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The Important Role of Non-Organization Law

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# The Important Role of Non-Organization Law

Larry E. Ribstein

## **Abstract**

The proliferation of partnership-based business organizations raises questions concerning the law's role in shaping firms. Although many scholars have focused on business organization statutes, at least in the U.S. this law may be trivial in the sense that it simply reflects underlying business concerns. That is because firms easily can choose the applicable governance law, and therefore can avoid bad or unsuitable laws. I show that non-organization law may have a greater effect than organization law on the structure of firms because firms cannot easily avoid this law. Federal and state non-organization laws might significantly reduce the usefulness of business organization standard forms where transaction cost and legal considerations conflict. The efficiency of non-organization laws therefore depends on whether their interference with organization law can be reduced without unduly compromising their policy goals.

## THE IMPORTANT ROLE OF NON-ORGANIZATION LAW

Larry E. Ribstein\*

Draft of May 17, 2005

### Abstract

The proliferation of partnership-based business organizations raises questions concerning the law's role in shaping firms. Although many scholars have focused on business organization statutes, at least in the U.S. this law may be trivial in the sense that it simply reflects underlying business concerns. That is because firms easily can choose the applicable governance law, and therefore can avoid bad or unsuitable laws. I show that non-organization law may have a greater effect than organization law on the structure of firms because firms cannot easily avoid this law. Federal and state non-organization laws might significantly reduce the usefulness of business organization standard forms where transaction cost and legal considerations conflict. The efficiency of non-organization laws therefore depends on whether their interference with organization law can be reduced without unduly compromising their policy goals.

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\* Corman Professor, University of Illinois College of Law. This paper was prepared for the Wake Forest University School of Law 2005 Business Law Symposium, *The Future of Closely Held Business Entities*, April 15, 2005. Comments from Henry Hansmann, as well as Conference participants Bob Hillman, Doug Moll, Alan Palmiter, and Ben Tennille, are gratefully acknowledged.

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Questions concerning the number and shape of particular business associations have come to prominence with the revisions and proliferation of non-corporate, partnership-based business organizations, particularly including the limited liability company (LLC). Practitioners rather than academics have driven these developments. In particular, the standard economic analysis of business associations, the “theory of the firm,” so far has been little help in answering these questions. While economists have focused on contractual terms as ways to reduce transaction and agency costs,<sup>1</sup> they have paid less attention to *business associations*, or firms’ legal forms. Yet theories of business forms matter because they can assist in the design of business organization statutes and, less obviously, of non-business organization regulation.<sup>2</sup>

This paper delineates three forces that shape business organizations: the federal or unitary structure of the legal system; transaction and agency cost considerations; and non-business-organization regulatory and tax law. In a federal system with an internal affairs choice of law rule, firms can avoid organization law simply by choosing their state of organization. It follows that, in such a system, organization *law* has less influence in shaping firms than underlying *economic* constraints on organizational form.

This observation is consistent with Bernard’s Black’s thesis that even apparently mandatory business organization rules are “trivial” because parties would have adopted them anyway, they can be avoided by advanced planning, the political forces that shape corporate law can change them, or the rules cover rare or otherwise unimportant matters.<sup>3</sup> My analysis reduces these reasons for triviality to their common cause – firms’ ability to choose the applicable internal governance law.<sup>4</sup>

While Black explains why much of state and even federal organization law is trivial,<sup>5</sup> it implies that, where the conditions of triviality do not exist, law becomes

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<sup>1</sup> See, e.g., Ronald H. Coase, *The Nature of the Firm*, 4 *ECONOMICA* 386 (1937); Michael Jensen & William Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 *J. FIN. ECON.* 305 (1976).

<sup>2</sup> I have traced the history and theory of alternative business forms in a series of articles over the last 13 years. See Larry E. Ribstein, *Why Corporations?* 1 *BERK. BUS. L. J.* 183 (2004); Larry E. Ribstein, *Making Sense of Entity Rationalization*, 58 *BUS. LAW* 1023 (2003); Larry E. Ribstein, *The Evolving Partnership*, 26 *J. CORP. L.* 819 (2001); Bruce H. Kobayashi & Larry E. Ribstein, *Choice of Form and Network Externalities*, 43 *W. & M. L. REV.* 79 (2001); Larry E. Ribstein, *Changing Statutory Forms*, 1 *J. SM. & EM. BUS. L.* 11 (1997); Larry E. Ribstein, *Statutory Forms for Closely Held Firms: Theories and Evidence from LLCs*, 73 *WASH. U. L. Q.* 369 (1995); Larry E. Ribstein, *The Deregulation of Limited Liability and the Death of Partnership*, 70 *WASH. U. L. Q.* 417 (1992). The present article updates and supplements this work to reflect both recent legal developments and new theories of business organization law.

<sup>3</sup> See Bernard Black, *Is Corporate Law Trivial? A Political and Economic Analysis*, 84 *NORTH. U. L. REV.* 542 (1990).

<sup>4</sup> Similarly, Black says that his “central theme . . . is that state lawmakers respond to corporate needs. This means that mistakes will get fixed. . . . Corporate lawmaking by the states is not fiat but rather a dialogue between lawgivers and the corporate community.” *Id.* at 574.

<sup>5</sup> Although Black discusses some exceptions to triviality, including federal law, he concludes that “[t]aken as a whole, I do not think that the exceptions seriously weaken the claim of triviality, both

important.<sup>6</sup> Thus, rules that firms cannot easily select by contract or by choosing their state of organization can determine the shape of business associations. This parallels Coase's observation that law's importance to efficiency depends on transaction costs.<sup>7</sup> I emphasize the critical factor that accounts for the importance of non-organization law from a transaction cost perspective – the cost of exit. Federal tax, securities and bankruptcy laws and some state non-organization laws are important because firms can minimize their impact only by complying or changing their transaction form.<sup>8</sup> For example, non-organization law can be seen as underlying the LLC's rise in the late 1980's and 1990's; the survival of the close corporation despite the availability of business forms that better accommodated the needs of closely held firms; and the persistence of the corporate form as the nearly exclusive format for publicly held firms despite the significant governance costs inherent in that form.

This analysis can inform policymakers how to make regulatory and tax laws more efficient. Federal and state laws might significantly affect the content of business organization standard forms where transaction cost and legal considerations conflict. The efficiency of non-organization laws would then depend on whether their interference with organization law can be reduced without unduly compromising their policy goals.

This article differs at least in focus from other recent theories of organizational form. Hansmann & Kraakman<sup>9</sup> analyze two types of rules and their "essential" role in business organization law – "affirmative asset partitioning" of the entity's assets from claims by owners and their creditors, and "defensive asset partitioning" of the owner's assets from claims against the business entity. This identifies the aspects of organization law that are distinct from other areas of the law, including agency, property, trust and contract. But these "essential" rules should not necessarily matter more to policymakers than other aspects of statutory business forms that are intended to minimize the costs of organizing business firms. By contrast, changing the focus from organization to non-organization law can help policymakers minimize these laws' perverse governance effects.

Along similar lines, Margaret Blair's suggestion that the continuity of the corporate form was significant in enabling the modern firm,<sup>10</sup> even if accurate,<sup>11</sup> merely

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definitionally and in fact." *Id.* at 577.

<sup>6</sup> See *id.* at 557 (noting that "[a]t some point, the cost of avoiding a rule is large enough so that we can't call the rule trivial").

<sup>7</sup> See Ronald H. Coase, *The Problem of Social Cost*, 3 J. L. & ECON. 1 (1960).

<sup>8</sup> Those interested in corporate governance may have little political influence on laws that relate only tangentially to governance and affect other interest groups more directly.

<sup>9</sup> See Henry Hansmann & Reinier Kraakman, *The Essential Role of Organization Law*, 110 Yale L.J. 387 (2000).

<sup>10</sup> Margaret M. Blair, *The Neglected Benefits of the Corporate Form: Entity Status and the Separation of Asset Ownership from Control*, in CORPORATE GOVERNANCE AND FIRM ORGANIZATION: MICROFOUNDATIONS AND STRUCTURAL FORMS (Anna Grandon, ed.) at 45-66 (Oxford University Press, 2004); Margaret M. Blair, *Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century*, 51 UCLA L. Rev. 387 (2003).

<sup>11</sup> For an argument that it is not, see Ribstein, *Why Corporations*, *supra* note 2.

shows how firms' need for continuity influenced choice and design of business forms. This does not support the conclusion that business organization laws' continuity provisions themselves were important in shaping modern firms. The present article shows the extent to which non-organization law does matter in this regard.

Although this paper focuses on the design of standard business forms, and not directly on private parties' choice among these forms, the two topics closely relate. Because standard forms reflect parties' business needs, the same factors that would lead parties to select particular forms would also tend to cause legislatures in a competitive federal environment to design the forms to include these features.

This article proceeds as follows. Part I discusses the structural elements of the system that determine the roles of the other elements of organizational choice. Part II discusses transaction cost considerations that determine entity form and the design of business organization statutes. Part III identifies the role of important non-business-organization tax and regulation. Part IV concludes with a discussion of some normative implications and potential extensions of the analysis.

## I. SYSTEMIC RULES

Under U.S. law, those who are affected by business organization statutes can either contract around them or exit at low cost. The ability to exit is critical, since it limits the extent to which the political system can impose mandatory rules, irrespective of interest group preferences. The costs of exit depend, in turn, on systemic rules that determine how easily private parties can avoid laws that impose costs on them. Subpart A discusses the basic unitary or federal nature of the system. Subpart B discusses the parties' ability to contract for application of a particular state law. Subpart C discusses mechanisms for the generation of law that are necessary to facilitate effective arbitrage.

### A. FEDERAL SYSTEM

A major aspect of the law-creation structure is whether a system is federal in nature – that is, consists of subordinate jurisdictions bound by a central government and constitution. In general, a federal system creates a kind of "free trade zone" that facilitates jurisdictional competition.<sup>12</sup> Indeed, it has been pointed out that "[f]or most of the last 300 years, the richest nation in the world has had a federal structure."<sup>13</sup> By contrast to the US, subordinate political entities are much less important in other federal systems such as Germany<sup>14</sup> and Australia,<sup>15</sup> and many countries give their subordinate political entities little power.

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<sup>12</sup> See Larry E. Ribstein, *Politics, Adaptation and Change*, 8 AUST. J. CORP. L. 246 (1998).

<sup>13</sup> Barry Weingast, *The Economic Role of Political Institutions: Market-Preserving Federalism and Economic Development*, 11 J. L. ECON. & ORG. 3 (1995). For other historical and comparative discussions of different federal systems, see William Riker, *Federalism: Origin, Operation, Significance*, (1964); Friedrich A. Hayek, *The Economic Conditions of Interstate Federalism* (1939), reprinted in F. Hayek, *Individualism and the Economic Order*, ch. 12 (1948).

<sup>14</sup> See David Currie, *The Constitution of the Federal Republic of Germany*, 101 (1994).

<sup>15</sup> See L. Zines, *Constitutional Change In The Commonwealth*, 79, 86-98 (1991); H. Gibbs, *The Decline of Federalism?*, 18 U. QUEENSLAND L.J. 1 (1994).

The key elements of the success of the federal system in the US are the common language and constitutional protections that increase firms' feasible choices among legal regimes. A firm that does not like the regulation a particular state imposes can do business elsewhere without worrying about losing important constitutional protections or having to do business in a different language.

## B. CHOICE OF LAW RULES

A firm's ability to arbitrage among different legal systems depends importantly not only on the existence of multiple available regimes, but also on firms' ability to choose a particular regime and avoid others – that is, on the applicable choice of law rules. Most importantly for the issues discussed in this paper, the “internal affairs rule” provides that, by choosing where to incorporate, a firm can choose the particular state's law that applies to its internal governance and members' liability irrespective of where the business conducts its operations.<sup>16</sup> Unless courts enforce the firm's incorporation choice, interstate firms would be subject to different rules in each state in which its owners reside. This could, in effect, require firms to issue different classes of stock with different rights in each state. It is usually easier for the firm simply to comply with the most stringent rule in all states, which would undermine effective choice of law.

