus external capital markets, 109 Qu. J. Econ. 1211 (1994).

\textsuperscript{15} David S. Scharfstein and Jeremy C. Stein, The Dark Side of Internal Capital Markets: Divisional Rent-Seeking and Inefficient Investment, 55 J. Fin. 2537 (2000)(rent seeking managers of weaker divisions may have lower opportunity costs of lobbying).

\textsuperscript{16} Michael Jensen and William Meckling (1992)


\textsuperscript{18} Jensen, Free Cash Flow, supra note –.
\end{footnotesize}
sector, this tradeoff over liquidity bears significantly on the desirability of endowments.\textsuperscript{19} They are valuable when they smoothe the cycles of the supply of charitable funds and of charitable needs, but they also provide free cash at the discretion of charity managers.

The paper addresses two questions: (1) what factors determine the optimal delegation of authority over capital reallocation, and (2) how legal partitions of internal capital markets contribute to achieving this optimum. In a simple, principal-agent analysis involving two ventures, an internal capital market encompassing both projects is more likely to be optimal if there are large efficiency gains from reallocating capital – for example, if the distribution of payoffs from each project are negatively correlated with each other – and if the conflict between the interests of managers and investors is small – for example, if the private benefits and venture values are positively correlated. The analysis becomes more complex and interesting when there are multiple, heterogeneous investors, whose interests diverge. The common example is the conflict between shareholders and creditors, where managers are to some degree loyal to their shareholders. Although a sole investor might prefer to exploit the economies of internal capital allocation, the creditors of a leveraged firm may wish to restrict transfers of capital among ventures that benefit, for example, risk-seeking shareholders. Therefore, the scope of the internal market may be inversely related to the degree to which shareholders have leveraged their investments. Indeed, many of the legal mechanisms for preventing capital redeployment are creditor-initiated: for example, security interests and fraudulent conveyance obstacles to capital movements between firms.

If a principal wishes to restrict the reallocation of capital between ventures, she has a range of means at her disposal to raise the cost of doing so. The principal may instruct the agent to pursue projects using factors that have greater asset-specificity and are therefore less liquid. This raises the cost of, and thereby deters, switching. Alternatively, the principal may use different hierarchical structures to divide decision making authority. For example, the investor can delegate the management

of each venture and the reallocation decision to distinct agents. This is the characteristic of Williamson’s M-form. The reallocation task may be assigned to an intermediary who is less informed than the project managers and whose involvement is short-term. This fragmentation of authority reduces the ability of managers to increase private benefits by shifting capital between ventures because it requires the various agents to contract with each other at a cost.

In this sense, the paper is related to scholarship on hierarchical authority structures that exploit asymmetric information. It also bears some similarity to a recent model of Hart and Moore that assigns authority between two types of decision makers: specialized (who concentrate on specific assets) and coordinators (who identify ways to exploit synergies between assets). Their coordination function refers to the joint use of two or more assets, but it might be extended to cover the sale or mortgage of one asset to finance a project involving the other. In particular, they find that if the probability of a coordination idea is low, the coordinator should be senior in authority if that unlikely idea would be very profitable or should become a specialist otherwise. Similarly, this paper 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 be removed from project managers (either to an intermediary if the unlikely reallocation would be valuable or otherwise to the principal). The Hart-Moore model focuses on differences in the likelihood of profitable ideas coming to, respectively, the specialists and coordinators. The ICM explanation, in contrast, emphasizes the role of hierarchical structure in reducing agency problems in capital redeployment decisions. Like Hart-Moore but unlike other models of organizational hierarchies, this paper treats the production of information as

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Asset partitioning through legal organizations is a substitute or reinforcement for the hierarchical and other contractual solutions. The principal may incorporate the projects in separate legal entities. Corporate formalities often required in capital transfers between firms raise the cost and thereby deter reallocation of capital. Indeed, the corporate entity presents a higher barrier to the shifting of capital between corporations if both entities are controlled (but not wholly owned) by the same person (self-interested transactions), as opposed to an arm’s length relationship. Where debt financing is used, laws of fraudulent conveyance preclude the shifting of capital when the source firm thereby becomes insolvent or undercapitalized. The more an enterprise is fragmented into discrete firms, the greater the constraint of fraudulent conveyance rules. Creditors also use security interests to impede the reallocation of capital within firms.\(^{23}\) Security interests impede the conversion of nonliquid into liquid assets that are more readily available to finance other ventures. In addition, the associated priority right deters future lending against those assets. Placing the assets of a venture in a trust provides even greater protection against the removal of capital, given the strict fiduciary obligations imposed on the trustee. Yet, perhaps because the trust is so strict and air tight, it is more often used in commercial enterprises for passive investments (e.g. securitization of receivables) than operational assets.

The second half of the paper turns to the tradeoffs of internal capital markets in the charitable sector and the alternative mechanisms for partitioning assets dedicated to charitable purposes. The potential for conflicting interests is greater in charities than in commercial organizations. In addition to the usual conflict with managers and with creditors, donors also have divergent preferences among themselves that make them more averse to the flexibility of internal capital markets than for-profit investors. In the charitable sector, trusts are important complements to corporations as mechanisms to achieve the desirable segregation of ventures. In contrast, security interests are more common in the commercial sector. The difference is partly due to the fact that most charities have few tangible assets that can serve as valuable collateral. However, it may also be due to the greater concern about the

\(^{23}\) Triantis, Financial Slack, supra note –.
agency problems of capital reallocation among charitable projects. Trusts are more air tight than security interests and the imposition of trusts on charitable ventures reflects a judicial presumption that donors prefer to restrict the ability of even informed managers to move capital among charitable ventures. As a result of this constraint, one would expect intermediaries, such as charitable foundations, to play a significant role in providing desirable flexibility in addressing changes in conditions and information. Yet, the agency problems between donors and foundation intermediaries are also more difficult to control than their counterparts in the commercial sector. As a result, this part of the paper concludes by proposing a more active role for for-profit intermediaries, such as banks, in financing charitable ventures.

