

# Conflicts in Property

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*Property concerns conflicts — both conflicts between individuals and conflicts of interest. Conflicts between individuals have long been the paradigmatic property focus. According to this view, property debates circle around issues of autonomy and productive competition. But this is an impoverished view. In this Article, we shift attention to conflicts of interest. By helping people manage conflicts of interest, a well-governed property system balances interdependence with autonomy and productive cooperation with productive competition. We identify three mechanisms woven throughout property law that help manage conflicts of interest: (1) internalization of externalities; (2) democratization of management; and (3) de-escalation of transactions. We show that property law predictably selects among these mechanisms depending on the ratio of economic to social benefits that people seek from a group resource. When economic concerns predominate, property law typically uses contribution-based allocations of rights and responsibilities mediated by formal, foreground procedures, while at the social end of the spectrum we tend to see more egalitarian substantive rules operating as an informal, background safety net.*

## INTRODUCTION

Property is conflict. More precisely, property exists to govern conflicts. Property conflicts come in two forms: conflicts of individuals and conflicts

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of interest. While the first form has received the most scholarly attention, the second has quietly come to dominate the development of property law. This Article brings conflicts of interest to the fore.

Conflicts of individuals have long been the paradigmatic property struggle. We both want to fish; there are not enough fish. I got there first; so I argue that the fish are mine. Based on a rule of "first possession" for governing such interpersonal conflicts, the state may give me a property right such that I can exclude you from the fish. "Trespass" is another such rule. I own Blackacre; you own Whiteacre. The state allows us each to exclude the other. If I want to cross your Whiteacre, I must acquire the right from you. According to this conception, the drama of property consists in governing the productive struggle between autonomous excluders, with each individual cloaked in the Blackstonian armor of "sole and despotic dominion."<sup>1</sup>

From this perspective, conflicts of interest are never good. They represent war within rather than among individuals. Individuals at war with themselves are disabled from acting forthrightly and decisively as market transactors. So, when conflicts of interest do arise, they should be eliminated. People can avoid them in two ways. They can escape the conflict either by redefining the underlying relationship so that they no longer need to trust each other or by disclosing the conflict so that there is no longer a betrayal of trust. Either escape or disclosure restores the parties to their autonomous status as formally-equal, unconflicted parties, all contributing in their own self-interested ways to creation of well-functioning markets. But this is an impoverished view of property.

Focusing on productive competition overlooks the equal value of productive cooperation. Large parts of property law encourage productive cooperation by helping people manage conflicts of interest rather than avoid them. I want to fish from our lake, and I want us to leave fish for our children; I want to irrigate our land, and I want your help in harvesting. Often, an individual or a subset of owners decide how a group's resource will be used — consumed and invested, managed, or alienated. Disclosure cannot effectively address difficulties of conflicts of interest that inhere in such cases, and escape means giving up the advantages of cooperation through property.

Property law knows better than these two disappointing strategies. A thick and rather sophisticated set of property rules encourages decision-makers not only to satisfy their self-interest, but also to take into account the interests of

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1 2 William Blackstone, *Commentaries on the Laws of England* \*2 (Univ. of Chi. ed. 1979) (1765-69).

their fellow group members. The state addresses these intrapersonal conflicts of interest through laws of co-ownership, partnership, and marital property, for example. According to this conception of property law, the drama of property consists in creating governance institutions that manage conflicts of interest arising within those individuals who control, use, or transfer group resources.

A conflict of interest can be more sharply defined. We can say that someone has a conflict of interest if, and only if, that individual (1) is in a relationship with another requiring the exercise of judgment on the other's behalf and (2) has some interest tending to interfere with the proper exercise of judgment in that relationship.<sup>2</sup> For the purposes of this definition, "the relationship required must ... involve one person trusting (or, at least, being entitled to trust) another to do something for her — exercising judgment in her service."<sup>3</sup> Managing conflict stands for any "partial realigning of interests, not enough to eliminate the conflict of interest but enough to make it seem likely that benefits will more than repay the costs."<sup>4</sup>

This concern for "partial realigning of interests" can help bring large areas of property law into focus. While property law encourages individuals to compete productively, it also encourages them to govern group resources so as to create the economic and social gains possible from cooperation. In this conception, conflicts of interest play a subtle role and should be avoided in some circumstances, managed in others. A well-governed property system fosters both productive competition and productive cooperation, autonomy and interdependence, exclusion and governance, avoidance and management of conflicts of interest.

In this Article, we situate the management of conflicts of interest at the core of property governance. Part I demonstrates how property governance solves conflicts of interest for individuals acting in their own self-interest and as decision-makers over group resources in which they have a stake. We tease out the governance mechanisms by which property law helps people manage these conflicts, create interdependence, and achieve the gains possible from productive cooperation. More particularly, we show how property governance serves to (a) internalize, (b) democratize, and (c) de-escalate conflicts — three mechanisms that allow people to engage safely in productive cooperation, rather than always falling back to competition.

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2 See Michael Davis, *Introduction to Conflict of Interest in the Professions* 1, 8 (Michael Davis & Andrew Stark eds., 2001).

3 *Id.*

4 *Id.* at 12-14.

Part II explains the patterns that emerge from the heterogeneous solutions that property law provides to manage conflicts of interest. First, we show that the ratio of economic to social benefits in a particular group-resource setting best predicts and best justifies the property form chosen for managing conflicts. Second, we show that when "economic" considerations predominate in managing a group resource, the property form typically uses formal and foreground mechanisms for "partial realigning of interests," whereas at the "social" end of the group resource spectrum, property forms usually use informal and background safety net rules. Third, and finally, we show that substantive rules for managing conflicts also range predictably along the economic to social spectrum, with contribution-based allocation of rights and responsibilities at one end and egalitarian substantive rules at the other. The conflicts of interest prism helps make sense of an otherwise bewildering array of discrete property doctrines.