The internal affairs rule applies throughout the US as to types of business associations that the states permit for local firms. This rule might be viewed as a result, rather than a precondition, of regulatory arbitrage.<sup>17</sup> Firms have incentives to avoid jurisdictional contacts with states that could trigger costly regulation or litigation.<sup>18</sup> Firms also can reduce the likelihood that a state's law will be applied by not establishing headquarters or significant operations in that state. Because they benefit from local business activities of interstate firms, interest groups have incentives to lobby for a rule that permits firms to do business locally while contracting to be bound by other states' laws, including those regulating the firms' internal governance.<sup>19</sup>

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<sup>16</sup> See Restatement (Second) of Conflict of Laws § 302(2) (1971).

<sup>17</sup> Of course, the internal affairs rule was not the product of the charter competition that the rule eventually enabled, and it is unlikely state legislatures and courts intentionally relinquished their power over incorporations to enable this competition. See Frederick Tung, *Origins of the Internal Affairs Doctrine*, Loyola-LA Legal Studies Research Paper No. 2005-8 (March 16, 2005), available at [http://papers.ssrn.com/paper.taf?abstract\\_id=686592](http://papers.ssrn.com/paper.taf?abstract_id=686592). Rather, as discussed immediately below in the text accompanying note 19, interest groups promoted the rule existed because of states' limited jurisdictional reach and the economic benefits these groups would lose if firms moved away.

<sup>18</sup> Due process prevents courts from asserting jurisdiction over parties who lack “minimum contacts” with the state in the sense of directing their conduct toward the forum. See U.S. Const. amend. V; *Asahi Metal Indus. Co. v. Superior Ct.*, 480 U.S. 102, 111-12 (1987). With respect to minimum contacts, see *World-Wide Volkswagen Corp. v. Woodson*, 444 U.S. 286, 297 (1980); *Int'l Shoe Co. v. Washington*, 326 U.S. 310, 316 (1945).

<sup>19</sup> See Larry E. Ribstein, *From Efficiency to Politics in Contractual Choice of Law*, 37 Ga. L. Rev. 363 (2003). Analogously, international competition for investment capital has spurred corporate law competition within the EU and elsewhere. See Ehud Kamar, *Beyond Competition for Incorporations* (May, 2005), available at <http://law.bepress.com/cgi/viewcontent.cgi?article=1383&context=alea>; Larry E. Ribstein, *Cross-Listing and Regulatory Competition*, *Review of Law & Economics*: Vol. 1: No. 1, Article 7, <http://www.bepress.com/rle/vol1/iss1/art7> (2005).

There are limits to firms' ability to engage in regulatory arbitrage even in a federal system. States or other subordinate units have significant incentives to tax and regulate foreign firms at the behest of local business, consumer or other interest groups. Moreover, the costs of avoiding states increase as trade becomes more national and international in scope. This creates political pressure for federal and uniform laws. The tension between "trivial" business association laws and "important" laws that shape business organizations therefore is likely to persist.

### C. LAW-GENERATING MECHANISMS

Even if states enforce contractual choice of law, effective regulatory arbitrage depends on firms' having alternatives that suit their needs. However, states' incentives to meet demand for law differ from those of commercial sellers. Politicians may earn political support for laws that actually hurt firms and the state's competitive position but help local proponents of regulation. However, politicians may be unable to reap gains from efforts to pass efficient laws because there is no intellectual property protection for legal innovations.<sup>20</sup>

Significantly, lawyers who work independently or through bar associations also have incentives to create law. For example, the Delaware legislature defers completely to the powerful Delaware corporate bar.<sup>21</sup> More generally, state bar associations have been instrumental in creating and promoting new unincorporated business forms.<sup>22</sup> Bar groups and individual lawyers also increase the value of business association laws by providing what amounts to after-market support in the form of treatises and other explanatory material, advice, opinion letters, and continuing legal education programs. These law-creators are motivated not only by individual reputational and financial benefits, but by the increased market for legal services promoted by new legal rules and standard forms. Both types of incentives depend partly on firms' demand for the law of the state in which the lawyers are licensed, which in turn affects the demand for the lawyers' services. While professionals might favor inefficient laws that increase the demand for their services, inefficient rules may reduce the number of people and firms who choose to be governed by the law.<sup>23</sup> This gives lawyers an incentive to maximize the value of the applicable law to all contracting parties.

State licensing of lawyers bears on lawyers' incentives to create law.<sup>24</sup> Licensing laws impede entering the practice of law in a particular state. Although any lawyer can advise on any state's law, only lawyers licensed in a state can advise clients based there and use the local state courts, and local laws are generally applied to those parties and in

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<sup>20</sup> See Bruce H. Kobayashi & Larry E. Ribstein, *Class Action Lawyers as Lawmakers*, 46 ARIZ. L. REV. 733 (2004).

<sup>21</sup> See Larry E. Ribstein, *Delaware, Lawyers and Choice of Law*, 19 DEL. J. CORP. L. 999 (1994).

<sup>22</sup> See Carol R. Goforth, *The Rise of the Limited Liability Company: Evidence of a Race Between the States, but Heading Where?*, 45 SYRACUSE L. REV. 1193 (1995).

<sup>23</sup> See Ribstein, *supra* note 19.

<sup>24</sup> See Larry E. Ribstein, *Lawyers as Lawmakers: A Theory of Lawyer Licensing*, 69 MO. L. REV. 299 (2004).

those courts.<sup>25</sup> High quality courts explain at least some of the demand for Delaware corporate law.<sup>26</sup> State licensing thus gives the lawyers of a state special access to local law and the after-market servicing involved in practicing under that law. This is significant in comparing the effect of the state and federal law of business associations, as discussed in more detail below in Part III. Though lawyers who specialize in federal tax and bankruptcy practice likely have incentives to contribute to law-creation in these areas, they would not have the same incentive to create *efficient* law that exists for state business association law, since those subject to federal tax and bankruptcy law have little ability to choose the applicable law.

## II. BUSINESS ORGANIZATION STATUTES

Because of the systemic rules discussed in Part I, state business association laws respond to rather than determine firms' business needs. In general, these laws reduce the transaction costs of establishing efficient governance structures.<sup>27</sup> These functions of standard business forms are summarized by Hansmann & Kraakman:<sup>28</sup>

(1) simplifying the drafting of the firm's charter; (2) helping to avoid mistakes in choosing the details of the organization's form; (3) putting all parties on notice of nonstandard provisions (by effectively requiring that all nonstandard provisions, and only those provisions, must be specifically set out in the organization's charter); (4) providing owners with a highly credible device for bonding their commitments to each other and to those with whom they and the firm deal; (5) facilitating the efficient evolution of standard-form provisions, which are in part a public good; and (6) permitting modification of existing relationships among the parties involved in a firm, without requiring the parties' explicit consent, when existing contractual arrangements prove inefficient.

Hansmann & Kraakman add, however, that “the commercial order of a contemporary market economy could still be established without these features of organizational law.”<sup>29</sup> By contrast, they assert that affirmative asset partitioning – that is, protecting the entity from claims by and against the owners – “is the only important feature of modern firms for which substitutes could not be crafted, at any price that is even remotely conceivable, using just the basic tools of contract, property, and agency law.”<sup>30</sup>

Hansmann & Kraakman's analysis clarifies what organization law adds to other bodies of law, including property and contract. To the extent that their analysis emphasizes the important law on which organization law builds, it is consistent with the

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<sup>25</sup> *See id.*

<sup>26</sup> *See* Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225 (1985).

<sup>27</sup> *See* Ribstein, *Statutory Forms*, *supra* note 2.

<sup>28</sup> *See* Hansmann & Kraakman, *supra* note 9 at 437.

<sup>29</sup> *Id.*

<sup>30</sup> *Id.*

approach in this paper. Business organizations look the way they do because of the underlying constraints firms must contend with, including transaction costs and non-organization law, rather than because of the legal business forms they select. That is because the systemic rules discussed in Part I ensure that the legal business forms reflect these underlying constraints. The following discussion develops this point, focusing on the aspects of state standard forms emphasized by Hansmann & Kraakman and Margaret Blair.

## A. ENTITY SHIELDING

“Affirmative asset partitioning,” or what Hansmann, Kraakman & Squire later call “entity shielding,”<sup>31</sup> protects the business entity from attempts by owners or their creditors to compel distributions or liquidation and thereby impede the creation of going concern value. Entity shielding helps ensure that business decisions are made by designated managers or collectively by the owners, and therefore serve the firm’s purposes rather than those of individual owners.

In analyzing entity shielding, it is necessary to distinguish liquidation restrictions that apply among the owners from those that apply to the owners’ creditors. With respect to protection from the owners’ creditors, non-organization law does not let firms credibly assure its creditors of priority over the owners’ personal creditors because owners have an incentive to externalize the cost of their debt by offering their creditors access to the firm’s assets.<sup>32</sup> While a firm’s assets could be placed in trust and thereby secured from the owners’ creditors, something like business entity law would be necessary to separate the trustee’s personal creditors from those of the business. It follows that state business entity laws give firms protection they cannot obtain under other law.

Hansmann & Kraakman also characterize as essential the aspect of affirmative asset partitioning that prevents owners themselves from compelling liquidation of the firm. But even in the absence of special organization law, firms feasibly could contract to restrict owners’ liquidation rights. Indeed, partnership agreements long have included such restrictions though partnership statutes provide for dissolution at will. Owners want the same sort of assurance that they will be treated like comparable co-owners as to distribution and liquidation rights that they do for other owner rights, including voting rights.

While Hansmann & Kraakman plausibly argue that entity-shielding is “essential” in the sense of being a distinct feature of business organization law, the rules are not important in shaping firms independent of underlying transaction costs and non-organization law. Hansmann, et al demonstrate that shielding the entity from owners’ creditors responded to business needs in the sense that it arose only when business conditions made it feasible by enabling creditors easily to identify and track the assets owned by particular entities.<sup>33</sup> Restricting owners’ liquidation rights responds to *non-*

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<sup>31</sup> See Henry Hansmann, et al, *Law and the Rise of the Firm* (ms April, 2004).

<sup>32</sup> See Hansmann & Kraakman, *supra* note 9 at 408. Hansmann & Kraakman discuss the limitations imposed by current commercial law on establishing liens that “float” as to both assets and creditors, and the use of bankruptcy-remote entities to secure priority among creditors in bankruptcy. See *id.* at 417-21.

<sup>33</sup> See Hansmann, et al, *supra* note 31.

*organization* (property) law's restriction on the ability of tenants in common to waive their rights to force partition of property.<sup>34</sup> Here, too, organization law responded to owners' business needs for a strong corporate entity and to the creation of judicial remedies to protect locked-in owners from oppression.<sup>35</sup>

## B. OWNER SHIELDING

Hansmann & Kraakman distinguish limited liability, or what they call "defensive asset partitioning,"<sup>36</sup> and Hansmann, Kraakman and Squire call "owner shielding,"<sup>37</sup> from affirmative asset partitioning or entity shielding. Contract limited liability is less important than entity shielding because contracts with business creditors to limit owners' liability do not involve the incentive problem that owners face in contracting with personal creditors.<sup>38</sup>

While *tort* limited liability effectively requires organization law, Hansmann & Kraakman conclude that socially efficient business entities could be enabled even without limited liability.<sup>39</sup> In any event, tort limited liability can be viewed as responding to owners' vicarious liability that exists in agency or partnership relationships that are not limited liability business associations.<sup>40</sup> Since vicarious liability shapes limited liability business forms, it is this liability, and not the responding contracts, that is "important." Vicarious liability's importance derives from the fact that it is not subject to the internal affairs choice of law rule that applies to organization law.<sup>41</sup>

## C. CONTINUITY RULES

Margaret Blair argues that corporate rules barring owners from compelling cash-out of their interests or dissolution, as they can do in partnerships, were critical to the development of the modern corporation.<sup>42</sup> Specifically, these rules permit long-term aggregation of assets, and thereby reduce potential opportunism from individual owners' instigating break-up of asset-specific investments. Lamoreaux & Rosenthal also indicate the importance of continuity in choice of form in arguing that parties chose the corporate form in the 19th and early 20th centuries despite its greater risk of minority shareholder

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<sup>34</sup> *Id.* at 435.

