THE CLOSELY HELD FIRM: A VIEW FROM THE UNITED STATES

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[This paper discusses rapid changes in the United States law of closely held firms which may be relevant to Australia's moves toward changing its law relating to closely held firms. The United States is changing from a regime under which the close corporation is the only way for closely held firms to obtain limited liability to one in which firms can choose other forms, now including the limited liability company and limited liability partnership. These developments have significant implications for other issues, including the policies underlying limited liability, the role of statutory business forms, and the effects of jurisdictional competition.]

As Australia reevaluates its law on close corporations,[1] the recent United States law of business associations offers some potentially useful choices. Until relatively recently, closely held firms in the US had to compromise in choosing an organisational form. Each of the major vehicles — general and limited partnership and incorporation — combined advantages and significant drawbacks in terms of flexibility, tax treatment and members' personal liability. New choices recently have appeared and spread rapidly among the states — the 'limited liability company' ('LLC') and the 'registered limited liability partnership' ('LLP').

This paper surveys these developments and considers some of the major issues they raise. Among other things, recent US history suggests that reform of Australian law of proprietary firms should go beyond simplification and streamlining to include the development of non-corporate business forms designed to suit the needs of closely held firms. At the same time, it is important to keep in mind that not all of the circumstances which produced these developments in the US are present in Australia, particularly including jurisdictional competition and tax incentives to develop non-corporate business forms.

I INGREDIENTS IN THE STEW: THE UNDERLYING LEGAL CONDITIONS

This Part reviews the tax, regulatory and constitutional rules that have shaped the US law of closely held firms. The importance of these circumstances will become more apparent later in this paper.

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1 Simplification Task Force, A-G's Department, First Corporate Law Simplification Bill, Exposure Draft (July 1994) ('Exposure Draft').

A *What Law Applies?*

States apply the law of the state of organisation to the internal affairs (including management and member rights and liabilities) of the foreign firm — the so-called 'internal affairs' rule.[2] A corporation or limited partnership must make a formal filing in the state under whose law it is organising and then register as a foreign corporation or limited partnership under the foreign corporation or foreign limited partnership law of all states in which it transacts business.[3] The internal affairs rule applies even if the firm fails to make a foreign filing, although the failure may trigger fines and other penalties.

The United States Constitution may or may not compel application of the law of the state of organisation. The Commerce Clause,[4] which gives Congress power '[t]o regulate Commerce ... among the several states...' and the Full Faith and Credit Clause[5] which provides that 'Full Faith and Credit shall be given in each State to the public Acts, Records, and judicial Proceedings of every other State,' among other provisions, arguably apply in this regard. However, US courts never have explicitly constitutionalised the 'internal affairs' rule.[6]

Because of these rules on choice of law, each state has its own corporate law. Corporations 'shop' among the 50 states for the law they prefer. The state competition to provide corporate law has been largely won by Delaware for the largest corporations. Many states have adopted some version of the Model Business Corporation Act, which was drafted by a committee of the American Bar Association.

Since a partnership is informal, and therefore does not formally choose an organisational state, the formation state for partnerships may not always be clear. Moreover, even if the parties do clearly agree that the law of a particular state applies, general choice of law principles applicable to contracts do not compel courts to enforce the law of contractually selected states that lack significant contacts with the contractually selected states or whose policies conflict with those of a state that is closely connected with the transaction.[7] Uncertainties about choice of law create a need for uniformity of partnership law.[8] Most states have adopted the Uniform Partnership Act (UPA) for general partnerships, and

2 *Restatement (Second) Conflict of Laws* (1971) §302 (law of state of incorporation ordinarily governs as to corporate 'internal affairs' unless another state has a more significant interests); §307 (law of state of formation governs as to extent of shareholder's liability to creditors). See also *Bank of Augusta v Earle* 38 US 519 (1839) (although corporations not constitutionally protected as 'citizens', states normally grant comity to foreign corporation law). The same rule probably applies to limited partnerships. Outside of the corporate area, however, choice of law involves some uncertainty. See below Part IV(C).

3 Revised Model Business Corporation Act (1984) ch 15; Delaware Code Annotated title 8, sub-ch XV; Revised Uniform Limited Partnership Act (1985) ss 901-8.

4 United States Constitution ('US Constitution') §8, cl 3.

5 US Constitution, Art IV, §1.

6 See generally Larry E Ribstein, 'Choosing Law by Contract' (1993) 18 *Journal of Corporation Law* 245.

7 *Restatement (Second) Conflict of Laws* (1971) §187(2).

8 The link between uniformity and enforcement of contractual choice of law is discussed below in Part V(C).

the Uniform Limited Partnership Act (ULPA) for limited partnerships. These acts were drafted by a quasi-official body called the National Conference of Commissioners on Uniform State Laws (NCCUSL).[9]

The uniformity of non-corporate law has, however, been eroding. NCCUSL has proposed a Revised Uniform Partnership which includes a choice of law provision,[10] and both LLC and LLP statutes include provisions for recognising the law of the formation state.[11] As a result, there is a developing state competition for non-corporate law just as there long has been for corporate law.

The ultimate result of all of this state competition to provide business association statutes in the US has been greater innovation and less order than the more centralised Australian system of company law. Nowhere has this been more evident than in the development of the law of proprietary firms.

B *The Role of Federal Regulation*

Unlike in Australia, internal corporate governance is left entirely to the states. The federal government regulates only disclosure and other market-related issues through the Securities Act of 1933 (the '1933 Act')[12] and the Securities Exchange Act of 1934 (the '1934 Act').[13] The 1933 Act requires firms to file registration statements and distribute prospectuses when they sell an instrument that is included in the broadly defined term 'security'[14] unless the sale is exempt. The 1934 Act, among many other things, requires larger companies to register classes of securities and provide regular information, as well as disclosure in proxy statements and tender offers.

The Securities and Exchange Commission ('SEC'), acting under its broad powers to administer the securities laws, has promulgated Regulation D,[15] which significantly reduced smaller firms' registration burdens under the 1933 Act. Moreover, interests in some types of closely held firms — namely limited liability companies and general partnerships — may not be subject to the securities laws at all because they are not deemed to be 'securities.'[16]

[9] The Uniform Partnership Act was originally promulgated in 1914 and revised in 1994. Virtually every state ultimately adopted the 1914 version, but so far only a couple of states have adopted acts based on the revised version. The Uniform Limited Partnership Act was originally adopted in 1916 and later revised in 1976 and 1985. Most states now have a limited partnership act based on the 1985 version.

[10] Revised Uniform Partnership Act (1994) §106.

[11] See below Parts III(A)(5), III(B)(4).

[12] 15 United States Code Annotated §§77a-77bbbb ('USCA').

[13] 15 USCA §§78a-78kk.

[14] 1933 Act §2(1), 15 United States Code §77b ('USC').

[15] SEC Rules 501-8, 17 Code of Federal Regulation ('CFR') 230.501-8.

[16] Larry E Ribstein, 'Form and Substance in the Definition of a 'Security': The Case of Limited Liability Companies' (1994) 51 *Washington and Lee Law Review* 807; Larry E Ribstein, 'Private Ordering and the Securities Laws: The Case of General Partnerships' (1992) 42 *Case Western Reserve Law Review* 1.

C *Tax Law*

Tax law is a fundamental part of the business association picture in the US Corporations are subject to a 'double tax' in the sense that the entity is taxed on income when earned and individual shareholders are taxed on dividends without a credit for dividends paid by the corporation. Under current circumstances of a corporate level tax rate comparable to the individual level rate and no reduced rate for capital gains most firms and holders suffer a tax penalty from incorporation whether income is retained by the corporation or paid out as dividends as soon as it is earned.[17]

Partnerships pay tax only on income earned by the firm, and not again when the income is distributed to the owners.[18] Partners who are active in the business may be able to deduct partnership losses up to their investment in the firm against their personal non-partnership income.[19] A business is taxed as a partnership under Subchapter K of the IRC if it is not a 'corporation,' a term that is defined to include 'association.'[20] Whether a firm is an 'association' depends on its 'resemblance' to a corporation.[21] The regulations provide that a business organisation is a corporation if it has at least three 'partnership' characteristics: continuity of life, centralised management, limited liability, and free transferability of interests.[22]

There are, therefore, strong tax incentives to create non-corporate business forms in the US At the same time, application of the classification rules for distinguishing corporations and partnerships has powerfully influenced when and how these business forms have emerged.