II. Commercial Organizations

A. Switching options and agency problems

Managers make decisions on the basis of hard and soft information. The qualitative difference between hard and soft information hinges on the ability of outsiders to observe the facts or, conversely, the ability of the manager to credibly communicate their existence. In the standard economic agency model, the principal cannot perfectly police the behavior of her agent by contract because significant portions of relevant information are soft: they cannot be proven to a court (unverifiable) and may even also be unobservable by the principal. In the hierarchies described below, 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 investor or a court. Alternatively, the cost of information may vary directly with the distance in a hierarchy from the project: for instance, because the breadth of the span of the principal’s responsibilities or concerns

The discussion that follows distinguishes between two functions in the management of financial capital: (i) the execution or operation of a venture and (ii) the reallocation over time of capital among
ventures. The investor (the principal) chooses to delegate these functions in one of the following three ways: First, the execution and allocation authority are delegated jointly to a single manager. Second, the allocation discretion is granted separately to an agent who has no execution authority. Third, the investor retains the allocation discretion and delegates only execution. The important distinction among these structures is the amount of soft information available to the person making the reallocation decision (diminishing as one moves from the first to last alternative).

Suppose that the investor seeks to invest a sum of money at time 0. There are two ventures in this economy (V1 and V2), each of which is sufficiently complex to require execution by a professional manager. The total value of each venture will be realized at time 2 and will yield $S$ to the investor and $B$ in private benefits to the manager ($V_i = S_i + B_i$). The source of these private gains is less important for the purposes of the paper than the assumption that they may be significant and vary from venture to venture. One might think of them as personal gains from opportunities to self-deal, build empires, entrench, enhance professional reputations, or consume perquisites.

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\begin{array}{ccc}
  \text{t=0} & \text{t=1} & \text{t=2} \\
  \text{investment} & \text{uncertainty resolution} & \text{payout of profit} \\
  \text{delegation of authority} & \text{capital reallocation} & \text{and private benefits} \\
\end{array}
\]

The payoffs to the investor and the manager from each venture is risky. The information of the manager is superior to that of the investor in the following manner. At t=0, investor and manager have symmetrical knowledge about the individual distributions of $S_i$ and $B_i$. On this basis, suppose that they contract for the investment of Investor’s capital in venture V1 because it has a higher net present value than V2. However, the parties are aware that V2 may turn out to be the better choice ex post. At time 1, the state of the world at t=2 becomes observable to managers, but not to investors or third parties. For example, suppose that V1 is a manufacturing plant for computer hardware and V2 is a venture in

\[24\] As in Williamson’s M-form corporation and analogous to the distinction between specialist and coordinator in Hart and Moore, supra.
drug research. At $t=1$, the manager may observe soft information about the condition of the market for hardware at $t=2$ or of a successful pharmaceutical discovery. If the manager has the authority, she may then choose to reallocate the capital from $V_1$ to $V_2$. At $t=2$, the financial payoff from the active project is realized, verifiable, and paid to Investor. The state of the world, however, is not observable to Investor (and hence not verifiable either). Therefore, Investor cannot discern whether the venture foregone would have yielded a higher return.

If an informed manager were also a faithful agent, the investor would delegate to the manager the authority to reallocate capital from $V_1$ to $V_2$ when the new information is revealed. The expected total investment payoff would be the discounted maximum of $V_1$ and $V_2$ in each possible future contingency. As long as there is some state in which $V_2>V_1$ and another in which $V_1>V_2$, this expected payoff may be higher (depending on the cost of shifting capital) than the payoffs from investing in either $V_1$ or $V_2$, or any combination of the two. The incremental gain is produced by the flexibility of deferring the investment decision until new information is revealed at $t=1$. Simply put, if the information revealed at $t=1$ might significantly change the optimal distribution of capital between $V_1$ and $V_2$, the flexibility is valuable. Setting aside any significant economies of specialization in the execution of the ventures, the investor might exploit the opportunities for flexibility by delegating both the execution and reallocation function to a single manager.

More realistically, managers are self-interested and seek to maximize their private benefits. Therefore, upon observing the information revealed at $t=1$, the manager of the integrated firm switches if $B_2>B_1$, but not otherwise. The manager is expected to exploit the flexibility to increase her private benefits, not the value of the investment. If the distributions of $V_i$ and $B_i$ are perfectly and positively correlated, the manager’s interests are aligned with the investor’s and the gains from flexibility are enjoyed by both parties. If they are perfectly negatively correlated, their interests are diametrically opposed and the manager’s discretion increases agency costs and decreases the return to the investor. The relationship between the distributions of $B_1$ and $B_2$ is also a factor. If they are correlated, the added agency cost from permitting the manager to shift resources between ventures is small.
The capital structure of business enterprises is such that the residual interest is not distributed among all contributors of capital: some investors (namely, creditors) hold fixed claims and specific contractual rights. Their means for controlling managerial decision making are different and this diversity strengthens corporate governance. Shareholders vote for the board of directors and enforce fiduciary duties on behalf of the firm. If freeriding among their members prevents the effective disciplining of managers, the market for corporate control acts as a first back-up. If it does not resolve the problem, creditors provide the final source of discipline on managers, particularly when they act through financial intermediaries such as banks. In particular, debt forces management to meet a schedule of repayments and to adhere to covenants and financial ratios, under the threat of acceleration and enforcement. The resulting reduction in managerial agency costs enures to the benefit of all investors. And, all other things equal, it improves the efficiency of a larger internal capital market.