<sup>35</sup> See Hansmann, et al, *supra* note 31 at 44 (discussing the development of judicial remedies).

<sup>36</sup> See Hansmann & Kraakman, *supra* note 9 at 396.

<sup>37</sup> See Hansmann, et al, *supra* note 31 at \_\_\_.

<sup>38</sup> See *id.* at 7; Hansmann & Kraakman, *supra* note 9 at 429.

<sup>39</sup> See Hansmann & Kraakman, *supra* note 9. See also Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879 (1991) (discussing inefficiency of limited liability for tort claims).

<sup>40</sup> See Larry E. Ribstein, *Limited Liability Unlimited*, 24 DEL. J. CORP. L. 407 (1999).

<sup>41</sup> See *infra* section III.E.2.

<sup>42</sup> See Blair, *Locking in*, *supra* note 10.

oppression.<sup>43</sup>

Continuity is a puzzling explanation for the rise of the corporate form, since partnerships long have been able to contract for significant continuity.<sup>44</sup> Although partnerships during much of the 20th century technically could not avoid dissolution and partner dissociation, there is authority indicating that they could do so in the late 19th century partnerships for a term.<sup>45</sup> More importantly, courts at all relevant times enforced buyout agreements that constrained partner exit.<sup>46</sup>

The important rule of vicarious liability probably accounts for the difference between corporations and partnerships regarding default continuity. The partnership dissolution-at-will default rule accommodated partners' vicarious liability with co-partners' need for continuity by letter partners freely terminate their continuing vicarious liability. In other words, the default rule assumes that, in the informal closely held firm, in which the parties are least likely to have engaged in substantial planning, the benefits of being able to terminate personal liability for business debts outweigh discontinuity and opportunism costs. At the same time, enforcing buyout agreements or permitting the partners to provide for a minimum term makes continuity available to firms in which the benefits of continuity exceed those of easy exit.

To the extent that continuity drives firms' choice of form, it is still not important in the sense stressed in this article because the rules in statutory standard forms reflect rather than determine transaction cost considerations. As changing business needs reduce the value of continuity,<sup>47</sup> standard form rules may change accordingly, thereby inviting the development of partnership-type forms that accommodate publicly held firms. Hansmann, Kraakman & Squire make the converse argument that partnership-type firms are moving toward more corporate-type entity characteristics because of developments in monitoring technologies.<sup>48</sup>

In any event, the key element in the evolution of business forms is not organization law itself, but the constraints imposed by transaction costs and non-organization law. Because organization law changes over time in response to changes in transaction costs and other law, it is these transaction costs and laws that matter most to the shape of business organizations.

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<sup>43</sup> See Naomi R. Lamoreaux and Jean-Laurent Rosenthal, *Corporate Governance and the Plight of Minority Shareholders in the United States Before the Great Depression*, NBER Working Paper No. W10900 (November 2004), available at [http://papers.ssrn.com/paper.taf?abstract\\_id=618582](http://papers.ssrn.com/paper.taf?abstract_id=618582).

<sup>44</sup> See Ribstein, *Why Corporations?*, *supra* note 2 at 193-195.

<sup>45</sup> See Hansmann & Kraakman, *supra* note 31 at 34; Ribstein, *Why Corporations?*, *supra* note 2 at 193-94.

<sup>46</sup> *Id.* at 194-95.

<sup>47</sup> *Id.* at 206-08.

<sup>48</sup> See Henry Hansmann, Reinier Kraakman and Richard Squire, *The New Business Entities in Evolutionary Perspective*, 2005 Illinois L. Rev. \_\_\_\_.

### III. IMPORTANT STATE AND FEDERAL LAWS

Given the structural rules discussed above in subpart I.A., state law responds to, rather than shapes, business needs because firms generally would rather select the state law that best suits their business needs than shape their business form to a particular state's law. By contrast, as to matters governed by federal and state non-organization law, firms may incur higher costs in avoiding than in complying with federal tax and regulation. This Part shows that federal tax and regulatory laws indeed have been a potent force in shaping state business organization law.

Federal *corporation* law, set forth primarily in the federal securities laws, has not so far pervaded the internal structure of firms, although some have argued that it is increasingly influential.<sup>49</sup> Black argues that, even if federal corporation law is not trivial, it is not especially important because political forces make it respond to firms' needs.<sup>50</sup> This is consistent with Becker's intuition that the competition among interest groups generally produces efficient laws.<sup>51</sup> But that would not necessarily apply to federal *non-organization* laws that indirectly shape business forms. While these laws may reflect the costs and benefits of the groups whose interests the law most directly affects, and that therefore are most active in promoting or opposing the law, they may not take into account increased governance costs that result indirectly from the regulation.

Non-organization law affects organizational forms partly by influencing parties' choice of form. Whether lawmakers will craft organization laws so as to minimize tax or regulatory costs may depend on the number of existing standard forms and the process of generating additional forms. If the costs of creating a new form are low, the regulatory needs of even a small group of firms might be enough to support creating a new standard form that caters to these needs. On the other hand, if it is costly to create new standard forms, some firms might be "orphaned" in the sense of having no standard forms that meet their needs. These firms therefore might incur higher governance costs than firms that can find a suitable form.

This Part discusses three types of federal law that bear on business association structure – tax law, bankruptcy, and governance-related regulation. It also discusses important state non-organization law that applies without regard to where firms are incorporated.

#### A. TAX LAW

Unlike state organization laws, firms cannot avoid federal taxes simply by changing their state of incorporation. Moreover, taxes may be high enough that avoidance can motivate them to incur significant governance burdens.

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<sup>49</sup> See Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588 (2003); Robert B. Thompson & Hillary Sale, *Securities Fraud as Corporate Governance: Reflections Upon Federalism*, 56 VAND. L. REV. 859 (2003); Robert B. Thompson, *Collaborative Corporate Governance: Reflections Upon Federalism*, 38 WAKE FOREST L. REV. 961 (2003).

<sup>50</sup> See Black, *supra* note 3 at 565.

<sup>51</sup> See Gary S. Becker, *A Theory of Competition Among Pressure Groups for Political Influence*, 98 Q.J. ECON. 371 (1983); Gary S. Becker, *Public Policies, Pressure Groups, and Dead Weight Costs*, 28 J. PUB. ECON. 329 (1985).

## 1. Tax classification rules

Federal tax considerations long have shaped the form of business associations, particularly closely held firms. The tax classification system determines whether a business is taxed on a "flow-through" basis, with income taxed directly to the owners and losses deductible against owners' income, or whether income is taxed to the business when earned, with distributions taxed again at the owner level. A business is taxed as a partnership under Subchapter K of the Internal Revenue Code if it is not a "corporation," a term that is defined to include "association."<sup>52</sup> *Morrissey v. Comm'r*<sup>53</sup> held that "association" status depends on "resemblance" to corporations.<sup>54</sup> The "Kintner regulations"<sup>55</sup> provided that a business organization is a corporation and not a partnership if it has at least three of the "corporate" characteristics of continuity of life, centralized management, limited liability, and free transferability of interests.<sup>56</sup>

In order to accommodate firms that sought to be partnerships for tax purposes, partnership-type statutes, particularly including limited partnership statutes, provided for features that made sense for tax but not necessarily business reasons.<sup>57</sup> The tax classification rules effectively forced firms that wanted limited liability to adopt at least one, and to be safe probably more, "partnership" tax features that they might not have adopted in the absence of tax law. First, for "continuity of life," firms provided by contract, or organized under statutes that provided, for dissolution on dissociation of a member and that the business can be continued after dissociation only by unanimous vote of the remaining members. This suits some closely held firms' need to provide for an exit right given the lack of a public market for their shares.<sup>58</sup> But firms often want to constrain exit rights to avoid premature liquidation of assets and loss of going concern value or the risk of opportunistic conduct by dissociating partners.<sup>59</sup> Second, for free transferability, firms restricted assignment of management rights without the consent of the other general partners.<sup>60</sup> While closely held firms may want to restrict the entry of new members, the power to block transfers, like the power to dissolve at will, can be used opportunistically.

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<sup>52</sup> See I.R.C. Sec. 7701(a)(3) (definition of "corporation"); *id.* Sec. 7701(a)(2) (definition of "partnership").

<sup>53</sup> 296 U.S. 344 (1935).

<sup>54</sup> *Id.* at 357.

<sup>55</sup> The name refers to *U.S. v. Kintner*, 216 F.2d 418 (9th Cir. 1954), in which the I.R.S. unsuccessfully sought to characterize a professional corporation as a partnership.

<sup>56</sup> See Treas. Reg. Sec. 301.7701-2(a) (superseded).

<sup>57</sup> See Larry E. Ribstein, *The Deregulation of Limited Liability and the Death of Partnership*, 70 WASH. U. L. Q. 417 (1992).

<sup>58</sup> See Larry E. Ribstein, *A Statutory Approach to Partner Dissociation*, 65 WASH. U. L. Q. 357 (1987).

<sup>59</sup> *Id.* at 384-89, 393-95; Edward B. Rock & Michael L. Wachter, *Waiting for the Omelet to Set: Match-Specific Assets and Minority Oppression in Close Corporations*, 24 J. CORP. L. 913 (1999).

<sup>60</sup> See Treas. Reg. Sec. 301.7701-2(e)(1) (superseded).

Third, firms avoided centralized management even if they might have had business reasons to specialize investment and management functions. Fourth, since the Kintner regulations implied that a tax “partnership” had to have at least two members,<sup>61</sup> states initially balked at providing for one-member unincorporated firms.

The Internal Revenue Service ultimately changed its regulations to allow closely held firms to choose between partnership and corporate taxation – in effect, to “check a box.”<sup>62</sup> Though this shows how interest groups and developments in state law ultimately can pressure the federal government into change,<sup>63</sup> it also indicates that federal law can affect the shape of state organization law for at least a substantial period. Moreover, the tax classification rules arguably differ from some of the rules discussed below in that they bear directly on firm governance, and therefore set up the sort of competition between relevant interest groups that can lead to efficient laws.<sup>64</sup> This is more characteristic of federal corporation law than of the other non-organization law discussed in this Part.

## 2. Tax reasons for the persistence of the public corporation

Most publicly held firms cannot “check a box” as to their partnership or corporate tax status, but rather are necessarily subject to the corporate tax regardless of organizational form.<sup>65</sup> The corporate tax, in turn, has influenced state business organization law by encouraging firms to retain earnings rather than distribute them to the owners. Firms therefore have an extra incentive to adopt a corporate structure in which managers have the power to control cash flow.<sup>66</sup> Conversely, if there were no second-level corporate tax or taxation of the firm’s earnings directly to shareholders, investors would be more likely to constrain managers’ discretion over distribution decisions in order to protect against agency costs and being taxed on undistributed income.<sup>67</sup> Moreover, the desirability of the corporate form is diminished by expanding supply markets that reduce the need for durable entities,<sup>68</sup> and by financial instruments

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<sup>61</sup> The regulations provided that “partnership” “may include *groups* not commonly called partnership.” Treas. Reg. Sec. 301.7701-3(a) (superseded; emphasis added). Also, a one-member limited liability partnership arguably had free transferability and centralized management, and therefore three of four Kintner factors.

<sup>62</sup> See Treas. Reg. §301.7701-1-3.

<sup>63</sup> See Ribstein, *Evolving Partnership*, *supra* note 2.

<sup>64</sup> See *supra* text accompanying note 51.

<sup>65</sup> See Internal Revenue Code §7704.

<sup>66</sup> Of course centralized management antedated the double corporate tax. The point here is that firms have incentives to adopt this structure even if the costs of strong centralized management would outweigh the benefits in the absence of the tax. See Ribstein, *Why Corporations?*, *supra* note 2.

<sup>67</sup> Shareholders easily could declare “homemade” dividends in publicly held firms by selling their shares. See Hideki Kanda & Saul Levmore, *Taxes, Agency Costs, and the Price of Incorporation*, 77 VA.L.REV. 211, 236-37 (1991). However, the market value of the shares would reflect projected distributions and associated governance and tax attributes.

