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The Evolving Partnership

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Abstract

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I. INTRODUCTION

The partnership form has rapidly evolved in the United States, particularly in recent years, as a result of competition between jurisdictions and among business forms. This provides an important lesson for Europe in the wake of *Centros*.¹ This Article shows that

1. Case C-212/97, *Centros Ltd. v. Erhvervs-og Selskabsstyrelsen*, 1999 E.C.R. I-1459 (1999), 2 C.M.L.R. 551 (1999). See also, Case C-167/01, *Kamer van Koophandel en Fabrieken voor Amsterdam v. Inspire Art Ltd.*, September 30, 2003, 2003 E.C.R. ____ (2003) (holding that the right of establishment in Article 48 barred the Netherlands from imposing local regulations on a company that was based locally but incorporated

competition creates a dynamic law that is responsive to the varied needs of modern firms. This is preferable to uniform lawmaking, which erroneously assumes that lawmakers can anticipate what optimal rules should be over time and across different firms.

The recent *Centros* decision raises important questions about the future of European law, particularly the law of business organizations. By characterizing a corporation as eligible for the privileges and immunities of a full-fledged citizen of its state of origin, including the right to establish a branch in a country outside its origin that is subject to home-state law,² *Centros* sets the stage for increased jurisdictional competition for European business law. Although *Centros* does not eliminate the rule that the law of the country in which a firm has its “real seat” or main office governs its internal affairs,³ it invites erosion of this doctrine by giving some firms a way to avoid its effect.

Centros might spur regulators either to more aggressive efforts to harmonize European business law,⁴ or to embrace jurisdictional competition for business law. This Article advocates the latter approach. Focusing on U.S. partnership law, which has developed recently in a setting of open competition among the fifty-one U.S. jurisdictions, this Article demonstrates that jurisdictional competition is preferable to a regime in which firms must comply with the rules of all states in which they do business, or in which a single lawmaking body provides all the rules.

Until recently, partnership law was uniform across U.S. jurisdictions, all but one of which had adopted the 1914 Uniform Partnership Act almost verbatim. During this stable era of partnership law, the partnership form was characterized by decentralized management directly by the owners, personal liability of members, and dissolution upon dissociation of a member. These features kept partnerships closely held, predominantly family affairs.

But partnership has always contained within it powerful seeds for change. Partnerships have been governed mostly by contract, unlike corporations, which are constrained by the concept of “state creation.” These seeds have now germinated. The stable era of partnership ended in the United States around 1988 and was replaced by a period of rapid development and change. Partnership law itself is now nonuniform across U.S. jurisdictions. More importantly, the partnership form itself has split into subforms, including the limited liability company (LLC) and the limited liability partnership (LLP), that provide a continuous spectrum of forms.

This recent history in the United States holds important lessons for Europe as it embarks on partnership law reform. A single set of business association rules issued by a central planner cannot meet the needs of various types of firms or respond to firms’ changing business needs. Central planning is hostage both to inherent limits on human

elsewhere solely in order to avoid these regulations); Case C-208/00, *Überseering BV v Nordic Construction Company Baumanagement GmbH (NCC)* 2002 E.C.R. I-9919 (2002) (denying a Dutch corporation the right to sue in Germany pursuant to the real seat rule was contrary to the right of establishment); .

2. *See id.*

3. For discussions of the implications of *Centros*, see Werner F. Ebke, *Centros—Some Realities And Some Mysteries*, 48 AM. J. COMP. L. 623 (2000); Eddy Wymeersch, *Centros: A Landmark Decision in European Company Law*, in *FESTSCHRIFT FÜR R.M. BUXBAUM* (Th. Baums ed., 2000); RONALD J. GILSON, *GLOBALIZING CORPORATE GOVERNANCE: CONVERGENCE OF FORM OR FUNCTION*, (Stanford Law and Economics Working Paper No. 192, Columbia Law and Economics Working Paper No. 174), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=229517.

4. This is the approach recommended by Ebke, *supra* note 3.

knowledge and foresight and to interest group politics. Rather, firms should be able to pick suitable rules by making both “horizontal” choices among the various jurisdictions and “vertical” choices among business forms available within jurisdictions. Moreover, more efficient rules can emerge from jurisdictional competition for business formations, and from an evolutionary process in which more efficient forms become more prevalent and less efficient forms fall into disuse.⁵ The primary engine of efficiency is the parties’ ability to contract for the applicable law, including selection of a firm’s internal governance rules through choice of the state of organization.⁶ There is significant evidence that permitting horizontal and vertical choice of business forms produces efficient outcomes.⁷ In particular, the recent, rapid changes in partnership and related business forms in the United States, discussed above, provide a kind of laboratory in which to test the efficiency of various regulatory approaches. New and more efficient legal structures have evolved that regulators could not have envisioned only a few years ago. Moreover, the “lock-in” effects that some theoreticians imagined have not impeded the evolution of business forms. Instead of being locked in, inefficient old forms have been swept away. This is the world that *Centros* potentially opens to Europe.

This Article proceeds as follows. Part II broadly describes partnerships, contrasting the traditional and new varieties and contrasting the partnership form with the corporate form. Part III discusses the forces that have shaped partnership in the United States, primarily firms’ ability to engage in horizontal choice among jurisdictions and vertical choice among business forms. Part IV discusses the evolution in partnership terms wrought by these competitive forces. This process suggests that optimal partnership rules defy top-down theorizing and planning. Part V presents some implications of the analysis, particularly for present and future European law. Part VI presents concluding remarks.

II. THE NATURE OF PARTNERSHIP

This Part broadly describes the subject of this Article.⁸ Subpart A shows that the partnership form, though mutable, is essentially defined by its contrast with the corporate form. Subparts B and C describe the beginning and ending points of the evolutionary process discussed below in Part II, while Part III provides more detailed descriptions of specific partnership issues.

A. Partnership vs. Corporation

The partnership is fundamentally a contractual entity. Courts and commentators often describe partnership as proceeding from contract,⁹ and as arising from the intent of

5. See *infra* text accompanying notes 78-82; Larry E. Ribstein & Bruce H. Kobayashi, *Economic Analysis of Uniform State Laws*, 25 J. LEGAL STUD. 131, 149-150 (1996).

6. See Erin A. O’Hara & Larry E. Ribstein, *From Politics to Efficiency in Choice of Law*, 67 U. CHI. L. REV. 1151, 1152-53 (2000); Larry E. Ribstein, *Choosing Law by Contract*, 18 J. CORP. L. 245 (1993).

7. See *infra* Part III.C.5.

8. For another general description, see Larry E. Ribstein, *Partnership*, in 3 NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 10-13 (Peter Newman ed., 1998).

