Delaware Journal of Corporate Law

VOLUME 24 1999 NUMBER 2

LIMITED LIABILITY UNLIMITED

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ABSTRACT

Many types of economic relationships, including joint ventures, franchises, and joint operating agreements, resemble economic firms but differ from them in critical respects. Because of these nonfirm attributes, the parties to such relationships may not want the owner vicarious liability that comes by default with the legal characterization of a relationship as a partnership or agency. In order to clarify that the relationship does not trigger vicarious liability, the parties can form a corporation or other limited liability business association. However, the statutory default rules of these business associations do not fit many borderline firms. This article proposes a way out of this dilemma: creating statutes authorizing "Contractual Entities" whose owner liability and other terms would be governed solely by their filed operating agreements. The article analyzes potential arguments against the proposal, including those relating to the appropriate scope of limited liability and the functions of statutory forms. It also discusses the political aspects of adopting Contractual Entity statutes and some implications of the proposal for the future of limited liability and of contractual choice of law.

*Foundation Professor of Law, George Mason University School of Law. Funding was provided by the George Mason University Law and Economics Center. This article is derived from the Francis G. Pileggi Distinguished Lecture in Law, delivered by the author at the Widener University School of Law on October 16, 1998. The article benefited from many helpful comments at the lecture, including those from Professor Lawrence A. Hamermesh, Professor Ann E. Conaway Stilson, and Mr. Martin I. Lubaroff.

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The number and variety of limited liability business forms such as limited liability companies (LLCs) and limited liability partnerships (LLPs) have increased rapidly in recent years. These new forms received the IRS's imprimatur through revenue rulings clarifying their partnership taxation status.[1] Most recently the IRS threw open the doors with a "check-the-box" tax classification system that permits most nonpublicly held unincorporated firms to be taxed as partnerships.[2] Removing the tax constraints on business associations means that new types of business entities will emerge or existing entities will evolve. Accordingly, it is time to think creatively, including the previously unthinkable, about the future of business associations. One view of these developments is that there are too many different types of firms. Now that "check-the-box" has removed many of the tax reasons for distinguishing between firms, business association statutes should be combined into a single statute, perhaps with variations for individual provisions.[3] This view of the functions of business association statutes is heavily tax-influenced.[4] It emphasizes the costs of having too much choice while it ignores the benefits, beyond tax considerations, of separate business association statutes in providing coherent sets of default rules for filling contractual and regulatory gaps for the many kinds of firms in the real world.[5]

Taking a very different tack, this article suggests that there are not, and cannot be, enough business forms to suit all business relationships. A principal generally is vicariously liable for an agent's conduct[6] unless the owner acts through a statutory limited liability business association.[7] This protection, however, comes at a cost. Firms whose owners want to limit their liability normally must adopt one of the standard form governance contracts the state provides for limited liability firms. These standard forms include default rules concerning such matters as management and fiduciary duties that the owners of many types of businesses may not want. Yet it may

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[1]*See, e.g.*, Rev. Proc. 95-10, 1995-3 I.R.B. 20 (clarifying the conditions under which the Internal Revenue Service will consider a request for a ruling as to partnership tax classification of an LLC).

[2]*See* Treas. Reg. §§ 301.7701-1 to -3 (1998) (providing that a domestic "eligible entity," including a business firm other than a corporation, joint stock company, insurance company or bank, is not treated as a corporation for income tax purposes unless it elects this treatment).

[3]*See* Robert R. Keatinge, *Universal Business Organization Legislation: Will It Happen? Why and When*, 23 DEL. J. CORP. L. 29, 49 (1998).

[4]Thus, Keatinge takes 17 pages to discuss the tax "Forces Shaping the Revision of Business Organization Law" and only three pages to discuss all others. *Id.* at 47-67.

[5]*See* Larry E. Ribstein, *Statutory Forms for Closely Held Firms: Theories and Evidence from LLCs*, 73 WASH. U. L.Q. 369, 377-84 (1995).

[6]RESTATEMENT (SECOND) OF AGENCY § 219 (1958).

[7]*See infra* Part I.B.

be costly to waive the inappropriate rules, and courts do not enforce all waivers. In short, firms sometimes have to choose between risking vicarious liability for their owners and being bound to their co-investors by inappropriate fiduciary duties or management rules. Thus, some firms might prefer to have limited liability without being saddled with a standard form. As looser business structures replace traditional hierarchical relationships, there are an increasing number of forms on the borderlines of existing doctrinal cubbyholes. A legal mechanism is needed for handling these emerging forms of business.

This article challenges the idea that a business firm must fit into one of the accepted business association categories in order to limit its owners' liability for the firm's debts. I propose statutory provisions authorizing a "contractual entity" (CE) that is governed entirely by the parties' contract and the default rules appropriate to the specific type of contract. This would free idiosyncratic contracts from the limitations of existing standard forms merely because there is no other way for the owners to limit their liability. Perhaps the default rule should change so firms' owners would have limited liability unless they agree otherwise. As radical as these ideas may seem, they are merely the culmination of a long process, which has accelerated in recent years, of eroding restrictions on limited liability.[8]

This article disputes the necessity but not the importance of standard forms of business associations. Even if state legislatures widely accepted the CE, most firms probably would continue to organize as business associations precisely because these statutes do serve important functions.[9] One way to analyze these functions is to see what would happen if firms tried to dispense with standard forms. Thus, even if the open-ended entity proposed here would be used only in a limited number of cases, it is a useful thought experiment to better understand and improve on existing standard forms.

The article proceeds as follows. Part I analyzes the basic problem that creates a need for the "CE" — the existence of business structures that do not easily fit existing business association statutes. As discussed in Part II, firms may be forced to adopt unsuitable standard forms because of the inherent constraints on the development of new forms. Part III discusses the costs these constraints might impose on firms, including forcing them to

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[8]*See generally* Lynn M. LoPucki, *The Death of Liability*, 106 YALE L.J. 1, 5 (1996).

[9]The author has written about these functions in several previous articles, including Ribstein, *supra* note 5; Larry E. Ribstein, *Changing Statutory Forms*, 1 J. OF SMALL & EMERGING BUS. L. 11 (1997) [hereinafter Ribstein, *Changing*]; Larry E. Ribstein, *Linking Statutory Forms*, 58 LAW & CONTEMP. PROBS. 187 (Spring 1995) [hereinafter Ribstein, *Linking*]; Larry E. Ribstein, *Form and Substance in the Definition of a "Security": The Case of Limited Liability Companies*, 51 WASH. & LEE L. REV. 807 (1994) [hereinafter Ribstein, *Form and Substance*]; Larry E. Ribstein, *An Applied Theory of Limited Partnership*, 37 EMORY L.J. 835 (1988).

adopt unsuitable default rules, while Part IV analyzes the costs and benefits of the CE alternative. Finally, Part V takes the analysis a step further, by considering the elimination of the basic rule that gives rise to the business association constraint — i.e., default vicarious liability.

I. THE QUASI-FIRM

It is a central tenet of the law of business associations that owners of firms are, by default, vicariously liable for the firm's debts.[10] However, the economic and legal definitions of a firm are imprecise. Part I discusses some specific examples of "quasi-firms" that share "firm" and non-"firm" characteristics. These firms create the need for a new type of non-business association that transcends the boundaries of the traditional firm.[11]

A. *Defining a "Firm": Law and Economics*

At first glance, the legal and economic definitions of a firm seem to be reasonably coherent and consistent. Ronald Coase defined a firm as a hierarchical relationship in which owners determine inputs and outputs and share profits pursuant to a contractual governance structure.[12] He supported his economic theory in part by citing legal rules that tracked his definition.[13] Under these rules, an owner is one who both controls another and receives the profit from use of that control. A sole controller and residual claimant is a principal in an agency relationship,[14] while one who shares ownership rights is a partner.[15] Holding owners vicariously liable, in turn, is a sensible default rule because vicarious liability protects victims while imposing minimal marginal costs on owners. Owners' control enables them to take

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[10]*See, e.g.*, UNIF. PARTNERSHIP ACT § 15 (1914) (stating that partners are jointly liable for the partnership's debts); REV. UNIF. PARTNERSHIP ACT § 306 (1994) (stating that partners are liable jointly and severally for partnership debts).

[11]For an article reaching similar conclusions about a particular type of "virtual" firm, but proposing to solve the problem by creating another specific type of business association, see Ann E. Conaway Stilson, *The Agile Virtual Corporation*, 22 DEL. J. CORP. L. 497 (1997).

[12]*See* Ronald H. Coase, *The Nature of Firm*, 4 ECONOMICA 386, 388 (1937).

[13]*See id.* at 403. For a modern examination of this aspect of Coase's theory, see Scott E. Masten, *A Legal Basis for the Firm*, 4 J.L. ECON. & ORG. 181 (1988).

[14]*See* RESTATEMENT (SECOND) OF AGENCY § 1(1) (1957) (providing that agency "results from the manifestation of consent by one person to another that the other shall act on his behalf and subject to his control, and consent by the other so to act").

[15]Partnership is defined mostly with reference to profit-sharing. *See* UNIF. PARTNERSHIP ACT § 7(4) (1914); REV. UNIF. PARTNERSHIP ACT § 202 (1994). *See* 1 ALAN R. BROMBERG & LARRY E. RIBSTEIN, BROMBERG & RIBSTEIN ON PARTNERSHIP § 2.07(a) (1996) (applying the theory of the firm to rules for determining the existence of a partnership relationship).

loss-avoidance measures,[16] while their profit-share gives them incentives to do so carefully.[17]

Beyond simple definitions, however, lies much ambiguity. Economics tells us that owners of firms should be vicariously liable, but not what constitutes a legal firm or who its owners are. Thus, it is not clear what kinds of control and benefit give rise to agency and partnership. The definition of partnership presents particular difficulties. Partnership law defines a partnership as "an association of two or more persons to carry on as co-owners a business for profit."[18] Since partners are both agents and principals, a partner does not work primarily on behalf of a co-partner,[19] and may share management responsibility rather than agreeing to be subject to the other's direction. Because control is more ambiguous in partnership than in agency, partnership statutes focus on profit-sharing. If the parties share profits, the relationship may be presumptively a partnership.[20] But profit-sharing is a form of incentive compensation or risk-sharing in many relationships, such as employer-employee or debtor-creditor, in which the parties do not intend to be co-owners. Thus, the partnership statutes provide that profit-sharing is not presumptive evidence of a partnership if the relationship is one of several types designated in the statute.[21] If the relationship fits in one of the specific categories, the court must still weigh the profit-sharing evidence against other evidence. When faced with new types of transactions in the burgeoning market of the mid-nineteenth century, the courts had to find a way to distinguish partnership from non-partnership.

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[16]For an explanation of vicarious liability that also relies to some extent on the potential for loss avoidance by the principal see Alan O. Sykes, *The Economics of Vicarious Liability*, 93 YALE L.J. 1231, 1233-42 (1984).

[17]Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777 (1972) (explaining that a manager has an incentive to monitor profit seeking activities by being the residual claimant of the profits). For a discussion of the relevance of the Alchian-Demsetz theory to the definition of partnership, see BROMBERG & RIBSTEIN, *supra* note 15, § 2.07(a).

[18]*See* UNIF. PARTNERSHIP ACT § 6 (1914). R.U.P.A. uses similar language both to define a partnership and in stating how a partnership is formed. REV. UNIF. PARTNERSHIP ACT §§ 101(4), 202 (1994).

[19]*See* RESTATEMENT (SECOND) OF AGENCY § 1 (1957).

[20]*See* UNIF. PARTNERSHIP ACT § 7(4); REV. UNIF. PARTNERSHIP ACT § 202(c)(3).

[21]*See* UNIF. PARTNERSHIP ACT § 7(4) (1914); REV. UNIF. PARTNERSHIP ACT § 202 (1994). Case law indicates that other profit-sharing relationships, such as husband-wife, also may not be presumptive partnerships. *See* BROMBERG & RIBSTEIN, *supra* note 15, § 2.10.

profit-sharing relationships.[22] The courts have focused on control,[23] although the type of control needed may be different from that required for agency.

One might try to identify firms by identifying the characteristics of transactions that give rise to ownership-type relationships. This approach, however, also causes problems. Klein, Crawford, and Alchian[24] and Williamson[25] theorize that assets tend to be organized into hierarchically enforced firm contracts when the interdependence of the assets creates contract enforcement problems. Because the assets cannot easily be interchanged, each party to the relationship has an opportunity to "hold up" the other for most of the surplus value, or "quasi-rent,"[26] produced by combining the assets.[27] Following this approach, a relationship involving joint governance of firm-specific assets might be considered a firm whose parties have the sort of control and profit-sharing rights that characterize legal ownership. Parties, however, often combine full-fledged governance with market and reputational incentives to prevent contracting parties from engaging in opportunistic conduct.[28] Conversely, even some legal firms may not fit the economic definition because their governance is too weak to

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[22]*See* Naomi R. Lamoreaux, *Constructing Firms: Partnerships and Alternative Contractual Arrangements in Early Nineteenth-Century American Business*, 24 BUS. & ECON. HIST. 43, 60 (1995).