## I. PROPERTY CONFLICTS

### A. Conflicts and Conflicts of Interest

Currently, most property scholars seem to have little interest in conflicts of interest and their regulation. Of course, conflicts are hardly alien to property. Quite the contrary. In the conventional view, conflicts pervade property. But these conflicts are of a very different type. The conventional narrative of property is one of conflicts between autonomous excluders.<sup>5</sup>

The Blackstonian tradition, which conceptualizes property as sole and despotic dominion,<sup>6</sup> invites and supports this analysis. While no one seriously thinks anymore that property always and necessarily entails unqualified dominion,<sup>7</sup> the conception of "property as exclusion" is still perceived as the regulative idea of private property.<sup>8</sup> If property is *about* exclusion, as scholars such as Thomas Merrill and James Penner have recently argued,<sup>9</sup> then

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5 See Carol M. Rose, *Property as Storytelling: Perspectives from Game Theory, Narrative Theory, Feminist Theory*, in *Property and Persuasion: Essays on the History, Theory, and Rhetoric of Ownership* 25 (1994).

6 Blackstone, *supra* note 1.

7 Even Blackstone did not. See Carol M. Rose, *Canons of Property Talk, or, Blackstone's Anxieties*, 108 *Yale L.J.* 601 (1998).

8 See Jeremy Waldron, *Property Law*, in *A Companion to Philosophy of Law and Legal Theory* 6 (Dennis Patterson ed., 1999).

9 Thomas W. Merrill, *Property and the Right to Exclude*, 77 *Neb. L. Rev.* 730, 730 (1998); James E. Penner, *The Idea of Property in Law* 103 (1997).

the doctrinal home for property conflicts is trespass law. As the paradigmatic doctrine for regulating conflicts between strangers, trespass law seems to have very little to do with conflicts of interest and their regulation. Because conflicts of interest require a background relationship in which one is entitled to *trust* another person, the notion of conflicts of interest seems, indeed, to be irrelevant to the main actors in property dramas — excluders with no strong entitlement to each other's trust.

We do not deny that property is *also* about exclusion: conflicts giving rise to trespass law are part of the landscape of property. But the traditional discourse, with its focus on exclusion, independence, and competition, overstates its case. Exclusion can exhaust the field of property only if one, somewhat arbitrarily, sets aside large parts of what is property law, at least according to the conventional understanding found in the case law, Restatements, and academic commentary. Property institutions provide structures for various types of interpersonal relationships — from strangers and market transactors, through landlords and tenants, members of a local community, neighbors, co-owners, and partners, to the intimate relationships among family members.<sup>10</sup> Accordingly, people experience property as both a locus of competition and an arena for cooperation. In other words, governance — the ongoing management of cooperative relationships — typifies property at least as much as exclusion does. For this reason, the concept of conflict of interest and the discussion of strategies for regulating conflicts of interest can highlight important aspects of property law.

## **B. Avoiding and Managing Conflicts of Interest**

Property law is filled with a diverse array of mechanisms for dealing with conflicts of interest. Some of these rules allow people to avoid conflicts of interest; others — of particular interest to this Article — help them manage conflicts of interest.

Because of our societal commitment to exit, property law does, and indeed should, allow people to avoid, rather than manage, conflicts of interest. Exit is a bedrock liberal value. It stands for the right to withdraw or refuse to engage; it is the ability to dissociate, to cut oneself out of a relationship with other persons.<sup>11</sup> The commitment of (liberal) law to exit — to the idea of open boundaries that enable geographical, social, familial, and

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10 For an account of this realist conception of property, see Hanoach Dagan, *The Craft of Property*, 91 Cal. L. Rev. 1517 (2003).

11 See Albert O. Hirschman, *Exit, Voice, and Loyalty* 19-21 (1970).

political mobility — "enhances the capacity for a self-directed life, including the capacity to form, revise, and pursue our ends."<sup>12</sup> Thus, for example, in the co-ownership and marital property areas, partition and divorce are simple mechanisms for escaping conflicts of interest. We value exit so highly that mechanisms such as partition and divorce are essentially unwaivable.<sup>13</sup> These mechanisms recast resource struggles from conflicts of interest into conflicts of individuals, shifting people from productive cooperation to productive competition.

Avoidance has been relatively better documented in the literature over the years but proves less germane to the more theoretically-promising issues involved in managing conflicts of interest. So, instead of focusing first on partition or divorce, we look at how property law facilitates cooperation for people who do want to work together. The challenge of what we call liberal commons institutions, such as co-ownership and marriage, is to facilitate people's ability to reap the economic and social benefits of productive cooperation in the difficult context where the possibility of exit — of escaping the conflicts of interests inherent in property governance — threatens the very possibility of trust and reciprocity.<sup>14</sup>

To face this challenge, each of these property institutions contains rules for managing conflicts of interest in three spheres of decision-making that may affect the collective interest in a resource: decisions about consumption and investment, about management, and about alienation. Each of these spheres can be helpfully analyzed as a forum for "partial realigning of interests." Given the multiplicity and apparent diversity of property governance rules in each of these spheres, however, even a bare catalogue of these rules would be a daunting and unproductive task. So, we do not attempt a full restatement. Instead, our task here is to highlight some patterns that emerge across a wide set of these institutions and show how property law provides a general set of solutions to conflicts of interest.

### C. Internalization, Democratization, and De-Escalation

Canvassing property law as a whole, we uncover three primary tools that

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12 Leslie Green, *Rights of Exit*, 4 *Legal Theory* 165, 176 (1998); see also Michael Walzer, *The Communitarian Critique of Liberalism*, 18 *Pol. Theory* 6, 11-12, 15-16, 21 (1990).

13 See respectively Hanoch Dagan & Michael A. Heller, *The Liberal Commons*, 110 *Yale L.J.* 549, 567-70 (2001); Carolyn J. Frantz & Hanoch Dagan, *Properties of Marriage*, 104 *Colum. L. Rev.* 75, 85-87 (2004).