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 new reason for segregating assets. Shareholders may exercise their control over managers to induce them to reallocate capital in order to increase the riskiness of the firm. (For example, shareholders may prefer to switch from V1 to V2 because V2 has become riskier, even if V2 is less profitable). Thus, creditors are worried not only about the usual private benefits motivating manager’s decisions, but also the scope for risk alteration. The concern of lenders with risk alteration is highly significant. One manifestation is their preoccupation with financing projects or ventures, rather than firms. Further evidence comes from the fact that, although they often prefer to provide credit to discrete firms (e.g. project finance) and they usually seek guaranties from related entities. The critical difference between this arrangement and the financing of the same project in a larger integrated company, consistent with this paper’s focus, is the greater ability of the borrower to reallocate capital in the latter case.

The foregoing may be summarized in terms of real options. The flexibility to move resources between ventures is essentially the ability to defer the final allocation until uncertainty is resolved: that is, a valuable real option - a switching option - on the difference between the payoffs of the two ventures.
The value of this real option exists separately from and in addition to the expected returns from the investment in each of the ventures at t=0. In this example, however, there are three options that correspond to the three underlying assets: (a) the value belonging to the investor \((S_2-S_1)\), \(^{25}\) (b) the private benefits to the agent \((B_2-B_1)\), and (c) the aggregate value produced by the investment \((V_2-V_1)\).

The principal wishes to maximize the option value associated with investor returns; the agent maximizes the option value associated with private benefits, and the socially optimal condition maximizes the option on aggregate value. Yet, the parties cannot contract ex ante to ensure this optimal outcome because of the unverifiable quality of the relevant information. They can only decide the degree to which the agent has flexibility to maximize her option on private benefits (e.g. debt covenants) and then take measures to try to align those benefits as much as possible with aggregate value. The following discussion reviews a range of mechanisms for constraining flexibility.

B. Contractual constraints on switching

Clearly, the more liquid the assets, the easier it is to move capital. Cash flow from proceeds of a venture are readily redeployed between uses. Beyond cash and near-cash assets, liquidity is synonymous with the absence of information asymmetry concerning asset value and consequently the ease with which capital may be redeployed. The more specialized the asset, the less liquid and the greater the discount demanded by a purchaser of the asset. There are alternatives to outright asset sales, but they cannot avoid this problem of illiquidity. For example, a manager may sell new shares or borrow against assets, and thereby dilute existing interests in the old venture in order to fund a new one. The cost, and ease, of doing so remains a function of how specialized the assets are -- that is, their liquidity. Accordingly, one mechanism for impeding reallocation is to require by contract that projects be pursued with assets of higher specificity and lower liquidity.

The interest of investors and managers as to the holding of cash or liquid assets diverge (as do

\(^{25}\) Si can be divided, in turn, into shareholder and debtholder interests on which respective options exist.
interests among investors). The justification for keeping cash reserves, even in low interest bearing instruments, are very similar to the reasons for allowing the movement of capital between ventures. Indeed, V1 may be an investment in Treasury Bills. The liquid funds provide flexibility to exploit options as they become available without drawing on external market. Managers, however, value this flexibility because it also enhances their ability to extract private benefits from their positions. Michael Jensen, among others, has identified the efficiency of forcing managers to pay out free cash flow, particularly in industries which are expected to produce few highly profitable growth options.\textsuperscript{26} If monitoring or reporting reveals the presence of a cash reserve, the investors can compel its distribution by contract or otherwise.

The investor may also control the prospect of capital movements through its delegation of the reallocation decision (or the management of the real option). For example, assume that the investor makes some positive investment in each of V1 and V2 and that there is an opportunity for readjustment at t=1. Consider the following four alternative hierarchical decision making structure. If the firm’s real option is valuable and the manager’s option on private benefits is not significant, the investor will seek to maximize flexibility and may therefore appoint one manager to execute both ventures and reallocate at t=1. See Figure (1). In contrast, if either the reallocation option is not particularly valuable for the firm or the agency costs of giving the manager discretion are too large, the investor may decide to retain two managers: M1 and M2 execute V1 and V2, respectively. See Figure (2). Although M1 and M2 may each appropriate private benefits from their respective ventures, they cannot increase these benefits by shifting resources at t=1 unless they contract between themselves to do so. M1 and M2 have soft information about their respective ventures that will make such contracting significantly more cumbersome than the manager's unilateral action in Figure (1). This transaction cost threatens to offset the private value obtained from shifting capital at t=1 and may thereby deter it.