II THE WAY THINGS WERE: BEFORE LLCS

This Part surveys the business association landscape that existed in the US prior to 1988. In general, it presents a picture of a law constrained by tax and other factors which offered unsatisfactory compromises for closely held firms.

A *General Partnerships*

The general partnership form is by far the most flexible of the business forms, since it is governed almost entirely by contract. Partnership statutes broadly let

17 William A Klein and John C Coffee, *Business Organization and Finance*, (4th ed, 1990) 317-26; Merton Miller, 'The Modigliani-Miller Propositions After Thirty Years' (1988) 2 *Journal of Economic Perspectives* 99.

18 Internal Revenue Code, 26 USCA §701 ('IRC').

19 IRC §§702, 704. Losses incurred by investors who are not active in the business (ie, 'passive' losses) cannot be deducted against non-'passive' income: see IRC §469.

20 IRC §7701(a)(3) (definition of 'corporation'); IRC §7701(a)(2) (definition of 'partnership').

21 *Morrissey v Commissioner of IR* 296 US 344 (1935).

22 Treasury Regulations §301.7701-2(a). For leading cases interpreting these regulations, see *Zuckman v US* 524 F 2d 729 (Ct Cl 1975); *Larson v Commissioner of IR* 66 TC 159 (1976).

partners agree to any form of management.[23] Moreover, the default provisions of the UPA include features that suit closely held firms — direct member participation in management, per capita voting and financial right, restricted transferability and easy exit through dissociation and dissolution.

The main drawback of the general partnership form has been the members' personal liability. The Uniform Partnership Act provides that each member is liable for the debts of the business.[24] The recent history of closely held business law in the US could be summarised as a search for a partnership-type form of business with partnership tax features that offers members protection from personal liability. Before showing how this search ended, the following sections will survey the main alternatives to the partnership form that were available before the advent of the LLC.

B *Corporations*

The business corporation traditionally has been the commonest business form in the US for both publicly and closely held firms. The corporate form offers the important advantage of limited liability. Once shareholders have paid the amount due for their shares, their shares are deemed 'fully paid and non-assessable,' meaning that the shareholders have no further liability for the debts of the firm.

One trade-off for limited liability is that corporate income is subject to a separate 'entity-level' tax. More importantly, corporation statutes prescribe rules that may not suit closely held firms. These include voting according to financial contributions even if members also have made non-financial contributions; management by a board of directors which can take important decisions out of owners' hands; free transferability of management rights; and the illiquidity of minority shareholders who can neither sell their shares in the market nor compel dissolution of the firm.

To be sure, courts long have provided for flexibility of corporate provisions to accommodate closely held firms,[25] and corporation statutes now let close corporations enter into agreements that, among other things, dispense with board management.[26] But even statutes that provide for complete flexibility are not a complete solution for the problems of closely held firms because the corporate form is inherently poorly suited to closely held firms. The ease of forming corporations by a simple short-form filing and the high cost of anticipating and

[23] Uniform Partnership Act §18 ('UPA') (the rights and duties of the partners determined 'subject to any agreement between them'); Alan R Bromberg and Larry E Ribstein, *Bromberg and Ribstein On Partnership* (1988) §6.03.

[24] UPA (1914) §15.

[25] See, eg, *Clark v Dodge* 269 NY 410, 199 NE 641 (1936) (permitting enforcement of agreement that allocated management functions directly to shareholder).

[26] See, eg, Delaware Code (1983) title 8, ss 343, 350 (permitting certain agreements in firms that elect close corporation status by certificate provision); Revised Model Business Corporation Act (1991) s 7.32 (permitting certain agreements in non-publicly-traded corporation if agreement is set forth in articles of incorporation and bylaws, or is in writing and 'made known to the corporation', in either event only if approved by all those who are shareholders at the time).

drafting for the many problems that may occur when the parties disagree in relation to the value of the transaction, mean that close corporation owners often are locked into unsatisfactory arrangements.

Thus, courts often must resolve the problems of close corporation shareholders. Judges have created common law buyout remedies and have aggressively enforced statutory 'oppression' remedies that are available for closely held firms.[27] Yet these remedies are hardly a panacea. Rather, they create a potential judicial 'wild card' that creates costly uncertainty for parties to closely held firms. For example, in the leading case of *Donahue v Rodd Electrotype Co*[28] the court gave a minority shareholder the right to sell his shares to the corporation at the 'control' price for which the corporation bought the shares of the majority shareholder. The parties probably never intended this result: it gave the minority shareholder even more than what he would have received if he had been a partner, which he was not.[29] Under 'oppression' statutes, many courts have applied a 'reasonable expectations' test. While this test has been praised as an 'attractive middle course,'[30] judicially-administered remedies threaten the security of the agreements the parties have made.[31] For example, the remedy may give minority shareholders considerably more leverage than they were ever intended to have. Adopting customised shareholder agreements[32] does not necessarily resolve the problems created by these remedies because of the costs of anticipating and planning for remote eventualities may be prohibitive for closely held firms. This, indeed, is why statutory and judicial remedies are necessary in the first place.

C *Limited Partnerships*

The parties can adopt limited liability without incorporation by forming a limited partnership.[33] Although a limited partnership must have at least one general partner who has unlimited liability,[34] the parties effectively can obtain

[27] See, eg, NY Business Corporations Law §1104-a.

[28] 367 Mass 578, 328 NE 2d 505 (1975).

[29] Frank Easterbrook and Daniel Fischel, 'Close Corporations and Agency Costs' (1986) 38 *Stanford Law Review* 271.

[30] Jennifer Hill, 'Protecting Minority Shareholders and Reasonable Expectations' (1992) 10 *Company and Securities Law Journal* 86, 90. This article includes a useful discussion from an Australian perspective. For a discussion of the US cases, see Robert B Thompson, 'Corporate Dissolution and Sharheolders' Reasonable Expectations' (1988) 66 *Washington University Law Quarterly* 193.

[31] *In the Matter of Pace Photographers Ltd* 71 NY 2d 737, 530 NYS 2d 67, 525 NE 2d 713 (1988) (holding that a shareholder was entitled to the statutory remedy of a fair-value buyout notwithstanding a buy-sell agreement providing for sale at a much lower price). See also Thompson, above n 30, 226-8 (discussing relationship between oppression remedy and shareholder agreements).

[32] For a recent discussion of these agreements from an Australian perspective, see Vivien R Goldwasser, 'Shareholder Agreements-Pòtent Protection for Minorities in Closely Held Corporations' (1994) 22 *Australian Business Law Review* 265.

[33] For a discussion of limited partnerships in Australia, see Ian M Ramsay, 'The Expansion of Limited Liability: A Comment on Limited Partnerships' (1993) 15 *Sydney Law Review* 537.

[34] Revised Uniform Limited Partnership Act §101(7) (defining 'limited partnership').

complete limited liability by incorporating the general partner. Moreover, the parties also can obtain single-level partnership taxation. But they must shape their governance rules to avoid adopting three of the four 'corporate' tax characteristics.[35] They must also be concerned about the limited partnership 'control rule,' which provides that limited partners may be held liable as general partners if they take part in the control of the business.[36] Despite a wide 'safe harbour' of acts that do not constitute taking part in control,[37] the rule inhibits limited partners from taking over failing or mismanaged firms. Limited partnership statutes also impose strict remedies for distributions even by solvent firms that may, in effect, force the firms to retain earnings that are nevertheless being taxed directly to the partners.[38]

D *Close Corporation Statutes*

Corporation statutes often include special 'close corporation' provisions that apply to firms that elect to be covered, or fit a statutory definition of close corporations, or both.[39] Some of these statutes provide for default provisions for closely held firms.[40] But these provisions do not completely solve close corporations' problems. First, limitations on the types of firms that may use the statutes exclude firms that otherwise need to be treated as closely held firms, and create potential uncertainty about firms' status and the enforceability of their shareholder arrangements.[41] This adds to the uncertainties inherent in judicial remedies questions concerning the remedies which should be available to shareholders who opt out of, or do not qualify, for close corporation treatment[42] For example, in *Toner v The Baltimore Envelope Co*[43] the court denied minority shareholders a common law buyout in a company that could have, but did not, elect to be subject to the buyout procedures available to a special close corporation under the relevant statute. *Sundberg v Lampert Lumber Co*[44] held that a statute permitting buyouts in defined close corporations precluded

35 See below Part IV(A).

36 Revised Uniform Limited Partnership Act (1985) §303; Uniform Limited Partnership Act (1916) §7.

37 Revised Uniform Limited Partnership Act (1985) §303(b).

38 Uniform Limited Partnership Act (1916) §17(4); Revised Uniform Limited Partnership Act (1985) §608 (a); Larry E Ribstein, 'An Applied Theory of Limited Partnership' (1988) 37 *Emory Law Journal* 835, 888-9.