9. See, e.g., *Bradley v. Bradley*, 554 N.W.2d 761, 765 (Minn. Ct. App. 1996); ALAN R. BROMBERG &

the purported partners.¹⁰ In contrast, the corporation is often described as a state-created legal “person.”¹¹ The most famous expression of that view is in *Trustees of Dartmouth College v. Woodward*,¹² which characterized a British crown charter granted to Dartmouth College as “a contract, on the faith of which, real and personal estate has been conveyed to the corporation”¹³ and thus entitled to protection under the contract clause of the U.S. Constitution.¹⁴ Constitutional protection came as part of a Faustian deal by which the firm recognized the state (in this case, the Crown) as its creator. According to Chief Justice Marshall, the corporation was a “mere creature of law,”¹⁵ suggesting that it had rights that private contract could not create. This characterization reflects entrepreneurs’ early practice of obtaining special state charters that granted permission to incorporate. However, special chartering was replaced long ago by general incorporation, in which the state’s only involvement in creating the corporation is accepting the articles of incorporation for filing.¹⁶

Although the advent of general incorporation reinforced the view of the corporation as a contract among the parties to the firm, vestiges of the corporate person theory survive through shareholders’ limited liability for torts and the special corporate choice of law rules. With respect to tort liability, it might seem that, because the firm’s owners cannot insulate themselves from tort creditors solely by contracting among themselves, limited liability is a state privilege, and the firm is to some extent a creation of the state rather than of private contract. This is inaccurate because limited liability is simply a feature of a particular type of contract.¹⁷ More importantly, limited liability provided an excuse for distinguishing corporations from other types of contracts that did not apply to partnerships. Similarly, the corporate person theory supports the “internal affairs” choice of law rule that applies the law of the incorporating state to certain legal issues. Without this rule, corporations would be subject to the vagaries of enforcement of contractual choice of law. By contrast, a state-created corporate entity, like any other state citizen, is

LARRY E. RIBSTEIN, BROMBERG AND RIBSTEIN ON PARTNERSHIP § 2.05(d) (1988 & Supp. 2001).

10. See BROMBERG & RIBSTEIN, *supra* note 9, § 2.05(a); H.T. Hackney Co. v. Robert E. Lee Hotel, 300 S.W. 1, 2 (Tenn. 1927) (“A partnership can only arise by a voluntary contract of the parties.”).

11. See Larry E. Ribstein, *The Constitutional Conception of the Corporation*, 4 SUP. CT. ECON. REV. 95 (1995) (discussing various constitutional implications of the entity view).

12. 17 U.S. (4 Wheat.) 518 (1819).

13. *Id.* at 644.

14. U.S. CONST. art. I, § 10, cl. 1.

15. *Trs. of Dartmouth Coll.*, 17 U.S. at 627.

16. For a discussion of the evolution of American corporate law from special to general incorporation, see Henry N. Butler, *Nineteenth Century Jurisdictional Competition in the Granting of Corporate Privileges*, 14 J. LEGAL STUD. 129 (1985).

17. See Ribstein, *supra* note 11, at 101-03. By the same token, limited liability is a feature of a creditor’s contract with the firm vis a vis other creditors. The fact that a state filing is a prerequisite to enforcing limited liability does not make the term noncontractual, anymore than does the filing requirement for secured credit. Nor does the fact that limited tort liability may create an externality, which is true of other types of contracts, or that it is infeasible to opt into or out of this rule by private contract, which reflects Coase’s insight that legal rules matter in the presence of transaction costs. See R. H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960). Whether or not limited liability involves a special type of contracting problem which justifies special regulation, as argued in John Armour & Michael J. Whincop, *An Economic Analysis of Shared Property in Partnership and Close Corporation Law*, 26 J. CORP. L. ___, ___ (2001), the main point in the text is that regulation cannot properly be justified simply by designating the relationship as “noncontractual.”

subject to the protection of the creating state. Again, the apparent distinction between corporations and other contracts, though illusory,¹⁸ shaped the different legal treatment of corporations and partnerships. In short, incorporated firms exchanged their autonomy as contractual entities for favors accorded state-created entities. This gave states a reason to apply special restrictions to corporate contracting that they would not apply to ordinary contracts.

Partnerships, by contrast, never made this Faustian deal. Traditionally, partners are vicariously liable for debts of the firm. Moreover, while they can select the law of a particular state to govern their contract (and in the United States courts normally enforce these clauses),¹⁹ enforcement is not as invariable as the application of the incorporation state's law under the U.S. internal affairs rule.

Distinctions between partnerships and corporations seem to be diminishing. Partnership-type businesses, such as LLCs and LLPs, have limited liability based on state filings and are subject to corporate-type internal affairs rules.²⁰ There is an increasing trend toward recognition of partnerships as entities.²¹ However, the entity characterization is simply a way to summarize the effect of partnership law for various (although not necessarily all) purposes, and does not change the fundamental nature of partnership.²² Partnerships remain contractual despite these corporate trappings.²³

B. The Traditional Partnership

Although partnerships have remained true to their basically contractual nature, the specific rules of partnership have changed significantly. That change and its explanations are the focus of this Article. The basic model of the partnership set forth in the Uniform Partnership Act (UPA) is for a very closely held and informal firm. Each partner has, by default, an equal power to control the business and to share in profits, irrespective of his capital investment.²⁴ Thus, each partner is both a co-principal and an agent in a principal-agent relationship. As an agent, a partner can bind the business to acts within the scope of the agency²⁵ while, as a principal, a partner is personally liable for the acts of the firm's other partners and employees.²⁶ It follows from their role as co-principals that each partner can veto important acts, such as amending the partnership agreement and

18. See Ribstein, *supra* note 6 (comparing enforcement of contractual choice of law for corporations and for other types of contracts).

19. See generally BROMBERG & RIBSTEIN, *supra* note 9, § 1.04.

20. See generally ALAN R. BROMBERG & LARRY E. RIBSTEIN, BROMBERG AND RIBSTEIN ON LIMITED LIABILITY PARTNERSHIPS AND THE REVISED UNIFORM PARTNERSHIP ACT ch. 6 (2001); LARRY E. RIBSTEIN & ROBERT A. KEATINGE, RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES ch. 13 (1992 & Supp. 2001).

21. See, e.g., REV. UNIF. P'SHIP ACT § 201 (amended 1997), 6 U.L.A. 55 (Supp. 2001).

22. For a discussion of the many cases applying both entity and aggregate characteristics of partnership, see BROMBERG & RIBSTEIN, *supra* note 9, § 1.03. It is not clear the extent to which section 201 of the Revised Uniform Partnership Act (RUPA) will change the results in these cases. For a criticism of the RUPA provision on this basis, see BROMBERG & RIBSTEIN, *supra* note 20, § 8.201.