<sup>68</sup> See Ribstein, *Why Corporations?*, *supra* note 2 at 206-08.

that reduce the need to use general business assets to cross-collateralize business debts.<sup>69</sup>

### 3. Tax reasons for the persistence of the close corporation

Now that closely held firms can choose the organizational form that suits their non-tax needs, it would seem that they would want to be partnerships. Partnership-type business forms, including the LLC. These forms suit firms with active owners who cannot sell into public markets because it gives owners strong rights to manage directly and to cash out of or dissolve the firm at will.<sup>70</sup> Firms that want to restrict exit can agree to buyout or some other continuation mechanism, while the most informal firms that do not engage in customized planning get the free-exit default rule they most likely prefer. By contrast, the corporate form is designed for larger, publicly held firms that need continuity to protect significant asset-specific investments.<sup>71</sup>

The closely held corporation inserts the square peg of the corporate form into the round hole of the closely held firm. It traditionally does not allow member exit by default, but rather provides for dissolution only on majority shareholder vote just as in a standard form corporation. Coupled with the lack of a public market, this facilitates oppression of minority shareholders by those in control. Courts and legislatures have attempted to plug this gap by providing oppression and buyout remedies,<sup>72</sup> but these open-ended remedies create uncertainty and unintended results.<sup>73</sup>

Given the problems with the close corporation form and the freedom of “check a box,” one would expect closely held firms now to form or switch to partnership or LLC form rather than as close corporations. In fact, while the data shows marked increases in LLC filings, corporate filings have held fairly steady.<sup>74</sup> One writer explained the persistence of the C Corporation form despite the tax advantages of partnerships by emphasizing non-tax reasons such as business people’s unfamiliarity with partnership

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<sup>69</sup> See Hansmann, et al, *supra* note 31.

<sup>70</sup> See U.P.A. §31, 38 (1914); R.U.P.A. §801 (1997); Bromberg & Ribstein, *supra* note 102, ch. 7.

<sup>71</sup> See *supra* text accompanying notes 42-43.

<sup>72</sup> See N.Y. Bus. Corp. L. §1104-a; Donahue v. Rodd Electrottype Co., 367 Mass. 578, 328 N.E.2d 505 (1975).

<sup>73</sup> See Frank Easterbrook & Daniel Fischel, *Close Corporations and Agency Costs*, 38 STAN. L. REV. 271 (1986); Larry E. Ribstein, *The Closely Held Firm: A View from the U.S.* 19 MELB. L. REV. 950, 955 (1995). For recent examinations of important issues in oppression cases see Douglas K. Moll, *Shareholder Oppression & 'Fair Value': Of Discounts, Dates, and Dastardly Deeds in the Close Corporation*, \_\_DUKE L.J. \_\_ (2005); Douglas K. Moll, *Shareholder Oppression and Dividend Policy in the Close Corporation*, 60 WASH. & LEE L. REV. 841 (2003).

<sup>74</sup> For example, the 2002 and 2004 Reports of the Jurisdictions of the International Association of Commercial Administrators show that filings for domestic and foreign LLCs for the 36 states reporting data for both Reports increased from 415,556 to 702,336 while the comparable numbers for domestic for-profit and professional corporations are 634,147 and 748,951. The 2003 and 2004 annual reports are available at [www.iaca.org](http://www.iaca.org).

equivalents to stock options.<sup>75</sup> This has been characterized as a “network” advantage of the corporate form.<sup>76</sup> But this explanation is theoretically suspect and contradicted by data in the similar context of the choice of the LLC over the LLP form.<sup>77</sup>

Tax rules may explain the close corporation’s survival.<sup>78</sup> Most importantly, Congress has channeled closely held firms into the close corporation form through Subchapter S of the Internal Revenue Code,<sup>79</sup> passed in 1958 to give closely held corporations many of the tax advantages of partnership. It has always been intended to compete with Subchapter K of the Internal Revenue Code, promulgated in 1954, as a way to avoid the corporate tax. When states made the limited partnership a more viable alternative to incorporation, Congress liberalized Subchapter S.<sup>80</sup> But Subchapter S is still somewhat restrictive. A close corporation currently may not elect Subchapter S status if it has more than seventy-five shareholders,<sup>81</sup> any shareholders are not individuals, estates, non-resident aliens or certain types of trusts, and the firm has more than one class of stock.<sup>82</sup> The “one class of stock” requirement is particularly troublesome, since it does not permit differences among owners in liquidation or dividend preferences, except to the extent that the owners also hold conventional debt.

Though Subchapter S would seem to be irrelevant today under the “check the box” rule<sup>83</sup> because of its eligibility restrictions and inflexibility, it accommodates closely held firms that have incentives to avoid Subchapter K. First, Subchapter K remains very complex, and errors may be penalized under the “anti-abuse” rules.<sup>84</sup> Second, Subchapter K, but not Subchapter S, requires the firm to allocate unrealized gains or losses in contributed property to contributing members.<sup>85</sup> Third, and perhaps most importantly, LLC owners may be less protected than S Corporation shareholders from self-

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<sup>75</sup> See Joseph Bankman, *The Structure of Silicon Valley Start-Ups*, 41 UCLA L. Rev. 1737 (1994).

<sup>76</sup> See Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757, 821-22 (1995).

<sup>77</sup> See Kobayashi & Ribstein, *Choice of Form*, *supra* note 2.

<sup>78</sup> See *id.*; John W. Lee, *A Populist Political Perspective of the Business Tax Entities Universe: “Hey the Stars Might Lie but the Numbers Never Do,”* 78 TEX. L. REV. 885 (2000).

<sup>79</sup> See Internal Revenue Code §§1361-63. Only a corporation can file under Subchapter S. See *id.* §1361.

<sup>80</sup> See Subchapter S Revision Act of 1982 [cite].

<sup>81</sup> I.R.C. §1361(b)(1)(A). The original limit of 35 was raised to 75 by the Small Business Job Protection Act of 1996, Pub. L. No. 104-188, §1301, 110 Stat. 1755, 1777 (1996).

<sup>82</sup> I.R.C. §1361(b)(1)(D),

<sup>83</sup> See *supra* text accompanying note 62.

<sup>84</sup> Treas. Reg. § 1.701-2 (1995); Larry E. Ribstein & Robert Keatinge, RIBSTEIN & KEATINGE ON LIMITED LIABILITY COMPANIES, §17-3.

<sup>85</sup> I.R.C. § 704(c).

employment tax on their shares of the firm's income.<sup>86</sup> The IRS proposed in 1997 to clarify when LLC owners would be treated like limited partners and therefore not subject to the tax,<sup>87</sup> but Congress suspended the effect of these regulations.<sup>88</sup> This S Corporation advantage may, however, be shrinking, as the IRS has been increasingly willing to rely on the proposed regulations,<sup>89</sup> which may partly account for some recent increases in LLC filings.<sup>90</sup>

Other tax rules give closely held firms an incentive to use Subchapter C of the Internal Revenue Code despite the seeming tax disadvantage of standard-form corporate taxation. The corporate tax may not be much of a burden for firms whose owners would be taxed at high marginal rates and need not realize capital gains, particularly if the firm can significantly reduce taxable earnings through salary and other deductions.<sup>91</sup> Also, venture capital start-up firms have specific tax incentives to use the C Corporation form.<sup>92</sup> The venture capitalist and entrepreneurs usually plan to exit through a public offering. Given the bias against the partnership form for publicly held firms discussed above in Section 2, the firm will want to incorporate eventually, and has a tax incentive to incorporate from the beginning so that it can do a tax-free organization with the IPO entity.<sup>93</sup> Many investors in these venture capital firms are tax exempt or institutional investors that do not pay tax on dividends, do not need tax losses,<sup>94</sup> and in any event are passive and therefore cannot deduct losses against other income.<sup>95</sup> Tax-exempt investors also avoid partnership investments that might subject them to tax on unrelated business income.<sup>96</sup> Venture capital startups' use of the close corporation form ups might, in turn, have a feedback effect on the corporate form by attracting a "clientele" of investors with

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<sup>86</sup> See I.R.C. § 1402.

<sup>87</sup> Prop. Treas. Reg. § 1.1402(a)-2, 62 Fed. Reg. 1702 (Jan. 13, 1997).

<sup>88</sup> Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 935, 111 Stat. 788 (1997) (providing that "[n]o temporary or final regulation with respect to the definition of a limited partner under section 1402(a)(13) of the Internal Revenue Code of 1986 may be issued or made effective before July 1, 1998").

<sup>89</sup> See Ribstein & Keatinge, *supra* note 84, §21-8.

<sup>90</sup> See *supra* note 74 (showing data on LLC filings).

<sup>91</sup> See Lee, *supra* note 78 at 921; Kobayashi & Ribstein, *supra* note 2 at 99; Leandra Lederman, *The Entrepreneurship Effect: An Accidental Externality in the Federal Income Tax*, 65 OH. ST. L. J. 1401 (2004).

<sup>92</sup> See Victor Fleischer, *The Rational Exuberance of Structuring Venture Capital Startups*, 57 TAX L. REV. 137 (2003).

<sup>93</sup> The Code permits tax free reorganizations between corporations, but not partnerships. See I.R.C. §368.

<sup>94</sup> This raises the question whether the investors tend to be tax-exempt or have these other characteristics *because* the firms are C Corporations.

<sup>95</sup> See I.R.C. §469.

<sup>96</sup> See *id.* §511; Ribstein & Keatinge, *supra* note 84, §17.23.

particular planning needs.

#### 4. Other income tax effects on business structure

The application of partnership or corporate tax involves many issues other than those relating to choice of organizational form or single-level or double-level taxation. For example, a partnership tax rule lets partners receive tax-deferred compensation by structuring the compensation as a “profits” rather than a capital interest.<sup>97</sup> Because the rule turns solely on whether the interest has “liquidation” value, and not on whether it has economic value at the time of receipt, it effectively subsidizes partner compensation. Because such a preference would reduce capital gains distributions to managers, the rule apparently discourages venture capital firms from giving non-managing investors a preferred return that would address moral hazard problems between managers and investors<sup>98</sup> The partnership tax safe harbor for pure profits interests might, in turn, explain state LLC provisions that explicitly permit firms to issue membership interests without capital contributions.<sup>99</sup>

#### 5. Estate and gift tax

Partnership and LLC statutes have been designed to accommodate family firms whose owners use limited partnerships or LLCs to transfer the business to family members without substantial estate or gift tax.<sup>100</sup> The tax on the transferred interest depends partly on whether family members can cash out of the firm at full market value. Family members cannot avoid receiving full market value simply by a partnership agreement provision restricting transfers because only state statutory restrictions matter under the Internal Revenue Code.<sup>101</sup> Partly for this reason, many state statutes eliminated default cash out rights for limited partnerships<sup>102</sup> and LLCs.<sup>103</sup> Yet restricting exit may involve significant costs in closely held firms by subjecting members who have neither

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<sup>97</sup> See Rev. Proc. 93-27, 1993 -2 C.B. 343.

<sup>98</sup> See Victor Fleischer, *The Missing Preferred Return*, UCLA School of Law, Law-Econ Research Paper No. 05-8 (February 22, 2005), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=671363](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=671363).

<sup>99</sup> See Ribstein & Keatinge, *supra* note 84, ch. 5, app. 5-1 (tabulating state statutes).

<sup>100</sup> See generally, *id.*, ch. 18. There is a similar explanation for the increasing use of so-called “dynasty” trusts. See Robert H. Sitkoff & Max M. Schanzenbach, *Jurisdictional Competition for Trust Funds: An Empirical Analysis of Perpetuities and Taxes*, \_\_\_YALE L. J.\_\_\_ (2005).

<sup>101</sup> See 26 U.S.C. § 2704 (providing that an “applicable restriction” on liquidation rights can be disregarded in valuing the interest for tax purposes); *id.* § 2704(b)(3)(B) (providing that an “applicable restriction” does not include “any restriction imposed, or required to be imposed, by any Federal or State law”); Treas. Reg. § 25.2704-2(b), 26 C.F.R. § 25.2704-2(b) (defining “applicable restriction” as one that is “more restrictive than the limitations that would apply under the State law generally applicable to the entity in absence of the restriction”).

<sup>102</sup> See Alan R. Bromberg & Larry E. Ribstein, BROMBERG & RIBSTEIN ON PARTNERSHIP § 17.02(d)(3) (2004).