39 These statutes fall into three general types. First, provisions applicable only to non-public corporations or corporations that fit within a definition of 'close corporation' which usually refers to some combination or number of shareholders, absence of a public offering or listing on a securities exchange, and use of stock transfer restrictions: see, eg, Model Business Corporation Act (1991) §7.32. Second, provisions applicable to any corporation that elects coverage: see, eg, Maryland Corporations and Associations Code ss 4-101- 4-603. Third, provisions applicable to corporations that both elect to be covered *and* meet a statutory definition of a 'close corporation': see, eg, Delaware Code Annotated (1983) title 8, §§341-56.

40 See, eg, Maryland Corporations and Associations Code ss 4-101- 4-603.

41 Jennifer Hill, 'Close Corporations in Australia — The Close Corporations Bill 1988' (1989) 15 *Canadian Business Law Journal* 43, 53-4.

42 Ibid 41, 58 (raising this question under the Australian Close Corporation Bill 1988).

43 304 Md 256, 498 A 2d 642 (1985).

44 390 NW 2d 352 (Minn App 1986).

application of a common law buyout right to a corporation that did not fit the definition of a 'close corporation.'

An even more important problem of close corporation statutes is that they are *corporation* statutes. Accordingly, courts may apply general corporate provisions which are inappropriate for closely held firms in resolving issues are not explicitly covered by the statute or by the parties' express agreement. For example, when close corporation provisions do not explicitly allow a buyout or dissolution it is unclear whether the courts should apply the partnership or the corporate model.[45]

Finally, state close corporation statutes do not solve the 'double taxation' problem. Close corporations can avoid the double tax by filing under Subchapter S of the IRC. But the Subchapter S election imposes many organisational restrictions on the firm, including prohibiting more than thirty-five shareholders,[46] restricting who may own stock,[47] forbidding an allocation of dividend and liquidation rights that creates more than one 'class' of stock,[48] and prohibiting the S Corporation from owning a corporate subsidiary.[49] S Corporation treatment also has several operational drawbacks compared to partnership, including a requirement that shareholders allocate income, loss, deduction and credit in direct proportion to their interests in the corporation.[50]

E *Impediments to the Evolution of New Business Forms*

This Part has shown that each of the dominant business forms for closely held firms has organisational drawbacks, most importantly personal liability or double taxation. The states have promulgated limited liability business forms such as partnership associations[51] and business trusts[52] that eliminate some cumbersome corporate attributes. Yet widespread acceptance of these forms has been impeded by two important factors — federal tax rules and limitations on jurisdictional competition.

As discussed above,[53] federal tax rules provide that firms that have too many 'corporate' characteristics cannot obtain partnership-type tax treatment. Although parties may be able to obtain private Internal Revenue Service ('IRS')

[45] Larry E Ribstein, 'Linking Statutory Forms' (forthcoming in (1995) *Law and Contemporary Problems*).

[46] IRC §1361(b)(1)(A).

[47] All shareholders of Subchapter S corporations must either be individuals, estates, or certain types of trusts and may not be nonresident aliens: ibid §1361(b)(1).

[48] Ibid §1361(b)(1)(D).

[49] Ibid §1361(b)(2)(A).

[50] Ibid §1377.

[51] Michigan Compiled Laws Annotated (1989) §449.301; New Jersey Statutes Annotated (1993) §42:3-1 (but prohibiting formation of new limited partnership associations as of 21 September 1988); Ohio Revised Code Annotated (1992) s 1783.01; Edward Schwartz, 'The Limited Partnership Association — An Alternative to the Corporation for the Small Business with "Control" Problems?' (1965) 20 *Rutgers Law Review* 29.

[52] See, eg, Delaware Code Annotated, title 6, §§3801-3815; Larry E Ribstein, 'Limited Liability and Theories of the Corporation' (1991) 50 *Maryland Law Review* 80, 125.

[53] See above Part I(C).

rulings classifying the firm as a partnership, the cost of obtaining these rulings restricts their use. Accordingly, these forms cannot be viable alternatives to partnership until the IRS issues rulings generally classifying the forms as partnerships.

State competition to supply law has been hampered in two ways. First, it is costly to incorporate in one state and pay foreign incorporation fees in another state in which a firm does business. Second, only corporations can be sure that non-formation states will apply formation-state law, including the law relating to member liability. Without specific statutory provisions authorising 'foreign' firms to transact business in the state, a state might not recognise the limited liability or other features of new business forms such as business trusts and LLCs.[54]

As discussed in the next Part, solution of these problems of tax and interstate recognition enabled the development of new business forms to proceed rapidly.

III What's Happening Now? LLCs and LLPs

Beginning in 1988, there have been explosive developments in the US law of closely held firms. All but three jurisdictions now have statutes providing for limited liability companies (LLCs)[55] and about half the states have statutes providing for registered limited liability partnerships (LLPs). This Part will first describe each of these new business forms, and then discuss some of the circumstances which triggered their development.

A *Limited Liability Companies*

The first important development was the advent of the LLC. In general, the LLC resembles a partnership except for the members' limited liability and provisions borrowed largely from limited partnership statutes to protect creditors from members' potential abuse of limited liability.

1 *Formation*

All LLC statutes require firms to publicly file articles or a certificate, just as limited partnerships must do. The provisions on contents of the filed document are generally similar to those under RULPA.

2 *Management and Control*

A critical difference between LLC statutes and limited partnership and corporation statutes is that the statutes at least permit management directly by

[54] See above n 7 (discussing choice-of-law rules applicable to contracts); *Means v Limpia Royalties* 115 SW 2d 468 (Texas Civil App 1938) (refusing to recognise the limitation of liability of an Oklahoma business trust).

[55] The exceptions are Hawaii, Massachusetts and Vermont. For an overview of the history and policy considerations relating to LLCs, see Larry E Ribstein, 'Statutory Forms for Closely Held Firms: Theories and Evidence' (forthcoming) *Washington University Law Quarterly*. For detailed analyses and tabular summaries of all 48 LLC statutes, see Larry E Ribstein and Robert R Keatinge, *Ribstein and Keatinge On LLCs* (1994) Ch 4-13.

members rather than through managers. Indeed, the vast majority of LLC statutes provide that, like partnerships, LLC's are managed by members unless the members agree otherwise. However, LLC statutes differ from general partnerships in providing for a mechanism by which the firm can elect to be managed by a board of managers by so providing in the articles of organisation. In a manager-managed LLC, unlike a partnership, the members generally have no authority merely as members to bind the LLC in transactions with third parties.

3 *Transfer of Interests*

LLC statutory provisions on transferability of interests are similar to those in partnership statutes. This is not coincidental, since the transferability provisions are designed with a view to the tax characterisation rules — that is, to avoid the 'corporate' characteristic of free transferability.

4 *Dissociation and Dissolution*

As with transferability, LLC statutes mimic partnership statutes regarding dissolution and dissociation, again with an eye on the tax laws. However, LLC statutes provide for somewhat greater continuity of the firm than under the Uniform Partnership Act by permitting members to dissociate without necessarily causing winding up of the firm.

5 *Foreign LLCs*

All LLC statutes include provisions similar to those in corporate and partnership statutes for registration of LLCs formed under the law of another state and for application to those LLCs of the law of their formation jurisdictions.

B *Limited Liability Partnerships*

The latest stage in the evolution of unincorporated limited liability firms would seem to be the next logical step in development — simply add limited liability to the partnership. These statutes will be summarised below.

1 *LLP as a General Partnership*

All of the statutes provide that a general partnership may become an LLP by filing a certificate. Notwithstanding the filing, the LLP remains a general partnership.[56]

2 *Limited Liability*

LLPs' most significant feature is that their members have a restricted form of limited liability. All LLP statutes provide that LLP partners are not personally liable for the negligence or other misconduct of other partners or employees

[56] Most statutes explicitly so provide in their definitions of 'partnership': see, eg, Arizona Statutes (1994) §29-206; Delaware Code (1994) title 6, §1506(a); Illinois Statutes (1994) ch 805 §205/6; Utah Code (1994) §48-1-3; Virginia Code (1994) §50-6.

unless the partner participated in or supervised the wrongdoing. Under most statutes LLP partners *are* liable for several categories of conduct, including misconduct in which they are involved directly or indirectly involved through supervision; and conduct that is no more than a breach of contract. In other words, LLPs have 'limited limited liability.' The hybrid nature of the limited liability of LLP members raises several questions concerning the extent of partners' duties to contribute toward payment of partnership debts,[57] whether partnership rules should be interpreted differently for LLPs and for other general partnerships, and how LLPs should be categorised under non-partnership statutes.