23. See generally Larry E. Ribstein, *Fiduciary Duty Contracts In Unincorporated Firms*, 54 WASH. & LEE L. REV. 537 (1997).

24. See UNIF. P'SHIP ACT § 18(a), (e) (1914), 6 U.L.A. 526 (1995).

25. *Id.* §§ 9-14, 6 U.L.A. 400-454 (1995).

26. *Id.* § 15, 6 U.L.A. 456 (1995).

admitting new partners.²⁷ It follows, in turn, from these significant management powers and partner liability that partners cannot freely transfer all of their partnership rights.²⁸ Instead, they exit by cashing out of or liquidating the firm, in either case through at least a technical dissolution.²⁹

C. The New Partnership

Many of these basic default rules have carried over into modern U.S. law, including the Revised Uniform Partnership Act of 1994 (RUPA), but with some important modifications. Partners now can limit the agency power of non-managing members, at least in real estate transactions.³⁰ The partners' personal liability for the debts of the firm has been qualified by requiring creditors to first exhaust partnership assets, even in tort cases.³¹ Exit provisions have been significantly revised to eliminate the absolute requirement of dissolution upon partner dissociation.³²

Even more important than these changes in general partnership law, the partnership form has splintered into other forms. This, in effect, reserves general partnerships only for the most informal relationships. LLCs, while having many partnership characteristics, have the corporate features of limited liability, an option for centralized management, and even—under many statutes—restrictions on dissociation of members.³³ LLPs are essentially general partnerships with limited liability. This allows firms to eliminate vicarious liability while retaining the general partnership form, which may be advantageous in complying with regulations and facilitating the transition from general partnership. As discussed below, these changes resulted from jurisdictional competition in the U.S. federal system and have made the partnership form more adaptable to business needs.

III. COMPETITION AND CHANGE

This Part discusses the principal force that produced the changes discussed above—jurisdictional competition within the U.S. federal system. As previously discussed, other forces also played a role in the change, including contractual avoidance and external shocks such as tax law changes.³⁴ This Article emphasizes jurisdictional competition in order to focus on the potential effects of the *Centros* case. Subparts A and B distinguish two forces of jurisdictional competition: “horizontal” choice among jurisdictions, and “vertical” choice among the various business forms available in each jurisdiction. Subpart C discusses the effects of competition, particularly eroding formerly mandatory state and

27. *Id.* § 18(g)-(h), 6 U.L.A. 526 (1995).

28. *Id.* § 27, 6 U.L.A. 736 (1995).

29. UNIF. P'SHIP ACT §§ 29-31, 38 (1914), 6 U.L.A. 752-71, 880 (1995).

30. *See* REV. UNIF. P'SHIP ACT § 303 (amended 1997), 6 U.L.A. 63-64 (Supp. 2001).

31. *See id.* § 307, 6 U.L.A. 73-74 (Supp. 2001); *infra* Part IV.A.1.

32. *See* REV. UNIF. P'SHIP ACT. § 103 (amended 1997), 6 U.L.A. 44-45 (Supp. 2001) (permitting partnership agreement to waive provisions of act except for those listed); *id.* § 801, 6 U.L.A. 108-09 (Supp. 2001) (providing for continuation of the firm in certain situations); *infra* Part IV.F.

33. *See generally* RIBSTEIN & KEATINGE, *supra* note 20, ch. 8, at 11-12.

34. *See* Larry E. Ribstein, *Politics, Adaptation and Change in Corporate Law*, 8 AUSTL. J. CORP. L. 244 (1998).

federal rules. These limits on firms' ability to avoid mandatory rules indicate that jurisdictional competition constrains regulation without eliminating government's power to regulate efficiently.

Before beginning this analysis, it is important to note the significant difference between horizontal and vertical choice discussed here and an alternative menu-type approach to business association statutes that offers firms choices with respect to each of several issues. Although jurisdictions might compete to provide different menus, menu options, in themselves, are not comparable to horizontal choice because a single rulemaker determines the options. Nor are menus comparable to vertical choice, because menu options arise in a single business form rather than offering choices among distinct business forms. This issue relates to the costs and benefits of linkage, discussed below.³⁵

A. Horizontal Choice

Horizontal choice arises in the United States because firms can choose the rules that govern their internal structure at low cost by organizing under the rules of any "incorporation" state while doing business or locating assets in one or more "host" states. Thus, horizontal choice arises by contract alone, unconstrained by the firm's location. Firms' ability to contract for any state's internal rules prevents states from imposing strong and costly regulation on firms' internal structures. While this rule initially applied mainly to corporations, more recently it has spread to unincorporated firms such as the LLC and LLP, which permit corporate-type choice through filings in the state of organization.³⁶ Until recently, general partnerships had less flexibility because they were subject to general choice of law rules and because the UPA had been adopted in fifty of the fifty-one U.S. jurisdictions. However, general partnership moved closer to other business associations with the promulgation of RUPA in 1994 by the National Conference of Commissioners on Uniform State Laws (NCCUSL), and the spread of LLP provisions. RUPA introduced to U.S. partnership law both nonuniformity and explicit recognition of contractual choice of law.³⁷ LLP provisions, which have been adopted in every state and were added to RUPA in 1997, accelerated these changes by permitting general partnerships to select governing state law through corporate-type filings.³⁸

Because this Article seeks to offer lessons from the United States for Europe, it would be useful to briefly describe the conditions that create jurisdictional choice. To begin with, it has been thought that constitutional protection under the commerce clause and privileges and immunities clause of the U.S. Constitution enabled interstate competition for corporate governance.³⁹ But the Constitution has played a smaller role in facilitating this competition than these commentators suppose. Because corporations are *artificial* persons, they are not protected by the privileges and immunities clause.⁴⁰ Thus,

35. See *infra* Part IV.H.

36. See *supra* note 20 and accompanying text.

37. See REV. UNIF. P'SHIP ACT §§ 103, 106 (amended 1997), 6 U.L.A. 44, 53 (Supp. 2001) (providing that governing law under section 106 is subject to contractual variation under section 103).

38. See *id.* § 103(b)(9), 106(b) (amended 1997), 6 U.L.A. 45, 53 (Supp. 2001) (providing that any such filing supersedes any contradictory choice of law selected in the agreement).

39. See Butler, *supra* note 16.

40. See *Paul v. Virginia*, 75 U.S. (8 Wall.) 168, 181 (1869) (stating corporations are "mere creation of local

their ability to do business outside their states of incorporation under the formation state's rules, including rules regarding limited liability, depends solely on comity between host and incorporation states rather than the Constitution.⁴¹ Nor does the "dormant commerce clause"⁴² of the U.S. Constitution support horizontal choice. Although the clause theoretically might be interpreted to compel a state to enforce a firm's internal rules in order to permit it to do business in several states, in fact states can protect local creditors and shareholders and other internal interests as long as they do not discriminate against foreign corporations.⁴³ Finally, the full faith and credit clause of the U.S. Constitution⁴⁴ does not in itself require states to give full effect to other states' laws, as distinguished from judicial decrees or other state acts.