Of course, the choice between one and two managers is affected by other factors. For example, economies of specialization would lean toward two managers and economies of scale or

\textsuperscript{26} Supra note –.
scope toward one manager. If these economies are significant, the parties might consider two other delegating structures. First, suppose that specialization economies dominate. In Figure (3), M1 and M2 execute their respective ventures. However, in order to exploit some of the flexibility at t=1, the investor appoints an intermediary, N, to make the allocation decision. This agent is a modestly informed party (that is, less than the manager and more than the investor) who observes some, but not all, of the soft information and to whom the investor might entrust capital reallocation decisions. This intermediary may be inside or outside the boundaries of a firm. For example, a CEO allocates capital among divisions and ventures within the firm.27 A bank moves capital among its borrowers and a venture capitalist cycles through investments and realizations across many entrepreneurs. For our purposes, they share a common position in the decision-making hierarchy and the same intermediate quality of information. The means by which intermediaries exercise control over capital allocations vary only slightly in substance. Banks retain discretion over advances under lines of credit and they set payment maturities and acceleration provisions for outstanding amounts. Venture capitalists stage investments and hold seats on boards of directors. The most significant difference among these various intermediaries, therefore, may be the nature of their compensation rather than their position inside or outside the firm.28

On the other hand, if the economies of scope and scale outweigh those of specialization, the investor is tempted to retain a single manager for both ventures. However, the investor may nevertheless wish to constrain the movement of capital if the conflict of interest regarding flexibility is sufficiently severe. In Figure (4), the investor employs only one agent, but takes steps to impede the shifting of resources. The manager may promise not to reallocate at t=1. Yet, the reallocation itself may be subtle and not observable to the investor. For example, administrative burdens may be shifted

27 The argument has been made that a CEO’s (empire building) interest in governing an large, profitable firm coincides with the investors’ interest in profits when it comes to resource allocation among divisions. Jeremy C. Stein, Internal Capital Markets and the Competition for Corporate Resources, 52 J. Fin. 111 (1997).

or there may be transfers between ventures at prices at odds with arm’s length terms. Moreover, the contractual sanction against a breaching agent depends on her solvency and on prompt detection. Of course, any provision that generally serves to align the interests of manager and investor will also reduce the risk of inefficient capital shifting.

The parties may interpose an intermediary to police the manager and to make reallocation decisions in this case as well as in Figure (3). This may be especially valuable if the property rights (formal authority) in the assets are held by a number of principals. Again, the intermediary offers an intermediate solution to the efficient exploitation of flexibility. The benefits are somewhat compromised because of the limited ability of the intermediary, relative to the manager, to observe and process information. And, agency costs are not entirely avoided. Rather, the extraction of private gains from flexibility is constrained because of the requirement that the manager collude to share his private gains from switching with the intermediary. As before, asymmetric information concerning private benefits (and the related transaction costs) may frustrate this contract.

C. Legal organizational boundaries

The parties may further constrain reallocation by employing other legal boundaries for internal capital markets that raise the cost of redeploying capital. The separation of business operations into discrete corporations has many explanations.\(^{29}\) For the purposes of the paper, it should be observed that corporate boundaries define a number of legal obligations that impede capital movements.

First, accounting standards mandate varying levels of disclosure with respect to movements of

\(^{29}\) E.g. Lynn M. LoPucki, The Death of Liability, 106 Yale L.J. 1 (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.” (at 21). James J. White, Corporate Judgment Proofing: A Response to Lynn LoPucki’s Death of Liability, 107 Yale L.J. 1363 (1988): “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.” (At 1391).
of assets between business operations. The degree of required disclosure depends on whether the operations are distinct corporate entities or divisions within a single corporation. Asset transfers between divisions are less transparent to readers of financial statements than transfers between separate corporations, particularly if the firms are related. If a single company maintains distinct business segments in different industries, the FASB rules do mandate that the following financial information concerning revenue, profit and identifiable assets be presented in disaggregated form. These disclosures, however, may not be substantial enough to alert investors of all transfers between segments. Moreover, the rules permit the segment-based information to be displayed in footnotes or in a separate schedule, instead of the body of the financial statements. FASB rules for related party transactions are significantly more stringent. They apply to transactions between a parent company and its subsidiaries, between subsidiaries of a common parent and between any other type of affiliates. The disclosures must describe the transaction itself and its terms. Moreover, the firm, upon disclosing the related party transaction cannot imply that the transaction was made at an arm’s length basis unless it can substantiate such claim.

The securities disclosure rules regarding related party transactions are reinforced by the state corporate law regulation of these transactions. Corporate statutes generally require that the terms of a transaction between firms with common directors or officers (“interested directors”) be disclosed. Shareholders may challenge in court the fairness of the transaction. The statutes provide varying degrees of protection to a corporation where the transaction is ratified by disinterested directors or by the shareholders (e.g. ratification may shift the burden of persuasion to the plaintiff shareholder).


FAS 14, ¶¶ 6, 15, 22, 28.

FAS 57, ¶¶ 1, 2a-d, 3.

E.g., Delaware General Corporation Law §144; New York Business Corporation Law §713.
contrast, no disclosure, ratification or fairness oversight is invoked in the case of transfers between divisions of a single corporation: These are subject to the business judgment rule under the general fiduciary of care. To be sure, a subsidiary is free (within limits of business judgment rule) to make a dividend payment to its shareholders, including its parent; and the parent can reinvest it in another subsidiary.34 However, this avenue for reallocation is more costly than if the transfer were effected between divisions: some capital exits the enterprise to minority shareholders and the corporations must observe formalities in declaring and paying dividends.