<sup>103</sup> See Ribstein & Keatinge, *supra* note 84, ch. 11, app. 1 (2004).

management power nor exit rights to potential oppression by the managers and controlling owners.<sup>104</sup> Restricted exit therefore may not mesh well with other statutory features, and organization law accordingly may differ from what it would be in the absence of tax law.

The combination of survival of the close corporation discussed in section 3 and the rules discouraging liquidity in family partnerships discussed in this section leads to a curious overall configuration of statutory standard forms for closely held firms. On the one hand, tax law discourages closely held firms from adopting the partnership form though this would better suit their needs in the absence of tax considerations. Courts must then provide cumbersome buyout and dissolution remedies for close corporations. On the other hand, tax law encourages firms that do form partnerships to adopt corporate rules discouraging liquidity, thereby negating a main advantage of the partnership form of providing an alternative to the excessive continuity and open-ended judicial remedies of the corporate form. Courts might then have to assist these firms, too, by providing buyout remedies that traditionally were unnecessary in partnerships.<sup>105</sup>

## **B. BANKRUPTCY**

Federal bankruptcy law has significantly affected the shape of partnership law. As discussed below in this subpart, federal bankruptcy law has directly affected some partnership rules. It may have had broader indirect effects by “vestigializing” state partnership law – that is, reducing state lawmakers’ incentive and ability to craft law regarding insolvent firms.<sup>106</sup>

### **1. The dual priorities rule**

Federal law significantly affects the availability of partners’ individual assets to partnership creditors in bankruptcy, part of Hansmann & Kraakman’s “owner shielding.” General partnership law traditionally included a “dual priorities” or “jingle” rule, pursuant to which partners’ creditors have priority over the partnership’s creditors as to partners’ assets, while the partnership’s creditors have priority over partnerships’ creditors as to the partnership’s assets.<sup>107</sup> This rule arguably efficiently economizes on creditors’ monitoring costs by reducing creditors’ need to pay attention to assets and debts other than those of their immediate debtors.<sup>108</sup> But the 1978 Bankruptcy Code effectively changed the rule by removing partners’ creditors’ priority in partners’ assets where both the partners and the partnership are debtors in bankruptcy, at least in Chapter

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<sup>104</sup> See Ribstein, *supra* note 58.

<sup>105</sup> See Douglas K Moll, *Minority Oppression and the Limited Liability Company: Learning (Or Not) From Close Corporation History*, \_\_ WAKE FOR L. REV. \_\_ (2005).

<sup>106</sup> See David A. Skeel, Jr., *Rethinking the Line Between Corporate Law and Corporate Bankruptcy*, 72 TEX. L. REV. 471, 474 (1994) (applying discussing bankruptcy’s “vestigialization” of corporate law).

<sup>107</sup> UPA §40(i) (1914).

<sup>108</sup> See Larry E. Ribstein, *The Illogic and Limits of Partners’ Liability in Bankruptcy*, 32 WAKE FOR. L. REV. 31, 65-67 (1997).

7 (liquidation) bankruptcies.<sup>109</sup> The Revised Uniform Partnership Act (RUPA) ratified the change by eliminating the dual priorities rule in 1994.

Hansmann & Kraakman argue that, given the rise of the corporate form, “the partnership form retains value only as an unlimited liability alternative to the corporate form, which implies that the claim of partnership creditors should be strengthened--they should have the same claim on the assets of individual partners as do individual creditors.”<sup>110</sup> They later claim that the federal elimination of the dual priorities rule fashioned the partnership “for dedicated use by owners who wished to maximize firm creditworthiness by pledging their personal assets in full to firm creditors.”<sup>111</sup>

However, it is not clear that creditors and debtors want only the choice between these extremes. Vicarious liability might be efficient for many creditors *only* if the dual priorities rule constrains their monitoring costs. This seems confirmed by the history of the dual priorities rule. Though corporate-type limited liability was available to any firm that wanted it prior to the 1978 Bankruptcy Code, partnership statutes retained the dual priorities rule until and beyond that time. Thus, the 1978 bankruptcy law change did not reflect any apparent change in underlying demand by contracting parties. Moreover, Great Britain has retained the dual priorities rule. The difference between the U.S. and England seems better explained by political activity by the bankruptcy bar in the U.S.<sup>112</sup> than by differing creditor monitoring costs in the two countries.

## 2. Owner shielding: exhaustion

Hansmann & Kraakman’s explanation of the demise of dual priorities is hard to square with the parallel history of the “exhaustion” rule, which precludes partnership creditors from recovering out of partners’ individual assets until they have exhausted efforts to get recovery out of partnership assets. This rule helps shield owners’ assets from claims of creditors of the firm and thereby reduces the monitoring costs of owners’ personal creditors. RUPA adopted a strong exhaustion rule in 1994,<sup>113</sup> reflecting the trend toward exhaustion in partnership cases.<sup>114</sup> If the effect of the 1978 Bankruptcy Code was to reserve the partnership form for those who wanted to dedicate partners’ assets to firm creditors, as Hansmann & Kraakman argue, it is not clear why partnership law would include an exhaustion rule. This further supports the important role of bankruptcy law rather than of underlying transaction cost considerations in explaining the demise of the dual priorities rule.

Bankruptcy law also is internally inconsistent with regard to the scope of vicarious liability and monitoring economies. While bankruptcy reduces owner shielding

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<sup>109</sup> See Bankruptcy Code (11 U.S.C.) §723.

<sup>110</sup> See Hansmann & Kraakman, *supra* note 9 at 428, n. 60.

<sup>111</sup> See Hansmann, et al, *supra* note 31 at 44.

<sup>112</sup> See *infra* Part IV.

<sup>113</sup> See RUPA §307(d) (1997).

<sup>114</sup> See Bromberg & Ribstein, *supra* note 102, §5.08(f) (discussing extension of exhaustion requirement from contract cases involving joint liability to tort cases involving joint and several liability).

by eliminating the dual priorities rule, it *increases* the effect of exhaustion by enjoining actions of both firm and individual creditors against even *non-bankrupt* partners.<sup>115</sup> Thus, partners are protected from vicarious liability to the firm's creditors under state exhaustion law prior to the firm's bankruptcy and by the federal stay thereafter. While enjoining partners' individual creditors helps ensure that partners' assets can be used to pay the debts of the bankrupt partnership, this use of assets is governed by state law rules on contribution,<sup>116</sup> which clearly separate the partnership entity from the individual partners.<sup>117</sup> Thus, the stay's effect is mainly to increase partners' protection against vicarious liability, or owner shielding, by delaying creditor actions against partners.

There is strong reason to believe that the above bankruptcy rules are not only inconsistent with state law, but also inefficient. In the absence of bankruptcy law, state partnership law would develop subject to the constraint of state competition of business organization laws.<sup>118</sup> These firms would choose laws that reflected the interests not only of their owners, but also of at least voluntary creditors, who can force contractual adjustments if they do not like the applicable default rules. By contrast, firms cannot easily exit federal bankruptcy law. This provides more opportunity for political rent-seeking, specifically by the bankruptcy bar in encouraging firms' and creditors' use of the bankruptcy courts.<sup>119</sup> Moreover, the application of bankruptcy law prevents the development of coherent state partnership law regarding partners' vicarious liability. Neither lawmakers nor interest groups have significant incentives to press for state law innovations when bankruptcy law likely will apply in any event. In other words, state partnership law on partners' liability has been "vestigialized."<sup>120</sup>

If bankruptcy law explicitly applied state law as to partners' liability for partnership debts, partnership law might have developed differently. Until the "check the box" tax rule, lawmakers and business people had an incentive to push partnership law toward permitting partners to limit their liability so they could get both liability protection in partnership and partnership tax treatment. This supports both exhaustion and the dual priorities rule. But with the adoption of "check the box," firms were free to obtain limited liability in partnership-type entities. The parties then might have rejected both dual priority and exhaustion for the reason Hansmann & Kraakman suggest – that

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<sup>115</sup> See 11 U.S.C. §105; Larry E. Ribstein, *Partner Bankruptcy and the Federalization of Partnership Law*, 33 WAKE FOR. L. REV. 795 (1998).

<sup>116</sup> See 11 U.S.C. §723(a) (providing that "[i]f there is a deficiency of property of the estate to pay in full all claims which are allowed in a case under this chapter concerning a partnership and with respect to which a general partner of the partnership is personally liable, the trustee shall have a claim against such general partner to the extent that *under applicable nonbankruptcy law* such general partner is personally liable for such deficiency" (emphasis added)). Actions against bankrupt partners are stayed under 11 U.S.C. §365.

<sup>117</sup> Both UPA §40(a) (1914) and RUPA §807(a) (1997) provide that the assets of the partnership include the contributions of the partners toward payment of partnership liabilities.

<sup>118</sup> Although general partnership laws are technically not subject to the internal affairs rule that applies to corporations and other limited liability firms, there is substantial authority supporting the enforcement of a similar rule by private contract. See Bromberg & Ribstein, *supra* note 102, §1.04.

<sup>119</sup> See *infra* text accompanying note 180 (noting interest group influence on bankruptcy law).

<sup>120</sup> See Skeel, *supra* note 106.

limited liability is freely available in other ways. Alternatively, business people might have wanted exhaustion and dual priorities in non-limited-liability partnerships as suggested above, or perhaps one and not the other. In any event the state law rules discussed above clearly are not important in themselves, but rather have been shaped by non-organization, including bankruptcy, law.

### 3. Effect of partner's bankruptcy

The Bankruptcy Code bars so-called “ipso facto” clauses that attempt to deny a debtor’s bankruptcy estate the value of the debtor’s executory contracts.<sup>121</sup> Partnership agreements have been treated as executory contracts for this purpose.<sup>122</sup> Thus, federal law may determine the effect of a partner’s or partnership’s bankruptcy on the firm’s continuity. Specifically, a bankrupt partner may be allowed to continue as such even if the partner would be dissociated and the partnership dissolved by the bankruptcy under state law.

As with partners’ vicarious liability, state law on the effect of partner bankruptcy might have developed differently in the absence of bankruptcy law. Given the often close ties among partners and their multifarious and interrelated contributions to the firm, partners likely would want to terminate their relationship when a partner undergoes a fundamental change like bankruptcy. If there were no federal ipso facto rule, state partnership law might have developed nuanced rules that permitted such consequences while dealing with situations that present the most potential for abuse.<sup>123</sup> For example, state organization law might have invalidated buyout provisions that apply *only* on bankruptcy. Such clauses present the greatest risk of moral hazard since partners arguably lack adequate incentives to protect their creditors after they have become debtors in bankruptcy.

## C. FEDERAL REGULATION

Since federal laws often have empty or circular definitions of terms, courts may borrow state law on seemingly related issues. While this may increase ex ante predictability and reduce litigation costs as compared with developing new federal common law on the issue from scratch,<sup>124</sup> state law may not serve the policies underlying the federal law. More importantly for present purposes, if the federal courts develop distinctly federal definitions, the parties might plan their business relationships around those definitions. Federal law then might drive the design of organizational forms. On the other hand, relying on state law could induce firms to use state business forms that are exempt from federal coverage. Federal law then might affect organization law indirectly by encouraging the development of clienteles for business forms that could cause the

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<sup>121</sup> See Bankruptcy Code (11 U.S.C.) §365(e)(1)(A).

<sup>122</sup> See generally, Ribstein, *supra* note 115.

<sup>123</sup> For a careful attempt to apply both bankruptcy and state law policies that indicates how state courts might have been able to reconcile debtor and creditor interests in the absence of bankruptcy, see *Milford Power Co., LLC v. PDC Milford Power, LLC*, 866 A.2d 738 (Del.Ch., 2004) (holding that an ipso facto clause should be preempted only to the extent that it deprived a member of economic rights).

<sup>124</sup> See 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).

form to evolve differently than they would have in the absence of federal law. An intermediate approach could mesh federal policy objectives with the certainty and predictability of a formal approach. The courts might rely on the parties' choice of form where the choice constructively notifies the parties that the relationship is not the type protected by federal law, and where the standard form is unlikely to be used by parties who need the federal law's protection.<sup>125</sup> The following subsections discuss situations where these issues have been particularly important.