[23]*See id.*; BROMBERG & RIBSTEIN, *supra* note 15, § 2.07(b).

[24]Benjamin Klein et al., *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J.L. & ECON. 297 (1978).

[25]*See* OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM (1985). Asset-specificity can be reconciled with Alchian and Demsetz' earlier explanation for firms based on teamwork: moral hazard in teams creates a need for specialized investments in monitoring the team. *See* Armen A. Alchian & Susan Woodward, *Reflections on the Theory of the Firm*, 143 J. INST. & THEO. ECON. 110, 115 (1987).

[26]*See* ALFRED MARSHALL, PRINCIPLES OF ECONOMICS 453-54, 626 (8th ed. 1936).

[27]*See* Klein et al., *supra* note 24, at 297-99. More precisely, when one asset derives some of its value from combination with a second asset, the owner of each asset potentially has the power to extract some of the extra value, or "rent," his asset confers on the other by threatening to withdraw it. *Id.*

[28]For articles exploring these alternatives, see, e.g., GEORGE BAKER, ET AL., RELATIONAL CONTRACTS AND THE THEORY OF THE FIRM (Dec. 29, 1997) (unpublished manuscript, on file with *The Delaware Journal of Corporate Law*); Gerald T. Garvey, *Why Reputation Favors Joint Ventures over Vertical and Horizontal Integration: A Simple Model*, 28 J. ECON. BEHAVIOR & ORG. 387 (1995); Bengt Holmström & John Roberts, *The Boundaries of the Firm Revisited*, 12 J. ECON. PERSP. 73 (1998); Benjamin Klein & Kevin M. Murphy, *Vertical Integration as a Self-Enforcing Contractual Arrangement*, 87 AM. ECON. REV. 415 (1997); Klein et al., *supra* note 24.

prevent hold-up.[29] In short, there is a continuum of "firm-ness" rather than a strict dichotomy between firms and non-firms.[30]

Thus, the categories of relationships that comprise legal "firms" are necessarily imprecise. For economists, these ambiguities are simply grist for more analysis. For lawyers and their clients, however, the uncertainty is more problematic. If a court decides that a relationship crosses the line into co-ownership of a firm, the parties may be vicariously liable for debts.[31] They also may have management and profit-sharing rights and fiduciary obligations under agency and partnership default rules. As shown in the following subsections, modern stresses, particularly including rapid technological change, have increased the ambiguity and created a need for a legal fix.

B. *Franchise Contracts*

The franchise contract is a classic example of a hybrid of firm and non-firm.[32] Franchising is the classic case of relation-specific assets. For example, the franchisee invests in knowledge and equipment (such as "golden arches") that relate specifically to the franchise. The franchisor therefore can "hold up" the franchisee by threatening the loss of the franchise. This hold-up power lets franchisors punish franchisees that try to get a free ride on the franchise system by delivering low-quality goods and services at the high-quality franchise price. At the same time, franchisors may use their power over franchise assets opportunistically to extract some of the surplus created by joint efforts with franchisees. Thus, the greater the hold-up powers of franchisors, the weaker the franchisees' *ex ante* incentives to make relation-specific investments, such as expertise related to the specific franchise.

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[29]*See* Lamoreaux, *supra* note 22, at 68-69 (noting that general partnerships may provide little protection against hold-up because they can be dissolved at will). *See also* Naomi R. Lamoreaux, *Partnerships, Corporations and the Theory of the Firm*, 88 AM. ECON. REV. 66 (1998) (noting that general partnerships have a higher degree of continuity, or "firm-ness," than limited partnerships because, while both can be dissolved at will, limited partners have more incentive to dissolve because they have a priority right to distributions).

[30]*See* WILLIAMSON, *supra* note 25, at 244-48; Henry N. Butler & Barry D. Baysinger, *Vertical Restraints of Trade as Contractual Integration: A Synthesis of Relational Contracting Theory, Transaction-Cost Economics, and Organization Theory*, 32 EMORY L.J. 1009, 1045 (1983); Lamoreaux, *supra* note 22, at 66.

[31]*See* UNIF. PARTNERSHIP ACT § 15 (1914); REV. UNIF. PARTNERSHIP ACT § 306(a) (1994).

[32]*See* Paul H. Rubin, *The Theory of the Firm and the Structure of the Franchise Contract*, 21 J.L. & ECON. 223 (1978); *see generally* James A. Brickley & Frederick H. Dark, *The Choice of Organizational Form: The Case of Franchising*, 18 J. FIN. ECON. 401 (1987) (discussing the economics of franchising).

These circumstances suggest that the brand name owner might be better off owning the outlet and hiring local managers than franchising. This might, however, simply replace free-riding with agency costs since hired managers would lack high-powered incentives to maximize the profits of the franchise.[33] Agency costs may be high because the franchisor cannot effectively supervise remote outlets. Similarly, the franchisor may not want to take the risk of bearing the liabilities triggered by a remote outlet.

In short, in order to balance these considerations, the franchise relationship is likely to combine elements of a firm and long-term non-firm contract. For example, the franchisor may have extensive and detailed powers over the franchise that stops just short of formal ownership. It may not be clear, however, if the franchisor's control and profit-sharing make it an owner for purposes of vicarious liability.[34] The franchisor cannot reduce this exposure by specifying in the contract that it does not own the outlet, since customers and other third parties are not bound by the contract.[35]

One way out of this problem is for the brand-name owner to acknowledge its ownership of the outlet but form a limited liability business association with the outlet owner. This would ensure that third parties could look solely to the venture for payment of claims. The difficulty with this solution is that the business association subjects this outlet owner to fiduciary duties, including the duty not to terminate, as well as management, profit sharing and other rights that may be difficult or impossible to waive in the agreement. Reducing the risk of liability to third parties may not be worth all of this extra baggage.

C. *Joint Ventures and Other Coalitions Between Firms*

Firms are increasingly engaging in cooperative relationships that fall short of full-fledged integration. There are several possible explanations for this development.[36] The loosening of antitrust law invites cooperative ventures.[37] Increased competition resulting from, among other things, takeover-induced restructuring and reduced regulatory and international

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[33]*See* Brickley & Dark, *supra* note 32, at 405.

[34]*See, e.g.*, Nichols v. Arthur Murray, Inc., 56 Cal. Rptr. 728, 731 (Cal. Ct. App. 1967) (finding that the right to control is an important factor in determining whether an agency relationship exists).

[35]*See id.* (holding franchisor liable to customer despite contract provision disclaiming franchise relationship).

[36]*See generally* Norman E. Rosen, Symposium, *Joint Ventures, Including Strategic Alliances, to Develop Computer Technology*, 61 ANTITRUST L.J. 861 (1993).

[37]*See, e.g.*, SCFC ILC, Inc., v. VISA USA, Inc., 36 F.3d 958 (10th Cir. 1994); Thomas A. Piraino, Jr., *Beyond Per Se, Rule of Reason or Merger Analysis: A New Antitrust Standard for Joint Ventures*, 76 MINN. L. REV. 1 (1991).

barriers to competition makes it harder for firms to stand alone. The fast pace of technological development brings with it rapidly decreasing costs and prices, as well as free-riding rivals who quickly mimic new technology.[38] This reduces the returns from innovation and increases the need for cooperation. But firms' alliances may need to be temporary enough to respond to rapid change.[39]

Firms have responded to these pressures by forming joint ventures or looser cooperative enterprises.[40] The recent announcement of joint marketing plans by the major airlines is a prominent example.[41] These ventures let firms share investments in risky new inventions, in entering risky new markets, or in reducing free rider problems by cooperating with rivals in research and development. Such ventures may not be traditional "firms,"[42] and indeed may not be firms at all because the parties do not co-own the assets.[43] Although these ventures do have the attributes of a firm in that the venturers share partnership-like governance and profit-sharing rights,[44] in other respects they may compete, or at least deal at arm's length. Indeed, the antitrust laws may require the parties to preserve competition to the extent possible.[45] Most importantly, the strong possibility of deadlock gives the venture the attributes of a long-term relational contract[46] because the parties must rely more on renegotiation and reputational incentives[47] than on governance mechanisms.

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[38]*See* Charles T.C. Compton, *Cooperation, Collaboration, and Coalition: A Perspective on the Types and Purposes of Technology Joint Ventures*, 61 ANTITRUST L.J. 861, 868-69 (1993).

[39]For a discussion of the problems of applying existing fiduciary, liability and other rules to such "agile virtual" firms, see Stilson, *supra* note 11.

[40]*See* Larry E. Ribstein & Bruce H. Kobayashi, *Joint Ventures*, *in* NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 376, 376-79 (Peter Newman ed., 1998).

[41]*See* Martha Brannigan et al., *Delta and United Air Plan Huge Alliance*, WALL ST. J., Apr. 24, 1998, at A3 (discussing plans by United and Delta to sell seats on each other's domestic flights and combine their frequent-flier programs).

[42]*See* Joseph F. Brodley, *Joint Ventures and Antitrust Policy*, 95 HARV. L. REV. 1523, 1527 (1982) (characterizing joint ventures as a "distinct" type of firm).

[43]*See* Alchian & Woodward, *supra* note 25, at 132 (noting that although venturers are interreliant in that they depend on the services of the venture, assets are not owned in common); Oliver Hart & John Moore, *Property Rights and the Nature of the Firm*, 98 J. POL. ECON. 1119 (1990).

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

[45]*See* Brodley, *supra* note 42, at 1530-34.

[46]*See generally* WILLIAMSON, *supra* note 25; OLIVER E. WILLIAMSON, MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS (1975); Ian R. MacNeil, *Contracts: Adjustment of Long-Term Economic Relations Under Classical, Neoclassical, and Relational Contract Law*, 72 NW. U.L. REV. 854 (1978).

[47]*See* Brodley, *supra* note 42 (discussing importance of these features in differentiating joint ventures from traditional firms).

It follows from this analysis that the parties to the joint venture may not fit neatly into traditional business association categories. Like brand-name and outlet owners, the venturers may want to avoid both vicarious liability for the enterprise's debts and default business association rules that are suited to hierarchical governance structures. The main problem with partnership and other organizational forms for joint ventures is that the venturers would still be locked into strong partnership-type co-management default rules and strong fiduciary duties. Duties forbidding competition and requiring disclosure are particularly inappropriate for venturers whose managers compete or deal at arm's length with each other outside the limited scope of the venture. Such duties may be relevant where, for example, a manager decides whether to expand into a venturer's territory, buys the venture's inputs from or sells its output to his employer, or takes business opportunities that the venture could have exploited.[48]

The joint venturers may try to waive fiduciary duties in their agreement. These waivers are probably enforceable.[49] For example, in *AB Group v. Wertin*,[50] the court noted:

> [In construction,] [p]artnership or joint venture agreements between developers often involve parties who are already business competitors [with] fingers in many pies and have . . . united their resources for a specific project only. Economic efficiency is promoted when such partners are able to modify fiduciary duties to accommodate their unrelated business. . . . Without that freedom, such partnerships or joint ventures might never be formed, and the jobs and wealth later created never brought into being.

Recent statutes, however, may create uncertainty as to the enforceability of blanket waivers in the operating agreement.[51] Even if the agreement is enforceable, the venturers cannot cheaply anticipate such everyday matters as sourcing and distribution. The venturers' consent to specific acts may not be viable if it is obtained without disclosure of material facts. Disclosure,

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[48]*See* Zenichi Shishido, *Conflicts of Interest and Fiduciary Duties in the Operation of a Joint Venture*, 39 HASTINGS L.J. 63, 74-75 (1987) (examining the anticompetitive effects of a joint venture).

[49]*See generally* Larry E. Ribstein, *Fiduciary Duty Contracts in Unincorporated Firms*, 54 WASH. & LEE L. REV. 537 (1997) (concluding that courts generally enforce fiduciary waivers in unincorporated firms).

[50]69 Cal. Rptr. 2d 652, 662 (Cal. Ct. App. 1997).

[51]*See* REV. UNIF. PARTNERSHIP ACT § 103(b) (1994); UNIF. LIMITED LIABILITY COMPANY ACT § 103(b) (1995).

in turn, may be impracticable because it would reveal venturers' confidential information. The parties might rather rely on reputational incentives and negotiation than on legal duties.[52]

Given the problems of fitting into existing cubbyholes, joint venturers may want to define their own relationship in their contract and avoid existing sets of default rules. In other words, the parties may prefer an entity that is governed by their specific contract rather than by the default rules of a standard type of business association.

D. *Law Firms*

An important reason for the existence of law firms is that they can give reputational bonds for promises of care and loyalty that cannot be given by individual lawyers or smaller firms.[53] Lawyers invest their human capital to some extent in developing the firm's reputation. Because lawyers' investments are specialized to the firm's reputation, they contract for ownership rights, including rights in control, profits and determination of membership, in the law firm that owns the reputation.[54] The lawyers also have a strong incentive to monitor the activities of their co-partners to ensure that they do not harm the firm's reputation. Thus, they may be willing to take responsibility for their colleagues' errors in return for being able to charge the clients more. In other words, vicarious liability might be an efficient term in contracts between some law firms and some clients.