Some more recently enacted LLP statutes limit the liability of LLP partners for both contract-type and tort-type liabilities[58] While this is a simpler and more straightforward approach, it intensifies the questions about how partnership rules should be applied to LLPs and whether LLPs are 'true' partnerships for purposes of non-partnership statutes.

3 *Registration and Related Duties*

In return for their limited liability, LLP members sacrifice some of the informality of general partnership. LLP provisions prescribe registration formalities, restrict the name of the LLP, and, in some cases, require the firm to carry insurance.

4 *Recognition of Foreign LLPs*

Choice of law issues until now have been minimal in partnership law because of the uniformity of partnership law. Any questions about choice of law were not easily settled because partnerships are not subject to the explicit 'internal affairs' rule of corporate law. LLP statutes have changed this picture by introducing important new choice of law questions regarding member liability. They simultaneously help to settle these questions by including provisions for registration of LLPs formed under the law of another state and application to those LLPs of their formation-state law.

5 *A Further Variation: the LLLP*

Some LLP statutes provide that a *limited partnership* can register as an LLP, thereby producing an 'LLLP' — that is, a limited liability limited partnership. This firm would be a limited partnership in all respects except that the general partner would have the limited liability of a partner in an LLP. Although the firm could achieve a similar result by incorporating the general partner, this would subject the general partner to corporate tax treatment. The LLP mechanism also

[57] Suppose, eg, that a partnership has $50,000 in assets, and $100,000 in debts divided equally between 'contract' debts, for which partners retain individual liability, and 'tort' debts, for which they do not. It is not clear whether the $50,000 in assets should be used to pay tort debts, leaving partners with their full contribution liability. Although this seems inconsistent with the partners' limitation of liability, denying any recovery to the tort creditors also seems inconsistent with their continued right of action against the partnership entity.

[58] See, eg, Minnesota Statutes (1995) §323.14; New York Partnership Law §26 (McKinney's Consolidated Laws of New York Annotated (1995) ch 39, s 26).

may be better than reorganising the general partner as an LLC, which would involve creating a new entity, with potential tax and liability consequences.

C *Explanations for the Rise of the LLP and LLC*

This section discusses the history of LLCs and LLPs and the reason for their sudden and rapid emergence at this particular point in time.

1 *The Effect of the Change in Tax Rules*

The most cause of the emergence of LLPs and LLCs is a change in tax rules. The first LLC statute was adopted in Wyoming in 1977 at the request of a private firm (Hamilton Oil). But it was not until 11 years later that the IRS decided to classify a Wyoming LLC as a partnership for tax purposes.[59] The 1988 Ruling, in turn, may have been spurred by a series of tax changes in the mid-1980's which made corporate-type double taxation more costly, and thereby increased parties' incentives to escape the corporate tax. These changes caused top corporate level tax rates to exceed top individual rates, eliminated the lower 'capital gains' rate on gains on the disposition of stock, and repealed the doctrine which let corporations avoid corporate-level recognition of gain on assets they sold or distributed to shareholders.

2 *Enforcing Jurisdictional Choice*

The Service's imprimatur on LLCs discussed in the previous subsection quickly spurred legislative activity in several states. These new statutes included provisions which clarified that the law of the formation state would be applied to 'foreign' LLCs. This solved the problem of interstate acceptance of this new form of limited liability.[60]

3 *Changing the Opportunity Costs of Limited Liability*

The adoption of LLC statutes also may have been partly attributable to changes in legal rules regarding limited liability. These rules in effect reduced the opportunity cost of limited liability by reducing the value of partners' personal liability.

First, state courts have extended the requirement that partnership creditors exhaust partnership assets before proceeding against individual partners. The exhaustion requirement defers partners' personal liability pending an unsatisfied judgment against the partnership or a determination of partnership insolvency.[61] This requirement may delay or prevent recovery of the debt, particularly if creditors must sue all partners in order to obtain an unsatisfied judgment against the partnership.

The traditional rule requires exhaustion only for contract-type (joint) liabilities,[62] but not for tort-like claims for which the partners' liability is joint

[59] Internal Revenue Service, Revenue Rulings 88-76, 1988-2 Cumulative Bulletin 361 (1988).

[60] See above Part II(E).

[61] Bromberg and Ribstein, above n 23, §5.08.

[62] See, eg, *Arbor Village Condominium Association v Arbor Village Ltd* 642 NE 2d 1124 (1994).

and several.[63] Although the Uniform Partnership Act makes the traditional distinction between joint and joint and several liability,[64] some states now prescribe joint and several liability of partners for all partnership obligations.[65] Several courts have responded by applying the exhaustion requirement even to joint and several liability.[66] This move was recently endorsed by the Revised Uniform Partnership Act.[67]

Courts' expansion of the exhaustion requirement in state partnership law works together with recent cases under federal bankruptcy law which also tend to block creditors' direct access to partners' assets. Several cases have enjoined actions against non-bankrupt partners by creditors of bankrupt partnerships.[68] This, in effect, relegates creditors to a collective proceeding unless they can preemptively strike solvent partners prior to the partnership's bankruptcy.

These changes in the law of personal liability have reduced the impact on firms' cost of credit of adopting limited liability. At the same time, they may not equally decrease the costs to partners of personal liability, since partners still have to incur the costs of monitoring the firm and their co-partners' wealth to guard against potentially disastrous personal liability. Thus, firms have more reason to adopt a limited liability business form.

4 *The Role of the Bar*

LLC statutes and related developments have been largely attributable to the efforts of bar groups who have initiated proposals for LLC legislation and have urged the proposals through the legislature.[69]

5 *Changes in Demand for Limited Liability*

The rapid spread of LLC and LLP statutes could be viewed as responses to an increased demand for limited liability by lawyers, accountants and other professionals because of their expanding exposure to securities law,[70] savings

[63] See, eg, *Catalina Mortgage Co v Monier* 800 P 2d 574 (Ariz en banc 1990) (on certified question: limited partnership's creditor may obtain judgment against general partner and reach his assets prior to exhaustion of partnership assets; limited partnership was in bankruptcy reorganisation).

[64] UPA §15(b) makes partners jointly liable for 'debts and obligations of the partnership' other than those specified in UPA §§13 (wrongful acts, eg, torts) and 14 (breaches of trust), for which the liability is joint and several by UPA §15(a).

[65] See, eg, Arizona Revised Statutes Annotation (1994) §29-215; Colorado Revised Statutes (1990) §7-60-115; Georgia Code Annotated (1994) §14-8-15.

[66] See, eg, *In re Norman* 32 BR 562, 565 (West Dist Missouri 1983).

[67] See Revised Uniform Partnership Act §307(d) (1994) ('RUPA').

[68] See generally Paul R Glassman, 'Third-Party Injunctions in Partnership Bankruptcy Cases' (1994) 49 *Business Lawyer* 1081.

[69] This is indicated by the author's work on LLC legislation and by statements made at meetings of the American Bar Association Section on Business Law, Partnership Committee, Subcommittee on Limited Liability Companies.

[70] For a review of the expanding securities law liability of lawyers, see Marc I Steinberg, 'Attorney Liability under the Securities Laws' (1991) 45 *Southwestern Law Journal* 711. This shift in demand is unlikely to be stopped by the Supreme Court's recent decision eliminating aiding and abetting liability under Rule 10b-5 and §10(b) of the Securities and Exchange Act of 1934. See *Central Bank of Denver NA v First Interstate Bank of Denver NA* 114 S Ct 1439 (1994) (*Central Bank*). Firms still face potential direct liability under the securities laws, as well as both direct and aiding and abetting liability under banking and other laws. For

and loan, malpractice and other liability.[71] This expanding liability raised doubts concerning the adequacy of traditional means, such as liability insurance, of protecting professional partners' personal assets.[72] Moreover, partners cannot easily protect themselves through monitoring from liability resulting from a sudden shift in the law.

D *Summary and Analysis*

The developments discussed in this Part have provided new business forms that better accommodate the needs of closely held firms. These developments suggest that, until recently, the menu of available forms was restricted artificially by tax and other law, rather than naturally by firms' demand for better statutes. Changes in tax law, limited liability, and interstate acceptance of limited liability spurred the acceptance of new limited liability forms of business.