If shareholders were concerned about agency problems in switching, one might think that corporate charters would limit the purposes that the corporation would be authorized to pursue and thereby invoke the vestige of the ultra vires doctrine that permit shareholders to enforce such restrictions. Yet, once released by state statutes from the historical requirement of a limited purpose, corporations adopted liberal charter provisions that allowed for any lawful purpose. Although some commentators have suggested that this is inefficient and that it reveals a race to the bottom in state regulatory competition,35 it is too widespread to justify such a simple explanation. Nevertheless, restrictions on purpose are more common in loan agreements and might be enforced by creditors rather than shareholders.

A common explanation for diversified conglomerates is that they reduce insolvency risk and thereby reduce expected bankruptcy costs. The equally common retort is that conglomerates present more opportunities for management to misbehave, and agency problems are accordingly greater: the threat of insolvency itself disciplines management. Therefore, fragmenting the conglomerate into distinct corporations may reduce agency costs by increasing the risk of insolvency. Specifically, the incentive of managers to opportunistically switch investments between firms is controlled to a greater extent by the law of fraudulent conveyances. In particular, if a firm makes a transfer or incurs an obligation without

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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.\textsuperscript{36}

Lenders can contract for a significant mechanism for segregating assets within a firm: the security interest. Both the property and priority rights associated with security interests are important in this regard. Under the property right, a security interest impedes the sale of an asset by following the asset into the hands of a transferee. The priority right is relevant because a firm can reallocate capital either by selling its existing assets outright or by borrowing against them. The presence of a priority interest in the asset prevents future borrowing against it. There are significant exceptions to each rule that allow efficient asset transfers or new borrowing, but they tend to block wholesale movements in capital without the consent of the secured lender.\textsuperscript{37} Thus, if there are unrelated advantages to integrating projects in a single firm, security interests offer a mechanism for segregating assets that may not interfere with these objectives.

The trust is a more air-tight partitioning mechanism. If the assets in V1 are held by its manager in trust, the manager is constrained from diverting cash flow to V2 and from selling or pledging assets in order to fund V2. As with security interests, the trust can recover property transferred to a person other than a bona fide purchaser for value. These prohibitions are backed by the trustee’s obligation to account and severe sanctions for breach of her fiduciary responsibilities. Trusts have several uses in commercial enterprises, but one most clearly reflects the partitioning concern of this paper: securitization. Although several explanations have emerged, the most economically plausible is that securitizing of receivables helps to control agency problems by limiting managerial discretion over cash

\textsuperscript{36} Uniform Fraudulent Transfer Act. In addition, note restrictions on distributions to shareholders under corporate law that apply to intercorporate dividends. E.g. Del. Corp.

\textsuperscript{37} Triantis, Financial Slack, supra note –.
flows.\textsuperscript{38} In a typical securitization deal, the firm sells its receivables to a separate entity (the special purpose vehicle) which is often a trust. The proceeds are received by the firm and distributed to investors, used to refinance outstanding obligations or invested in new projects. Iacobucci and Winter suggest that the task of monitoring free cash is made easier when the cash comes in one large infusion at the sale rather than periodically as the receivables are collected.\textsuperscript{39} Thus, securitization restricts the manager’s discretion to redeploy resources over time as the firm’s accounts mature. This efficiency relies on the legal enforcement of the trust so that the manager of the firm has no discretion over the receipts. In this regard, the trust is a more potent organizational form than a corporation.

III. Charitable Organizations

Information asymmetries afflict external markets for charitable ventures. It is often difficult for a charity to communicate the extent and the urgency of a social need. Therefore, internal capital markets and diversified charities might be valuable. However, although intermediaries such as the United Way and community foundations play a significant role in allocating funding to specific projects, the execution and allocation functions are typically separate. Moreover, once funds are designated for a particular charitable purpose, they generally cannot be shifted to another, more valuable venture. Unrestricted endowments are generally frowned upon. As one commentator put it, American donors believe in “just-in-time charity”\textsuperscript{40} and have serious concerns about managerial allocative discretion. A consequence, of course, is that some urgent and priority social needs may not be met in time.

Charities introduce several distinctive challenges to the task of capital allocation. In the

\textsuperscript{38} Edward M. Iacobucci and Ralph A. Winter, Asset Securitization and Asymmetric Information (Working Paper 2002).

\textsuperscript{39} Supra note –.

\textsuperscript{40} Marvin Olasky, Charity Doesn’t Have to Mean Bureaucracy, Wall St. J. (2001)
commercial context, the investor seeks to maximize her financial return on capital. In the charitable sector, a donor is an investor who seeks a philanthropic return in the form of satisfaction from having contributed to the improvement in the welfare of others. This (deliberately) unspecified description of the motivation of donors makes the information set relevant to capital allocations difficult to define. In the matching of investors and ventures, the donor holds private information about her preferences that is much more significant than her counterpart’s information in the for-profit sector. Moreover, matching entails not only dynamic capital allocation among charitable ventures, but also between charitable and for-profit opportunities. The charitable manager is less likely to have clearly superior information to make the latter determination. To focus on this problem, the discussion begins with organizations devoted to single charitable purposes.