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[52]*See* Compton, *supra* note 38, at 868; Joseph Kattan, *Antitrust Analysis of Technology Joint Ventures: Allocative Efficiency and the Rewards of Innovation*, 61 ANTITRUST L.J. 937, 945 (1993).

[53]*See generally* Larry E. Ribstein, *Ethical Rules, Agency Costs and law Firm Structure*, 84 VA. L. REV. 1707 (1998). Lawyers' promises of loyalty are credence goods that clients would have to take on trust in the absence of a reputational bond. *See* Michael R. Darby & Edi Karni, *Free Competition and the Optimal Amount of Fraud*, 16 J.L. & ECON. 67, 69 (1973). As to reputational bonding generally, see Benjamin Klein & Keith B. Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 J. POL. ECON. 615 (1981); Klein et al., *supra* note 24; Oliver Williamson, *Credible Commitments: Using Hostages to Support Exchange*, 73 AM. ECON. REV. 519 (1983).

[54]*See* Hart & Moore, *supra* note 43, at 1135 (concluding that a group of agents more than half of whom are needed to generate marginal products from assets will own the asset as a coalition and adopt a majority-vote rule). Oliver Hart has written separately that law firms may be an example of a cooperative in which the firm supplies its name and administrative services to the lawyers. *See* OLIVER HART, FIRMS, CONTRACTS, AND FINANCIAL STRUCTURE 52-53 (1995). This may understate the extent to which the lawyers' contributions are specialized to each and to the firm in the typical large law firm, though it may more accurately characterize the looser law firms described below.

The traditional law firm is, however, changing in many ways.[55] In particular, the rapid growth in the number of partners per firm and increased competition among firms has made it more likely that a partner's value outside the firm will exceed that inside the firm.[56] These developments reduce potential rewards for investing in developing the firm's reputation and increase lawyers' incentives to invest in their own reputations separate from that of the firm. Smaller law firms may have little reputation apart from those of the individual members and, therefore, resemble aggregations of independent contractors more than co-ownership relationships.

The hybrid nature of law firms creates uncertainty concerning the appropriateness of vicarious liability. If lawyers in a law office did not co-own the firm's reputation, they would have little incentive to monitor their colleagues to preserve this reputation, apart from legal liability. To be sure, some firms might prefer to operate under vicarious liability as a substitute for the reputational bond.[57] But many others may not want this liability, particularly since they are not in a good position to monitor their colleagues. Nevertheless, if a court finds that they had enough of the trappings of a firm, the associates may be vicariously liable for the others' malpractice.[58]

Lawyers in loose associations therefore would want to clarify their liability by forming limited liability business associations such as limited liability companies, professional corporations and limited liability partnerships. They may not, however, want the default rules associated with these forms, especially loyalty and good faith duties that cannot easily be waived. One recent case illustrates the problems that might arise from applying these rules. In *Beasley v. Cadwalader, Wickersham & Taft*,[59] a New York-based law firm decided to close its Florida office. The firm's top Florida partner, before joining the New York firm, had his own firm and local reputation. The partner sued, claiming that the closing of the Florida office resulted in his expulsion in bad faith and was contrary to the

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[55]*See, e.g.*, RICHARD ABEL, AMERICAN LAWYERS (1989); ROBERT L. NELSON, PARTNERS WITH POWER: THE SOCIAL TRANSFORMATION OF THE LARGE LAW FIRM (1988).

[56]Jack L. Carr & G. Frank Mathewson, *The Economics of Law Firms: A Study in the Legal Organization of the Firm*, 33 J.L. & ECON. 307, 328 (1990).

[57]*See id.*

[58]*See* Kansallis Fin. Ltd. v. Fern, 40 F.3d 476, 479 (1st Cir. 1994) (imposing vicarious liability where phone was answered in the name of the firm, and defendants advertised themselves as a firm in both the phone book and lawyer's directory and renewed their lease in the name of the firm, describing themselves as a partnership); Beckman v. Farmer, 579 A.2d 618, 627 (D.C. 1990) (holding that guaranteed payments to lawyer raised question concerning lawyer's status as partner). *See also* Falzarano v. Leo, 635 A.2d 547, 549-50 (N.J. Super. App. Div. 1993) (holding that lawyer whose name appeared in firm name is partner under ethical rules).

[59]No. CL-94-8646 "AJ," 1996 WL 438777, at *1 (Fla. Cir. Ct. July 23, 1996), *aff'd.*, Cadwalader, Wickersham & Taft v. Beasley, 728 So. 2d 253 (Fla. Dist. Ct. App. 1998).

partnership agreement. He won a substantial judgment. If instead of being admitted as a partner in the New York firm, the plaintiff had been more loosely affiliated through a cost-sharing arrangement, the New York office might have been able to terminate the arrangement at will without liability to the Florida partner. However, it is unclear under such an arrangement whether the New York partners have vicarious liability for the actions of the Florida partners, or vice versa.

Thus, some law firms might prefer a more open-ended "contractual entity" that is governed by the parties' explicit contract and carries no unwanted baggage of default rules.

E. *Joint Operating Agreements*

Investments in natural resources differ significantly from standard-form partnerships or similar co-ownership relationships. Owners of working interests are normally completely passive, trusting managers to superintend the mining or oil drilling. This may be a rational course of action, since the returns may depend more on the inherent characteristics of the resource than on the manager's skills.[60] Thus, owners do not have enough of a role in management to justify imposing fiduciary duties on them, such as a duty to refrain from competing with each other in locating other similar investments[61] or vicarious liability to third parties for mining accidents.[62] Nevertheless, since the investors share profits from the property, they may be partners. As such, they may be vicariously liable for the firm's debts and owe fiduciary duties to each other, including the duty of care and the duty not to compete.

Partnership statutes can reduce the risk of partnership characterization by explicitly providing, as one statute reads that "ownership of mineral property under a joint operating agreement" is a "circumstance[]" that "by itself, does not indicate that a person is a partner in the business."[63] It follows that profit-sharing under such an agreement, which would be prima

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[60]Alchian & Woodward, *supra* note 25, at 115-16, would describe investments like this as lacking "plasticity" in the sense of alternative ways the resources can be used. They theorize that this makes it less necessary for the investors to invest firm-specific human capital in monitoring the managers. This contrasts with, for example, high-technology or drug firms that rely heavily on open-ended research and development and therefore on a large component of managerial discretion that increases potential agency costs.

[61]*See* Rankin v. Naftalis, 557 S.W.2d 940, 945 (Tex. 1977); Warner v. Winn, 197 S.W.2d 338, 342 (Tex. 1946).

[62]*See* Bolivar v. R & H Oil & Gas Co., 789 F. Supp. 1374, 1382 (S.D. Miss. 1991).

[63]TEX. REV. CIV. STAT. ANN. art. 6132b-2.03(b)(4) (West 1999).

facie evidence of partnership under other partnership statutes,[64] would not alone establish the existence of a mining partnership. Provisions like these help to clarify that the relationship is governed by the operating agreement, supplemented by agency principles.[65] But even under these statutes there may be some uncertainty about whether the relationship has crossed the line into partnership. For example, a party arguing for partnership could claim that profit sharing by the venturers is prima facie evidence of partnership independent of the operation of the mine under the operating agreement.

These uncertainties, and the greater uncertainties in the absence of provisions on joint operating agreements, give the parties some incentive to choose a limited liability form of business. Yet, as with the other relationships discussed in this Part, if they do so they may subject themselves to unwanted firm-like characteristics, such as fiduciary duties. The parties may prefer a statute that permits the firm to be a "CE" with limited liability, governed solely by the parties' operating agreement.

F. *Sole Proprietorships*

Unsuitable default rules present particular problems for sole proprietorships. Although sole owners cannot limit their liability for their own acts, they may want to avoid personal exposure for acts of their employees on behalf of the business. The proprietor has long been able to incorporate, and now may form a limited liability company under most LLC statutes.[66] Such statutes are, however, structured for multiple owners and are therefore unsuitable for sole proprietorships. They include default rules that are irrelevant to sole proprietorships, including rules for voting, management, restrictions on transfer of ownership and management rights, continuation of the firm after member dissociation, and managers' fiduciary duties.[67] The main problem such rules raise for sole proprietorships is that the sole owner may have to engage in useless decisional formalities in order

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[64]UNIF. PARTNERSHIP ACT § 7 (1914) and REV. UNIF. PARTNERSHIP ACT § 202 (1994) provide that profit sharing is presumptive evidence of partnership, though UNIF. PARTNERSHIP ACT § 7(2) and REV. UNIF. PARTNERSHIP ACT § 202(c)(3) provide that profit sharing alone does not necessarily convert co-ownership of property into co-ownership of the business.

[65]*See Bolivar*, 789 F. Supp. at 1382 (applying agency principles to mining partnership).

[66]*See* 1 LARRY E. RIBSTEIN & ROBERT KEATINGE, RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES app. § 4.03 (1998).

[67]*See generally* Larry E. Ribstein, *The Loneliest Number: The Unincorporated Limited Liability Sole Proprietorship*, 1 J. ASSET PROTECTION 46 (May/June 1996). That article notes the additional problem that waivers of statutory provisions in LLCs are accomplished through "operating agreements," which do not exist in a strict sense in one-member firms. This problem is being fixed through special definitions of "operating agreement" in statutes that permit one-member firms. *See* RIBSTEIN & KEATINGE, *supra* note 66, § 4.16, nn.11-12 (1998).

to minimize the risk of a court's piercing the veil and imposing personal liability on the owner.

A more important problem is that a court might characterize employees, creditors, and others as co-owners. As a result, these participants might have fiduciary and other rights, as well as liabilities related to the firm that do not mesh with the parties' intended relationship. Although this is a risk in any firm, it is more of a risk in a sole proprietorship because the absence of co-owners makes it more likely that those designated as creditors and employees share management and financing responsibility. If the parties decide to confirm their limited liability by forming an LLC or corporation in which both are co-owners, they then also confirm the rights and liabilities they do not want. The solution to this dilemma is to permit the parties to form a CE that has limited liability but is governed strictly by the contract. The parties could then allocate rights among the proprietor and other participants while specifying that only the entity is liable for its debts.

G. *Relationships Other than For-Profit Businesses*

One of the most important potential uses of the CE is in economic relationships that do not involve operation of a business for profit. Examples include (1) passive co-ownership of property as tenants in common or as joint tenants with the right of survivorship rather than as partners; or (2) non-business activities such as a neighborhood pool or sports club.[68] Since a partnership is defined as the co-ownership of a business for profit,[69] neither of these types of relationships would be a partnership that would trigger vicarious liability for the participants.[70] If, however, the parties undertake a business activity and profit-sharing they could be characterized as partners and each held personally liable for debts relating to the business. Though the parties' intent to not be partners is probably enforced among the parties,[71]

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[68]*See* Carlton Cricket & Football Social Club v. Joseph, (1970) V.R. 487, 497 (concluding that an Australian football club was unincorporated entity that had no existence apart from its members and therefore could not make a binding contract).

[69]*See* UNIF. PARTNERSHIP ACT § 6 (1914); REV. UNIF. PARTNERSHIP ACT §§ 101(6), 202(a) (1994).

[70]*See* BROMBERG & RIBSTEIN, *supra* note 15, § 2.06.

[71]*See* Rooney v. Rooney, 605 A.2d 520 (Vt. 1992) (holding that where brothers clearly intended that farm be owned in joint tenancy farm passed to surviving joint tenant). *Cf.* District of Columbia v. Riggs Nat'l Bank, 335 A.2d 238, 242-43 (D.C. 1975) (holding that survivorship feature attached to partnership savings accounts maintained as joint tenancy with right of survivorship to the extent that the funds were unnecessary to satisfy creditor claims and were subject to inheritance tax). *But see* Estate of Palmer, 708 P.2d 242, 248-49 (Mont. 1985) (characterizing a similar relationship as a partnership, over a strong dissent that relied on *Riggs*).

there is no assurance that the parties' intent will be enforceable as to third parties.

The parties might be able to avoid the risk of vicarious liability by forming a limited liability firm such as an LLC or corporation. As noted, because of its flexibility and tax advantages, the LLC is the more likely choice.[72] Many LLC statutes provide that an LLC may be organized for any lawful "purpose" not limited to a for-profit business.[73] However, the existence of special statutory provisions for non-profit corporations intended to protect public contributors to charities suggests that non-profit firms cannot be formed under other business association statutes.