IV ISSUES RAISED BY THESE DEVELOPMENTS

This Part discusses some important policy issues suggested by the foregoing historical review of the development of the law of closely held firms.

A *Who's Afraid of Limited Liability?*

The most important question lurking behind the development of closely held firms is the extent to which there should be restrictions on limited liability.[73]

1 *Limited Liability and Voluntary Creditors*

Partners can enter into enforceable 'non-recourse' contracts with creditors which provide that the creditors may not have recourse to the partners' individual assets.[74] Limitation of liability in the partnership agreement coupled with notice to creditors comparable to that provided under the name and registration provisions of the LLP statutes might be enough to create limited liability by contract even in a non-LLP. A statute reduces the costs of making these contracts.[75]

discussions of the implications of *Central Bank*, see 'Symposium on the *Central Bank* Decision: The Demise of Aiding and Abetting?' (1994) 49 *Business Lawyer* 1429-87.

[71] See Lisa Isom-Rodriguez, 'Limiting the Perils of Partnership' (July/August 1993) *The American Lawyer* 30 (noting that large settlements in savings and loan cases by Kaye, Scholer and Jones, Day law firms spurred interest in LLPs, and quoting one lawyer as saying that the Kaye, Scholer case was a 'clarion call to action' on limited liability). Although securities law liability is imposed directly on participants, it impacts on limited liability by reducing the firm's assets available to pay other debts, including malpractice liabilities.

[72] Dan L Goldwasser, 'Damage Control For Professional Liability' (July 1991) 61 *CPA Journal* 16 (noting accountants' concern about the adequacy of protection from such things as liability insurance, particularly in the wake of collapse of Lavanthol & Horwath).

[73] For a recent analysis of this issue, see Ramsay, above n 33.

[74] *Dominion National Bank v Sundowner Joint Venture* 50 Md App 145, 436 A 2d 501(1981) (recognising enforceability of non-recourse-contracts); *Union Trust Co of Maryland v Poor & Alexander Inc* 168 Md 400, 177 A 923 (1935) (enforcing non-recourse contract in 'investment trust'); Ribstein, above n 52, 112-3.

[75] Ibid 113-4.

The real question concerning limited liability to voluntary creditors is why firms and creditors would want to enter into such contracts. The owners presumably have to pay higher credit costs to third parties in return for limiting their liability. These costs reflect the reduced pool of assets from which creditors can collect their debts and the fact that limited liability may induce owners to engage in risky practices.[76]

Limited liability may be worth the increased credit costs to owners in publicly traded firms because, as many writers have pointed out, limited liability facilitates transferability of shares which is necessary for the creation of efficient securities markets.[77] The cost-benefit trade-off is harder to see in closely held firms such as general partnerships in which shares normally are not freely transferable. Even in closely held firms, limited liability reduces the owners' need to monitor their co-owners' activities.[78] But while the advantages of limited liability to owners are less in closely held firms, the risks to creditors may be even higher than in publicly held firms because limited liability may encourage owners of closely held firms to engage in excessively risky conduct. So why would general partners ever be willing to pay the higher credit costs of limited liability?

One reason may be that the costs of limited liability to creditors — and therefore the increased credit charges they would demand — are not as great as one might suppose. Creditors' benefits from members' personal liability depend partly on the joint probability that the firm will not be able to pay the debts and that the owners will. The combination of thinly capitalised firms and wealthy owners may not be very common. Moreover, creditors must consider their costs of determining what the owners own, of making sure that owners do not transfer their own assets out of reach prior to collection, and of collecting from owners' personal assets.[79] The costs of collecting debts from individual partners may be high in view of exhaustion requirements under state law and co-debtor stays and injunctions under federal bankruptcy law.[80] These costs may erase any benefits from personal liability, particularly for relatively small debts.

Even where members' personal liability is valuable to creditors, the parties may be better off by agreeing to individual guarantees by the wealthiest partners rather than to across-the-board personal liability for all owners. In this way, owners would incur the costs of personal liability only to creditors who are willing to pay for the extra protection.

[76] Paul Halpern, Michael Trebilcock and Stuart Turnbull, 'An Economic Analysis of Limited Liability in Corporation Law' (1980) 30 *University of Toronto Law Journal* 117; Woodward, 'Limited Liability in the Theory of the Firm' (1985) 141 *Journal Inst & Theo Econ* 601; Ribstein, above n 52, 97-8.

[77] Frank H Easterbrook and Daniel R Fischel, 'Limited Liability and the Corporation' (1985) 52 *University of Chicago Law Review* 89; Halpern, Trebilcock and Turnbull, above n 76; Ramsay, above n 33; Woodward, above n 76; Ribstein, above n 52, 99-100.

[78] Ribstein, above n 52, 101-6.

[79] Larry E Ribstein, 'The Deregulation of Limited Liability and the Death of Partnership' (1992) 70 *Washington University Law Quarterly* 417.

[80] See above Part III(C)(3).

2 *Involuntary Creditors*

The most important policy question regarding limited liability is whether it should be available against *involuntary creditors* such as accident victims.[81] The objection to this result is that involuntary creditors are not in a position to contract to adjust the cost of credit to reflect the increased risks posed by limited liability.[82] Accordingly, shareholders may engage in excessively risky conduct, the costs of which are borne by society. There are several possible responses to this criticism:

- The problem of ignoring risks is not as serious as it might seem.[83] Firms insure against tort liability because, even with limited liability, owners have reason to be concerned about loss of corporate assets.[84] Employee-members and non-member managers could lose their jobs if the firm becomes insolvent because of tort claims. Also, the firm may have to insure to appease unsecured voluntary creditors who would have to share with tort creditors in the event of an insolvency. If the company does insure, its insurance rates, and the availability of insurance, depend to some extent on the riskiness of the business. Thus, limited tort liability is likely to be a problem only for some firms that can avoid owning substantial assets, do not sell their products into markets in which risks are likely to be efficiently priced, and can have large potential tort liabilities.
- In evaluating the costs and benefits of limited liability, it is important to keep in mind that unlimited liability is not a panacea for creditors. Even corporate shareholders can evade personal liability by, for example, shifting assets to family members.
- Even if owners and managers face a significantly higher risk of loss of wealth from torts under unlimited liability, this may not impose much additional incentive on them to be careful. Owners, like firms, can insure. Also, even limited liability owners and agents will act carefully to preserve their personal reputations for probity and care.
- Even if personal liability increases owners' incentives to be careful, this increase may not be a good thing: Some tort or malpractice cases impose liability for unknowable risks or for injuries that were easily preventable by

[81] Similar arguments may apply to some voluntary creditors, such as professional firm clients or ordinary consumers, whose information and other transaction costs are high relative to the amount of the debt.

[82] Halpern, Trebilcock and Turnbull, above n 76; Henry Hansmann and Reinier Kraakman, 'Toward Unlimited Shareholder Liability for Corporate Torts' (1991) 100 *Yale Law Journal* 1879 (advocating *pro rata* liability in corporations); David W Leebron, 'Limited Liability, Tort Victims, and Creditors' (1991) 91 *Columbia Law Review* 1565 (suggesting unlimited tort liability in some situations); Alan Schwartz, 'Products Liability, Corporate Structure, and Bankruptcy: Toxic Substances and the Remote Risk Relationship' (1985) 14 *Journal of Legal Studies* 689 (suggesting unlimited liability if assets and insurance insufficient to satisfy knowable tort claims).

[83] Ribstein, above n 79.

[84] Easterbrook and Fischel, above n 77; Ribstein, above n 79.

plaintiffs.[85] Unlimited liability may even *reduce* overall incentives for care by deflecting lawsuits from immediately negligent parties to remote non-negligent owners.

- Unlimited liability causes a shift from first-party insurance, such as accident and worker-compensation policies, to third-party insurance. This shift may increase overall insurance costs by, among other problems, causing over-insurance in relation to the expected loss, higher administrative costs, higher costs of diversifying risks for insurance companies, and less ability to separate insureds into risk pools.[86]
- Any benefits of unlimited tort liability must be balanced against the costs it imposes on owners. Among other things, owners have to incur costs in monitoring their co-owners and may not be able to fully delegate decision-making to other managers or owners.