14 See generally Dagan & Heller, *supra* note 13.

property law has developed to manage conflicts of interest: internalizing externalities; democratizing management; and de-escalating transactions. These three tools correspond roughly to the conflict of interest dilemmas that arise from consumption and investment, collective governance and decision-making, and policing exit from and entry into group property resources.

### *1. Internalization*

Consider cases where individuals want to transform the group resource, either by taking something out for their individual benefit or by investing something that may benefit all members of the group. A co-owner wants to chop down trees on co-owned land or to invest in machinery for the common enterprise; people want to invest in businesses but are worried that their associates might impose upon them excessive liabilities. In these instances, the individual's self-interest may diverge from her interest in her co-owners' or partners' welfare. Property law offers a range of doctrines for managing these conflicts.

One common approach to conflicts of interest regarding consumption of and investment in group resources is to interpose governance rules that partially or wholly concentrate the costs or benefits of such a decision on the individual. For example, the co-owner may have to account to the community for the value of trees chopped and may be able to pocket at least some of the gains attributable to his or her individual investment in the commons resource.<sup>15</sup> Likewise, a variety of property-holding forms — such as the limited liability company and the limited liability partnership — offer mechanisms allowing members to participate in management and control but also constrain the liability of members for the actions of their co-venturers.<sup>16</sup> By internalizing the consequences of individual decision-making, property governance rules regarding consumption and investment help people take autonomous decisions regarding the group resource while

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<sup>15</sup> *Id.* at 584-86.

<sup>16</sup> See J. William Callison & Maureen A. Sullivan, *Limited Liability Companies: A State-by-State Guide to Law and Practice* (2003). For two representative examples, see Tex. Rev. Civ. Stat. Ann. art. 6132a-1, § 3.03 (Vernon Supp. 2004) (limited partner's liability for debts of or claims against the partnership is restricted to the limited partner's capital contribution to the partnership plus any additional amounts agreed to be contributed); Ky. Rev. Stat. Ann. § 362.220 (Michie 2002) (partner in a registered limited liability partnership personally liable only for his own negligence, malpractice, wrongful acts, and misconduct).

preserving productive cooperation. Internalization proves to be a powerful tool in managing conflicts of interest.

## 2. Democratization

Sometimes a community may decide to reserve certain types of management decisions to the group as a whole, rather than allowing individual autonomy, say for decisions that have larger or more enduring consequences for the resource. For example, a unit owner may want the condominium to put a new roof on the building or a spouse may want to mortgage the family house. Again, the individual owner's self-interest and her regard for the community's interest may diverge.

To address conflicts of interest that go to fundamental management decisions, property law often limits the scope of action open to individuals and shifts decision-making to a sphere of democratic self-governance. Condo owners or spouses may be disabled from acting directly. Property law instead interposes governance institutions that empower owners to act indirectly, such as through an elected condo board or through joint agreement in a community property.<sup>17</sup> There are many such conflict-transforming institutions that align individual and group goals by aggregating individual preferences or objectives. These range from participatory institutions, like a simple majority rule, to representative or hierarchical mechanisms, such as a condo board in a common interest community or a board of directors in a close corporation.<sup>18</sup>

## 3. De-Escalation

In many cases, people just do not want to manage conflicts. They want to avoid them, leave a bad relationship, and get on with their lives (or opt for exclusion and autonomy). Property law offers a range of governance tools for de-escalating the conflicts of interest that arise as people exit from and enter into cooperative property institutions. For example, rules like rights of first refusal, cooling-off periods, and exit taxes are intended to ease conflicts of interest by allowing the individual to leave, but to do so in a way that is community-enhancing.<sup>19</sup> Similarly, rules regarding who can enter a

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17 See respectively, e.g., Restatement (Third) of Servitudes ch. 6, pt. D (2000); J. Thomas Oldham, *Management of the Community Estate During an Intact Marriage*, 56 *Law & Contemp. Probs.* 99, 112-15 (1993) (discussing representational management of community property arising by operation of law).

18 See, e.g., Henry Hansmann, *Condominium and Cooperative Housing: Transactional Efficiency, Tax Subsidies, and Tenure Choice*, 20 *J. Legal Stud.* 25 (1991).

19 See Dagan & Heller, *supra* note 13, at 598-601.



community and the terms of entry help to de-escalate conflicts. By exercising some control over who enters, existing members can find new members who are relatively more likely to take a community-enhancing approach to the conflicts of interest that may arise.<sup>20</sup>

The three approaches property law applies in managing conflicts of interest — internalizing externalities around individual use and investment decisions, democratizing a set of fundamental management decisions by shifting authority from individual to group control, and de-escalating tensions around entry and exit — are ideal types, which, in turn, cover vastly divergent rules. Thus, for example, internalizing consumption and investment decisions by owners can be achieved by limiting access to the joint resource or by an opposing rule that allows access but then provides some accounting mechanism for costs and benefits. Democratizing management, in turn, can be accomplished by an elected hierarchical management; but it can also be secured using a more participatory set of procedures. And de-escalating tensions can be achieved by relying on exit through sales into the market or through procedures regulating entry and exit. A restatement of the rules dealing with consumption and investment, management, and alienation across the wide range of liberal commons institutions would need to include rules of all of these types and many more.