Assuming non-profit or non-business relationships can be LLCs, they confront the problem of unsuitable default rules discussed above.[74] There is an awkward fit between the default provisions of LLC statutes and non-"business" or non-profit entities, because LLC statutes are based primarily on the partnership model, which is designed for for-profit business firms. LLC provisions for members who make capital contributions, receive distributions, and have fiduciary protection and information rights do not apply directly to entities, such as neighborhood associations, that do not invest capital and earn profits. In addition, LLC default rules designed to facilitate the continuity of a going concern do not apply to non-business relationships such as passive ownership of property. For example, a deceased LLC member's heirs get only an economic interest in the firm[75] rather than rights in the property itself, and members can transfer or offer as collateral only the economic interest in the entity rather than the firm's specific property.[76] The parties might prefer joint or common ownership rules, however, which do not provide for bifurcation of the firm and its property. Thus, in a joint tenancy with rights of survivorship, the deceased's entire interest passes to the joint owner rather than being divided between the firm and the heirs.

The parties could attempt to waive the default rules they do not want, including the rules for contributions and distributions and disposition of the

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[72]One reason for forming such a business association is to take advantage of restrictions on transfer in the business association statute to obtain valuation discounts for estate or gift tax purposes under I.R.C. § 2704 (1998).

[73]*See* RIBSTEIN & KEATINGE, *supra* note 66, § 4.10 n.5.

[74]The parties also might form an unincorporated non-profit association, but the uniform act for this kind of business is virtually useless in solving the problem of unsuitable defaults since it does not provide for governance rights. *See* Kenneth D. Lewis, Jr., Comment, *The Ramifications of Idaho's New Uniform Unincorporated Nonprofit Associations Act*, 31 IDAHO L. REV. 297 (1994).

[75]*See* UNIF. PARTNERSHIP ACT § 42 (1914); REV. UNIF. PARTNERSHIP ACT § 807 (1994) (providing for buyout of deceased partner when firm is continued by the surviving partners).

[76]*See* UNIF. PARTNERSHIP ACT §§ 24-28 (1914); REV. UNIF. PARTNERSHIP ACT §§ 501-504 (1994).

property on death. A court should enforce the underlying agreement,[77] including any waiver of partnership default rules.[78] A court nevertheless may decide to enforce partnership defaults.[79] As in the situations discussed above, the CE would be a possible solution for this type of relationship. If the joint tenants formed a CE, the relationship would clearly be governed by the underlying agreement while at the same time the participants would not risk liability as partners.

H. *Related Entities*

Business entities that are formally organized separately may resemble a single business enterprise. For example, a "parent" entity may own all of one or more firms that would be "subsidiaries" of the parent and "sisters" vis-à-vis each other. Pieces of a single real estate development may be under common management but each owned by different investors. The investors would pay less for their investments if they risked being charged with the risks — and the liabilities — of other pieces of the project. Conversely, what is formally a single business enterprise may actually be, or be in the process of becoming, a collection of separate firms. There is a trend toward replacing rigid top-down bureaucracies with more flexible internal markets and teams.[80]

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[77]*See* McMahon v. Pennsylvania Life Ins. Co., 891 F.2d 1251, 1254 (7th Cir. 1989) (holding that an agency manager for insurance company does not gain from being characterized as partner because this would not affect extent of profit-sharing compensation under employment contract); Leavell v. Linn, 884 P.2d 1364, 1366 n.2, 1367 (Wyo. 1994) (stating that "even if the agreement were construed to be a partnership agreement for the purposes of resolving this dispute, between these parties, then the terms of that agreement [waiving partition for forty years unless the outstanding mortgage is paid] would still govern"). *But see* Beckman v. Farmer, 579 A.2d 618, 659 (D.C. 1990) (holding that a partnership existed although there was a question concerning the plaintiff's rights under agreement; partnership determination criticized on this ground in concurring opinion).

[78]*See* Martinson v. Holso, 424 N.W.2d 664, 664-65 (S.D. 1988).

> [The court found the] Uniform Partnership Act did not prohibit an oral partnership agreement containing a provision for the surviving partner or partners to take all upon death of a partner, . . . [but an] instrument purporting to create a joint tenancy between decedent and his sister in certain leased property was a testamentary document, and, therefore, was void and unenforceable due to failure to comply with the statutory requirement for wills.

See also In re Estate of Kime, 356 N.E.2d 350, 353-54 (Ill. App. Ct. 1976) (holding that deceased father did not intend to exclude daughters from interest in family farm, so that the farm did not pass to brothers under partnership theory).

[79]*See In re* Marriage of Leathers, 773 P.2d 619, 623 (Or. Ct. App. 1989) (holding that wife-partner was entitled to share with her husband a half interest in a company despite an ante-nuptial agreement denying the wife an interest in her husband's after-acquired property).

[80]*See, e.g.*, MICHAEL HAMMER & JAMES CHAMPY, REENGINEERING THE CORPORATION (1993).

Unlike the situations discussed above in this Part, these collections of entities may resemble economic firms in that the overall entity exercises some control over the constituent entities. It would arguably follow that, by default, the liabilities of each portion of the enterprise would be attributed to the whole. However, the analogy to a single economic entity may be incomplete because, for various business reasons, the firm may want to achieve some degree of separation among the pieces. For example, workers may perform better when work is allocated to teams. Teams can do their own monitoring, and rewarding team members for performance provides a more direct incentive. Segregating liabilities may facilitate accurate tracking of the performance of individual teams. To achieve this, the parent may want to clarify the separate legal existence of the components immune from judicial interference, just as investors in a single firm hope to avoid vicarious liability by forming a limited liability entity. The problem in this context is that a court may "pierce the veil" — that is, ignore the legal separation and attribute the debts of each portion of the enterprise to the whole.

The business enterprise might avoid this result by attempting to emphasize the legal separation of component parts. Some of its efforts may be formalistic, such as maintaining separate accounting, decision-making processes and market-based transfer pricing among units.[81] These moves may impose minimal costs and, as with transfer pricing, may even be good business practices.[82] But the very ease of implementation may persuade a court to overlook form and emphasize the substance of a single firm. Therefore, the parent business may have to implement more costly measures, such as hiring separate managers for each unit and bringing in minority investors.

In short, as with the other situations discussed in this part, conventional legal business forms may not adequately serve the business purposes of the compartmentalized entity. A statute explicitly enforcing the economic firm's liability allocation may minimize the veil-piercing risk by giving a court less leeway to fashion its own boundaries for the firm. A 1996 amendment to the Delaware LLC statute accomplishes this result by permitting a Delaware LLC to designate series of members, managers or LLC interests with separate rights, powers or duties with respect to specified

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[81] *See, e.g.*, Abraham v. Lake Forest, Inc., 377 So. 2d 465, 468 (La. Ct. App. 1980) (refusing to pierce veil to impose real estate development subsidiary's debts on parent where "[s]eparate minute books were kept, resolutions were adopted, elections were held, positions and offices were filled and all of the facets of a separate formal corporation were observed by Alabama").

[82] *See* Richard A. Posner, *The Rights of Creditors of Affiliate Corporations*, 43 U. CHI. L. REV. 499, 513 (1976) (arguing that affiliate corporations have an incentive to maintain separate profit centers in order to best track performance of each component).

property, obligations, profits, losses, business purposes, and investment objectives.[83] The combined firm may charge liabilities to specific series if it provides for the series in its agreement, keeps separate records, separately holds or accounts for the assets of each series, and provides notice of the division into series in its certificate of formation.[84] Although by default each series is managed and controlled separately, this may be altered by contrary agreement.[85]

A "contractual entity" statute could accomplish the same thing by letting the parties define their firm, including the relationship among its parts, in the governing contract. Whether this offers an advantage over the Delaware series LLC depends on any formalities or limitations in the statutes and whether there is recognition of the series concept in states other than Delaware. Firms formed outside of Delaware may operate as foreign series firms in Delaware by complying with the Delaware statutory provisions,[86] but courts in other states may not recognize them as such. Even if other states adopt similar provisions, it may be some time before the concept is recognized widely enough to be useful for interstate firms. The contractual entity might become more widely accepted because of its multiple potential uses.

II. CONSTRAINED CHOICE OF STANDARD FORMS

As discussed in Part I, the central problem for participants in quasi-firms is having to ensure that each participant is not personally liable for the debts of the joint business without having to take on unsuitable default rules. As discussed throughout Part I, the courts may impose the consequences of partnership or agency on relationships that resemble these categories. The parties cannot easily ensure their limited liability by explicitly characterizing the contract as a non-partnership or non-agency.[87]

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[83]*See* DEL. CODE ANN. tit. 6, § 18-215(a) (1998); RIBSTEIN & KEATINGE, *supra* note 66, § 4.16.5.

[84]DEL. CODE ANN. tit. 6, § 18-215(b) (1998).

[85]*Id.* § 18-215(f).

[86]*Id.* § 18-215(m).

[87]*See, e.g.*, *In re* Medallion Realty Trust, 103 B.R. 8, 13 (Bankr. D. Mass. 1989) (finding partnership although parties drew compensation as salary, made declaration of trust rather than partnership agreement, and agreed among themselves that parties had no personal liability); Peterson v. BE & K Inc. of Ala., 652 So.2d 617, 623-27 (La. Ct. App. 1995) (concluding that joint venture was statutory employer of injured employee and so entitled to worker compensation immunity despite specific provision in Joint Venture Agreement that parties did not intend to form a partnership or create an agency relationship); Cajun Elec. Power Co-op v. McNamara, 452 So. 2d 212, 216 (La. Ct. App. 1984) (holding that relationship characterized as partnership only for tax purposes was partnership for other purposes); Madison Pictures, Inc. v. Pictorial Films, Inc., 151 N.Y.S.2d 95, 109 (N.Y. App. Div. 1956) (holding that agreement describing the parties and buyer

Contracting directly with the firm's creditors to limit the latter's recourse to the firm's assets is impracticable when the firm has many creditors or, as in accident cases, creditors' contacts with the firm are brief and casual. The parties to a firm-like relationship, therefore, may need to clarify their limited liability status by forming a limited liability business association.[88] But this solution introduces the problem of inappropriate default rules emphasized in Part I.

One possible solution to both problems is to increase the number of available limited liability standard forms. For example, new standard forms have been proposed for unincorporated non-profit firms[89] and for "agile virtual" corporations created by temporary alliances.[90] In order to understand the need for a contractual entity, it is necessary to understand the factors that limit production and use of new standard forms.

A. *Inherent Constraints on the Number of Statutory Business Forms*

In order to understand the constraints on the number of statutory standard forms, it is important to understand the functions of these forms. In general, standard forms can significantly reduce the costs of contracting, especially in complex contracts with many contingencies. *Statutory* standard forms are useful in several ways.[91] They provide coherent sets of gap-filling terms that reduce the costs of customized contracting and assist courts in filling contracting gaps.[92] They also reduce costs of learning the applicable terms for owners and third parties.[93] Finally, statutory business forms facilitate the development of "networks" of interpretive materials such as case law, business practices and legal advice that assist the parties in predicting how the terms of the statute will be applied.[94]

Privately generated forms, including those created by bar groups and law firms, can perform many of these functions. But the notoriety associated

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and seller and reciting that it expressed "the entire agreement between the parties . . . and there are no oral or implied representations, guarantees or conditions not contained" nevertheless was joint venture); Howard Gault & Son, Inc. v. First Nat'l Bank of Hereford, 541 S.W.2d 235, 237 (Tex. Civ. App. 1976) (holding that a farming operation was a partnership despite the language of the agreement).

[88]The alternative of providing by default for limited liability is discussed *infra* Part V.A.

[89]*See supra* note 77.

[90]*See supra* note 39 and accompanying text.

[91]*See generally* Ribstein, *supra* note 5, at 376-80.

[92]*See id.* at 378.

[93]*See id.* at 377.

[94]*See* Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757, 774 (1995).

with public statutes reduces the parties' costs of becoming informed about the applicable rules. In addition, public standard forms are more likely than their private counterparts to generate case law, customs, and practices that help in interpreting the terms.[95]

New statutory standard forms may also be useful in providing default rules for firms that do not fit under existing default rules. It follows from the above analysis, however, that the benefits of new statutory business forms depend significantly on the number of different forms available. First, extensive proliferation of standard forms raises the costs of learning the new rules incurred by firms' owners, creditors and others.[96] Thus, just as business association statutes reduce the costs of being informed about contract terms, having too many statutes may raise these costs.

Second, providing too many standard forms lowers the value they add in providing networks of interpretive materials by spreading these materials across many different terms.[97] Courts and legislatures can address this problem by "linking" the new forms to existing ones — that is, by applying case law standards created under one form to another.[98] They can also include new terms within existing standard forms or provide menus of individual default terms from which firms can select.[99] But these approaches also would reduce the benefits of new forms by reducing the differences between them.

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[95]*See* Ribstein, *supra* note 5, at 377-78.

[96]*Id.* at 391-403.

[97]This assumes that the additional standard forms do not increase the total stock of interpretive materials. That assumption is plausible because the stock of interpretive materials depends on the aggregate number of firms, which is probably not increased simply by adding more standard forms.