In general, it is important to keep in mind that the costs of unlimited liability are borne by society and *not* by owners who invest after the unlimited liability rule goes into effect. Thus, society may lose from unlimited liability just as it may lose from limited liability. For example, unlimited liability may reduce the size of firms below optimal levels because monitoring and other costs of unlimited liability may be particularly burdensome for large firms. Also, unlimited liability may make firms *too* cautious, as by discouraging socially beneficial products.

3 *Limited Liability and the Type of Business Association: LLCs and LLPs*

Even if limited liability is generally desirable, there is a further question whether it is an appropriate term of general partnerships, LLCs and other types of relatively flexible firms. Unless limited liability in the partnership or LLC form presents special problems, it would make no sense to forbid limited liability to partners or LLC members, while letting the same people limit their liability by forming corporations or limited partnerships.

One reason why limited liability may be a special problem for general partnerships and LLCs concerns their management structure. One of the costs of limited liability is that it may encourage managers to run the firm in a way that imposes risks on creditors. This risk is mitigated in a 'standard form' corporation by the fact that the firm is run by directors who may not be substantial owners, and who, therefore, may not gain from risky practices. Indeed, managers may have even more to lose from excessive risks than creditors because their jobs are at stake in the event of a possible bankruptcy. To be sure, the managers are elected by, and therefore must serve the interests of, the owners. But there is enough 'slack' in the owners' power to control the managers to leave room for the managers to act in some respects more like creditors' than like owners.

[85] Lewis A Kornhauser, 'An Economic Analysis of the Choice Between Enterprise and Personal Liability for Accidents' (1982) 70 *California Law Review* 1345; Alan O Sykes, 'The Economics of Vicarious Liability' (1984) 93 *Yale Law Journal* 1231.

[86] George L Priest, 'The Current Insurance Crisis and Modern Tort Law' (1987) 96 *Yale Law Journal* 1521.

Partnerships and LLCs, by contrast, generally combine ownership and control in the same people. This management structure may present special risks to creditors. These risks may explain the law's reluctance to allow close corporations to dispense with the board of directors. But now that these restrictions have been relaxed in close corporations, there is little reason not to allow limited liability for other types of firms.

Even if the form in which limited liability is available should be restricted, there is a further question whether extra taxation and formalities are the appropriate restrictions. Perhaps subjecting limited-liability firms to double-level corporate tax encourages them to retain capital which is available to creditors. But closely held firms can distribute much of their income tax free to owners as tax-deductible salaries and other expenses or can avoid the double-tax by organising as Subchapter S corporations. Thus, tax law does not encourage earnings retention as much as it imposes impediments that are little help to creditors. Nor is there any reason to believe that tort creditors are helped in any other way by an extra level of corporate tax.[87]

B *Transaction Cost Functions of Separate Statutes*

LLCs and LLPs also pose questions about the need for different types of statutes. Why is it not enough simply to allow the parties to firms to make their own contracts by, for example, liberalising close corporation statutes? One answer is that it is costly for firms to write customised terms. But this could be addressed by providing a single statute with a 'menu' of alternative terms. For example, the parties to a close corporation could be permitted to choose either an 'easy exit' option of partnership-type dissolution at will or a more corporate-style option of dissolution only by majority vote.

The answer to these questions is that separate statutory standard forms do serve potentially important functions in reducing transaction costs.[88] First, statutory standard forms reduce information costs by providing firms with clear and readily accessible sets of ground rules.

Second, separate statutes offer efficient default structures that minimise the need for customised drafting or selection of terms. If firms that adopt Term A probably also would want Term B, the statutes should provide this combination rather than forcing firms to make customised contracts. In other words, the statute should be 'coherent' in the sense of designed to suit the needs of most firms that are expected to form under it. For example, parties who want to participate actively in management probably also want to be able to exit the firm easily when they disagree with how it is being managed. Corporate statutes do not satisfactorily accommodate this combination of preferences. Similarly, there are problems with combining limited liability and decentralised management.[89]

[87] Ribstein, above n 79.
[88] See generally Ribstein, above n 45.
[89] See above Part IV(A)(3).

Third, embodying a business form in a separate statute, by establishing that the firm has adopted a particular governance form, helps courts determine how to decide cases that cannot be resolved by specific provisions in the applicable statute or contract. For example, by choosing to form a 'partnership,' a firm signals that, in the absence of contrary agreement, all members participate equally in management. Accordingly, in a firm that adopts the partnership form but agrees to corporate-type centralised management by a managing partner, the manager should have only such power to override the members as is expressly provided by the agreement. Conversely, in a firm that adopts the corporate form but agrees to partnership-type decentralised management, the manager has a default power to govern that the parties must explicitly override by agreement. In other words, identical ambiguous agreements could be interpreted differently depending on what type of standard form the firm has selected. Providing for different types of firms in the same statute by offering a 'menu' of terms may leave some uncertainty as to the appropriate model courts should use for filling gaps in the parties' agreement.

But a proliferation of separate statutes also has potential costs. A single statute, such as a corporation statute, is used by more firms and, so, will generate a larger stock of customised forms and judicial precedents than will separate LLC, LLP and corporate statutes.[90] These precedents and forms assist the parties to firms in planning. The availability of more judicial precedents helps the parties predict the resolution of disputes which, in turn, may reduce the number of disputes that are ultimately litigated.[91] Such benefits, however, may be small for narrow, specific rules that probably will require little interpretation, and for fiduciary duty rules whose application depends critically on the facts of each case.

In general, therefore, whether the efficiency of these new types of statutes depends partly on a balance of the benefits of offering separate statutes that are appropriate for individual firms against benefits such as more judicial precedents of channelling firms into a single standard form.

C *Jurisdictional Competition and Uniformity*

One of the most important issues regarding the development of closely held firms is whether the rules should be uniform for all firms — that is, provided by the federal government or adopted uniformly by all jurisdictions — or whether experimentation and diversity among the states should be allowed or

[90] This could be characterised as a 'network benefit' because the number of users of the form (the 'network') increases the form's utility: see generally Michael L Katz and Carl Shapiro, 'Network Externalities, Competition, and Compatibility' (1985) 75 *American Economic Review* 42. For recent criticism of this concept, see S J Liebowitz and Stephen E Margolis, 'Network Externality: An Uncommon Tragedy' (1994) 8 *Journal of Economic Perspectives* 133. For an application of the concept to corporate law, see Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts* (1994).

[91] George L Priest and Benjamin Klein, 'The Selection of Disputes for Litigation' (1984) 13 *Journal of Legal Studies* 1, 13-7.

encouraged.[92] The answer depends on an analysis of several interrelated issues. First, it is necessary to analyse the costs and benefits and benefits of uniform laws. Second, these costs and benefits depend, in turn, on the costs of relying on contractual choice of law. Third, both contractual choice of law and uniformity depend on the robustness of jurisdictional competition. These issues will be examined in turn. The last section summarises and points the way to a possible desirable outcome: spontaneous evolution of desirable uniformity.

1 *The Costs and Benefits of Uniformity*

Uniformity, whether it is imposed by a central federal government or arises by through adoption of the same law by state or provincial governments, has potential costs and benefits.[93]

The *benefits* of uniformity include:

- Eliminating the application of inconsistent state laws which may, for example, expose a business association to governance rules that differ for shareholders in each state.[94]
- Making it easier for firms or individuals that travel or transact business in several states to determine the law that applies to corporate transactions. Uniform laws not only clarify what rule applies, but also facilitate the development of a repository of judicial decisions that aid interpretation of statutory terms.
- Reducing litigation expense by trivialising otherwise difficult choice-of-law issues and eliminating deadweight litigation costs involved in forum shopping.
- Reducing 'externalisation' of costs by state legislators. State legislators may be able to help their constituents, such as consumers or investors, while hurting people and groups based outside the state, such as manufacturers or issuers.[95] The costs of such laws are externalised in the sense that they do not impact voters or, by extension, their elected officials. Uniform lawmakers presumably must take into account interstate social welfare rather than only the narrow constituent interests that would matter to state legislators.

The *costs* of uniformity include:

- Increasing the costs of exiting jurisdictions. As Charles Tiebout recognised, the ability of people and firms to exit jurisdictions whose policies they do not

[92] For an excellent review of the relevant issues, including many of those discussed below, see Ian M Ramsay, 'Company Law and the Economics of Federalism' (1990) 19 *Federal Law Review* 169.

[93] For a general discussion of the costs and benefits of uniformity, see Larry E Ribstein and Bruce H Kobayashi, *An Economic Analysis of Uniform Laws* (1994).