More critical to horizontal competition in the United States are the constitutional rules and cultural and institutional factors that provide an environment conducive to interstate competition.⁴⁵ The commerce clause at least forbids states from imposing trade barriers against out of state firms by discriminating against them merely because they are not incorporated locally. More importantly, firms are subject to constitutional protections such as due process wherever they do business in the United States. Apart from the Constitution, firms can do business in every state under the same basic legal institutions and language. Thus, firms' mobility is not inhibited by significant variations in the business environment among the states.

The ability to conduct interstate business, in turn, gives host states incentives to recognize incorporation state rules. Interest groups in each state stand to gain or lose in the resulting interstate competition. Accordingly, they push for rules that make their jurisdictions inviting to, or at least do not repel, interstate firms.⁴⁶ In particular, lawyers gain from promoting the use of the state's courts and of their own expertise as business planners.⁴⁷ State legislators may therefore stand to gain more from welcoming interstate firms and offering them friendly terms than by appeasing groups that would gain from the application of local law.

A Europe governed by a strong application of the *Centros* decision is both more and less conducive to jurisdictional competition than the United States. It is more conducive

law" and therefore have no constitutional right under the privileges and immunities clause to do business outside their states of incorporation).

41. *Id.* By contrast, the European constitution applied in *Centros* characterizes a corporation as eligible for the privileges and immunities of a full-fledged citizen of its state of origin. 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).

42. U.S. CONST. art. I, § 8, cl. 3 (providing that Congress has the power "[t]o regulate Commerce . . . among the several States").

43. See Ribstein, *supra* note 6, at 287-94.

44. U.S. CONST. art. IV, § 1 ("Full Faith and Credit shall be given in each State to the public Acts, Records, and judicial Proceedings of every other State. And the Congress may by general Laws prescribe the Manner in which such Acts, Records and Proceedings shall be proved, and the Effect thereof.")

45. See Bruce H. Kobayashi & Larry E. Ribstein, *Contract and Jurisdictional Freedom*, in *THE FALL AND RISE OF FREEDOM OF CONTRACT* 325 (F.H. Buckley ed., 1999).

46. See *id.*

47. See Larry E. Ribstein, *Lawyers as Lawmakers: A Theory of Lawyer Licensing*, 69 Mo. L. Rev. 299 (2004); Larry E. Ribstein, *Delaware, Lawyers and Contractual Choice of Law*, 19 DEL. J. CORP. L. 999 (1994), reprinted in 37 CORP. PRAC. COMMENTATOR 151 (1995). See also Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469 (1987) (discussing the role of lawyers in corporate context).

in the sense that it offers constitutional protection for foreign incorporation.⁴⁸ On the other hand, it is less conducive because the basic structures, such as common language and institutions, make it harder for multi-jurisdictional firms to operate in Europe than in the United States. This difference makes constitutional protection of foreign incorporation even more important in Europe than in the United States. Moreover, as discussed below in Part V, this difference ultimately may prevent U.S.-style jurisdictional competition from arising in Europe and may necessitate changes in how the competition model should be applied in this context.

B. Vertical Choice: Choice of Form

Firms can choose rules not only from among states, but also from among a variety of business forms within each state. A multiplicity of statutory forms provides different sets of default rules for different types of firms, which are valuable where the costs of customized contracting are high.⁴⁹ Among other things, these rules serve to form the basis of interpretive networks of cases and forms.⁵⁰ Although private organizations can generate forms, statutory promulgation is often helpful in generating networks and in providing enforcement mechanisms.⁵¹

Multiple business forms are beneficial because they offer alternative coherent bundles of rules for different types of firms.⁵² The traditional partnership form, discussed above, offers one such bundle in the sense that strong co-management and at-will dissolution naturally complement partners' personal liability.

Even more importantly, multiple forms within each state provide an additional dimension of regulatory competition that can break down inefficient mandatory rules. Multiple forms offer opportunities for regulatory arbitrage.⁵³ Consider, for example, the role of multiple business forms in facilitating moves from mandatory fiduciary duties to enforcement of fiduciary waivers or from vicarious partnership liability to limited liability. Legislators may resist such moves either because of opposition from strong interest groups such as trial lawyers, or because of genuine policy concerns about the costs of permitting free bargaining. But permitting the move in one of several standard forms may not trigger the same level of opposition because the new rule will apply only to firms that are willing to incur the switching and other costs of adopting liberal business forms⁵⁴ thereby limiting the number of firms likely to seek the benefits of the rule. In this way, partnership-type business forms can be used as proving grounds to test increased flexibility in internal governance rules.⁵⁵

48. See *supra* note 41 and accompanying text.

49. See Larry E. Ribstein, *Statutory Forms for Closely-held Firms: Theories and Evidence from LLCs*, 73 WASH. U. L.Q. 369, 380-83 (1995).

50. See Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757, (1995); Ribstein, *supra* note 49, at 378.

51. See *id.* at 378-80.

52. See *id.* at 380-83.

53. See Peter H. Huang & Michael S. Knoll, *Corporate Finance, Corporate Law and Finance Theory*, 74 S. CAL. L. REV. 175, 190 (2000) (discussing regulatory arbitrage as a respect in which capital structure may add value to the firm).

54. See *infra* Part II.C.5.

55. See Joseph A. McCahery & Erik P.M. Vermeulen, *The Evolution of Closely Held Business Forms in*

C. Effects of Choice

This Subpart discusses the effects of horizontal and vertical choice in eroding mandatory rules and contributing to the evolution of the partnership form. Sections 1 and 2 discuss the erosion of state and federal rules. Section 3 discusses the advantages of offering different forms for different types of firms. Section 4 shows that choice does not necessarily lead to chaos, but instead may lead to convergence on uniform rules where efficient. Finally, Section 5 shows evidence of the effectiveness of choice of law and choice of form, notwithstanding the “lock-in” effect some commentators have feared.

1. Erosion of State Restrictions

There have been two eras in which horizontal competition among states and vertical competition among forms eroded traditional restrictions on the internal structure of business associations. Innovations spread from single states and business forms, leading to a gradual process of nationwide recognition. These developments demonstrated the power of horizontal and vertical competition in breaking down state-imposed barriers to contractual freedom.

In the first era, competition broke down the practice of special chartering involving state legislators’ sale of charters to individual firms.⁵⁶ Beginning with New Jersey and Delaware, states passed general incorporation statutes, and other states gradually recognized the firms formed under these statutes.