A. Single-purpose charities

Henry Hansmann has written that nonprofit corporations (including charities) suffer from capitalization that tends to be sticky and unresponsive to changes in economic conditions. A charity is often undercapitalized when its needs increase, because debt capital is difficult to raise and donations are generally not available on demand. 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. The resulting “lock-in” of capital is an agency problem. The twin problems of under- and overcapitalization are in tension with each other. Attempts to ameliorate the former will tend to exacerbate the latter. For example, the accumulation of capital in the form of an endowment provides a ready source of funding in the event that donations are insufficient to meet charitable needs. However, the same endowment discourages the termination or contraction of charitable projects when their social value ceases to justify their cost. A very similar tradeoff arises in the management of liquid assets in for-profit corporations. These reserves are efficient when obstacles

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42 Id., at 292.
to external financing threaten profitable projects, but inefficient when the corporation’s investment opportunities are limited. Yet, the means by which shareholders can compel the payout of free cash in the commercial sector are largely unavailable to donors.

The timing of charitable needs and charitable contributions often do not coincide. First, donations are lumpy rather than continuous. Moreover, they vary with factors unrelated to, and even negatively correlated with, charitable need. During economic recessions, for example, the needs of the poor for food, shelter and health care intensifies. At the same time, however, the supply of charitable contributions may fall with the wealth of prospective donors. Second, in some cases, a pressing charitable need arises too quickly or is too complex to communicate to the donors in a timely fashion. Although the need may be very likely to generate eventually 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.

A charity may insulate itself from the effect of economic cycles by setting aside funds to use in lean times. One explanation offered for the accumulation of endowments is that they act as buffers against adverse economic conditions. In the multi-project organizations discussed below, endowments can also sidestep the problems of information asymmetry associated with complex, novel ventures. In this section, however, new needs are addressed in separate organizations and, by definition, these do not have accumulated endowments. Although endowments may mitigate the problems of uncorrelated donations and information asymmetry, these pools of funds have a detrimental impact on managerial incentives. Endowments typically serve as stronger evidence of fundraising success and efforts of a manager than the accomplishment of the charitable purpose. Therefore, managers are tempted to accumulate excessive amounts of capital. Moreover, pools of available funds tend to exacerbate the risk of excessive private benefit consumption. Thus, the charity is faced with a tension between holding an endowment to ensure that sudden changes in charitable needs are met and

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43 Henry Hansmann, Why Do Universities Have Endowments, 19 J. Legal Studies 3, 19-26 (1990)
constraining the ability of managers to extract private benefits from the charity. The same tradeoff exists in for-profit firms. Liquidity is valuable when growth opportunities are plentiful and external financing is difficult, but it is inefficient when the corporation’s opportunities are limited and the checks on managerial misbehavior are weak.

Donors might enhance their control over capital allocation in charities by dedicating their gifts expressly to endowment or current use, and by retaining the power to modify or revoke their gifts in response to changed circumstances. According to the IRS, this type of control may jeopardize the availability of the charitable deduction to donors. More to the point, however, this solution calls for coordinated activity among individual donors to ensure that the right amount in aggregate is dedicated to endowment and optimal adjustments are made collectively over time. Charitable intermediaries, such as foundations, might coordinate these efforts and reallocate capital among charitable projects. However, they hold inferior information about charitable and for-profit ventures than managers in each sector, and inferior information about donor preferences than the donors themselves. More significantly, given the heterogeneity of donor preferenes, it is more difficult to align the incentives of the intermediary and the investor in the charitable than non-profit sector. An alternative option, therefore, might be the use of for-profit, financial intermediaries. Since charities are non-profits, who have no residual claimants, the financial contract between the intermediary and the charity must be debt. This suggests that banks could play a significant role.

One solution to the under-/overcapitalization problem of the charitable sector might be instead to remove obstacles to borrowing by the charity during times when donations temporarily fall short of needs. Once debt financing is available, donors should be more attracted to measures in the corporate charter or elsewhere that restrict capital accumulation. Debt financing resolves the problems of uncorrelated donations and information asymmetry described above in the following four ways. First, if persuaded of the marketability of the charitable cause, an institutional lender may provide bridge financing until economic conditions improve. Second, 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 may provide the bridge until donors can appreciate the merits of the cause. In these two cases, the creditor may lend against the prospect of future donations. Third, if the charity cannot communicate fully even to a lender the expected amount of future donations, it might offer as collateral existing assets to signal confidence in its expectation that future donations will allow it to redeem the collateral and thereby continue the charity. The charity’s entrepreneurs may take the further step and guaranty the repayment of the loan. Finally, the prospect of foreclosure over charity assets sets a fundraising goal for managers and enhances their incentives to publicize the cause.

In the case of a single charitable project, debt financing is a very plausible vehicle for reallocating capital in order to bridge gaps between charitable needs and donations. The restrictions on charitable corporations borrowing or mortgaging trust property may be avoided by appropriate provisions in the corporate charter. The debts owed to creditors who advance bridge financing can be satisfied out of the subsequent donations when they are made. Indeed, the creditors may even be able to garnish charitable pledges that are enforceable by the charity.\textsuperscript{44} If the anticipated donations do not materialize, the creditors may reach the assets of the trust. Although nonprofit corporations may not be petitioned involuntarily into bankruptcy, they may file a voluntary petition under either Chapter 7 or 11 of the Bankruptcy Code.\textsuperscript{45} The bankruptcy estate does not include property held in a charitable trust. That property continues to be dedicated to its charitable purpose. If that purpose has become impossible, illegal or impractical to carry out, the court may invoke the doctrine of cy pres to direct the application of the property to another charitable purpose falling within the general charitable intention of the settlor. However, creditors who can trace their contribution to the furtherance of the purpose of the trust may reach the trust property.