[94] For discussion of these potential costs of diversity, see Ronald J Daniels, 'Should Provinces Compete? The Case for a Competitive Corporate Law Market' (1991) 36 *McGill Law Journal* 130, 138; Larry E Ribstein, 'Choosing Law by Contract' (1993) 18 *Journal of Corporation Law* 245.

[95] Michael W McConnell, 'Federalism: 'Evaluating the Founders' Design' (1987) 54 *University of Chicago Law Review* 1484; Gordon Tullock, 'Federalism: Problems of Scale' (1969) 6 *Public Choice* 19.

like motivates governments to reflect voters' preferences.[96] In general, regulation at the state or provincial rather than federal level facilitates exit and thereby reduces the impact of mandatory rules. Conversely, uniform state laws decrease exit opportunities.

- Reducing experimentation and diversity. Uniform laws reduce the number of different laws on a given subject. Experimentation can produce laws that have fewer 'bugs,' and that are better-suited to particular parties and localities, than a single group of uniform lawmakers could produce.[97]

2 *Costs and Benefits of Enforcing Contractual Choice of Law*

In deciding whether the costs of uniformity outweigh the benefits, it is important to consider an important alternative to uniformity — allowing the parties to contractually select their own law. This is obviously particularly important in the context of business associations, where the parties long have selected the law that applies to their contract by selecting the state of organisation. If the parties can choose what law applies, they can eliminate problems of inconsistent laws, reduce the problem of determining the applicable law, trivialise forum-shopping and choice-of-law issues, and avoid cost-externalising and otherwise inefficient laws. At the same time, the states would retain the ability to innovate and experiment and the parties could exit onerous laws. However, enforcing contractual choice of law has its own set of costs and benefits.[98]

The *benefits* of enforcing choice-of-law clauses arise from increasing the supply of law 'products' parties can choose to govern their contracts.[99] If choice-of-law clauses were not enforced, contracting parties would be limited to the products provided them by states connected with the contract under applicable choice of law principles. Specific benefits include:

- Increasing the parties' ability to exit inefficient mandatory rules. It is difficult for a state to impose costs on non-resident corporate shareholders through its corporate law.[100]
- Giving states an incentive to compete for law business by providing efficient legal rules. Competition works by encouraging states both to develop new terms to attract new legal business and to revise their laws to retain legal business. This advantage helps to produce efficient mandatory and standard-

[96] Charles M Tiebout, 'A Pure Theory of Local Expenditures' (1956) 64 *Journal of Political Economy* 416.

[97] Daniels, above n 94, 138-9; Ribstein, above n 6.

[98] For a more detailed analysis of these costs and benefits, see Ribstein, above n 6.

[99] Roberta Romano has used the 'product' analogy to describe the choice-of-law process in corporate law: Roberta Romano, 'Law as a Product: Some Pieces of the Incorporation Puzzle' (1985) 1 *Journal of Law, Economics, and Organization* 225 (showing that states do compete to provide corporate contract terms, and that franchise tax revenues provides an important incentive to do so).

[100] Daniel R Fischel, 'From MITE to CTS: State Anti-Takeover Statutes, the Williams Act, the Commerce Clause, and Insider Trading' [1987] *Supreme Court Review* 47, 85.

form terms. If the selected state inefficiently changes its law or fails to make needed revisions it will quickly lose the patronage of contracting parties.

- Reducing problems that arise when different state rules may apply to different aspects of or parties to the contract. This is important in business associations because of the costs of coordinating differing management and financial rights that might be imposed across states.
- Enabling the parties easily to determine what law governs the transaction both at the time of contracting and at the time of litigation. In the absence of an enforceable choice of law clause, the parties must work through a complex multi-factor analysis in order to predict which law will apply.[101]

The *costs* of enforcing contractual choice of law concern the possibility that the states may 'race to the bottom' — that is, design their laws to appeal to dominant or informed parties who can dictate contractual choice of law. More specifically, enforcing contractual choice of law can involve the following problems:

- Facilitating evasion of mandatory rules. Indeed the argument against enforcing the contractual choice-of-law in these situations may seem to be precisely the same as that supporting the mandatory rule itself. Yet there is a difference between enforcing choice-of-law clauses and enforcing contracts. Enforcing a choice of law clause requires courts to apply a state law rather than solely the voluntary act of contracting parties. In other words, the parties cannot enter into a contract that all jurisdictions condemn. While a state might attempt to benefit its residents by allowing them to victimise non-residents in oppressive deals, the fact that the state's law applies to its own residents reduces states' incentives to legislate in this way. Moreover, the parties' choice of law is not obviously less appropriate than any other basis of selecting among potentially applicable state rules. Although the parties may have chosen a law the courts would not otherwise have applied, a residence state does not clearly have a greater 'interest' or other basis for regulating than the state chosen in the contract.
- Surprising unsophisticated parties. Yet how surprised can a party be by a clause that simply enforces the underlying contract? Moreover, the contractual term is set in long term contracts such as franchises and distributorships by negotiations among parties who are themselves sophisticated or who can hire advisors. If such parties do not understand the effect of the choice of law clause, the price will reflect their uncertainty. Indeed, suspicious negotiators may assume the worst from the designation of a particular state's law and over-discount for the clause. In this setting the party who chooses the law must reassure the other party or bear at least some of the cost of the other party's ignorance. Even in contracts among the relatively unsophisticated, the firms in competitive markets may be subject to market incentives to disclose and to

[101] For criticisms of the indeterminacy of modern choice-of-law rules, see Richard A Posner, *Problems of Jurisprudence* (1990) 430; Michael H Gottesman, 'Draining the Dismal Swamp: The Case for Federal Choice of Law Statutes' (1991) 80 *Georgetown Law Journal* 1.

constraints on cheating. In any event, regulators could minimise information costs by mandating disclosure of unusual and significant law-selection terms in specific circumstances.

- Imposing 'adhesion' contracts on parties with weaker bargaining position.[102] Yet it is not clear why this might be a special problem of enforcing contractual choice of law. Contracts are not 'adhesive' merely because the parties did not bargain. The law provides standard form contracts precisely in order to eliminate the costs of unnecessary 'dickering.' The courts and legislators can refuse to enforce certain types of contracts where abuse is likely. But there is no reason to believe that all choice of law clauses involve bargaining defects, and so no justification for a general rule invalidating choice of law clauses as per se unconscionable.[103]
- Circumventing state policies protecting non-contracting parties. For example, the choice of the law of State X in an automobile insurance contract should not bind the insured's victim, a non-contractual creditor, to accept application of X state's tort law. But so-called 'third parties' often are themselves contracting parties. For example, creditors can contract for protection from LBOs.

3 *States' Incentives to Compete*

The foregoing two sections show that uniformity may impose unnecessary costs as compared with letting the parties solve problems such as those relating to inconsistent state laws by contractually selecting the law that governs their transaction. This is particularly feasible in the business associations situation that is under discussion. But even if the parties can choose their own law, will the states compete to supply efficient laws? If not, it may be better for a central rule-maker, such as the federal government, to make the law. Alternatively, where no legislature has acted, the courts may be called on to fill the gap, as discussed in the next section.

If states cannot internalise the benefits from efficient contract rules, they may have inadequate incentives to devote legislative and judicial resources to developing and maintaining efficient contract rules. States can earn revenues by attracting franchise fees.[104] But legislators may lack incentives to serve the interests of the taxpayers as a group. Professors Jonathan Macey and Geoffrey Miller have argued that lawyers are a more effective group than taxpayers, as shown by their significant influence on Delaware law.[105] Lawyers not only wield

[102] This argument underlies the 'race to the bottom' argument for broad regulation of corporate governance: see, eg, Melvin A Eisenberg, 'Contractarianism Without Contracts: A Response to Professor McChesney' (1990) 90 *Columbia Law Review* 1321, 1322, 1328-9, 1331; Melvin A Eisenberg, 'The Structure of Corporation Law' (1989) 89 *Columbia Law Review* 1461, 1486-7.

[103] That is particularly so where the contract chooses the entire local law of a particular jurisdiction, since a state's entire law as to a complex contract probably cannot be expected at the time of contracting to peculiarly disadvantage one of the parties.

[104] Romano, above n 99, 233-42 shows that franchise tax revenues are an important factor in generating jurisdictional competition regarding corporations.

[105] Jonathan R Macey and Geoffrey P Miller, 'Toward an Interest-Group Theory of Delaware Corporate Law' (1987) 65 *Texas Law Review* 469.

the conventional power of a cohesive interest group, but in most states actually draft complex business statutes.