## II. A TYPOLOGY OF CONFLICTS IN PROPERTY

In this Part, we show that the multiplicity of property solutions to conflicts of interest is neither chaotic nor unprincipled. Rather, these solutions can be explained by reference to the divergent characters of the underlying property institutions. Property law supports a wide range of institutions that facilitate the economic and social gains possible from cooperation. Some of these institutions, such as a close corporation, are mostly about economic gains — securing efficiencies of economies of scale and risk-spreading — with social benefits being merely a (sometimes pleasant) side-effect. Other institutions, such as marriage, are more about the intrinsic good of being part of a plural subject, where the *raison d'être* of the property institution refers more to one's identity and interpersonal relationships,

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<sup>20</sup> See Margaret A. McKean, *Success on the Commons: A Comparative Examination of Institutions for Common Property Resource Management*, 43 J. Theoretical Pol. 247, 263 (1992).

while the attendant economic benefits are perceived as helpful byproducts rather than the primary motive for cooperation.<sup>21</sup> The underlying characters of the divergent relationships prove to be the key to explaining property law's devices for managing conflicts of interest.<sup>22</sup>

### A. Conflict Management and the Characters of Property Institutions

We begin by stating our most general proposition regarding how property law partially realigns stakeholders' interests: management rules track the economic or social character of the underlying property institution. Our distinction between economic and social is not about whether the activity is economic or not, in some absolute sense. After all, we are dealing with property institutions that always have economic implications, especially at the "end-game" when relationships break down and people move from managing conflicts of interest to escaping them. Thus, even in the marital property context, end-game rules concern themselves primarily with economic allocation rather than facilitating social interactions. But colorful dramas at the end-game of property institutions should not obscure the daily — but ultimately more germane — mid-game life of these property institutions.<sup>23</sup> Hence, we focus on the role of property institutions as forums for various types of interpersonal relationships. Our reference to the "characters" of the different property institutions seeks to capture their predominant or underlying purposes.

The differing purposes of property institutions are all-important, as they should guide the rules that are needed to support the mid-game, interpersonal relationship that the underlying property institution aims to facilitate. Even rules about the end-game (partition or divorce) can be analyzed from this perspective because they can, and should, serve as background norms to channel and shape the expectations of participants in the varying property

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21 See Frantz & Dagan, *supra* note 13, at 81-84.

22 Notice that a public-spirited goal does not, of itself, make a property form "social" in our taxonomy if this goal is mostly *external* to the members' relationships *inter se*. For this reason, it should not be surprising that the prevalent institutional form of nonprofit organizations is business-like. See, e.g., Evelyn Brody, *Institutional Dissonance in the Nonprofit Sector*, 41 Vill. L. Rev. 433 (1996); Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & Econ. 301, 318-21 (1983); James J. Fishman, *The Development of Nonprofit Corporation Law and an Agenda for Reform*, 34 Emory L.J. 617 (1985).

23 For the claim that instead of focusing on law's pathologies, lawyers should turn their attention to the way it functions in people's daily lives, see H.L.A. Hart, *The Concept of Law* 79-88 (1961).

institutions at stake.<sup>24</sup> In other words, mid-game purposes dealing with the daily and the mundane inform end-game rules dealing with failures and pathologies. Rather than focusing analysis on the failures of these property institutions, we instead look at the core period of success, the period that provides stakeholders with their predominant motivation for entering the relationship and that structures the rules for conflicts management.

In many contexts, the economic and social mid-game purposes tend to reinforce one another. This is because interpersonal capital facilitates trust, which, in turn, gives rise to economic success, and economic success tends to strengthen trust and mutual responsibility.<sup>25</sup> But, at times, economic success and social cohesion push in different directions. While neither front can be wholly abandoned — because either total economic failure or the collapse of social cohesion will effectively end cooperative resource management — different property institutions (from close corporations to families) allow differing emphases for economic success and social cohesion. More precisely, for property institutions at the economic end of the spectrum, ideal-typic parties to conflicts of interest are (implicitly) conceptualized by law as "absentee investors"; by contrast, at the social end, they are "active participants."

As property institutions approach the economic pole of the spectrum, it becomes more likely that stakeholders will be treated as "absentee investors," interested in maximizing profit while minimizing their daily involvement.<sup>26</sup> This role affects the nature of the legal rules regulating potential conflicts of interest in all three decisional spheres. Concerns about potential conflicts of interest in the sphere of individual consumption and investment decisions — that is, how to internalize costs of over-use and under-investment — will be allayed by limiting individual access to the resource. Potential conflicts of interest in the sphere of democratizing management decisions, in turn, are likely to be handled by setting hierarchical and formal procedures. And in the third sphere, that of de-escalating conflicts during transactions, there will be little internal control because market transactions provide ample policing against the external effects of stakeholders' decisions.

By contrast, as a property institution approaches the social pole,

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24 See Dagan & Heller, *supra* note 13, at 597-98; Frantz & Dagan, *supra* note 13, at 95-98.

25 See Philip Pettit, *The Cunning of Trust*, 24 Phil. & Pub. Aff. 202, 209-10 (1995).

26 See, e.g., Henry Hansmann & Rainer Kraakman, *The Essential Role of Organizational Law*, 110 Yale L.J. 387, 423-25 (2000); Mark J. Roe, *Strong Managers, Weak Owners: The Political Roots of American Corporate Finance* 4-8 (1994).

stakeholders are increasingly understood — by themselves and by others — as active participants in a joint endeavor, members in a purposive community. Thus, concerns about over-use and under-investment can no longer be solved by limiting access. The law must detail what we call a sphere of "individual dominion" — a realm of decisions regarding consumption and investment that a member can make on her own. In this realm, the potential abuses of over-use and under-investment must be regulated head-on by setting accounting rules that protect against such opportunism. Furthermore, when we get to the sphere of more fundamental managerial decisions, hierarchies become — at least in liberal legal environments — increasingly unacceptable. Where the economic aspect is tangential to the role of the joint resource as a focal point of a community's self-identification, participatory procedures are called for. The closer a property institution is to the social pole, the greater the emphasis is on voice — the more likely, in other words, that we will find a republican governance regime in which joint management is not only a means to the end of maximizing yield, but also a forum and a medium of community-building. Finally, in these types of property institutions, the market does not provide sufficient protection against external effects of stakeholders' transactional decisions. The more social the institution, the greater the risk of opportunistic exit and entry. Thus, the more social it is, the more collective control we see over exit and entry. Supporting predominantly social property institutions requires legal mechanisms aimed at policing opportunistic exit and preempting opportunistic entrants.<sup>27</sup>

As these sketches suggest, the economic/social spectrum informs the animating values that drive law's solutions to conflict of interest problems. The discussion below develops the argument by showing that this spectrum helps explain, and indeed justify, many of the rules addressing problems of conflict of interest in consumption and investment, management, and alienation of group resources. In other words, situating legal rules in context transforms seeming chaos into a coherent legal landscape.