\textsuperscript{44} In re Upper Peninsula Development Bureau, 110 N.W. 2d 709 (S.C. Mich. 1961).

\textsuperscript{45} Bankruptcy Code 303(a)(an involuntary case may not be commenced against a corporation that is not a “moneyed, business or commercial corporation”). A creditor cannot convert a Chapter 11 case of a nonprofit into a Chapter 7, but it may move to appoint a Chapter 11 trustee. Bankruptcy Code 1104(a)(1).
Draft: April 2002

There are, however, nonlegal obstacles that may explain why large-scale institutional debt financing to charities is uncommon. First, for reasons of public relations, lenders may wish to avoid foreclosing on charitable assets. Second, although they may be generally aware of information asymmetry concerning charitable needs, donors are generally motivated by an ex post perspective that drives them to fund additional social benefits rather than to refinance the benefits that have already been achieved. Therefore, donors are more enthusiastic about contributing directly to the charitable cause or even an endowment than to the repayment of debt. This phenomenon diminishes the amount of donations that the charity can expect after it borrows to finance a new project and therefore reduces the attractiveness of debt financing.

B. Multiple-purpose charities

In many cases, a charitable organization pursues a range of projects and is funded by many donors with heterogeneous objectives. The resulting multiplication of conflicts within the charity raises the question of when various charitable objectives are pursued within an integrated organization. To be sure, there may be economies of scope in pursuing a number of related charitable projects. A charity may have specific information about a community that enables it to efficiently provide food, clothing, education and health care to the community, even though its donors may have different priorities. This information may not be as effectively transmitted between even well-meaning separate organizations. More directly relevant to this paper is the exploitation of the expertise of charity managers in allocating funds across different projects based on superior information about needs and costs that change over time. With managerial discretion, however, comes the risk of self-interested action that undermines the goal of providing the maximum philanthropic return to donors.

Even if donors had access to information about the private benefits extracted by their managers, they suffer from significantly impaired governance ability relative to their for-profit counterparts. The

46 Hansmann, The Role of Nonprofit Enterprise, supra note –, at 877.
governance of multi-purpose charities is complicated by the heterogeneity of their donors. For instance, charitable corporations rarely give voting rights to their donors because voting is a poor method for aggregating donor preferences. First, there is no obvious manner in which to allocate votes. Donors contribute different amounts at different times, and their charity uses those amounts at different times. Although it may be possible to allocate votes according to the amount contributed by each donor and adjusted on a first-in-first-out basis, this tracing mechanism is awkward to implement and relatively easily manipulated by management. Second, organizations governed by votes among heterogeneous donors will be unstable and will tend to shrink. At each stage, minority voters will be reluctant to contribute for fear of being overwhelmed by the preferences of the majority. Thus, whereas shareholder voting is a prominent governance feature of for-profit corporations and critical to the operation of the market for corporate control, it plays a trivial role in charities.

The heterogeneity of donor interests also bears on the exercise of other governance instruments. The efficiency of internal capital markets in for-profit firms is impeded by the influence activities of divisional managers who lobby headquarters for larger allotments of funds. In a charitable corporation, this phenomenon is exacerbated by the potential influence activity of donors, who unlike shareholders, have heterogeneous stakes in the transfer of capital among projects. Thus, the concerns with freeriding among shareholders in the commercial sector is replaced by a wariness of intradonor opportunism in the enforcement of fiduciary duties in the case of multipurpose charities. Not surprisingly, therefore, standing to enforce fiduciary duties or remove managers is typically confined by law to the Attorney General.

Indeed, Hansmann is particularly skeptical about the preference aggregating function of voting in either politics or nonprofits and says “the principal role of voting in firms is much as it is in most democratic governments: not to aggregate and communicate preferences, but simply to give the electorate some crude protection from gross opportunism on the part of those in power.” HANSMANN, THE OWNERSHIP OF ENTERPRISE 289 (1996).

The alternative form of donor control is the restricted gift to the charitable corporation. It is variously described as a transfer with a condition subsequent or a separate charitable trust in which the corporation acts as trustee. Either form compels the corporation to use the gift for the precise purpose specified by the donor. I will assume that restricted gifts are treated as trusts in the jurisdiction of the charitable corporation. The restricted donation has the advantage of removing the problem of conflict among donors while preserving the gains from economies of scope. However, it compromises the benefit of an internal capital market in which funds are moved by managers among purposes in response to changing needs, conditions and information. The flexibility of the charity is inversely related to the proportion of restricted gifts. On the other hand, unrestricted gifts facilitate the pursuit of self-interested objectives by managers, including the extraction of quasi-rents from individual donors. The optimal degree of flexibility, and hence the optimal mix of restricted and unrestricted gifts, depends on the volatility of the charitable environment. Unfortunately, a collective action problem may impede the achievement of this optimum. Each donor has the incentive to restrict her gift in order to protect her priorities and to hope that others will provide the unrestricted funds that may be shifted to fund valuable opportunities in the future.