Professor Ian Ayres has questioned whether states have adequate incentives to innovate for closely held firms.[106] He argues that foreign incorporation costs keep close corporations from 'shopping' for the best statute, and that legislators do not want to supply close corporation statutes because judicial decisions on close corporation issues could reduce the value of the state's corporate precedents for public corporations. One also could argue that, even if state legislators do compete to supply statutes for closely held firms, they will not necessarily 'race to the top' because there is no active stock market with an efficient pricing mechanism to discipline the close corporation charter market.

On the other hand, these problems might not seriously impede an efficient competition for close corporation charters.[107] First, foreign incorporation costs are a function of what states choose to charge for both domestic and foreign chartering. Accordingly, in predicting the amount of this competition it is necessary to consider the states' underlying incentives to compete. Second, even if *close corporation* statutes create problems for public firms, it may be that creating separate statutes — that is, LLC and LLP statutes — may address these problems. Third, there is no need to rely on an efficient stock market to produce a 'race to the top' for closely held firms when the members themselves participate in management and therefore can evaluate the firm's choice of chartering jurisdiction.[108] Finally, despite Ayres' doubts about legislators' incentives to compete for close corporation charters, the competition may be driven largely by *lawyers*. Lawyers can gain from their state's having an efficient law through the increased litigation in their jurisdiction the law would attract. As experts and members of a specialised community that stays well-informed about the law[109] they can expect to gain the most from litigation and other legal business based on that law.

To be sure, there is a danger that some lawyers — mostly litigators rather than commercial lawyers — might prefer legal rules that foster a socially excessive amount of litigation.[110] Accordingly, whether and how states compete to supply law depends on whether lawyers' incentives to improve the law and to gravitate

[106] Ian Ayres, 'Judging Close Corporations in the Age of Statutes' (1992) 70 *Washington University Law Quarterly* 365 (questioning lawmakers' incentives to develop legislation for close corporations); Jeff MacIntosh, 'The Role of Interjurisdictional Competition in Shaping Canadian Corporate Law: A Second Look', University of Toronto Law and Economics Working Paper Series, WPS-18 (1993) (questioning Canadian incentives to innovate in corporate legislation).

[107] Ribstein, above n 55.

[108] Nevertheless, the choice might be determined by lawyers who may have self-interested reasons for selecting particular types of LLC statutes.

[109] The existence of such specialised communities, such as the Delaware bar, partly explains why lawyers in a particular state can capture the benefits of an efficient state law even though the law can be applied in other states: see Larry E Ribstein, 'Efficiency, Markets and Competition: A Comment on Easterbrook & Fischel's *Economic Structure of Corporate Law*' (1992) 87 *Northwestern University Law Review* 254.

[110] Macey and Miller, above n 105 (reaching this conclusion about Delaware corporation law).

toward states with efficient laws outweigh their incentives to gain from perverse laws that maximise attorneys' fees.[111]

Questions concerning the amount and type of jurisdictional competition with respect to closely held firms have been largely answered by the rapid development of the law of LLCs and LLPs. These statutes evolved in many respects by becoming more efficient over time.[112] Moreover, there is evidence that the evolution and competition was spurred directly by lawyers, perhaps because they saw the statutes as a way of attracting legal business and as efficient limited-liability vehicles for their own practices. Indeed, the development of LLPs itself might spur further jurisdictional competition in the development of partnership law because of newfound diversity between the states and LLP provisions for recognising foreign law.[113]

An important implication of the salutary effects of jurisdictional competition is that, if uniformity is, indeed, a good thing, jurisdictional competition may drive state statutes to evolve toward efficient uniformity. There is some evidence that LLC statutes have spontaneously moved toward uniform provisions in those situations in which uniform laws are most appropriate — where there is little benefit to diverse rules, and where diversity would impose potentially significant information and other costs.[114]

D *Statutes v Judicial Rules*

If there has been inadequate jurisdictional competition regarding closely held firms, perhaps *courts* should take up the slack and make the rules for closely held firms that legislatures have failed to do.[115] But there are costs associated with this solution. First, judicial rules such as those giving relief for 'oppressive' conduct in the close corporation, are vague and unpredictable.[116] Second, firms that adopt a statute may be implicitly adopting the contract this represents. Judicial remedies for 'oppressive' conduct may override this implicit contract.[117]

E *Tax and Regulatory Consequences of Choice of Form*

Tax and regulatory laws may have perverse effects on the substantive law of business associations by making it necessary for firms to adopt statutory forms that are not well-suited to their business in order to minimise tax and regulatory costs. The most prominent example is the tax distinction between partnerships and corporations for purposes of determining whether to impose the 'double'

[111] Larry E Ribstein, 'Delaware, Lawyers and Choice of Law' (1994) 19 *Delaware Journal of Corporate Law* 999.

[112] Ribstein, above n 55.

[113] See above Part III(B)(4).

[114] Bruce H Kobayashi and Larry E Ribstein, *Evolution and Uniformity* (1994).

[115] Ayres, above n 106. For a discussion from an Australian perspective of tradeoffs between legislative and judicial rules, see Ian M Ramsay, 'Corporate Law in the Age of Statutes' (1992) 14 *Sydney Law Review* 474.

[116] See above nn 27-32 and accompanying text.

[117] See above n 31 and accompanying text.

corporate tax. The US tax distinction between corporations and partnerships based on whether they have 'corporate' or 'partnership' characteristics[118] is an artificial distinction which forces limited-liability closely held firms such as LLCs to incur the transaction costs of adopting rigid rules transferability, continuity of life and centralisation of management in order to reap tax benefits.[119] The courts also have paid some attention to the *form* of the business in deciding how to apply the federal securities laws.[120] The regulatory impact of the choice of form is pervasive. Recently, for example, SF Broadcasting was forced to change from an LLC to a corporate structure when questions were raised whether SF was structured by one of its owners, News Corporation's Fox Television Stations, to circumvent foreign ownership laws and FCC limits on how many stations one company can own.[121]

On the other hand, despite the potential costs of linking tax and regulatory consequences to the type of firm, such linkage may be the best way to provide clarity and predictability and to give the parties some leeway in contractually maneuvering around an otherwise mandatory statute.[122]

V CONCLUDING REMARKS: IMPLICATIONS FOR AUSTRALIA

As is clear from the foregoing discussion, rapid changes are occurring in the US law of closely held firms. Most importantly, the US is changing from a regime under which the *close corporation* is the only way for closely held firms to obtain limited liability to one in which firms can choose other forms, now including the LLC and LLP. It seems likely, in view of the greater suitability and adaptability of these forms to closely held firms, that they, and not the close corporation and limited partnership, represent the future of closely held firms in the US Indeed, preliminary data shows that LLC formations are starting to overtake formation of limited partnerships and corporations.[123]

The development of the LLC and LLP forms have implications for other issues:

- The role of limited liability in business associations is expanding in the US It is even conceivable, given the development of the LLP, that limited liability may become the 'default' term in the sense that at some time in the future most *general* partnerships will have limited liability and members of closely held (and other) firms will have to contract for personal liability
- Tax and regulatory statutes play important roles in the development of business associations.

[118] See above n 22 and accompanying text.

[119] Ribstein, above n 79.

[120] Ribstein, above n 16.

[121] Elizabeth Jensen, 'SF Broadcasting Acts to Speed FCC Clearance', *Wall Street Journal* (New York), 17 October 1994.

[122] Ibid.

[123] Ribstein, above n 55.

- Jurisdictional competition, perhaps driven by lawyers, is alive and well in the US This suggests, in turn, that uniform or federal laws may be unnecessary and counterproductive.

These developments have potentially important implications for Australia. First, as Australians undertake to change and modernise the law relating to closely held firms, they should consider alternative forms of business association, such as the LLC and partnership-based forms of business, and not merely changes to close corporation legislation.

Second, the recent movement in Australia toward more centralisation and federalisation of the law of business associations may be misguided. Of course, there are important differences between the US and Australia, such as population and the number of jurisdictions, that may point to a different direction for Australia. Yet much more work has to be done on the optimal conditions for jurisdictional competition before it is possible to conclude that it will not work for Australia as it has in the US[124]

In short, this outsider immodestly suggests that current moves to reform the law in Australia which focus merely on 'tweaking' the regulations that apply to proprietary companies,[125] may not go far enough. It may be that what is needed is a whole new perspective — from several thousand miles away.

[124] For a comparative discussion between the US and Australia, see Ramsay, above n 92, 198-201.
[125] Exposure Draft, above n 1.