The second era is the recent history of the partnership form. Even after the spread of general incorporation, closely held firms that wanted limited liability had to be satisfied with unaccommodating corporate default and mandatory rules. For example, centralized management through a board of directors, restricted transferability of ownership interests, voting according to ownership interests, and continuation of the firm following a member’s exit are all provisions unsuited to closely held firms. Corporations’ contracts for partnership-type governance rules were sometimes strictly interpreted or simply not enforced.⁵⁷ While states adopted statutory and judicial rules for “incorporated partnerships,” firms that adopted such forms remained exposed to the default rules of the chosen corporate form beyond the specific partnership-type provisions they agreed to.

The logical response to this situation was giving firms the option to adopt partnership-type business forms that included limited liability. But U.S. tax law reduced the benefits of adopting limited liability partnership-type forms by essentially applying two-tier corporate taxation to such firms. The next Section discusses the change in federal tax law that accommodated the development of partnerships with limited liability. That change unleashed state competition regarding partnership-type limited liability forms. The LLC spread rapidly from two states in 1988 to all fifty-one jurisdictions only six years later. As LLCs evolved, they became more flexible and better adapted to closely held firms’ needs.⁵⁸

Europe, 26 J. CORP. L. ___, ___ (2001) (discussing the possibility of regulatory arbitrage in Europe through the introduction of a new LLC business form).

56. See *supra* note 16 and accompanying text.

57. See generally LARRY E. RIBSTEIN & PETER V. LETSOU, BUSINESS ASSOCIATIONS ch. 5 (4th ed. 2003).

58. See *infra* Part IV.

These new forms not only brought new flexibility in themselves, but also helped loosen the rules of existing forms. States developed LLPs and changed the older limited partnership form. Moreover, the greater contractual freedom permitted in the partnership form appears to be spreading back to the traditionally more constrained corporate form. Some states, particularly Delaware, recognized the contractual nature of partnership by passing statutes that explicitly provided for enforcement of broad fiduciary duty waivers.⁵⁹ This provided a precedent for dropping restrictions on corporate waivers.⁶⁰

2. Erosion of Federal Rules

A federal system subordinates state law to federal law in some respects. This would seem to significantly constrain state competition.⁶¹ However, it is important to keep in mind that state law often defines the terms and the contexts in which federal law operates. Thus, changing state rules can reduce the impact of federal constraints.

A good example of this process concerns federal tax constraints on state business forms. Federal tax law once restricted the availability of limited liability by using this feature as an important part of the test for determining whether a firm was subject to corporate tax treatment.⁶² Although the Internal Revenue Service (IRS) nominally applied a four-factor test that required at least two corporate characteristics in addition to limited liability to hold that a firm was a “tax corporation,” it had signaled that limited liability alone could cause a firm to be considered a corporation by initially proposing that the first LLCs be taxed as corporations.⁶³

While the IRS was pondering LLCs, state legislatures and businesses were changing the limited partnership form.⁶⁴ Businesses formed limited partnerships with corporate

59. The first such statute was appended to Delaware’s limited partnership statute. See DEL. CODE ANN. tit. 6, § 17-1101(c)-(d) (1999).

60. See Larry E. Ribstein, *Unlimited Contracting in the Delaware Limited Partnership and its Implications for Corporate Law*, 16 J. CORP. L. 299 (1991). Indeed, one possible result is Delaware’s recent authorization of charter provisions permitting contracting with regard to corporate opportunities, similar to provisions in LLC and partnership statutes. See DEL. CODE ANN. tit. 8, § 122(17) (1999).

61. The constraint is not necessarily inefficient. In some situations federal law might provide a vertical dimension of jurisdictional competition that disciplines inefficient state law. See Albert Breton & Pierre Salmon, *External Effects of Domestic Regulations: Comparing Internal and International Barriers to Trade*, 21 INT’L REV. L. & ECON. 135 (2001).

62. For a discussion of the policy arguments for basing tax classification on limited liability and a history of the erosion of this approach, see Jeffrey A. Maine, *Linking Limited Liability and Entity Taxation: A Critique of the ALI Reporters’ Study on the Taxation of Private Business Enterprises*, 62 U. PITT. L. REV. 223 (2000). Maine notes that the IRS ultimately accepted a broader-based entity approach to classification that led to reduction and eventual elimination of a limited liability test, but does not explain why this occurred. See *id.* For arguments against this approach to tax classification, see Larry E. Ribstein, *The Deregulation of Limited Liability and the Death of Partnership*, 70 WASH. U. L.Q. 417, 456 (1992).

63. See 45 Fed. Reg. 75,709 (1980). Although the Service later withdrew the regulations (I.R.S. News Release IR-82-145 (Dec. 16, 1982); I.R.S. Announcement 83-4, 1983-2 I.R.B. 30 (Jan. 14, 1983)), it issued a private letter ruling classifying an LLC as a corporation (Priv. Ltr. Rul. 83-04-138 (Oct. 29, 1982)) and decided that it would not issue additional private rulings concerning LLC classification (Rev. Proc. 83-15, 1983-1 C.B. 676).

64. See Ribstein, *supra* note 62, at 426. This activity was at least partly attributable to the Tax Reform Act of 1986, which, among other things, caused top corporate tax rates to exceed top individual rates and eliminated the lower tax on capital gains.

general partners, thereby giving firms virtually complete limited liability. Also, state legislatures eroded the “control rule” pursuant to which limited partners who participated in control took on the personal liability of general partners. This forced the IRS to make increasingly fine distinctions in order to maintain the tax distinction between corporations and partnerships. The IRS also had to choose between greatly broadening the corporate tax and making official what the changes in the limited partnership form now implied. In 1988, the IRS chose to classify a Wyoming LLC as a partnership for tax purposes.⁶⁵ This led to the rapid development and spread of LLC statutes⁶⁶ and the development of the LLP.⁶⁷

3. Variation and Adaptability

Increased choice of form not only eroded federal and state restrictions on form, but also allowed firms to customize their contracts to suit their individual needs. As discussed in more detail below, the currently available range of business forms suits firm-specific preferences in such respects as degree of formality and centralization of management. State laws offering several different sets of default rules allow a firm to adopt a set of rules that is coherent (in the sense that the different rules work together), that invites efficient gap-filling by courts, and that helps ensure efficient application of regulatory provisions.⁶⁸ This permits more efficient matching of default rules with various types of firms.