[98]*See generally* Ribstein, *Linking*, *supra* note 9, at 206 (discussing the advantages and disadvantages of linking general and limited partnerships). The discussion of linkage raises the question of whether the new form should replace an existing form. Problems with this approach include forcing firms to incur the costs of switching and the difficulty that legislators and others have in assessing all present and future uses of a business form. For a debate of some of the issues concerning replacing or supplementing existing statutes, compare Ribstein, *Changing*, *supra* note 9, at 28-35 (arguing for repeal of the Uniform Partnership Act following a transition period after adoption of the Revised Uniform Partnership Act) with Allan Vestal, *Should the Revised Uniform Partnership Act of 1994 Really be Retroactive?*, 50 BUS. LAW. 267, 289-90 (1994) (arguing that U.P.A. should be preserved after adoption of R.U.P.A. and firms never forced to switch to the Revised Uniform Partnership Act). As discussed below, questions concerning which new forms should be promulgated could be resolved by permitting new forms to evolve out of private contracts — a process that will be enhanced by permitting open-ended CEs.

[99]*See* Ribstein, *Linking*, *supra* note 9, at 214.

B. *Legislators' Incentives to Create New Forms*

Section A suggests that the net social gains from creating new standard forms may be limited and, therefore, that the optimal number of standard forms may be fairly low. The supply of standard forms may be limited further because legislators lack incentives to produce the optimal number of business association statutes.

Legislators, particularly if they only serve part-time, often adopt uniform laws to conserve scarce legislative resources.[100] This option, however, is not available for new types of business association statutes because uniform law promulgators generally act only after a consensus has developed as to the contents of the form.[101] Legislators also get help from local lawyers, who have reputational and other incentives for spearheading creation of new standard forms.[102] But this, too, is not an option in states that do not have large and aggressive bar organizations.

Even states with enough legislative and bar resources to enact new statutory standard forms may not do so. Legislators may not want to spend political capital passing laws that are opposed by strong interest groups. They may also not want to risk incurring reputational harm if the statute is criticized. At the same time, first-mover legislators may not capture the gains from successful innovation because state legislation can easily be copied by other states.[103]

C. *Choice of Law*

In considering whether states will adopt new business association forms, it is important to take into account the dynamics of interstate competition. Although, as discussed in Section B, legislators generally may lack incentives to innovate, legislators' incentives differ across states. If one state innovates others may follow. Delaware, for example, has a sophisticated business bar that sponsors new state legislation and does not

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[100] *See* Bruce H. Kobayashi & Larry E. Ribstein, *Evolution and Uniformity*, 34 ECON. INQUIRY 464, 470-71 (1996); *supra* notes 29-30 and accompanying text.

[101] *See* Larry E. Ribstein & Bruce H. Kobayashi, *Uniform Laws, Model Laws and Limited Liability Companies*, 66 COLO. L. REV. 947, 985 (1995) (discussing data from adoption of LLC statutes and uniform LLC law).

[102] *See* Larry E. Ribstein, *Delaware, Lawyers and Contractual Choice of Law*, 19 DEL. J. CORP. L. 999, 1009 (1994).

[103] *See* Ian Ayres, *Supply-Side Inefficiencies in Corporate Charter Competition: Lessons from Patents, Yachting and Bluebooks*, 43 KAN. L. REV. 541, 544 (1995); Ronald J. Daniels, *Should Provinces Compete? The Case for a Competitive Corporate Law Market*, 36 MCGILL L.J. 130, 148-49 (1991); Susan Rose-Ackerman, *Risk Taking and Reelection: Does Federalism Promote Innovation?*, 9 J. LEGAL STUD. 593, 594 (1980).

face opposition from strong interest groups.[104] Moreover, new business association standard forms may provide greater benefits in Delaware than elsewhere because they complement Delaware's existing inventory of sophisticated business legislation.

Apart from readily identifiable incentives, the mere existence of fifty rulemaking bodies allows for adventitious developments.[105] For example, the LLC was invented in Wyoming when a lawyer sought to meet a client's need[106] and only gained widespread use when it received favorable tax treatment.[107] The LLP was invented in Texas through the efforts of a Texas law firm that confronted significant liability.[108]

One state's invention of a new business form may not be very significant unless other states decide to adopt, or at least enforce, the new standard form. A state in which a firm transacts business need not apply the firm's formation state law as to matters such as member liability if that law contravenes the policies of the operation state, or the parties lack a strong connection to the specified state.[109] This may be a problem both for new business forms and for the interpretation of idiosyncratic provisions of more widely recognized forms. For example, though all states have now adopted LLC statutes, a one-member LLC may not be recognized as such in a state that does not clearly define such firms as LLCs.[110] Such firms would be forced into the default category of agency or partnership and, therefore, into vicarious liability.

To be sure, states may want to enforce new business forms to attract the firms that use them. These incentives may be partly responsible for the rapid interstate recognition and adoption of LLCs and LLPs.[111] But interstate acceptance can be explained by other circumstances as well. As discussed below in subpart D, the LLC had been adopted in only a few states until it received a tax ruling — eleven years after its creation — that made

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[104]*See* Ribstein, *supra* note 102, at 1014-18.

[105]*See* Kobayashi & Ribstein, *supra* note 100, at 468-80.

[106]*See* Ribstein, *supra* note 5, at 405.

[107]*Id.*

[108]*See* Susan Saab Fortney, *Seeking Shelter in the Minefield Of Unintended Consequences — The Traps Of Limited Liability Law Firms*, 54 WASH. & LEE L. REV. 717, 724 (1997).

[109]*See* RESTATEMENT (SECOND) OF CONFLICTS OF LAWS § 187(a) (1998); Larry E. Ribstein, *Choosing Law by Contract*, 18 J. CORP. L. 245, 262 (1993).

[110]The specific problem is that the state of operation may define a foreign firm that is entitled to recognition under the local statute as a "limited liability company." See RIBSTEIN & KEATINGE, *supra* note 66, app. 13-1 (tabulating state definitions of foreign LLCs). The local definition of that term may be limited to multiple-member firms. *See id.* app. 4-1 (tabulating state provisions on multiple member requirements of LLC statutes).

[111]*See* Bruce H. Kobayashi & Larry E. Ribstein, *Contract and Jurisdictional Competition*, *in* THE FALL AND RISE OF FREEDOM OF CONTRACT (F.H. Buckley ed., forthcoming 1999).

it a unique way to combine limited liability with partnership-type taxation. The LLP was particularly useful insulation from liability for professional firms that had to remain at least technically partnerships, and received nationwide backing from large accounting firms.[112] Without this sort of impetus, new business forms may not be widely recognized.

The problem of interstate recognition might seem greater for contractual entities that are not covered by any standard form. However, as discussed below,[113] a CE-type statute would provide a statutory mechanism for interstate recognition of an infinite number of private contracts without the need to create individual standard forms.

D. *Tax and Regulatory Effects*

A firm's choice of contract is, of course, determined not only by transaction costs, but also by taxes and regulations that impose additional costs for particular terms and for particular types of firms.[114] Politicians may want to restrict the supply of standard forms that would help contracting parties evade taxes or regulation of limited liability. They could do this by refusing to adopt these alternatives or by taxing or regulating them. Taxation or regulation might, in turn, reduce the demand for particular standard forms and thereby reduce the legislators' incentives to adopt these forms.

The recent history of business tax classification exemplifies this potential effect on the supply of standard forms. Firms have an incentive to avoid the corporate tax through partnership classification. The Internal Revenue Service imposed the corporate tax on firms that had at least three of the "corporate" features of limited liability: centralized management, continuity of life and free transferability.[115] Firms that wanted to combine limited liability with partnership-type taxation had to use Subchapter S which, among other things, imposed a "one-class-of-stock" restriction on capital structure.[116] The I.R.S.'s recognition of partnership-type firms with limited liability[117] came at the price of forbidding such firms from adopting too many other "corporate" features. Although the I.R.S. has now significantly loosened the restrictions by adopting "check-the-box," which

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[112]*See* Fortney, *supra* note 108, at 725-26.

[113]*See infra* Part IV.C.

[114]*See* Ribstein, *supra* note 5, at 384-90. Coase recognized this long ago. *See* Coase, *supra* note 12, at 393 (noting that firms can sometimes be explained by legal regulation, such as the sales tax).

[115]*See* Treas. Reg. § 301.7701-2(a)(3) (1995).

[116]*See* I.R.C. § 1361(b)(1)(D) (1998).

[117]*See* Rev. Rul. 88-79, 1988-2 C.B. 361-62.

allows firms to achieve their desired tax status irrespective of the form of organization,[118] the provisions of state LLC and limited partnership statutes still reflect the initial tax constraints.[119]

In assessing the tax and regulatory constraints on standard business forms, it is important to keep in mind that business association statutes can be either a shield from regulation or a sword for the government. To some extent these statutes facilitate contractual avoidance of tax or regulation by providing an explicit "safe" category of contracts, and reduce firms' uncertainty and litigation risk concerning what regulation applies.[120] For example, forming a partnership or LLC rather than a corporation arguably reduces the firm's exposure to antitrust,[121] securities,[122] employment discrimination,[123] or other regulation.[124]

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[118]*See supra* note 2 and accompanying text.

[119]For example, most state LLC statutes still contain default rules restricting transfer and continuity of the firm after a member's dissociation, provisions that are best suited to firms whose members have personal liability. *See* RIBSTEIN & KEATINGE, *supra* note 66, app. 7-1 (tabulating provisions on transferability); *id.* app. 11-1 (tabulating provisions on the effect of member dissociation).

[120]*See* Ribstein, *supra* note 5, at 387-88.

[121]Forming a firm such as a joint venture may provide somewhat more insulation from the antitrust laws than making a closely equivalent agreement that arguably restrains trade. Congress has relaxed antitrust standards for research and development and production joint ventures. *Compare, e.g.*, National Cooperative Research Act of 1984, 15 U.S.C.A. §§ 4301-4305 (1988) *with* National Cooperative Production Amendments of 1993, amending 15 U.S.C.A. §§ 4301-4305 (West Supp. 1994). Administrative agencies also have promulgated antitrust guidelines for research joint ventures (Antitrust guide concerning research joint venture, U.S. Department of Justice (1980)) and for intellectual property issues (Antitrust guidelines for the licensing of intellectual property, U.S. Department of Justice and the Federal Trade Commission (1995)), *reprinted in* 4 Trade Regulation Reporter (CCH) para. 13,132 U.S. Federal Trade Commission (1997). There are continuing efforts to encourage joint ventures by reducing the uncertainty of applying the antitrust laws. *See* Federal Trade Commission, Notice: comment and hearings on joint venture project, 62 Fed. Reg. 22945-8 (1997); Geanne Rosenberg, *Agencies Collaborate On Antitrust Policy*, NAT'L L.J., Mar. 2, 1998, at C2. *See generally* Ribstein & Kobayashi, supra note 40 (explaining the use of joint ventures in response to antitrust statutes).

[122]*See* Larry E. Ribstein, *Private Ordering and the Securities Laws: The Case of General Partnerships*, 42 CASE W. RES. L. REV. 1, 45-54 (1992) (showing that courts have virtually exempted general partnerships from securities regulation). *See also* Ribstein, *Form and Substance*, *supra* note 9, at 840 (advocating similar treatment for LLC interests).

[123]For discussions of application of employment discrimination law to partnerships, LLPs and LLCs, see ALAN R. BROMBERG & LARRY E. RIBSTEIN, BROMBERG & RIBSTEIN ON LIMITED LIABILITY PARTNERSHIPS AND THE REVISED UNIFORM PARTNERSHIP ACT § 7.03 (1998); BROMBERG & RIBSTEIN, *supra* note 15, § 2.02(b)(2); RIBSTEIN & KEATINGE, supra note 66, § 14.05.

[124]States may permit only certain types of entities to enter some types of businesses. *See, e.g.*, Meyer v. Oklahoma Alcoholic Beverage Laws Enforcement Comm., 890 P.2d 1361, 1363 (Okla. Ct. App. 1995) (holding that state constitutional prohibition of "corporations, business trusts, and secret partnerships" from being licensed to sell alcohol addressed all business entities known at the time of the provision and therefore authorized only individuals and partnerships).

On the other hand, as discussed below,[125] the government may be able to tax or regulate the relatively clear category of transactions described by a business association statute more easily than it can the ambiguous transaction described in an idiosyncratic contract with highly tailored rules. For example, the formation of a contractual entity might not trigger a Hart-Scott-Rodino filing, unlike the formation of a corporation or more formal business entity.[126] A non-firm, in effect, may be able to fly below regulatory or tax radar.

III. COSTS OF CONSTRAINED CHOICE

This Part discusses the potential problems arising from business entities' need to organize under limited liability statutes and the limited menus of rules these statutes offer. The problems discussed in this Part create the need for the open-ended "contractual entity" discussed below in Part IV.

A. *Unsuitable Default Rules*

Part I alluded to the problems of subjecting firms to inappropriate standard form rules. This Section describes these problems in more detail. The problem of inappropriate standard form rules long afflicted partnership-type firms that incorporated when this was the only reliable way to ensure limited liability.[127] Even if courts and legislatures allow close corporations to opt out of corporate rules, the parties may not specify customized rules regarding dissolution and buyout, perhaps because these terms are worth too little at the time of formation to justify significant drafting costs.[128] Courts then had to decide whether the parties wanted to be treated like partners with the power to sell their shares back to the firm or compel dissolution, or whether they wanted to be treated according to the

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[125] *See infra* Part II.D.