The presence of distinct trusts within a charitable corporation that are created by restricted gifts refines significantly the partitioning of assets available to creditors.\(^{49}\) Indeed, like security interests, they subpartition assets within the corporation. Case law indicates that the right of a creditor to reach any particular asset of a charity depends on two factors: (i) whether the asset is or was acquired by means of a restricted gift (as opposed to unrestricted funds) and (ii) whether the creditor’s loan was used to further the specific charitable purpose of the gift (as opposed to the broader purposes in the corporate charter).\(^{50}\) Thus, restricted funds create pools of assets that are available only to creditors who

\(^{49}\) The theory that organizational forms create value by partitioning assets and thereby exploit monitoring efficiencies among creditors is due to Hansmann and Kraakman, supra note –.

\(^{50}\) In other words, if the creditor’s advances are used for purposes other than those of the restricted donation, the creditor may not reach the fund – at least without a cy pres proceeding. See Hobbs v. Bd. of Edu. of N. Baptist Convention, 253 N.W. 627 (Neb. 1934); Crane v. Morristown Sch. Found., 187 A. 632 (NJ 1936).
contribute to the restricted purpose.

The impact of restricted gifts on creditors is demonstrated in Judge Posner’s opinion In re Joliet-Will County Community Action Agency.\textsuperscript{51} Joliet-Will was a nonprofit organization that provided a variety of services to the community, including child care, family planning, legal assistance, foster grandparents, and insulation for low-income housing. Joliet-Will was funded exclusively by federal and state agencies, and trade creditors. Due to mismanagement, the organization became insolvent and filed under Chapter 7 of the Bankruptcy Code. The trade creditors comprised primarily suppliers of insulating materials. Judge Posner noted that the federal grant terms imposed minute controls on the use of those funds, prohibited the switching of unused funds between items specified in the grant budget and required the reconveyance to the government upon demand of any personal property purchased with federal funds. On this basis, Posner found that the funds and any personal property acquired with them remained property of the government and that Joliet-Will held this property as a trustee or custodian. Only creditors who provided goods or services within the scope of one of the grants would be entitled to payment out of these assets. The assets were unavailable to all other creditors.

The subpartitioning of assets created by restricted gifts induces lenders to make project-specific loans. The lender providing bridge financing for a new charitable purpose (“X”) knows that it can only be repaid out of donations restricted to the furtherance of X and, subject to an important qualification described below, perhaps also from unrestricted funds and property. The lender is also aware that creditors providing financing for other projects will not be able to reach assets dedicated to X. This system of priorities gives each creditor the incentive to screen carefully and monitor distinct charitable projects. This pattern of financing has important disciplinary advantages over endowments built by unrestricted donations, without unduly compromising the ability of managers to discover and exploit emerging charitable opportunities. If a new opportunity arises, managers must persuade a sophisticated lender that the project will attract sufficient funding over time. This is a healthy and arguably not excessively burdensome check on managerial discretion. Lenders may be justifiably concerned about

\textsuperscript{51} In re Joliet-Will County Community Action Agency, 847 F.2d 430 (7th Cir. 1988).
the subsequent incentives of managers to collect donations dedicated to the funded project and 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 it has no value on resale, its idiosyncratic significance to the charity managers may
reduce the moral hazard threat.

The ability of a lender to rely on unrestricted funds is compromised by the ability of managers to
dedicate such assets to specific trusts and thereby remove them from the reach of its general creditors.
In a recent bankruptcy case, the court permitted the debtor to shelter its unrestricted donations in this
manner. Parkview Hospital was a non-profit osteopathic hospital that established a fund, named
initially the Research Activity Fund and subsequently the Development Fund. In the stated purposes of
the Fund were the promotion of education and recruitment of osteopathic physicians, as well as the
funding of scientific research. These projects could be financed only by the income and not the
principal of the Fund. The Hospital solicited specific donations to the Fund and, in addition, it regularly
allocated all unrestricted donations to the Hospital into this fund. The Bankruptcy Court held that all the
amounts in the Fund were subject to a charitable trust, including those derived from unrestricted gifts.
Although the fund was held in an account with a creditor, Mid-American Bank, the court held that it
was unavailable to satisfy the Bank’s claim, despite its apparent set-off right. Instead, the bankruptcy
trustee had a fiduciary duty to administer the charitable trust in accordance with its terms. The court
added, however, that if there were any indication that the hospital was putting money from operations
into the Fund in an attempt to prevent creditors from reaching them, it would have ruled differently.
Therefore, even unrestricted funds might fall beyond the reach of creditors if they are allocated to
specific restricted funds by the charity itself, unless creditors can show it was meant to hinder the
collection efforts of creditors. The court did not indicate whether it would protect creditors by adopting
the constructive fraud approach of fraudulent conveyance laws.

52 In re Parkview Hospital, 211 B.R. 619 (N.D. Ohio 1997).
IV. Conclusion

Rarely does the law provide the means to achieve the first-best. The legal boundaries and constraints imposed on internal capital markets prevent the exploitation of valuable flexibility in capital budgeting. They remove the discretion over capital reallocation to less informed agents and they threaten significant transaction costs. However, they may serve as instruments to achieve a second-best outcome that avoids costly agency problems stemming from a manager’s discretion to reallocate capital over time. Corporate entities and security interests play an important role in this respect in commercial enterprises. In the charitable sector, the charitable trust more severely constrains the operation of internal capital markets. This paper provides a framework for examining in each context whether the appropriate balance has been reached in preserving flexibility and for assessing the effectiveness of legal instruments employed to this end.