Consider, for example, the choices offered by the three leading partnership-type business forms. The general partnership form suits very closely held firms managed directly by their owners not only in terms of its default management rules,⁶⁹ but also its rules regarding owners’ power to bind the firm.⁷⁰ In contrast, management and control are sharply separated in limited partnerships, as exemplified by the limited partnership “control rule” which penalizes limited partners who participate in management.⁷¹ The

65. Rev. Rul. 88-76, 1988-2 C.B. 360.

66. See Larry E. Ribstein, *The Emergence of the Limited Liability Company*, 51 BUS. LAW. 1 (1995). A court recently noted the effect of the change in tax classification rules on the development of LLC law:

The Virginia statutory requirement that prevented the continuity of life corporate attribute from attaching to Virginia limited liability companies necessarily permitted events over which the company had no control to jeopardize its very existence, potentially in the prime of its economic life. With the change in the IRS regulations, it was no longer necessary to avoid this corporate attribute. Potentially serious problems could be avoided by eliminating dissolution upon enumerated unforeseen events. As of July 1, 1998, a Virginia limited liability company may have, effectively, perpetual existence. The same Act that gave Virginia limited liability companies perpetual existence also added § 13.1-1040.1 which addressed events causing a member’s dissociation. The events that previously led to the dissolution of the company now result in the member’s dissociation.

In re Garrison-Ashburn, L.C., 253 B.R. 700, 706-07 (Bankr. E.D. Va. 2000).

67. See generally Larry E. Ribstein, *Possible Futures for Unincorporated Firms*, 64 U. CIN. L. REV. 319 (1996) (discussing history and development of LLP form).

68. See Ribstein, *supra* note 49, at 380-83.

69. See UNIF. P’SHP ACT § 18 (1914), 6 U.L.A. 526 (1995); REV. UNIF. P’SHP ACT § 401 (amended 1997), 6 U.L.A. 77-78 (Supp. 2001).

70. See UNIF. P’SHP ACT § 9 (1914), 6 U.L.A. 400-01 (1995); REV. UNIF. P’SHP ACT § 301 (amended 1997), 6 U.L.A. 60 (Supp. 2001).

71. See REV. UNIF. LTD. P’SHP ACT § 303 (amended 1985), 6A U.L.A. 144-45 (1995).

LLC falls between these extremes, offering a choice between centralized and decentralized management, multiple sets of fiduciary and agency rules to suit both options, and more ambiguous treatment under regulatory statutes.⁷²

4. *Evolution of Business Forms*

The important question about the erosion of regulation and the variations in state statutes is whether these changes efficiently meet firms' needs. Some might argue that, on the "supply side" of regulation, legislators are not adequately motivated to make efficient changes that do not serve the objectives of powerful interest groups.⁷³ Indeed, powerful groups might actively oppose changes that erode existing regulation favored by these groups. There is also arguably a "demand side" problem in that firms will be impeded from making choices among laws and forms that optimally suit their needs because they are locked into existing forms.⁷⁴ Some might claim that state competition will produce a "race-to-the-bottom," where firms perversely choose statutes that are socially inefficient, perhaps because they hurt creditors.

Several arguments, however, support the proposition that business forms will evolve efficiently. First, with respect to the role of interest groups, there is strong reason to believe that lawyers can be the engines of efficiency. Transactional lawyers have much to gain from promoting efficient business laws in their states.⁷⁵ Such laws give firms incentives to physically locate in the enacting state and to hire local lawyers who are proficient in the local law. The potential free-rider problem is ameliorated by state lawyer licensing laws that exclude lawyers from some of the benefits of practicing under the law of a state in which they are not licensed and by the fact that lawyers earn individual reputational benefits from participating in law reform efforts.⁷⁶ These factors help solve problems on the supply-side of regulation⁷⁷ by giving a particular interest group the incentive to drive efficient law reform.

A second argument for efficient evolution is that, as Armen Alchian has observed, even if legislators lack knowledge, motivation, and foresight to supply efficient laws, such laws may nevertheless emerge through the "adaptive mechanism" of the marketplace.⁷⁸ Evolution through experimentation is consistent with Hayek's observation that "if left free, men will often achieve more than individual human reason could design or foresee."⁷⁹ These insights are relevant to both common⁸⁰ and statutory⁸¹ law. In other

72. See generally RIBSTEIN & KEATINGE, *supra* note 20; Ribstein, *supra* note 66.

73. For discussions of the supply-side problem, see Ian Ayres, *Judging Close Corporations in the Age of Statutes*, 70 WASH. U. L.Q. 365 (1992); Douglas J. Cumming & Jeffrey G. MacIntosh, *The Role of Interjurisdictional Competition in Shaping Canadian Corporate Law*, 20 INT'L REV. L. & ECON. 141 (2000).

74. See *infra* text accompanying notes 83-86.

75. See *supra* text accompanying notes 46-47.

76. See Ribstein, *Lawyers' Licensing*, *supra* note 47.

77. See *supra* text accompanying note 73.

78. See Armen Alchian, *Uncertainty, Evolution, and Economic Theory*, 58 J. POL. ECON. 211 (1950). See also Martti Vihanto, *Competition between Local Governments as a Discovery Procedure*, 148 J. INST. & THEORETICAL ECON. 411 (1992) (showing how jurisdictional competition can produce unexpected discoveries).

79. Friedrich A. Hayek, *Individualism: True and False*, in INDIVIDUALISM AND ECONOMICS ORDER 1, 11 (1948).

80. See, e.g., Paul H. Rubin, *Why is the Common Law Efficient?*, 6 J. LEGAL STUD. 51 (1977).

81. See Bruce H. Kobayashi & Larry E. Ribstein, *Evolution and Uniformity*, 34 ECON. INQUIRY 464

words, it is necessary to look beyond the actions of individual participants in the process to the outcome of the process itself. For example, although particular firms or interest groups caused enactment of the first LLC and LLP statutes,⁸² these statutes are best viewed merely as mutations that spurred evolution. The ultimate form and success of LLCs and LLPs depended on the ensuing process of jurisdictional competition rather than on the circumstances in which these business forms were born.

Third, there are strong arguments against “lock-in” or “path dependence” as constraints on efficient evolution of statutory forms. These terms can be taken to refer to individuals’ or firms’ inability to adopt terms that, but for lock-in, would optimally suit their needs.⁸³ The most coherent explanation of lock-in is “network externalities,” which asserts that, because individual economic actors do not internalize all network benefits, the most efficient products are not necessarily the ones that succeed in the market.⁸⁴ This theory has been applied to business association standard forms,⁸⁵ which depend on networks of users to create beneficial features such as case law and expertise. But there are several problems with this theory. Among other things, it is not clear what should be considered an “externality,” because market actors can internalize the benefits from creating networks, and it will rarely be clear whether a product or business form has failed because of its inherent defects or because of network externalities.⁸⁶

Fourth, a race to the bottom is unlikely to occur with respect to closely held firms. Unlike publicly held corporations, legislators would not be competing for franchise fees.⁸⁷ Indeed, it has been argued that, because of this, there would be inadequate supply-side competition to provide closely held business forms.⁸⁸ But as noted above, transactional lawyers help drive this competition, and they do not have strong incentives to promote business forms that hurt creditors. Moreover, the strong trial lawyer bar has incentives to protect their tort creditor clients.