## **B. Addressing Consumption and Investment**

Legal rules addressing conflicts of interest in the context of consumption and investment by individual stakeholders take three main forms: limiting access to the joint resource, providing for an accounting based on the relative contribution of the individual parties, and prescribing a regime that

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<sup>27</sup> See Dagan & Heller, *supra* note 13, at 596-601.

collectivizes their individual inputs and outputs. Each form is based on a specific understanding of the parties' relationship and would be ill-suited if transplanted to an alien context.

As a corner case, beyond the direct scope of the Article, consider a shareholder in a publicly held corporation. Such a shareholder is precluded from having access to the assets of the firm: she can neither consume these resources nor make any (individual) decisions regarding investment in them.<sup>28</sup> Other stakeholders in property institutions do have some access to the joint resource, but the scope of their rights to consume and invest and, even more importantly, the legal consequences following such individual acts vary significantly.<sup>29</sup> More specifically, as we shift from economic to social, we are shifting away from simple stakeholding and towards a more robust set of rights and responsibilities. In-between the absentee owner and the spouse, we can find cases of active members in "Lockean communities" — communities committed to awarding rights or wages to those who contribute to the collectivity by engaging in purposeful value-creating activities.<sup>30</sup> In such cases, contribution-based accounting rules safeguard the community against abuses of the decision-making power in consumption and investment decisions. Then, at the polar social end of the spectrum — marital property — not only is the realm of individual involvement the most expansive, it is also the most egalitarian.<sup>31</sup>

The law of co-ownership provides a nice example of a Lockean community. Internalization typifies the regulation of consumption and investment decisions in both common law and civil law traditions. This

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28 See, e.g., Model Bus. Corp. Act §§ 6.30, 6.40, 8.01 (1998); see also Robert Charles Clark, *Corporate Law* § 3.2.1 (1986) (directors have formal legal authority to manage corporation); Hansmann & Kraakman, *supra* note 26. *But cf.* Del. Code Ann. tit. 8, § 351 (allowing charter of close corporations to indicate management by owners rather than board of directors); N.Y. Bus. Corp. Law § 620 (2004) (allowing more robust ownership voting control over directors in corporations whose shares are not traded on national securities exchanges or regularly quoted in an over-the-counter market).

29 See Dagan & Heller, *supra* note 13, at 582-90; see also Alan R. Bromberg & Larry E. Ribstein, *Bromberg and Ribstein on Partnerships* §§ 3.04-3.05 (2004) (discussing abiding ambiguity in model partnership acts between "aggregate" and "entity" theories of property holding).

30 See Stephen Buckle, *Natural Law and the Theory of Property* 149-52 (1991) (discussing Lockean justification for property rights as reward for productive labor); Stephen R. Munzer, *A Theory of Property* 255-67, 285-87 (1990) (pointing to the centrality of desert for labor to the justification for private property).

31 See Frantz & Dagan, *supra* note 13, at 126-32.

mechanism is firmly established in the Continental tradition with clear rules prescribing liability for the fair market value for use<sup>32</sup> and an entitlement to pro rata contribution for investment in preservation of the common resource.<sup>33</sup> The rules of the common law fall short in some respects: liability for use is contingent upon the ouster of the absentee commoner,<sup>34</sup> and the entitlement to contribution is in most cases deferred up until the time of partition.<sup>35</sup> These differences are not insignificant.<sup>36</sup> But for our purposes the similarities are much more important. Both traditions allow individual commoners access to the common resource for the purposes of consumption and investment. Both therefore need to set internalization rules that manage the resulting conflicts of interest that come about from the divergence between the self-interest of the individual commoner and the collective interest. And — our main point here — these internalization rules assume a Lockean baseline, which is the premise of law's accounting procedure, calculating individual inputs and outputs.

Compare this scheme with the law of marital property. As a liberal commons institution, marital property law is also concerned with possible conflicts of interest between spouses in their investment decisions in the marital estate. While the rhetoric of individual contribution still pervades marital property law, its actual doctrine has very little to do with the Lockean desert-for-labor principle.<sup>37</sup> Instead of an accounting mechanism of individual inputs and outputs, the most basic norm of marital property law is equal division upon divorce.<sup>38</sup> This norm takes different forms in different jurisdictions — a bright line rule, a presumption, or a "starting point" that applies at the very least with regard to the family home.<sup>39</sup> What is important for our purposes here is again the common denominator of these different doctrines: their rejection of the accounting logic of Lockean

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32 In this respect, Israeli law, for example, follows the Continental tradition, prescribing: "A joint owner who has used the joint property shall pay to the other joint owners, according to their shares in the property, suitable to recompense for the use thereof." Israel Land Law, 1969, § 33, 23 L.S.I. 283, 288 (1968-69).

33 See § 748 BGB, translated in *The German Civil Code* 122 (Ian S. Forrester et al. trans., 1975); Israel Land Law § 32.

34 See, e.g., 2 *American Law of Property* § 6.13, at 52-54 (A. James Casner ed., 1952).

35 See, e.g., Roger A. Cunningham et al., *The Law of Property* § 5.9, at 215-16 (2d ed. 1993).

36 See Dagan & Heller, *supra* note 13, at 611-13.

37 See Frantz & Dagan, *supra* note 13, at 89-90.

38 See, e.g., Martha Garrison, *The Economic Consequences of Divorce: Would Adoption of the ALI Principles Improve Current Outcomes?*, 8 *Duke J. Gender L. & Pol'y* 119, 124 (2001).