## 1. Securities laws

The federal securities disclosure and anti-fraud laws apply to transactions involving the purchase or sale of a "security," which the statutes define to include the open-ended category of "investment contract."<sup>126</sup> While the latter term literally could include partnership interests, there are policy arguments against this interpretation. Unlike publicly held corporate stock, partnership interests are not standardized, and partners usually invest enough to avoid corporate-type free-rider problems that inhibit large groups of securities owners from investigating firms. The latter factor relates directly to the most important prong of the general definition of a "security" – that the investor be seeking profits from the "efforts of others" rather than from his own participation in the business.

Recognizing these difficulties, the federal courts have devised a specific test for the existence of a security in the partnership context. *Williamson v. Tucker*<sup>127</sup> held that there was a strong presumption against characterizing a partnership as an investment contract that is rebutted only when the partners depend so much on a particular manager that they cannot replace him or the partners otherwise exercise ultimate control. Some courts applying *Williamson* have deemphasized the partners' rights and duties under the particular partnership agreement, recognizing that partnership law itself gives the partners significant power over the firm, and that the partners' investments in the firm and their vicarious liability for partnership debts give them strong incentives to exercise this power.<sup>128</sup> These cases suggest that choice of the partnership or LLC rather than corporate form might bear on whether the interest is a security. The form-over-substance approach is supported by the Supreme Court's decision that "stock" is a per se "security" because it is explicitly listed in the definition.<sup>129</sup> Other cases have looked more to the application of substantive policy factors.<sup>130</sup>

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<sup>125</sup> For applications of this intermediate approach, see Ribstein, *supra* note 124; Larry E. Ribstein, *Private Ordering and the Securities Laws: The Case of General Partnerships*, 42 CASE WEST. RES. L. REV. 1 (1991).

<sup>126</sup> See Securities Act, of 1933, § 2(1), 15 U.S.C. § 77b; Securities and Exchange Act of 1934, §3(a)(10); 15 U.S.C.A. § 78c(a)(10).

<sup>127</sup> 645 F.2d 404, 424 (5th Cir.), cert. denied, 454 U.S. 897 (1981).

<sup>128</sup> See *Matek v. Murat*, 862 F.2d 720, 730-31 (9th Cir. 1988); *Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc.*, 840 F.2d 236, 240-41 (4th Cir. 1988); *Goodwin v. Elkins & Co.*, 730 F.2d 99, 102-07 (3d Cir. 1984); Ribstein, *supra* note 125.

<sup>129</sup> See *Landreth Timber Co. v. Landreth*, 471 U.S. 681 (1985).

<sup>130</sup> See, e.g., *Koch v. Hankins*, 928 F.2d 1471 (9th Cir. 1991). See generally Bromberg &

To the extent that the *Williamson* line of cases makes it easier for firms to avoid the securities laws if they are partnerships or LLCs than if they are corporations, the securities laws may influence choice of form in some situations. For example, some publicly or widely held firms have used the LLC form to develop cellular telephone licenses.<sup>131</sup> Apart from whether this undermines the policies underlying the securities laws, encouraging publicly held firms to use partnership-type forms could be inefficient if these firms would otherwise be better off as corporations.

On the other hand, if the definition of a “security” is designed purely to effectuate the policies underlying the securities laws, firms might choose standard forms, and states therefore might design those forms, to include the features that would minimize the risk that the interests are securities, particularly including giving members direct participation in control. But apart from the securities laws, many LLCs might prefer centralized management in order to facilitate specialization of investment and management roles.

Finally, a rule barring or limiting application of the securities laws to general partnerships exemplifies the intermediate approach described above of compromising formal and substantive considerations. The traditional general partnership fits this approach because the partners’ personal liability gives them strong incentives to participate in management, thereby satisfying the “efforts of others” prong of the definition of a security.<sup>132</sup> This is reinforced by the partnership default rules of co-management, restricted transferability and the power to dissolve at will.

The intermediate approach applies less well to limited liability partnership-type forms. Limited liability makes these firms more suited to centralized management, particularly now that the tax classification rules allow tax partnerships with corporate features.<sup>133</sup> State statutes might invite application of the intermediate approach by preserving the appearance, though not the reality, of partnership default rules. For example, some statutes enable firms to give managers strong internal and external powers, while still taking the form of “member-managed” firms.<sup>134</sup> This has the advantage from a pure contracting perspective of enabling flexibility, but at the cost of clarity as to the “managers” roles. In light of this cost, it is not clear firms would want this flexibility in the absence of securities law related incentives for firms to provide for the appearance of decentralized management.

## **2. Employment discrimination laws**

The employment discrimination laws raise the question of who counts as a

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Ribstein, *supra* note 102, §2.13(e).

<sup>131</sup> See, e.g., *SEC v. Parkersburg Wireless Limited Liability Co.*, 991 F Supp 6 (D DC 1997) (holding that interests in a wireless cable LLC were securities). Other LLC cases are analyzed in Ribstein & Keatinge, *supra* note 84, §§14:2-14:3.

<sup>132</sup> See Ribstein, *supra* note 125.

<sup>133</sup> See *supra* section III.A.1. This illustrates how the effects of two or more federal laws on standard forms may interact.

<sup>134</sup> For a general discussion of regulatory constraints on LLC governance, see Carol Goforth, *Continuing Obstacles to Freedom of Choice for Management Structure in LLCs*, 1 J. SMALL & EM. BUS. LAW 165 (1997).

protected “employee.”<sup>135</sup> Beginning with Justice Powell’s concurrence in *Hishon*,<sup>136</sup> the courts have addressed the questions of whether a partner or partner-like employee of a partnership-like professional corporation should be deemed an employee. Several cases applied a “bona fide partner” test that treats partners as employees for federal anti-discrimination law purposes if they did not have the power or status normally associated with state law partners.<sup>137</sup> Other cases applied similar tests to professional corporations.<sup>138</sup>

*Clackamas Gastroenterology Associates, P.C. v. Wells*<sup>139</sup> addressed but did not settle this debate. In determining whether a professional corporation had enough “employees” to be covered by the Americans with Disabilities Act, the Supreme Court applied an EEOC test that, in turn, relied mainly on state law definitions of master, servant and independent contractor and that emphasized the parties’ degree of control. This seems to focus on the relevant federal policies, since control matters to whether the “employee” needs the protection of the discrimination laws. But, as the dissent noted, control is arguably irrelevant to the specific issue in the case of whether the firm was large enough to justify applying the discrimination laws.

The important issue for present purposes concerns the implications of the federal discrimination test for the choice and design of state business forms. As in defining a security, firms might want to use terms and forms that would maximize the chances of avoiding this regulation, other things equal. Under *Clackamas*, this would mean allocating some control to the members even if they would not be given control powers in the absence of the discrimination laws. This may conflict with firms’ other governance objectives, since centralized decision-making may be as desirable in a large professional

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<sup>135</sup> See, e.g., Americans with Disabilities Act, 42 U.S.C. §12111 (4) (“the term “employee” means an individual employed by an employer”).

<sup>136</sup> *Hishon v. King & Spalding*, 467 U.S. 69, 79 (1984) (noting that the employment discrimination laws probably do not regulate employment decisions involving bona fide partners).

<sup>137</sup> See *Strother v. Southern California Permanente Medical Group*, 79 F.3d 859 (9th Cir. 1996), (partnership agreement provided for partnership rights, including the rights to be elected to the firm’s board of directors, which managed the firm, to vote on amendments to the partnership agreement, board representatives, partner discharges, and termination of the partnership, but plaintiff had little control over the board, was compensated based on her performance, was subject to discipline for poor performance, and was one of 2400-2500 “partners,” suggesting rights comparable to those of an employee); *Ehrlich v. Howe*, 848 F. Supp. 482 (S.D. N.Y. 1994) (plaintiff was jointly and severally liable for partnership debts, shared profits and losses, voted as a partner, had a sufficient voting interest to be able to block partnership decisions with one other partner, participated in hiring decisions and could be terminated only by unanimous vote of the other partners); *Rhoads v. Jones Financial Companies*, 957 F. Supp. 1102 (E.D. Mo. 1997) (plaintiff was a partner rather than an employee of a brokerage firm despite lack of control); *Simpson v. Ernst & Young* 850 F. Supp. 648 (S.D. Ohio 1994) (“partner” who had “few, if any, meaningful attributes” as such was not “bona fide partner”).

<sup>138</sup> See *Hyland v. New Haven Radiology Assocs.*, 794 F.2d 793 (2d Cir. 1986) (“employees” treated as such); *Fountain v. Metcalf, Zima & Co., P.A.*, 925 F.2d 1398 (11th Cir. 1991); *E.E.O.C. v. Dowd & Dowd*, 736 F.2d 1177 (7th Cir. 1984) (“employees” treated as partners).

<sup>139</sup> 538 U.S. 440 (2003).

partnership as in any large firm.<sup>140</sup> It arguably follows that, in the absence of discrimination law concerns, such firms would be run by bodies similar to corporate boards of directors. Giving significant power to individual members in order to minimize the chances of applying the discrimination laws could increase decision-making costs.<sup>141</sup> Individual members could be protected from opportunistic managerial decisions by giving them some right to cash out of the firm. But if the employment discrimination laws emphasize direct control powers, this could reduce firms' flexibility in balancing the firm's needs with those of individual partners.

As with the definition of a security, the employment discrimination laws also could affect parties' choice of form, and thereby indirectly affect the design of business forms. Although *Clackamas* purports to disregard form, it arguably permits distinctions based on the firm's choice of form under state law. In particular, the Court considers "whether the parties intended that the individual be an employee, as expressed in written agreements or contracts."<sup>142</sup> This suggests that in cases where the control issue is close it may matter whether the firm is a partnership, LLC or a professional corporation because the parties' intent is to some extent indicated by their choice of form. Where the employment discrimination laws have important business consequences – as where firms particularly need to be able to "downsize" by shedding non-producing partners – this might drive a firm's choice of form if other choice-of-form considerations are closely balanced. Large professional firms therefore might tend to be partnerships even if they would be better off from a pure contracting perspective adopting some other form. Moreover, this choice of form might have feedback effects similar to those noted with respect to the definition of a security. Large professional partnerships might demand that partnership statutes include default terms that are appropriate for larger firms. This could encourage the development of a distinct standard form for large partnerships, or of changes in the standard partnership form to govern such firms.

Given these competing considerations, the best solution for the employment discrimination area, as for the securities cases, may be an intermediate approach based on partner liability. This is the approach Judge Easterbrook applied concurring in *Equal Employment Opportunity Commission v. Sidley Austin Brown & Wood*.<sup>143</sup> The majority held that an EEOC subpoena should issue against a large law firm. Judge Easterbrook reasoned that partners in a standard form partnership were not employees for discrimination law purposes:

[I]t makes both linguistic and economic sense to say that someone who is liable without limit for the debts of an organization is an entrepreneur (a principal) rather than an "employee" (an agent). Unlimited liability and profit-sharing give each partner an interest in monitoring (and if need be expelling) those other partners who are shirking or otherwise not carrying their part of the load. Their

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<sup>140</sup> See Robert W. Hillman, *The Bargain in the Firm: Partnership Law, Corporate Law, and Private Ordering Within Closely-Held Business Associations*, 2005 U. Ill. L. Rev. \_\_.

<sup>141</sup> For example, in *Sidley*, under pressure from the EEOC, the firm gave the partners the power to vote on the Brown, Wood merger.

<sup>142</sup> *Id.* at 450.

<sup>143</sup> 315 F.3d 696 (7th Cir. 2002).

actions in this respect are those of owners.<sup>144</sup>

This is similar to the approach proposed above for the definition of a security.<sup>145</sup> A potential problem in this context is that the discrimination issue is likely to arise regarding a particular type of firm – that is, professional firms – which recently have indicated a strong preference for limited liability. Thus, applying the test to professional firms might force them to trade governance for discrimination law objectives. For example, some large law firms for which limited liability would otherwise be appropriate<sup>146</sup> might nevertheless adopt vicarious liability in order to have the freedom to terminate older partners without risking liability under the federal discrimination laws. Despite this problem, as in the securities context, application of the intermediate approach might be the best available way to accommodate all of the objectives of the federal law while minimizing the impact on state business forms.