(1996), reprinted in *UNCERTAINTY AND ECONOMIC EVOLUTION* (John Lott ed., 1997).

82. In the case of LLC statutes, a single firm, Hamilton Brothers Oil Company, and its lawyers and accountants, caused the adoption of the initial Wyoming statute. For accounts of the history of the LLC, see William J. Carney, *Limited Liability Companies: Origins and Antecedents*, 66 U. COLO. L. REV. 855 (1995); 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); Susan Pace Hamill, *The Origins Behind the Limited Liability Company*, 59 OHIO ST. L.J. 1459 (1998). LLP statutes were instigated to protect Texas law firms against liability in connection with the collapse of savings and loan institutions. See BROMBERG & RIBSTEIN, *supra* note 20, § 1.01; Susan Saab Fortney, *Seeking Shelter in the Minefield of Unintended Consequences—The Traps of Limited Liability Law Firms*, 54 WASH. & LEE L. REV. 717 (1997); Robert W. Hamilton, *Registered Limited Liability Partnerships: Present at the Birth (Nearly)*, 66 COLO. L. REV. 1065, 1068-74 (1995).

83. For discussions of alternative meanings of lock-in, see S.J. Liebowitz & Stephen E. Margolis, *Path Dependence, Lock-in, and History*, 11 J.L. ECON. & ORG. 205, 206-12 (1995); Ribstein, *supra* note 34, at 247; Mark Roe, *Chaos and Evolution in Law and Economics*, 109 HARV. L. REV. 641, 646-53 (1996).

84. See generally Joseph Farrell & Garth Saloner, *Standardization, Compatibility, and Innovation*, 16 RAND J. ECON. 70, 70-72 (1985); Michael L. Katz & Carl Shapiro, *Systems Competition and Network Effects*, 8 J. ECON. PERSP. 93 (1994).

85. See Klausner, *supra* note 50.

86. For a summary of alternative explanations for apparent network externality phenomena, see Larry E. Ribstein & Bruce H. Kobayashi, *Choice of Form and Network Externalities*, 43 WM. & MARY L. REV. 79 (2001).

87. For the leading franchise-fee-competition explanation of corporate law, see William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1999).

88. See Ayres, *supra* note 73.

The recent history of unincorporated business forms in the United States strongly supports efficient evolution through horizontal and vertical choice. First, and perhaps most strikingly, the LLC form has evolved rapidly since 1988 into a dynamic entity offering such features as flexible management and corporate-type continuity, rather than locking in the early Wyoming version of the LLC, which was based closely on the limited partnership.⁸⁹

Second, LLC statutes have spontaneously evolved toward uniformity with respect to the types of provisions for which uniformity is most efficient.⁹⁰ This compares favorably with the effects of the “official” Uniform Limited Liability Company Act promulgated by the NCCUSL.⁹¹

Third, there is evidence specifically refuting the role of network externalities in the development of unincorporated business forms. The LLP is very similar to the LLC except that it is designed to overcome network effects by permitting partnerships to access the existing network of general partnership case law and forms while opting into limited liability. If network externalities really did impede efficient evolution, partnership-type firms likely would opt for the LLP rather than the LLC form. In fact, the opposite has occurred, and firms’ choices between forms depend on state-specific regulatory and tax considerations rather than network effects.⁹²

This evidence suggests what might happen in a post-*Centros* Europe in which firms have greater ability to make horizontal and vertical choices. Indeed, there is direct evidence against a race-to-the-bottom in both Europe and the United States showing that firms tend to choose high-quality securities regimes even when they can choose lower-quality regimes.⁹³

All of this is not to say that business forms that evolve from horizontal and vertical choice necessarily are optimal. Firms may encounter some friction, including the effect of local regulations that firms can avoid only by locating their physical business elsewhere,

89. See generally Ribstein, *supra* note 49; Ribstein & Kobayashi, *supra* note 86.

90. See Kobayashi & Ribstein, *supra* note 81. For example, uniformity is most efficient and prevalent in transactions involving third party creditors who deal with many different firms and therefore face high potential information costs of sorting out the rules applicable to each firm. *Id.* at 468.

91. See generally Larry E. Ribstein & Bruce H. Kobayashi, *Uniform Laws, Model Laws and ULLCA*, 66 U. COLO. L. REV. 947 (1995).

92. See Ribstein & Kobayashi, *supra* note 86.

93. See Stephen J. Choi, *Assessing the Cost of Regulatory Protections: Evidence on the Decision to Sell Securities Outside the United States*, 2 *Theo. Inq. Law.* 613 (2001); (showing that firms that had been sued under the securities laws and investigated by the Securities and Exchange Commission tend to make U.S.-regulated securities offerings rather than foreign offerings, indicating that they are using U.S. federal securities laws to allay investor mistrust); JOHN C. COFFEE, JR., *THE COMING COMPETITION AMONG SECURITIES MARKETS: WHAT STRATEGIES WILL DOMINATE?* (Columbia Law and Economics Working Paper No. 192, September 2001), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=283822; Howell E. Jackson & Eric J. Pan, *Regulatory Competition in International Securities Markets: Evidence from Europe in 1999—Part I*, 56 *BUS. LAW.* 653, 691 (2001) (finding that the market demanded more securities disclosures than required by the minimum standards in E.U. Directives, and noting that “market developments in European capital markets to date do not offer support to critics of regulatory competition who claim that the issuer choice proposals would prompt a race to the bottom in international securities regulation.”); IAIN GERARD MACNEIL, *COMPETITION AND CONVERGENCE IN CORPORATE REGULATION: THE CASE OF OVERSEAS LISTED COMPANIES* (Social Science Research Network, 2001), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=278508.

which may limit firms' mobility enough to prevent development of optimal forms. For example, law firms necessarily are subject to ethical rules of the profession that apply in each state in which the firm practices. This keeps firms from avoiding inefficient ethical rules, such as rules that restrict noncompetition agreements and that therefore help prevent opportunistic exit.⁹⁴ The main point is not that evolution operates perfectly, but that offering some jurisdictional choice is likely to yield more efficient results—at least in the context of business forms—than rules promulgated by a single rulemaker.

5. *Competition and Regulation as a Dynamic Process*

Critics of jurisdictional choice might argue that many of the effects described in Section 4 are inefficient, particularly the erosion of federal and state regulation. However, it is important to keep in mind that erosion and evolution do not sweep away all regulation. With respect to state regulation, for example, professional firms must comply with substantial local regulations even if they can operate under the “internal affairs” rules of any state’s business association statute.⁹⁵ Avoidance of regulation involves such difficulties as choosing contractual terms that would not be optimal but for the regulation, the need to vote and revise existing agreements when switching forms, and the extra costs of organizing under the law of a favorable jurisdiction and then doing business as a “foreign firm” in the home state. Thus, regulation will continue to be effective even with jurisdictional choice except to the extent that firms derive strong net benefits from avoiding the regulation even taking into account market constraints. Moreover, it is important to keep in mind that firms have market-based incentives to serve customers’ needs even if they legally could adopt the rules of a lax jurisdiction.