39 See Frantz & Dagan, *supra* note 13, at 101.

baselines. A rule of equal property division on divorce discourages keeping an accounting of individual investments in and returns from the marital relationship. Contrariwise, equal division makes it easier for spouses to engage in sharing behavior that typifies marriage — investing in relationship-specific goods, specializing, and making individual sacrifices for the overall good of the marital community. Spreading the benefits and the risks of this kind of behavior equally between the parties transforms personal sacrifice into joint endeavor.<sup>40</sup>

The same egalitarian premise, but with a twist, applies to potential conflicts of interest in the consumption of marital assets. The basic rule follows the fundamental premise of sharing with no accounting by allowing normal consumption by a spouse even if it is not equal to the other spouse's consumption. But in order to protect a daily routine of no accounting, marital property law also anticipates the pathological cases and protects each spouse from abusive consumption choices by the other. Hence, it also includes an ancillary rule that provides remedies for extremely irresponsible or overly self-interested consumption decisions, such as in cases of gambling, drinking, and drug use, which tend both to benefit one spouse disproportionately and to threaten the integrity of the marital estate.<sup>41</sup>

### C. Regulating Collective Decision-Making

Paralleling the shift in underlying values guiding conflicts management, we also see a shift in the style of decision-making, moving from formal and hierarchical to informal and participatory. Predominantly economic property institutions are usually highly formal and hierarchical. Here, the regulation of conflicts of interest in the context of management decisions is addressed by *ex ante* rules that establish governing bodies, allocate powers among them, and prescribe procedures for their routinized operation.<sup>42</sup> These rules are typically foreground rules: rules that stakeholders and legal players alike

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40 *Id.* at 104.

41 *See* Oldham, *supra* note 17, at 161-64.

42 *See, e.g.,* Zohar Goshen, *The Efficiency of Controlling Corporate Self-Dealing: Theory Meets Reality*, 91 Cal. L. Rev. 393, 401-08 (2003); Edward B. Rock & Michael L. Wachter, *Waiting for the Omelet to Set: Match-Specific Assets and Minority Oppression in Close Corporations*, 24 J. Corp. L. 913 (1999); Frank H. Easterbrook & Daniel Fischel, *Close Corporations and Agency Costs*, 38 Stan. L. Rev. 271 (1986); Eugene F. Fama & Michael C. Jensen, *Agency Problems and Residual Claims*, 26 J.L. & Econ. 327 (1983).

expect to be deployed in the daily life of that property institution (and not only during the end-game, which is inevitably legal).

By contrast, predominantly social property institutions are highly informal and participatory. Parties to neighborly relationships often find formalistic decision-making and resort to law to be the beginning of the end.<sup>43</sup> So, if law is to facilitate such property institutions, it needs to act in softer ways by setting more participatory and looser procedures. Governance in these contexts is understood not only instrumentally, but also as a means to intensify the parties' interpersonal relations. Hence, republican participatory governance substitutes for the top-down governance of purely economic property institutions.<sup>44</sup> Further, instead of foreground rules, law typically employs background regimes for consensual decision-making. Thus, a majority rule can provide a safety net against the potential abuse by holdouts.<sup>45</sup> Similarly, community governance rules can operate indirectly to recruit third parties in protecting community resources: for example, by voiding decisions reached by an insufficient majority or through inappropriate procedures.<sup>46</sup>

At first blush, it may seem that the effect of the varying characters of property institutions on law's internalization mechanisms is substantive, while their effect on law's democratization mechanisms is formal. While the form/substance dichotomy maps to a large extent to these different mechanisms, it would be incorrect to ignore the ways in which management rules (democratization) implicate substance, while consumption and investment rules (internalization) implicate form. Thus, on the one hand, the norm of equality that typifies the social end of our spectrum informs not only substantive rights of spouses in the marital context, but also their voting rights. For instance, voice is not related to contribution in marriage.<sup>47</sup> On the other hand, law's democratization mechanisms for regulating potential conflicts over management are not the only background safety nets for the parties' relationships. Also, law's accounting rules governing consumption and investment decisions function in a similar way, affecting the parties' behavior and expectations and protecting them from abuse, rather than regulating their daily lives.<sup>48</sup>

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43 See, e.g., Robert C. Ellickson, *Order without Law: How Neighbors Settle Disputes* 60-64, 69, 76, 274 (1991); Elizabeth S. Scott & Robert E. Scott, *Marriage as Relational Contract*, 84 Va. L. Rev. 1225, 1285-87, 1294-95 (1998).

44 See McKean, *supra* note 20, at 258, 260-61.

45 See Dagan & Heller, *supra* note 13, at 577-79.

46 See generally Dagan, *supra* note 10, at 1535-50.

47 See Frantz & Dagan, *supra* note 13, at 103-06.

48 See Dagan & Heller, *supra* note 13, at 578.



But our focus in this section is on democratization: the differing ways in which property law addresses conflicts of interest that affect fundamental management decisions by setting procedures for collective management. The law of common interest communities provides a rich example for a formal and hierarchical management regime that typifies predominantly economic property institutions. A common interest community has the power to manage its common property and administer its servitude regime in a real-estate development or neighborhood.<sup>49</sup> It can raise funds (by way of assessment of fees); manage, acquire, and improve common property; adopt rules governing use of property; and set procedures to encourage compliance and deter violations.<sup>50</sup> A common interest community is managed by an association, which, in turn, is governed for most purposes by a representative government: a board elected by its members. The board is entitled "to exercise all powers of the community except those reserved to the members," and members have

the right to vote in elections for the board of directors and on other matters properly presented to [them], to attend and participate in meetings of the members, and to stand for election to the board of directors. Except when the board properly meets in executive session, [members] are [also] entitled to attend meetings of the board of directors and to a reasonable opportunity to present their views to the board.<sup>51</sup>

Compare this formal and hierarchical management structure to the informal and participatory regime applicable in predominantly social property. One example comes from the governance of commons property in the Continental tradition, in which the law prescribes only a basic norm of majority rule, accompanied by open-ended rules of disclosure, consultation, and fair hearing.<sup>52</sup> Another example comes from the rules community property law prescribes for the governance of marital property.<sup>53</sup> Transactions in the marital estate require joinder if they involve substantial amounts of money (such as community real estate or a business) or resources that reflect the group-identity of the marital community and the personhood

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49 Restatement (Third) of Servitudes §§ 6.4, 6.2(1) (2000).