[126] The Federal Trade Commission recently proposed a rule on pre-merger notification by LLCs under Clayton Act § 7A, 15 U.S.C. § 18a (1994), added by the Hart-Scott-Rodino Antitrust Improvements Act of 1976. *See* Premerger Notification: Reporting and Waiting Period Requirements, 63 Fed. Reg. 54713-54716 (Oct. 13, 1998) (effective Dec. 14, 1998). LLCs previously had been treated like partnerships and therefore did not trigger a filing. Although the FTC could revise its rule to embrace "contractual entities" or other new business forms, it would obviously be faced with daunting definitional problems.

[127] *See* Larry E. Ribstein, *The Closely Held Firm: A View from the U.S.*, 19 MELB. U. L. REV. 950, 954 (1995).

[128] *Id.* at 955.

default corporate rules they had actually adopted.[129] The wrong guess risked frustrating the parties' expectations.[130]

The advent of limited liability partnership-type firms, including limited liability companies and limited liability partnerships, reduced or eliminated this problem for many firms for which partnership-type default rules were appropriate. But as discussed in Part I, this is not a perfect solution for parties to contractual relationships such as joint ventures who want limited liability but not partnership-type default rules such as strong fiduciary duties. While the courts have generally enforced agreements,[131] they may apply fiduciary duties in the absence of waiver. Strong fiduciary language in the cases and apparently general language in the statutes may lead courts to apply fiduciary duties even where the parties do not intend these duties.

B. *Effect on Evolution of Standard Forms*

The optimal number of standard forms is impossible to determine precisely because it depends on the needs of particular firms that develop over time. Moreover, even if legislators could determine which standard forms provide net benefits at any particular time, they still would not know what the content of the statute should be. Both determinations could be made by allowing statutes to evolve out of contractual business entities. These contracts would provide information on new terms. Data on firms' use of the contracts or individual terms would provide a market test to discern whether the legislature should adopt a new standard form. Thus, permitting firms to develop idiosyncratic contracts with limited liability facilitates experimentation and evolution that could "incubate" new types of standard forms.[132] Conversely, reliance on a limited menu of business association statutes may slow adaptive change in business forms.

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[129]*See* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 246, 252 (1991) (observing that the leading close corporation buyout case, *Donahue v. Rodd Electrotype Co.*, 328 N.E.2d 505 (Mass. 1975), "overlooked . . . the basic question — which outcome would the parties have selected had they contracted in anticipation of this contingency?").

[130]EASTERBROOK & FISCHEL, *supra* note 129, at 246.

[131]*See* Ribstein, *supra* note 49, at 570-87.

[132]The process of transition from idiosyncratic contracts to standard forms may resemble the process of producing legal forms from custom. *See* Charles J. Goetz & Robert E. Scott, *The Limits of Expanded Choice: An Analysis of the Interactions Between Express and Implied Contract Terms*, 73 CAL. L. REV. 261 (1985). Once the contract "hardens" into a new standard form, this may inhibit flexibility. An evolutionary process has been at work in creating efficient uniformity in LLC statutes. *See supra* Part II.C.

Evolution not only tends to produce optimal business forms, but also plays an important role in breaking down regulatory constraints.[133] The Wyoming LLC, which spurred the developments that ultimately released limited liability business forms from tax law constraints, began with a private contract.[134] Though the drafting lawyer was able to secure the enactment of supporting legislation, this may not be feasible for one or more of the reasons discussed in Part II. If the legislature did not have to approve each new application of limited liability, the first step in the evolutionary process that pushes the regulatory "envelope" would be more likely to occur.

IV. THE CONTRACTUAL ENTITY

This Part proposes an alternative to business association statutes — the "contractual entity" — that may solve some of the problems with these statutes discussed above. It would free limited liability from the restrictions of existing business forms discussed in Part II and the costs discussed in Part III.

As indicated by its name, the proposed statute deals with what is essentially a contract within an entity shell. The contract or other governing document provides all of the rules, while the statute ensures that the entity, rather than the participants, bears the liabilities. This new type of filing would not replace existing statutes. Rather, it would add to the menu of available options a limited liability firm that is governed solely by its underlying contract and not by the default rules of any statute. Most firms probably would continue to use the off-the-rack rules in business association statutes.[135] Firms that do not fit existing categories may choose the new form. Similarly, firms for which limitations on existing business associations are particularly costly, including those described in Part I, might choose the new type of entity.

Section A describes the proposal. The remainder of this Part analyzes potential arguments against the proposal and discusses the political and practical aspects of adoption.

A. *Outline of the Proposal*

The proposed rule would let participants in any type of relationship obtain limited liability by (1) filing an operating document identifying the

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[133] *See* Kobayashi & Ribstein, *supra* note 100, at 466; Larry E. Ribstein, *Politics, Adaptation and Change*, 8 AUST. J. CORP. L. 244, 245 (1998).

[134] *See* Fortney, *supra* note 108, at 722.

[135] *See supra* Part IV.A.2.

limited liability entity and setting forth at least some terms of the entity; (2) disclosing that it is a CE by including those initials in the name; (3) stating that it is subject to the rules provided in the filed operating agreement, including those regarding member liability and fiduciary duties, if any; and (4) restricting amendment of the liability provisions of the agreement as to those who are creditors as of the time of amendment. Details of the proposal are discussed in the following subsections.

1. The Filing Requirement

The CE would be required to file publicly at least enough information to permit parties dealing with the entity to determine the scope of the members' liability, including terms concerning such matters as exhaustion of remedies and foreclosure. Some issues concerning the creditors' need for more disclosure are discussed in the next section.[136] In general, although third parties dealing with the entity and its members may want more information, a broader filing requirement — such as one that requires filing of the entire operating agreement — might be excessively costly not only for the state bureaucracy but also in terms of exposing confidential information. This suggests the need for a balancing process. For example, although creditors of parties to the contract may want to know enough about the parties' rights in the entity to evaluate the parties' creditworthiness, this can safely be left to contracts between the parties and their creditors as it is for general partnerships and other types of contracts. The possibility of dispensing with the filing is discussed below in Part IV.

2. Amendment

The CE statute should prevent the parties to a CE from amending their agreement to change their liabilities to creditors as of the time of the amendment. The issues here are similar to those regarding amendment of statutes,[137] except that retroactivity is more of a problem with private agreements. Statutes' notoriety allows for dealing with retroactivity issues by providing for a transition period during which creditors and others can learn of the change. Since CE-type agreements are idiosyncratic, creditors of individual firms would have to be notified of the amendment. CE statutes might include partnership-type provisions for carryover of partners' liability

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[136] *See infra* Part IV.B.1.

[137] *See* Kobayashi & Ribstein, *supra* note 100, at 468-80.

following dissociation, dissolution or conversion to a limited liability entity with respect to creditors who are not notified.[138]

3. Default Rules

In order to deal with the problems with existing business forms discussed above in Part I, the CE statute should specify that the parties have no duties to each other except as provided in their agreement. Such language would at least discourage judges from implying fiduciary duties. Yet this would not necessarily prevent the courts from implying good faith duties of the sort that are implicit in contracts generally as a matter of contract interpretation.[139]

In addition to the specific terms of the parties' agreement, "CEs" would be subject to the default rules appropriate to their particular type of contract. For example, a joint tenancy CE would be subject solely to the rules applicable to joint tenancy, and not to the possibly conflicting default rules of partnership.[140]

The CE agreement also might incorporate rules from other statutes by reference. This would be potentially useful, for example, to give creditors the comfort of familiar liability provisions from other statutes. Incorporation of provisions, however, involves the costs as well as the benefits of other types of linkage.[141] In particular, courts might infer from the presence of these provisions that the parties want other implied and default rules associated with the linked form, particularly including fiduciary duties.

4. Exclusions

As discussed in the next Part, the CE statute might prohibit certain types of relationships from adopting the CE form. The use of CEs for personal assets is particularly problematic.[142]

B. *Some Arguments Against the Contractual Entity*

The proposal described in Section A is, or at least seems to be, a radical departure from the current law of business associations. As such, it

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[138]*See* REV. UNIF. PARTNERSHIP ACT §§ 703, 806, 902(e) (1994).

[139]*See* Ribstein, *supra* note 49, at 583-84 (noting that good faith is a general contract interpretation principle that precludes parties from acting according to the letter but not the spirit of the contract).

[140]*See supra* Part I.F.

[141]*See supra* text accompanying note 105.

[142]*See infra* text accompanying notes 164-69.

is likely to be viewed skeptically. This section analyzes and rebuts some possible arguments that might be and have been made against the proposal.

1. Expansion of Limited Liability

Some might argue that the CE would be an unwarranted expansion of limited liability. As a preliminary matter, it is important to emphasize that the CE only marginally expands the availability limited liability. Contracting parties already can avoid vicarious liability under current law by not being partners or principals or by adopting one of the recognized limited liability forms. The "CE" can be viewed either as a way of clarifying that the parties are not in fact principals or partners, or as adopting limited liability without its default rule baggage. Neither of these characterizations represents a significant expansion of limited liability. CE statutes would, to be sure, permit parties to avoid creditor protection rules, such as restrictions on distributions, that conventional business association statutes now impose on particular types of firms.[143] However, this is already permitted by some limited liability business association statutes.[144] Moreover, the limited protection provided by such rules adds little to the protection provided by fraudulent conveyance laws.[145]

One might nevertheless argue that the CE's effect in permitting parties to clarify their limited liability status would hasten an undesirable trend toward inefficient externalization of tort harm. In a provocative recent article,[146] Professor Lynn LoPucki claims that firms can shed liability risk by employing strategies such as asset securitization in which the operating entity incurs the liability but bankruptcy-remote investors in the asset-holding firm reap the gains,[147] or by disaggregating the firm into

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[143]*See generally* Robert Hamilton & Larry E. Ribstein, *Limited Liability and the Real World*, 54 WASH. & LEE L. REV. 687, 713 (1997). Such provisions could be included in the CE statute, but this would undercut the primacy of each organization's idiosyncratic contract. Of course, the contract underlying the CE could include creditor-protection provisions if this would reduce the firm's cost of credit.

[144]For example, there are no restrictions on distributions in most limited liability partnership statutes (*see* BROMBERG & RIBSTEIN, *supra* note 123, § 4.04(d)) or in several LLC statutes (*see* RIBSTEIN & KEATINGE, *supra* note 66, app. 6-1).

[145]*See* Larry E. Ribstein, *Limited Liability and Theories of the Corporation*, 50 MD. L. REV. 80, 109-10 (1991).

[146]*See* LoPucki, *supra* note 8, at 25. *See also* Lynn M. LoPucki, *The Essential Structure of Judgment Proofing*, 51 STAN. L. REV. 147 (1998) (describing judgment-proofing as dividing a single business into components without functionally altering the firm, where one component generates high liability risks, the other owns most of the assets, and the two share the profits from externalizing tort risks).

[147]Among other horror stories, LoPucki summons the spectre of a zero-asset Exxon in which the operating entity only leases its tankers. *See* LoPucki, *supra* note 8, at 25-30.

affiliate companies.[148] The proposal discussed in this Article would contribute to these developments by, among other things, explicitly letting a broad "enterprise" make a CE filing by which it allocates liabilities separately to its component parts, similar to the "Delaware series" LLC.[149] This reduces the risk that a court will pierce the veil.[150]

Even if CEs would promote liability-insulating strategies, it is not clear this would reduce social welfare. LoPucki assumes that letting firms define their own allocation of liability serves little purpose other than hurting involuntary creditors. For example, he claims that markets are fooled into believing that asset securitization is a sophisticated way of manipulating assets to generate wealth, rather than understanding that it really just "reduces the financial responsibility of the company while leaving the company's level of liability-generating financial activity constant."[151] With respect to disaggregation, LoPucki says that computerization has made it possible to perform any task in any size of organization, thereby making economies of scale irrelevant.[152]

In making these claims LoPucki ignores the large institutional economics literature that shows that institutional design creates wealth. For example, segregating the liabilities of different units of a business can improve incentives and monitoring.[153] The finance literature on bankruptcy shows that asset securitization is not merely a financial sleight of hand, but can, among other things, clarify risks by isolating groups of assets,[154] or

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[148]*Id.* at 64-66.

[149]*See supra* text accompanying notes 83-86.

[150]The CE might, in one sense, shrink the scope of limited liability by providing a basis for liability where firms have not elected this option. This is analogous to holding that corporate provisions permitting firms to elect special close corporation treatment preclude special judicial treatment of firms that do not make the election. *See* Nixon v. Blackwell, 626 A.2d 1366 (Del. 1993) (declining to adopt a judicial rule protecting minority shareholders where the corporation had not elected special close corporation treatment). In other words, CE statutes arguably create a "negative pregnant" by supporting the inference that parties who have not elected to organize as a CE have agreed to vicarious liability. This may help creditors by reducing the risk of limited liability where the creditors expected vicarious liability and adjusted their credit charges and contract terms accordingly. The tradeoff is that parties to relatively informal transactions that are too small to justify heavy lawyering may rely on judicial gap-filling to clarify their relationship. This makes the "negative pregnant" a trap for the unwary. The potential solution is to change the default rule to limited liability. *See infra* Part V.A.