#### **D. FEDERAL DIVERSITY JURISDICTION**

Federal courts have diversity jurisdiction if the amount in controversy exceeds \$50,000 and no plaintiff has the same state of citizenship of any defendant.<sup>147</sup> *Carden v. Arkoma Associates*<sup>148</sup> held that diversity jurisdiction is determined in a limited partnership by looking through the firm to the individual members. The Court's broad reasoning clearly extends to other partnership-type firms:

The 50 States have created, and will continue to create, a wide assortment of artificial entities possessing different powers and characteristics, and composed of various classes of members with varying degrees of interest and control. Which of them is entitled to be considered a "citizen" for diversity purposes, and which of their members' citizenship is to be consulted, are questions more readily resolved by legislative prescription than by legal reasoning. . . . We have long since decided that, having established special treatment for corporations, we will leave the rest to Congress; we adhere to that decision.<sup>149</sup>

Consistent with this broad language, citizenship of an LLC has been determined by looking through the firm to individual members.<sup>150</sup> Also, some courts have applied

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<sup>144</sup> *Id.* at 709-10.

<sup>145</sup> *See supra* text accompanying note 125.

<sup>146</sup> *See* Larry E. Ribstein, *Ethical Rules, Agency Costs and Law Firm Structure*, 84 VA. L. REV. 1707 (1998) (showing that vicarious liability may prevent firm from reaching optimal size in terms of developing and leveraging reputational capital).

<sup>147</sup> *See* 28 U.S.C. §1332 (providing for diversity jurisdiction); *Strawbridge v. Curtiss*, 7 US 267 (1806) (requiring complete diversity of citizenship).

<sup>148</sup> 494 US 185 (1990).

<sup>149</sup> *Id.* at 197.

<sup>150</sup> *See* *Cosgrove v. Bartolota*, 150 F.3d 729 (7th Cir. 1997) (noting resemblance between LLC and limited partnership); *Belleville Catering Co. v. Champaign Market Place, L.L.C.*, 350 F.3d 691 (7th Cir. 2003); *GMAC Commercial Credit LLC v. Dillard Dept. Stores, Inc.*, 357 F.3d 827 (8th Cir. 2004);

*Carden* in dismissing derivative suits by partners<sup>151</sup> and LLC members<sup>152</sup> because the firm must be joined as a defendant and this destroys diversity.

*Carden*'s rule-based approach to diversity jurisdiction may reflect judges' reluctance to burden federal courts with diversity cases without explicit Congressional authorization. The rule also arguably squares with the traditional state law characterization of a partnership as an aggregate rather than, as a corporation, a separate entity. However, most states regard even a general partnership as an entity,<sup>153</sup> and LLCs are everywhere regarded as entities.<sup>154</sup> The aggregate/entity distinction simply describes the result the court has reached in the particular case rather than explaining how the court got there.<sup>155</sup> Not surprisingly, the rigid aggregate-based *Carden* rule leads to arbitrary distinctions. In particular, Judges Posner and Easterbrook have applied the corporate rule on diversity to professional corporations despite their arguable similarity to partnerships, variously emphasizing its resemblance to standard corporation and the need for predictability regardless of the precise form of the business.<sup>156</sup>

The main concern here is with federal rules' effect on state standard forms. Making the federal courts less available to non-corporate than to corporate firms could encourage firms to choose one form over another depending on whether they expect to litigate and prefer a particular forum. While diversity jurisdiction is unlikely to be an important choice of form factor, it may be a significant marginal factor when others are closely divided. Firms might prefer state courts for actions between the members because of the better developed state law on internal firm governance. But they might prefer a federal court's protection from local bias if they expect often to litigate outside their home states. Conversely, firms might prefer state courts if they expect to litigate mainly in their home states. This analysis suggests that larger interstate firms might want to

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Ribstein & Keatinge, *supra* note 84, §10.06.

<sup>151</sup> See *Bankston v. Burch*, 27 F3d 164 (5th Cir. 1994); *Whalen v. Carter*, 954 F2d 1087 (5th Cir. 1992); *Buckley v. Control Data*, 923 F2d 96 (8th Cir. 1991); *Curley v. Brignoli*, *Curley & Roberts Associates*, 915 F2d 81 (2d Cir.1990), *cert den* 111 S Ct 1430 (1991); *Bromberg & Ribstein*, *supra* note 102, §5.14.

<sup>152</sup> *Cabrini Development Council v. LCA-Vision, Inc.*, 197 FRD 90 (SD NY 2000); *Weber v. King*, 110 F Supp 2d 124 (ED NY 2000). As to whether these suits can be brought as class actions, see *Ribstein & Keatinge*, *supra* note 84, §10.06.

<sup>153</sup> This is true at least for the majority of states applying the Revised Uniform Partnership Act. See RUPA §201 (1997).

<sup>154</sup> See Uniform Limited Liability Company Act, §201 (1996); *Ribstein & Keatinge*, *supra* note 84, §3.08.

<sup>155</sup> See *Bromberg & Ribstein*, *supra* note 102, §1.03; *Ribstein & Keatinge*, *supra* note 84, §3.08. For an attempt to derive meaning from the entity-aggregate distinction in this context, see Daniel S. Kleinberger, *The Closely Held Business through the Entity-Aggregate Prism*, \_\_WAKE FOR. L. REV. \_\_ (2005).

<sup>156</sup> See *Hoagland ex rel. Midwest Transit, Inc. v. Sandberg, Phoenix & von Gontard, P.C.*, 385 F.3d 737, 743 (7th Cir., 2004) (Easterbrook, J., emphasizing the need for predictability, as long as "states are not using the label of 'corporation' to game the diversity statute"); *Saecker v. Thorie*, 234 F.3d 1010, 1013 (7th Cir. 2000) (Posner, J., the author of *Cosgrove*, noting that "the Wisconsin service-corporation goes far to assimilate professional to standard business corporations").

incorporate from a diversity jurisdiction standpoint because this increases their ability to access federal court when they need to avoid biased state courts, while still being able to use state court for shareholder derivative actions. Also, as with other choice-of-form considerations, factors that encourage clienteles of firms for particular forms can have a feedback effect on the standard form. In this case, diversity jurisdiction might reinforce governance and tax considerations in moving larger firms toward incorporation.

## **E. STATE LAW**

Given the systemic rules discussed in Part I, considerations similar to those that apply to federal law may also apply regarding state non-organization laws whose application firms cannot effectively control by contract.

### **1. Professional regulation**

Although firms generally can choose the state law that controls their internal governance, lawyers in each branch of a law firm are subject to the ethical rules of the state in which the branch is located.<sup>157</sup> Several of these rules relate to the firm's governance and structure, including those regarding the members' liability for the firm's debts; restrictions on whether non-professionals can own shares in the firm; restrictions on non-competition agreements; and the firm's duty to monitor its members' compliance with ethical rules.<sup>158</sup> Because a firm cannot easily choose the governing state law on these issues without physically relocating, state ethical rules can matter as much to the form of professional business organizations as the federal tax and bankruptcy law discussed above.

State ethical rules may affect standard business forms as well as the structure of individual firms. Most importantly, these rules may force professional firms to use business forms in their home state only because they cannot use another state's more suitable form. This, in turn, have a feedback effect on the design of the form. This has been particularly important in connection with the development of the limited liability partnership (LLP). State professional rules long prohibited professional firms from organizing as limited liability firms such limited partnerships or corporations (other than professional corporations). However, the potentially significant increase in the risk of vicarious liability in law firms that arose from the savings and loan scandals of the late 1980's caused lawyers to push the envelope of the existing partnership form in order to limit their liability. Texas passed the first limited liability partnership statute in 1991.<sup>159</sup> Large auditing firms facing similar restrictions on choice of form also sought a way to limit their liability within the partnership form. This indicates the importance not only of limitations on the form of professional firms, but of the expansion in vicarious liability in driving firms toward limited liability business forms.

Since LLP statutes were designed specifically to accommodate lawyers and other professionals, they include provisions specifically addressed to the needs of professional

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<sup>157</sup> See Larry E. Ribstein, *Ethical Rules, Law Firm Structure and Choice of Law*, 69 U. CIN. L. REV. 1161 (2001).

<sup>158</sup> *Id.* at 1167-69.

<sup>159</sup> See Alan R. Bromberg & Larry E. Ribstein, *BROMBERG & RIBSTEIN ON LLPS*, §1.01(a) (2005) (discussing the history of this statute).

firms. For example, because professional firms pay out much of their earnings in compensation, it would be costly to subject these firms to rigid rules prohibiting distributions while the firm is insolvent. This may explain why LLP statutes are less likely to include such rules than otherwise similar LLC statutes, and why the LLP statutes that do regulate distributions include special safe harbors for compensation.<sup>160</sup>

A professional-firm-specific standard form like the LLP, or any standard form that is designed for a particular type of firm, may be efficient because it provides rules that fit that type of firm. But forcing firms into a particular form also might constrain the evolution of firm structure. For example, professional firms may want to adopt a formal centralized management structure similar to that of a manager-managed LLC but which is unavailable in the LLP form.

## 2. Debtor-creditor laws

State laws regarding creditors' rights may be important to the form of business organizations depending on the application of the systemic rules discussed above in Part I. The legal rights of members' creditors are not important under this Article's analysis *unless* these rules are provided for in *non-organization* law that is not subject to the internal affairs rule or contractual choice of law.<sup>161</sup>

Even if organization law regarding creditors is not important, it may be inefficient. For example, partnership-type firms recently have been used for asset protection purposes, or to obtain what I have described as "reverse limited liability."<sup>162</sup> Partners or LLC members can transfer personal assets to a firm and leave their personal creditors only with the limited state law right to obtain a charging order.<sup>163</sup> This right may be worth little because the creditors have to wait for the firm, which the debtor controls, to make distributions on its ownership interests.<sup>164</sup> The creditor is helpless unless he can foreclose on the interest and become an assignee, which he cannot do under most limited partnership and LLC statutes. By contrast, the creditor of a corporate shareholder can attach the stock and become its owner, with full ownership rights.<sup>165</sup>

The firm's creditors' rights against owners may be important under this article's analysis unless the rules are subject to the internal affairs choice of law rule.<sup>166</sup> The

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<sup>160</sup> See *id.* §4.04(d).

<sup>161</sup> See *supra* subpart III.B.

<sup>162</sup> See Larry E. Ribstein, *Reverse Limited Liability and the Design of Business Associations*, 30 DEL. J. CORP. L. 199 (2005).

<sup>163</sup> See R.U.P.A. §504 (1997); U.L.L.C.A. §504 (1996); U.L.P.A. §703 (2001).

<sup>164</sup> See, e.g., *Baybank v. Catamount Construction, Inc.*, 141 N.H. 780, 693 A. 2d 1163 (1997) (holding that charging creditor lacked power to liquidate limited partnership despite creditor's argument that this would frustrate creditor's collection of debt).

<sup>165</sup> See Juliet M. Moringiello, *Seizing Domain Names to Enforce Judgments: Looking Back to Look to the Future*, 72 U. CINN. L. REV. 95 (2003).

<sup>166</sup> See *supra* text accompanying note 40.

development of new limited liability business forms has been impeded by courts' failure clearly to recognize owners' limited liability outside the state of organization.<sup>167</sup> Adoption of new forms has depended on the states' enactment of organization laws that include provisions applying foreign organization law to foreign firms, and thereby avoid the uncertainty of common law choice of law rules. In the meantime, firms may be channeled into the more traditional forms.