50 *Id.* §§ 6.5-6.8.

51 *Id.* §§ 6.2(3), 6.16, 6.18.

52 See Dagan & Heller, *supra* note 13, at 615-16.

53 A somewhat similar analysis applies in the majority of common law jurisdictions that recognize the tenancy by the entirety. See Dagan, *supra* note 10, at 1542-43, 1547-56.

of its members (again, the marital residence, but also its contents).<sup>54</sup> Joinder is desirable in these contexts to ensure that decisions do, indeed, aim to improve communal goods — to manage, in other words, the potential conflict between the interest of each individual spouse and the collective good. The joinder rule is a background rule. It neither prescribes any specific governance procedure nor does it require judicial intervention within a functioning marriage. Rather, in most cases where joinder is required, banks and other third parties are recruited to police conflicts of interest. Where such third parties realize that a transaction requires joinder to be binding, they are likely to require joinder before entering into that transaction with a single spouse, thus the joinder rule indirectly prevents self-serving violations by one spouse in a community.<sup>55</sup>

#### **D. Policing Exit and Entry**

Decisions to sell (or buy) a share in the common resource can affect the well-being of the community and thus may give rise to worries of conflicts of interest. Where predominantly economic property institutions are at issue, the pricing mechanism of the market sufficiently polices against abuse, so that there is no further need for a more fine-tuned de-escalating mechanism. This is indeed the law in the limiting case of our inquiry: share transactions during the routine life of publicly-held corporations.<sup>56</sup> As we move towards the pole of predominantly social institutions, things become more complicated. With respect to these property institutions, social cohesion is an increasingly important part of the value of the common resource, both to the remaining commoners and to the potential entrants. Here, to protect the community from opportunistic exit, we find rules aimed at ameliorating such potential conflicts of interest.

With some liberal commons institutions, these mechanisms take the form of moderate alienation restraints that protect cooperation values. Thus, one way to manage conflicts of interest in property institutions is by prescribing cooling-off periods. This technique applies in many co-ownership settings<sup>57</sup>

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54 See Frantz & Dagan, *supra* note 13, at 126.

55 See, e.g., John P. Dwyer & Peter S. Menell, *Property Law and Policy: A Comparative Institutional Perspective* 218 (1998).

56 In these institutions, the presumption in favor of free alienability can even extend to sales of controlling blocks of shares, which may allow large blockholders to capture arguably disproportionate premia for the sale of control. Cf. Frank E. Easterbrook & Daniel Fischel, *Corporate Control Transactions*, 91 *Yale L.J.* 698, 715-19 (1982) (arguing in favor of "market rule").

57 For example, Israeli law sets a time limit of five years for agreements restraining alienation and prescribes that the time limit on agreements restraining partition be

and was recently introduced (albeit in a controversial fashion) in some states that provide for waiting periods before divorce.<sup>58</sup> Cooling-off periods can help ameliorate the damaging domino effect of defection in consumption and investment decisions. Such "grace periods" are, at times, enough to motivate the parties' continued trust and cooperation even if fully "rational" parties would behave cooperatively only if the game were indefinite.<sup>59</sup>

Similarly, exit taxes that monetize the destructive effects of exit (the costs of recruitment and socialization of a replacement commoner) and are properly attuned to deter opportunistic departure<sup>60</sup> can also serve as legitimate background rules that act as a safety net for the community. The shift in marital property law from "title" theory, through "contribution" theory, to the increasingly prevalent norm of "equal division" upon divorce can be analyzed as an important example of such a virtuous exit tax.

Finally, de-escalating conflicts of interest on exit policing against opportunism on entry may require entry-control mechanisms, such as a right of first refusal. This technique — applied notably in the contexts of condominiums and cooperatives<sup>61</sup> — allows the continuing members of the group some degree of control over the identity of future transferees of the current commoners. By screening out non-cooperative entrants up front, the community also reduces the likelihood of exploitation later on by spiteful exiters or by exiters who insist upon side payments to ensure cooperative replacements.

These three techniques — cooling-off periods, exit taxes, and entry-control mechanisms — constitute a rich repertoire of de-escalation strategies for addressing the potential conflicts of interest generated by a member's

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left to the discretion of the court — after three years, the court may order partition despite the agreement if the court deems it just to do so. Israel Land Law, 1969, §§ 34(b), 37(b), 23 L.S.I. 283, 288 (1968-69).

58 Covenant marriage, first adopted in Louisiana, is one well-known example of waiting periods for divorce. La. Civ. Code Ann. arts. 9:272-75.1, 9:307-09 (West 2000). To the extent that covenant marriage does not allow immediate exit from emotionally or psychologically abusive relationships, it is obviously insupportable. See Jeanne Louise Carriere, *"It's Deja Vu All Over Again": The Covenant Marriage Act in Popular Cultural Perception and Legal Reality*, 72 Tul. L. Rev. 1701 (1998).