[151]LoPucki, *supra* note 8, at 54. The problem LoPucki seems to be discussing but never fully articulates is that techniques such as asset securitization and disaggregation generate wealth in market terms by ignoring costs to involuntary creditors that these markets do not take into account. This relates to the issue of externalization discussed below.

[152]*Id.* at 66 n.278.

[153]*See supra* Part I.G.

[154]*See* Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J.L. BUS. & FIN. 133, 134 (1994).

reduce bankruptcy costs by providing a contractual method for protecting valuable blocks of assets from piecemeal liquidation.[155] These benefits may be lost or significantly reduced if courts are free to ignore contractual allocations and make up their own enterprises based on their vague notions of the "true" boundaries of enterprises. Indeed, as LoPucki notes,[156] the inability to clarify the scope of the entity hurts creditors at least as much as debtors by making it harder for them to assess competing claims against a given pool of assets.

The costs of letting parties contractually define the entity are vague. The main risk is that the CE would facilitate externalization of tort costs. The degree of externalization depends on two main factors. First, there is the question of whether these costs really are ignored in contracting for asset protection.[157] For example, though Exxon seemingly can make its liability costs disappear just by changing the ownership but not the control of its assets, the success of this tactic depends on Exxon's ability to operate a large company that owns no assets. It must demonstrate its creditworthiness to unsecured voluntary creditors, notably including the firm's own managers and employees, in order to obtain goods and services. Moreover, the parent company must answer to its shareholders, environmental activists, legislators and regulators. Exxon knows that if it stirs the ire of these groups the consequences could outweigh the costs of bearing the liability. Finally, even if the Exxon example is a rare troubling example of a firm that would run amok without a legal rule, the appropriate response is legislation that targets the problem, such as mandatory asset and insurance requirements for oil tankers. The answer should not be a rule that forbids asset protection even in the absence of a significant externalization risk.

A second factor concerning the degree of cost-externalization is the appropriate scope of the underlying liability rule. Tort liability's expansion beyond the limits of its loss-prevention and loss-distribution rationales has implications for the appropriate scope of limited liability.[158] Where a tortfeasor such as a joint venturer or other business association cannot take effective loss-prevention measures it makes little sense to expand the liability

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[155] *See* Barry E. Adler, *A Theory of Corporate Insolvency*, 72 N.Y.U. L. REV. 343, 375-76 (1997); Randal C. Picker, *Security Interests, Misbehavior, and Common Pools*, 59 U. CHI. L. REV. 645, 646 (1992).

[156] *See* LoPucki, note 8, at 67-68.

[157] *See* Steven L. Schwarcz, *The Inherent Irrationality of Judgment Proofing*, 52 STAN. L. REV. (forthcoming 1999) (showing that judgment-proofing is already subject to legal constraints such as fraudulent conveyance law and lender liability as well as to market constraints such as the impact on the judgment-proofer's reputation and pricing and other constraints imposed by arm's-length parties to judgment-proofing transactions).

[158] *See* Larry E. Ribstein, *The Deregulation of Limited Liability and the Death of Partnership*, 70 WASH. U. L.Q. 417, 444-47 (1992).

by making it vicarious.[159] Nor does it make sense to expand liability where it is based solely on loss-distribution and has the effect of substituting costly third-party insurance for more efficient first-party insurance.[160]

Although concerns about tort creditors should not necessarily prevent adoption of CE statutes, they may be relevant in designing the statutes. The novelty and open-endedness of the CE arguably justifies requiring disclosure of such things as attributes of the business or requiring explicit statements about creditor protection. In other words, it might not be enough simply to refer the creditors to a filed document. The statute also might provide default rules regarding the members' limited liability and creditor access to the entity's property that apply unless explicitly waived. But the novelty factor also cuts the other way. Because creditors are likely to be suspicious of this new statutory option, they will insist on information as a condition of giving credit to the owners or taking their interests in the entity as collateral. They would therefore not need the protection of an information-forcing rule.[161]

CEs are most problematic to the extent that they provide limited liability for holding personal assets in a non-business use. Asset protection trusts already are available both under United States[162] and foreign[163] law that permit people to put assets outside creditors' reach while enabling the settlor to enjoy significant, if not total, control and benefit. The CE might, however, be a significant step forward to the extent that it enables avoidance of specific restrictions that have been written into the trust statutes. For example, the CE would not necessarily be subject to restrictions such as those in the Delaware act concerning use of the trust to bar alimony, child support or tort claimants.[164]

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[159]For discussions of the circumstances in which strict liability, including vicarious liability, is appropriate, see generally STEVEN SHAVELL, ECONOMIC ANALYSIS OF ACCIDENT LAW 170-72 (1987); Lewis Kornhauser, *An Economic Analysis of the Choice Between Enterprise and Personal Liability for Accidents*, 70 CAL. L. REV. 1345 (1982); Sykes, *supra* note 16, at 1236-39.

[160]*See* George L. Priest, *The Current Insurance Crisis and Modern Tort Law*, 96 YALE L.J. 1521, 1524-25 (1987).

[161]*See* Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 91 (1989).

[162]*See* ALASKA STAT. §§ 13.36.035, 34.40.110 (Michie 1997); Delaware Qualified Dispositions in Trust Act, DEL. CODE ANN. tit. 12, §§ 3570-3574 (1995); Karen Gebbia-Pinetti, *As Certain as Debt and Taxes: Estate Planning, Asset-Protection Trusts, and Conflicting State Law*, *in* ADVANCED ESTATE PLANNING TECHNIQUES 179, 185-86 (A.L.I. & A.B.A. Course of Study Materials, 1999).

[163]*See* LoPucki, *supra* note 8, at 32-38 (discussing use of offshore asset protection trust for protecting doctor's personal assets from patients' malpractice claims); *see also* James T. Lorenzetti, *The Offshore Trust: A Contemporary Asset Protection Scheme*, 102 COM. L.J. 138 (1997).

[164]*See* DEL. CODE ANN. tit. 12, § 3573 (1995).

The problems caused by personal asset CEs are not as serious as they might appear to be. Any asset protection vehicle, including the CE, would be subject to fraudulent conveyance law, which would preclude asset transfers that are actually or constructively intended to hinder creditors.[165] Voluntary creditors of individuals who use personal-asset CEs can protect themselves by insisting on security or guaranties as well as an interest rate that reflects the default risk. Indeed, this reverses the tables in the limited liability debate since in this case consumers would be protecting themselves from their business creditors. Moreover, using CEs explicitly to insulate assets has the virtue of clarifying the scope of liability through *ex ante* contracts in which the parties bargain over the extent and price of protection, instead of through asset protection maneuvers and bankruptcy exemptions[166] that apply *ex post* without bargaining.

Two problems with personal-asset CEs may, however, be serious enough to justify restricting the use of CEs to protect non-business assets from non-business liabilities. First, allowing participants to use CEs to undercut their individual liability is a much more drastic step than allowing limitations of vicarious liability. Limited liability is, at least, qualified by the owners' individual liability for their own acts. The considerations justifying restrictions on vicarious liability may not justify reducing individuals' liability for their own acts. Although asset protection vehicles, like limited liability, have been justified as a response to significant expansion of tort liability,[167] in this case the better response is arguably to address this expansion directly.

Second, the pattern of small-business lending suggests that personal-asset CEs would be used mainly in situations involving a significant moral hazard. There is data indicating that most small firm debt is unsecured but backed by the owners' personal guarantees.[168] It follows that banks and other large lenders would discourage business owners from using personal-asset CEs by, among other things, contracting for direct recourse against the CE assets. So the primary users of personal-asset CEs probably would be those such as owners of backyard pools whose potential

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[165]For a discussion of the application of fraudulent conveyance law to asset protection trusts, see Gebbia-Pinetti, *supra* note 162, at 207-37.

[166]Consumers can protect their non-human-capital assets in a liquidation bankruptcy through extensive state law exemptions. *See* FLA. CONST. art. X, §4; TEX. CODE ANN. §§ 41.001-.002 (West 1995). They can protect all of their non-human capital assets in exchange for giving up some post-bankruptcy income through a Chapter 13 bankruptcy.

[167]*See* Gebbia-Pinetti, *supra* note 162, at 212.

[168]*See* Ronald J. Mann, *The Role of Secured Credit in Small-Business Lending*, 86 GEO. L.J. 1, 26-37 (1997).

creditors — mainly tort victims — are not in a position to seek protection or compensation for credit risk, and thereby to constrain the debtor's conduct.[169]

In short, there is some need for care in extending the reach of asset protection vehicles. The better approach is through special-purpose statutes such as those providing for asset protection trusts that address the specific problems of protecting individuals' assets.

2. The Impact on Standard Forms

As noted in Section A, the CE proposal does not assume that standard forms are unimportant. Many business relationships can benefit from using standard forms through greater certainty and reduced drafting costs,[170] and because business association statutes can make it easier to apply tax and regulatory statutes to firms.[171] This is not a problem to the extent that parties can consider these benefits when deciding whether to form a CE. But this subsection considers possible objections to the CE based on reducing the benefits of standard forms for business relationships in general.

One potential negative effect of the CE is reducing regulatory efficiency made possible through standard forms. The CE makes it easier to evade tax and regulation by forming relationships that are not targeted by exiting the statutes. Legislators could minimize this problem by blocking evading parties from using the CE, but that solution would impose costs on the more legitimate relationships that otherwise would benefit from the CE. Alternatively, legislators could block evasion by taxing and regulating businesses according to their basic features rather than the business association form they select. But this solution foregoes the predictability and other efficiencies of basing tax and regulation on the business's standard form.[172]

Tax and regulatory evasion may not be a serious problem. While a CE may be able to avoid tax or regulation based on traditional business association categories, it also bears the costs of regulatory uncertainty. To be sure, some firms may lose little by regulatory uncertainty and gain much from avoiding tax or regulation. But special cases might be handled by specific exclusions without drastic revision of the tax or regulatory statutes, or seriously limiting the use of the CE by more legitimate businesses.

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[169]Another category of users might be professionals to protect against liability for their own malpractice. In many cases, clients, such as large corporations, can protect themselves. In any case, ethical constraints on limiting liability might prevent widespread use of CEs in this situation.

[170]*See supra* text accompanying note 5.

[171]*See supra* text accompanying notes 115-24.

[172]*See* Ribstein, *Form and Substance*, *supra* note 9, at 828-32.

A second potential cost of the CE is that it reduces the "network" benefits of standard forms.[173] Replacing some standard form business associations with CEs may reduce the stock of cases, forms and other materials that help interpret the provisions of business association statutes. But it is important to keep in mind that, as discussed in Part II, business relationships will be CEs only when standard forms provide inappropriate default rules. It follows that CEs would reduce the pool of interpretive materials only by removing those that cover the idiosyncratic situations, and therefore provide relatively poor guidance for more standard firms. The benefits of reducing erroneous interpretations may outweigh any costs of reducing the total amount of interpretive materials.

Third, CEs may trigger higher adjudication costs than firms covered by established standard forms. Although the parties can consider these costs when deciding whether to adopt a standard form, they may not internalize all of the costs because the court system is maintained by tax dollars. But, as discussed immediately above, CEs may replace standard forms mainly where this would avoid applying inappropriate default rules. Thus, the increased uncertainty and adjudication costs resulting from the absence of default rules must be balanced against the increased costs caused by the wrong rules.

C. *Adopting the CE: Are Statutes Necessary?*

As noted at the beginning of this Part, CEs should be put into operation by the adoption of a separate statute. Existing mechanisms for waiving statutory default rules are inadequate. Although the LLC or partnership operating agreement might attempt to waive any unwanted statutory default rules, many business association statutes include non-waivable terms.[174] Even Delaware law, which explicitly declares the primacy of business association agreements,[175] does not necessarily permit

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[173] *See supra* text accompanying note 95.

[174] *See, e.g.*, UNIF. LIMITED LIABILITY COMPANY ACT § 103(b) (1995); REV. UNIF. PARTNERSHIP ACT § 103(b) (1994).

[175] The first of these provisions was included in the Delaware limited partnership statute. Section 17-1101 provides in part:

> (c) It is the policy of this chapter to give maximum effect to the principle of freedom of contract and to the enforceability of partnership agreements.
> (d) To the extent that, at law or in equity, a partner has duties (including fiduciary duties) and liabilities relating thereto to a limited partnership or to another partner, (1) any such partner acting under a partnership agreement shall not be liable to the limited partnership or to any such other partner for the partner's good faith reliance on the provisions of such partnership agreement, and (2) the partner's duties and liabilities may be expanded or restricted by provisions in a partnership agreement.