This channeling may affect not only individual firms' choice of form, but also the design of standard forms. Because of the potentially significant costs imposed by tax and regulatory statutes, standard forms may be likely to reflect some firms' tax and regulatory needs. Firms that do not have the same tax and regulatory concerns nevertheless may have to accept or contract around these terms. For example, restrictions on exit in limited partnership and LLC statutes may let family firms minimize estate taxes but are not suited for other types of firms.<sup>168</sup>

This problem might be reduced if firms could choose from a broad menu of standard forms, or at least easily contract around the default rules of existing standard forms. However, even under the most flexible statutes it might be hard for firms to completely avoid fiduciary and good faith duties. Thus, I have suggested letting firms form "contractual entities" that give the parties limited liability without the constraints of recognized standard forms.<sup>169</sup> These contracts might provide the basis for evolution of standard forms tailored to the needs of specific groups of firms.<sup>170</sup>

### 3. Important state governance laws

Although state organization law is generally trivialized by the structural rules discussed in Part I, this is arguably not the case in two specific situations. First, state organization law may be important where states do not fully enforce the internal affairs rule, as in California, which applies its corporation law to "pseudo-foreign" firms that are incorporated elsewhere but substantially located in the state.<sup>171</sup> But given the very general enforcement of the internal affairs rule and the strong practical considerations

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<sup>167</sup> See *Greenspun v. Lindley*, 36 N.Y.2d 473, 330 N.E.2d 79, 369 N.Y.S.2d 123 (1975) (Massachusetts law does not necessarily control Massachusetts business trust in New York); *Means v. Limpia Royalties*, 115 S.W.2d 468 (Tex. Civ. App 1938) (Texas law controls limited liability of Oklahoma trust). Cf *Abu-Nassar v. Elders Futures, Inc.*, 1991WL 45062 (SD NY 1991) (applying New York veil-piercing law to Lebanese limited liability company). See generally, Ribstein & Keatinge, *supra* note 84, §§13.5-13.6 (discussing common law and constitutional law considerations in choice of law, with particularly application to LLCs).

<sup>168</sup> See *supra* subpart III.A.5.

<sup>169</sup> See Ribstein, *supra* note 40.

<sup>170</sup> A potential problem with this approach is that courts might not recognize use of the "contractual entity" as a way to avoid tax or regulation, at least until it has taken on specific features. This may be particularly true for the statutory restrictions on exit required for lower estate tax valuation under 26 U.S.C. §2704. See *supra* text accompanying note 101.

<sup>171</sup> See Cal Corp Code § 2115(a) (West 1990 & Supp 2000); P. John Kozyris, *Corporate Wars and Choice of Law*, 1985 Duke L J 1, 66-67 (discussing progression in New York statutes applying New York corporation law to foreign corporations with requisite domestic presence); Erin A. O'Hara & Larry E. Ribstein, *From Politics to Efficiency in Choice of Law*, 67 U. CHI. L. REV. 1151, 1205-06 (2000).

that underlie this rule, a state's attempt to impose significant internal governance regulation on foreign firms could force firms to withdraw business and assets from the state. Moreover, there is a question concerning the constitutionality of the "pseudo-foreign" statutes. The U.S. Supreme Court has indicated that the internal affairs rule is compelled under the dormant commerce clause by upholding a state anti-takeover law applied by state corporation law,<sup>172</sup> while invalidating a statute that applied to firms other than those incorporated in regulating state.<sup>173</sup> Though these decisions arguably do not hold that a state always must apply the incorporating state's internal governance law,<sup>174</sup> the Delaware Supreme Court has clearly held that the internal affairs rule is constitutionally compelled.<sup>175</sup>

State governance laws also may be important when they are applied to existing firms or completed transactions and whose effect therefore cannot readily be avoided by ex ante agreement or exit. This issue arose most prominently with state anti-takeover statutes adopted in the 1980's.<sup>176</sup> Again, this does not cast doubt on the general distinction between organization and non-organization laws because such ex post laws are exceptional. Moreover, a court might hold that a law that clearly changed an important contract right is unconstitutional under the contracts clause.<sup>177</sup>

#### IV. CONCLUDING REMARKS

This paper has argued that state organization law has not had an independent role in shaping business firms. Rather, this law simply *reflects* business and other considerations. This includes the business entity rules stressed by Hansmann & Kraakman and the rules regarding continuity stressed by Blair. To the extent that the *law* has been important in shaping business associations independent of business considerations, what matters has been *non-organization* law, including tax and bankruptcy law.

This analysis has several important lessons and implications. First, one cannot infer the efficiency or inefficiency of state business forms merely by analyzing the competitive state law process that produces these statutes. This competitive process can do no better than produce rules that perfectly suit firms' needs, *including* the need to comply with rules imposed by non-organization laws. These laws, in turn, may force costly compromises that must be taken into account in calculating the overall efficiency of business organization law.

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<sup>172</sup> CTS Corp. v. Dynamics Corp. of America, 481 U.S. 69 (1987).

<sup>173</sup> Edgar v. MITE Corp., 457 U.S. 624 (1982).

<sup>174</sup> See Larry E. Ribstein, *Choosing Law By Contract*, 18 J. Corp. L. 245, 287-94 (1993).

<sup>175</sup> See Vantagepoint Venture Partners 1996 v. Examen, Inc., 2005 Del. Lexis 179 (Del. May 5, 2005); McDermott, Inc. v. Lewis, 531 A. 2d 206 (Del. 1987).

<sup>176</sup> See Henry N. Butler & Larry E. Ribstein, *State Anti-Takeover Statutes and the Contract Clause*, 57 U. CIN. L. REV. 611 (1988).

<sup>177</sup> See *id.*; Henry N. Butler & Larry E. Ribstein, *The Contract Clause and the Corporation*, 55 BROOK. L. REV. 767 (1989).

Second, this article's analysis bears on the efficiency of non-organization law. Regulatory costs include not only direct compliance and incentive effects, but also firms' costs of avoiding regulation through their contracts and choice of form. Tax and regulatory statutes may encourage firms to enter into agreements such as those regarding allocation of management rights or dissolution that trade governance functionality for regulatory benefits. In other words, the firm may, in effect, receive a tax or regulatory subsidy for entering into contracts that would not make economic sense in the absence of tax or regulation.<sup>178</sup> For example, the double corporate tax on corporate earnings and dividends is potentially problematic not only because it taxes productive activity, but also because it discourages distributions, thereby locking funds in managers' hands and, possibly, exacerbating agency costs.<sup>179</sup>

The main source of this problem with the non-organization laws discussed in this article is that these laws are not subject to easy exit through contractual choice of law. Those who are adversely affected by the laws can seek relief only through exerting pressure on lawmakers. But firms that suffer indirect governance effects from tax or regulation may have significantly less influence than the groups who are affected more directly by the tax or regulation. For example, bankruptcy laws may reflect the influence of lawyers and others whose main concern is encouraging use of the bankruptcy process, often by making it easy to bring property into the bankrupt estate.<sup>180</sup> Lawyers may be opposed on specific issues by strong creditor or debtor groups. But the interests of non-debtor partners who happen to become caught up in a single bankruptcy are unlikely to carry much political clout.

Focusing attention on this problem might encourage lawmakers to take the problems into account in future legislation, rulemaking and judicial interpretation. In general, non-organization business regulation should be assessed for its impact on the governance of firms. The impact should be minimized to the extent possible consistent with other regulatory goals, including the statute's policy goals. For example, legislatures crafting securities and employment discrimination laws, or courts interpreting them, might apply an "intermediate private ordering" approach that permits opt out through use of specific standard forms,<sup>181</sup> or even a "check-a-box" approach<sup>182</sup> with limitations that address specific policy concerns.

Third, there is a lesson here about the design and number of business organization

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<sup>178</sup> See Ribstein, *Death*, *supra* note 2. This should be distinguished from a subsidy that encourages productive activity. For discussions of the subsidy to venture capital startups inherent in the tax advantages of pure profits interests, see Fleischer, *supra* note 98; Ronald J. Gilson & David M. Schizer, *Understanding Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock*, 116 HARV. L. REV. 875 (2003). For a discussion of tax subsidies to wealthy entrepreneurs, see Lederman, *supra* note 91. But the efficiency of such subsidies must be evaluated in light of their potential governance costs, taking into account effects on the design of standard forms.

<sup>179</sup> See *supra* subpart III.A.2.

<sup>180</sup> See generally David A. Skeel, Jr., *DEBT'S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA* (2001) (discussing the influence of lawyers and other interest groups on the development of bankruptcy law).

<sup>181</sup> See *supra* subpart III.C.

<sup>182</sup> See *supra* note 62 and accompanying text.

statutes. Because firms can use these statutes to avoid requirements under non-business organization law, the structure of business organization law bears on the structure of non-business organization law. The fewer and poorer the choices firms have among organizational forms, either between states or among forms offered by a given state, the less opportunity firms will have to mesh their organizational and regulatory needs. Thus, uniformity, federalization of business law, or “entity rationalization” of state business forms could force firms to comply with burdensome federal laws that they now can avoid through choice of form or choice of law. The efficiency of such a move would depend on the costs and benefits of the non-organization law that is made more binding by the closing or shrinking of the exit option. By offering many standard form options, legislatures could facilitate the creation of “niche” standard forms that firms could use to accommodate both regulatory and governance needs.

Fourth, this analysis has implications for law teaching. Business organization law can be understood only in a broader perspective that includes the aspects of non-organization law that most directly relate to governance. While this broader frame generally has been considered appropriate in business planning courses, it may also have significant pedagogical benefits whenever the non-organization law helps in understanding the history and application of the organization law.<sup>183</sup>

Fifth, this article demonstrates the importance of enforcing contractual choice of law, including its particular manifestation in the internal affairs rule. Contracting for the applicable law has the strong virtue of meshing laws with firms’ needs. The problems discussed in this article arise from firms’ being unable to do this for non-organization law that is not subject to contractual choice. To be sure, contractual choice facilitates evasion of regulation, and therefore may sacrifice regulatory goals. This article identifies a particular factor that lawmakers should weigh when considering the costs and benefits of enforcing contractual choice of law.

Finally, this article’s analysis has potential implications for comparative corporate law. On the one hand, the analysis suggests that organization law is more important in determining the firms’ business practices in regimes that apply the “real seat” rule, which requires firms to comply with the law of the place where their headquarters are physically located rather than being able freely to choose the incorporation state. In these regimes, organization law has some of the binding qualities of non-organization law in an incorporation regime like the U.S. Thus, non-U.S. and U.S. business law might start to converge if real seat countries moved toward adoption of an incorporation law, as is beginning to happen in Europe.<sup>184</sup> Similarly, even disclosure laws, which are now important because they are applied on a territorial basis, might become unimportant if they were subject to a jurisdictional choice regime.<sup>185</sup>

On the other hand, the important role of non-organization law in the U.S. raises

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<sup>183</sup> This is the approach throughout Larry E. Ribstein, *UNINCORPORATED BUSINESS ENTITIES* (3d ed. 2004).

<sup>184</sup> See Case C-212/97, *Centros Ltd. v. Erhvervs-og Selskabsstyrelsen*, 1999 E.C.R. I-1459 (1999), 2 C.M.L.R 551 (1999); Case C-167/01, *Kamer van Koophandel en Fabrieken voor Amsterdam v Inspire Art Ltd*, September 30, 2003, 2003 E.C.R. \_\_\_ (2003) (requiring member state to show an “overriding reason relating to the public interest” in order to block application of incorporating state law).

<sup>185</sup> See generally, Roberta Romano, *Empowering Investors, A Market Approach to Securities Regulation*, 107 *YALE L.J.* 2359 (1998).

doubts about the relative efficiency of the U.S. corporate legal environment compared to that of other countries. Although organization law in the U.S. is subject to jurisdictional competition that can cause it to efficiently reflect underlying business considerations, the relative efficiency of U.S. and non-U.S. systems ultimately depends on the role played in the U.S. by non-organization law. Thus, it has been argued that during the industrial era U.S. business organization law was less flexible, offered fewer choices and did not respond better to economic change better than comparable French law.<sup>186</sup> The authors emphasize that while French law made limited liability broadly available by 1925, the U.S. did not offer a comparable form until the late 20th century.<sup>187</sup> The authors probably underestimate the flexibility available through the close corporation and limited partnership forms. But it remains the case that U.S. organization law has been hampered not only by limitations in tax and other federal law, but also by the rigidity of state law given the need for interstate recognition of limited liability.<sup>188</sup>

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<sup>186</sup> See Naomi R. Lamoreaux & Jean-Laurent Rosenthal, *Legal Regime and Business's Organizational Choice: A Comparison of France and the United States during the Era of Industrialization*, 7 AM. L. & ECON. REV. 28 (2005).

<sup>187</sup> *Id.* at 51-53.

<sup>188</sup> See *supra* subpart III.E.2.