59 Cf. Martin J. Osborne & Ariel Rubinstein, *A Course in Game Theory* 135 (1994).

60 A complicated matter, to be sure. See Dagan & Heller, *supra* note 13, at 600-01.

61 See Mark D. Rosen, *The Outer Limits of Community Self-Governance in Residential Associations, Municipalities, and Indian Country: A Liberal Theory*, 84 Va. L. Rev. 1053, 1099-1101, 1126-27 (1998); Gregory S. Alexander, *Dilemmas of Group Autonomy: Residential Associations and Community*, 75 Cornell L. Rev. 14-15, 50-53 (1989); Hansmann, *supra* note 18, at 31-32.

decision to exit. But the context of exit raises another potential conflict of interest — a mirror-image of the one we have thus far discussed, namely, the fear that the exiter (or any individual commoner, for that matter) will be opportunistically diluted by other members of the community (the majority). Here again, for predominantly-economic property institutions, the pricing mechanism of the market provides a sufficient policing mechanism and there is no need for any further de-escalation technique. But as we move to more social property institutions, the market may not be enough. Sale may not sufficiently protect against opportunistic dilution, because it can be expected to undervalue the pro rata ownership share of the exiter. This undervaluation is increasingly likely and significant as the social benefits of cooperation, and the role of participatory management, are more central to the commons resource. For example, with co-ownership and partnership, the only way of policing against opportunism and preserving an individual right to exit is to allow a departing individual to dissolve the property institution. Thus, we can understand why the doctrine governing these contexts provides an inalienable right (which can be limited only temporarily) to partition or dissolution.<sup>62</sup>

### CONCLUDING REMARKS

Once released from the straightjacket of exclusion theory, property law proves to be fertile ground for inquiries about conflicts of interest. Because property is just as much about cooperation as it is about competition — because property law regulates governance at least as much as it addresses exclusion — property scholars should be thinking more creatively about mechanisms for managing conflicts of interest. Managing conflicts is the inevitable price of cooperative property institutions. To be sure, avoiding and escaping conflicts of interest are, and should be, important legal responses. In this Article, we take no issue with the centrality of the fee simple absolute and the importance of exit — by sale and, where needed, even by dissolution. However, in an increasingly interdependent world, people

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62 See, respectively, John E. Cribbet & Corwin W. Johnson, *Principles of the Law of Property* 114 (3d ed. 1989) (only agreements by co-owners not to partition that do not amount to restraint on alienation are enforceable and only for limited time); Revised Unif. Partnership Act § 801(a) (1996) (dissolution of partnership at will); Bromberg & Ribstein, *supra* note 29, § 7.01(a) (discussing right of dissolution at will as expressive of root norm of *delectus personarum*, that partners choose their associates).

frequently want or need to work together, but worry that others may take advantage of them. Property governance, properly understood as a set of techniques for managing conflicts of interest in liberal commons institutions, is law's response to this challenge.

Property law employs three types of techniques for partially realigning stakeholders' interests: internalization, democratization, and de-escalation. And the specific form of each technique is, by and large, fine-tuned to the character of the property institution. Table 1 below reorganizes and summarizes our claims on this matter. Of course, as we noted throughout, economic and social aspects inhere in every property governance form, so what we present as a dichotomy operates more as a spectrum. Also, there is not a necessary link between each mode of managing conflicts in property and each sphere of property governance. These associations are typical, but not inevitable.

**Table 1: *Managing Conflicts of Interest in Property***

		Type of Property Institution	
		1. Economic	2. Social
Methods to Resolve Conflict	1. Internalize (for individual use & investment)	Limited access	Accounting (contribution, equality)
	2. Democratize (for management)	Formal & hierarchical	Informal & participatory
	3. De-escalate (for entry & exit)	Market transactions	Some internal collective control

This Table summarizes our preliminary steps towards understanding how property law deals with — avoids and escapes, but also manages — conflicts of interest. As a byproduct, our inquiry may also yield a lesson regarding the concept of conflicts of interest itself, which in turn may apply outside the property context. We therefore conclude with the following thoughts, which we hope to develop in our future work.

Perhaps as we move along the economic/social spectrum, we have uncovered distinct *types* of conflicts of interest, rather than distinct *solutions* to a single type. By shifting the relationship between the active individual and the conflicting interest, our spectrum reveals multiple understandings

(or conceptions) of what constitutes the core meaning of a conflict of interest itself.<sup>63</sup>

On the predominantly economic pole, conflicts arise between the well-defined interest of an individual *qua* individual and that individual's obligation to advance the collective interest. Limiting access (or a Lockean accounting), hierarchical and formal governance, and market-based de-escalation devices are fine solutions to problems of conflicts of interest understood within the paradigm of an I/we dichotomy.

As one moves along the spectrum towards the more social contexts, this understanding of what constitutes a conflict of interest becomes increasingly problematic: the implicit dichotomies — between I and you, I and we, mine and yours, mine and ours — seem too reductive. At the social pole of the spectrum (e.g., marriage), conflicts of interest are, to an extent, *internal* to the individual actor, because the group is also part of the actor's own self-understanding.<sup>64</sup> As the plural identity of the collective group becomes a more constitutive element of each individual's self-understanding, applying understandings of, and responses to, conflicts of interest from the economic sphere threatens to undermine, rather than advance, the good that the property institution aims to encourage. Law's tools for internalization, democratization, and de-escalation in social property forms — equal sharing, informal and participatory governance, and collective mechanisms for regulating exit and entry — appropriately mirror the participants' social character.

More generally, property law's varied solutions to conflicts of interest respond to these underlying differences in the nature of the group resource dilemma. Reasonable solutions to conflicts of interest in predominantly economic property institutions are increasingly ill-suited as we move toward social property institutions (and vice versa). The inventory of management techniques employed by property law may seem at first sight confusing, almost chaotic. The conflicts of interest lens opens a new and challenging perspective that brings focus to this doctrinal muddle.

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63 Cf. Ariel Porat, *The Many Faces of Negligence*, 4 *Theoretical Inquiries L.* 105 (2003) (arguing that negligence law should be reconsidered to account for the variety of balancing of interests dilemmas that are regulated through tort liability).

64 See, e.g., Margaret Gilbert, *Living Together: Rationality, Sociality, and Obligation* 2, 8 (1996); Elizabeth Anderson, *Value in Ethics and Economics* 151 (1993); Milton C. Regan, Jr., *Family Law and the Pursuit of Intimacy* 147 (1993).