DEL. CODE ANN. tit. 6, § 17-1101 (1993). The Delaware limited liability company statute includes

a fully contractual entity. It provides that "the partner's duties and liabilities may be expanded or restricted by provisions in a partnership agreement,"[176] suggesting that these duties may not be eliminated.[177] Even if the statute permitted elimination, the statutory default rules, rather than those appropriate to the specific contract, would apply in the absence of contrary explicit agreement.[178] To draft with the needed specificity may prove costly. At the same time, a blanket waiver of all default duties arguably would be ineffective even under a statute that permitted waiver because it is inconsistent with adopting the standard form.

D. *Legislative Acceptance of the Contractual Entity*

Since statutory recognition of the contractual entity may be necessary, it is important to consider whether legislatures would be likely to pass such statutes. The impediment to passage is that the spread of the CE might force legislators and other participants in the lawmaking process to forego political benefits from taxing and regulating business associations. As already noted,[179] state legislators can tax and regulate the business associations that firms must adopt in order to obtain limited liability. As long as firms must choose from a limited menu of business associations rather than freely choosing their terms, these taxes and regulations become a price of limited liability. Trial lawyers and others who gain from the availability of vicarious liability may lobby against extensions of limited liability. At the same time, those who want this liability protection may lobby for relief. They might be willing to pay higher taxes and fees for unrestricted limited liability than if the limited liability came with onerous conditions such as rigid restrictions on distributions. Limited liability provisions may be even more valuable to debtor firms if they change members' liability provided for in existing

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a provision that is identical in all material respects. *Id.* § 18-1101.

[176]*Id.* § 17-171(d)(2).

[177]Deborah A. DeMott, *Fiduciary Preludes: Likely Issues for LLCs*, 66 U. COLO. L. REV. 1043, 1057 (1995). On the other hand, the Delaware limited partnership provision has been held to broadly support contractual freedom regarding fiduciary duties. *See* Sonet v. Timber Co., L.P., 722 A.2d 319, 322 (Del. Ch. 1998) (holding that agreement giving general partner "sole discretion" eliminated fiduciary duty in connection with merger converting limited partnership into real estate investment trust, noting that "principles of contract preempt fiduciary principles where the parties to a limited partnership have made their intentions to do so plain"); Kahn v. Icahn, No. 15,916, 1998 Del. Ch. LEXIS 223 (Del. Ch. Nov. 12, 1998), *reprinted in* 24 DEL. J. CORP. L. 738 (1999) (holding that agreement could authorize partner to compete and engage in other business ventures, reasoning that the partner did not have "immutable duties of loyalty irrespective of clear and unambiguous modifications of fiduciary duties provided in a legally enforceable partnership agreement").

[178]*See* Ribstein, *supra* note 49, at 577-83 (discussing application of default fiduciary duty rules in some cases in the absence of explicit waiver).

[179]*See supra* Part II.D.

contracts with partners and creditors.[180] Legislators stand between these groups, receiving political "rents" such as campaign contributions from interest groups that want more or less liability.

It is not clear why legislators would pass a CE statute if it means eliminating these rent-seeking opportunities. One reason may be that lawyers would compete for law business by establishing an appropriate statutory environment in their states.[181] But lawyers may not be as interested in promoting CEs as they have been in promoting other business forms. Open-ended statutes invite drafting mistakes that might trigger malpractice liability. Also, lawyers use expertise on specific types of business association statutes to promote themselves. Since CE statutes simply refer to underlying contracts they do not provide much opportunity for this type of promotion.

It is important to keep in mind, however, that some groups may want CE statutes. In particular, lawyers can gain from promoting use of the state's courts and of their own expertise as business planners.[182] These benefits may be significant. As Part I indicates, the CE is potentially appropriate for many types of economically significant contracts. Moreover, the CE creates more planning opportunities than conventional business associations.

Even if CEs would be politically infeasible in most states, at least one state may be hospitable,[183] and other states may then follow. Delaware may find that a CE statute is politically acceptable because it is only a small step beyond its freedom of contract provision.[184] Once Delaware had a CE statute, its law, and therefore its courts,[185] would become more hospitable for some types of transactions. This would give Delaware lawyers a competitive edge. Lawyers elsewhere would then seek CE statutes for their states to avoid losing business to Delaware lawyers.

In short, state law is a dynamic and incremental process whose end result general theory cannot reliably predict.[186] It is, therefore, unwise to assume that legislators will not pass CE statutes merely because there are theoretical reasons why they would not do so.

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[180]*See* Ribstein, *Changing, supra* note 9, at 27-28.

[181]*See* Ribstein, *supra* note 102, at 1014-18.

[182]*See* Jonathan R. Macey & Geoffrey Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469 (1987); Ribstein, *supra* note 102, at 1014-18.

[183]Indeed, the point of origin could be a foreign country, as suggested by the example of Cook Island spendthrift trusts. *See supra* note 163.

[184]*See supra* notes 176-79 and accompanying text.

[185]*See* Ribstein, *supra* note 109, at 282-86 (discussing relationship between choice of law and choice of forum).

[186]*See generally* Kobayashi & Ribstein, *supra* note 100, at 464.

V. BROADER IMPLICATIONS OF CONTRACTUAL ENTITIES

The CE has implications beyond merely clarifying the governance arrangements of relationships like those discussed in Part I. Among other things, as discussed in subpart A, recognition of the CE may lead to even broader acceptance of limited liability. Also, as discussed in subpart C, the CE may erode barriers to general acceptance of contractual or consensual choice of law.

A. *Expanding Limited Liability*

The proposed CE raises questions concerning how much further the availability of limited liability should be expanded.

There is an initial question concerning the importance of the public filing. I proposed several years ago eliminating the filing requirement for corporations and treating firms as corporations as long as they identify themselves as such.[187] This proposal makes even more sense now that limited liability has been so widely recognized for relatively informal non-corporate entities, and even for partnerships under LLP provisions. The reduction in formalities means that filings add very little to simple self-identification.

The question is whether the same considerations apply to CEs. The open-ended nature of CEs makes it more important to have a public record of terms of the relationship that can replace the statutory provisions governing conventional business associations. Voluntary creditors arguably could simply request the document, while the document obviously would not help involuntary creditors.[188] But the benefits of mandating disclosure in terms of reducing creditors' search costs probably outweigh firms' one-time disclosure costs; particularly given developing information technologies that could widely disseminate central filings at low cost.[189]

A mandatory filing for CEs makes sense only under the assumption of default vicarious liability for owners of firms. That default rule is the fundamental reason why business and non-business entities must adopt

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[187] *See* Larry E. Ribstein, *Limited Liability and Theories of the Corporation*, 50 MD. L. REV. 80, 86-87 (1991). Along similar lines, see William A. Klein & Eric M. Zolt, *Business Form, Limited Liability, and Tax Regimes: Lurching Toward a Coherent Outcome?*, 66 COLO. L. REV. 1001 (1995). LoPucki, *supra* note 8, at 66, refers to these proposals as "de-entification" because artificial entities would no longer be necessary to limit liability.

[188] *See* Ribstein & Kobayashi, *supra* note 187, at 129-30.

[189] This is analogous to the arguments for mandatory disclosure under the federal securities laws. *See* Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 681-82 (1984) (noting excessive information costs from securities regulation requiring investors and analysts to undertake redundant research).

standard business forms that subject them to unsuitable default rules, and therefore why CEs are necessary in the first place. Should vicarious liability be imposed only on firms or firm-like entities that elect to be subject to this rule? Although this is not the place for full discussion of this issue, it is worth noting that there are good arguments for making limited liability an appropriate default rule. Large creditors easily can obtain owner guarantees, as many now do.[190] On the other hand, firms have significant costs of contracting for vicarious liability with their many smaller creditors. Moreover, switching the default would not be as big a change in current law as might first appear. Given the large variety of limited liability business forms that are currently available even without the CE, government imposes few restrictions or costs on obtaining limited liability.

An argument against a limited liability default is that the vicarious liability default may encourage debtors to reveal credit risks that are peculiarly within their knowledge in order to persuade creditors to agree to extend credit under a limited liability rule.[191] Conversely, under a limited liability default, casual or unsophisticated creditors are less likely to inquire about liability risks. But even under a limited liability default firms have an incentive to reveal their assets in order to minimize their credit charges. Creditors are at least as likely to make negative as well as positive assumptions about these assets. Moreover, creditors who are unsophisticated or ignorant are equally injured in extending credit to limited liability firms that have opted out of the vicarious liability default rule. The costs of opting out of the vicarious liability default do not accrue to the benefit of involuntary creditors who cannot benefit from any increased leverage in obtaining information.

Whether the default rule should be switched ultimately depends on what types of new firms would obtain limited liability because of the switch. With increasing recognition of limited liability, the remaining personal liability firms arguably are mainly those very informal firms that could benefit from limited liability but for which the transaction and information costs of switching exceed the benefits. Under this scenario, a limited liability default rule would make sense by eliminating an unnecessary transaction cost barrier to adopting an efficient default. In other words, the vicarious liability default rule seems to be largely a trap for the unsophisticated. On the other hand, many firms do continue to be organized as sole proprietorships and partnerships, reflecting banks' practice of

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[190] *See supra* text accompanying note 168.

[191] *See supra* text accompanying note 168.

insisting on owner guarantees.[192] It arguably follows that small firms that do choose to be limited liability entities do so because they have no one like a large bank watching them and can impose costs on involuntary creditors. As with personal-asset CEs,[193] therefore, switching defaults might involve the adverse selection problem that the only affected firms would be those for which limited liability involved a significant social welfare loss.

B. *Other Uses of the CE Concept*

Just as the CE would expand the availability of limited liability beyond recognized standard forms, other general-purpose statutes might transcend existing categories in analogous ways. One possible area is family law. Some domestic arrangements, such as gay and polygamous relationships, are not legally recognized as marriages.[194] Couples who can marry may not want to subscribe to all of the rules of marriage. The parties to domestic relationships arguably ought to be able to settle many of their legal rights and duties by contract.[195] But many of the same impediments to recognizing new relationships that apply to business relationships also apply to domestic relationships, including network effects and legislators' resistance.[196] An open-ended domestic relationship — call it a "Domestic Entity" (DE) — would provide a mechanism for enforcing such contracts that would fill the gaps in the marriage standard form.

The DE's function would, of course, differ from that of the CE. Rather than avoiding vicarious liability the parties would be seeking to obtain the benefits of marriage, including tax advantages of filing joint returns, inheritance and adoption rights, and avoiding the reciprocal costs of cohabitation without marriage. They would also be seeking legal sanction for certain types of sexual relationships. The tax and regulatory consequences of the relationship therefore are even more important in this

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[192]*See* Mann, *supra* note 168, at 42 (discussing large banks whose loan portfolios include only 15% and 20% of limited liability entities).

[193]*See supra* text accompanying note 169.

[194]For a discussion of the legal treatment of same sex marriage, see William N. Eskridge, Jr., *The Case for Same-Sex Marriage: From Sexual Liberty to Civilized Commitment* (Free Press. 1996). For discussions of interstate recognition of same-sex marriages, see, e.g., Jennifer G. Brown, *Competitive Federalism and the Legislative Incentives to Recognize Same-Sex Marriage*, 68 S. Cal. L. Rev. 745 (1995); F.H. Buckley & Larry E. Ribstein, *Marriage and Choice of Law* (1998) (unpublished manuscript, on file with *The Delaware Journal of Corporate Law*); Larry Kramer, *Same-Sex Marriage, Conflict of Laws, and the Unconstitutional Public Policy Exception*, 106 YALE L.J. 1965, 1967 (1997); Note, *In Sickness and in Health, in Hawaii and Where Else?: Conflict of Laws and Recognition of Same-Sex Marriages*, 109 HARV. L. REV. 2038 (1996).

[195]*See* Buckley & Ribstein, *supra* note 194, at 40-42.

[196]*See supra* Part III.

context than for CEs. At the same time, the objections to an open-ended domestic relationship may be more intense than objections to open-ended limited liability. The family is a fundamental building block of society, and marriage law is intended to channel people into certain types of relationships.[197] Thus, the effect of forming a DE may be more limited than that of forming a CE. Nevertheless, the DE might prove useful in promoting the enforcement of less controversial aspects of domestic arrangements.

VI. CONCLUDING REMARKS

Many economic relationships face the Scylla-and-Charybdis choice of either accepting a risk of vicarious liability or subjecting themselves to the inappropriate default rules of a business association statute that is designed for completely different settings. This problem can be solved through an all-purpose "Contractual Entity" that lets the parties to the relationship choose all of its terms. The CE would be authorized through a relatively simple statute that would provide for filing, disclosure, and other basic rules. Such a statute would overcome unnecessary impediments to contractual freedom and open new opportunities for business planning freed of the constraints imposed by the limited menu of limited liability business forms. The CE also has far-ranging implications for the future of limited liability and of open-ended statutes in other areas of the law.

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[197]*See* Buckley & Ribstein, *supra* note 194, at 21; Carl E. Schneider, *The Channelling Function in Family Law*, 20 HOFSTRA L. REV. 495 (1992).