IV. THE OUTPUT OF THE PROCESS: THE ELEMENTS OF PARTNERSHIP

This Part discusses the specific effects of the processes described in Part III. It shows the extent to which partnerships have been engaged in a continuous process of change that has increased partnership-type business firms’ adaptation to their needs. The following Subparts review features of the general standard partnership form introduced in Part II and show both the theoretical uncertainty concerning what these features should look like and how experimentation in the “laboratory” of state laws has responded to this uncertainty.

A. *Partner Liability*

Vicarious liability of partners for the firm’s debts is still the default rule for U.S. partnerships.⁹⁶ This reflects partners’ incentives as profit-sharers and co-managers to

94. See Larry E. Ribstein, *Ethical Rules, Law Firm Structure, and Choice of Law*, 69 U. CIN. L. REV. (forthcoming Dec. 2001). For a discussion of opportunistic exit in law firms, see generally Robert W. Hillman, *Professional Partnerships, Competition, and the Evolution of Firm Culture: The Case of Law Firms*, 26 J. CORP. L. ____ (2001) (discussing adverse effects of partnership law on firm stability).

95. This will also be true under *Centros* which explicitly preserved a role for professional regulation. 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).

96. See UNIF. P'SHIP ACT § 15 (1914), 6 U.L.A. 456 (1995); REV. UNIF. P'SHIP ACT § 306 (amended 1997), 6 U.L.A. 69 (Supp. 2001).

monitor the firm and the potentially high moral hazard from limited liability when owner-managers deal with creditors.⁹⁷ Because creditors in these circumstances usually demand personal guarantees from owners,⁹⁸ making vicarious liability the default rule for contracts economizes on transaction costs. Owners of very closely held firms would gain little from tort limited liability because the firm's torts can often be attributed to the owners' acts.⁹⁹

Nevertheless, as discussed in the following Sections, it is not clear that vicarious liability should be the default rule for some, or even any, partnership-type firms. This uncertainty is reflected in variations in partner liability between the extremes of limited and vicarious liability.

1. Limited liability for Closely Held Firms

Even if vicarious liability is efficient for some firms, particularly owner-managed partnerships, limited liability may be an efficient default rule for other firms. Although commentators have highlighted the advantages of limited liability in facilitating public trading of shares,¹⁰⁰ limited liability may also be valuable in some closely held firms, particularly where ownership and management are specialized and even in some cases where owners manage the firm.¹⁰¹ If this is the case for many closely held firms, it follows that limited liability should be available as a default rule rather than forcing firms to enter into nonrecourse contracts with casual trade creditors and forcing their owners to bear vicarious liability in tort suits where nonrecourse contracts are not feasible. Alternatively, it may be efficient to adopt modified forms of limited liability, such as focusing vicarious liability on managers or providing for limited liability only for certain types of debts. Indeed, as discussed below in this Section, various forms of vicarious and limited liability have been tested in the laboratory of state law.

It has been argued that shareholder limited liability for corporate torts is inefficient¹⁰² and therefore is not part of the essential role of business forms.¹⁰³ From the

97. For analyses of vicarious liability based on the principal's ability to monitor, motivate or select agents, see Lewis A. Kornhauser, *An Economic Analysis of the Choice Between Enterprise and Personal Liability for Accidents*, 70 CAL. L. REV. 1345 (1982); Alan O. Sykes, *The Economics of Vicarious Liability*, 93 YALE L.J. 1231 (1984).

98. See Ronald J. Mann, *The Role of Secured Credit in Small-Business Lending*, 86 GEO. L.J. 1, 26-37 (1997) (showing evidence that most small firm debt is backed by the owners' personal guarantees).

99. See Robert B. Thompson, *Unpacking Limited Liability: Direct and Vicarious Liability of Corporate Participants for Torts of the Enterprise*, 47 VAND. L. REV. 1 (1994).

100. See Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89 (1985); Susan Woodward, *Limited Liability in the Theory of the Firm*, 141 J. INST. & THEORETICAL ECON. 601 (1985).

101. See Ribstein, *supra* note 62, at 428-38.

102. Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879 (1991).

103. See Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE L.J. 387, 431 (2000). Hansmann and Kraakman distinguish limited liability from "affirmative asset partitioning," or shielding the entity's assets from claims by owners' creditors. *Id.* at 394-96. See also Armour & Whincop, *supra* note 17 (analyzing the "essential" role of affirmative asset partitioning in a broader framework of business organization rules); *infra* note 162 and accompanying text (discussing variations in the degree of affirmative asset partitioning between partnership-type and corporate-type firms, particularly regarding "liquidation protection" of the firms from owners' individual creditors).

standpoint of the present Article's analysis, the main question is whether this assertion about inefficiency can be refuted by every state's acceptance of tort limited liability, including in closely held firms. One commentator has suggested that states' adoption of limited liability business forms is not evidence of efficiency because the forms were adopted over a brief period, without significant public debate, and primarily at the behest of lawyers.¹⁰⁴

In order to establish the inefficiency of the spread of LLC statutes, critics must ask why business lawyers were able to steamroll over all other interest groups in all fifty-one U.S. jurisdictions. States could have prevented the spread of limited liability within their borders, had they chosen to do so, simply by failing to recognize the LLC liability limitation.¹⁰⁵ Nor did LLC statutes move in under cover of night. The process took eight years from the time of the tax ruling that made LLCs viable until the last LLC statute was passed, during which time Westlaw reports that 350 law review articles were published with "limited liability company" in the title.¹⁰⁶ And trial lawyers, who long have vigorously pressed for extension of tort liability and opposed attempts to reform state tort and professional liability laws, lobbied hard against LLC statutes in several states, including Missouri, Ohio, Tennessee, Washington, and Oklahoma,¹⁰⁷ as well as against the California LLP act.¹⁰⁸ Finally, between the 1977 passage of the Wyoming law and the 1988 tax ruling, LLC statutes faced the significant federal tax classification hurdle, during which time opponents of limited liability might have prevailed at the federal level.¹⁰⁹

A benign explanation of the spread of LLC statutes is that they reflected closely held firms' increasing need for limited liability because of the increase in tort and malpractice exposure. Thus, LLC statutes represented a reverse swing of the tort pendulum after the tort revolution in the United States had left firms exposed to excessive tort risk. The statutes spread so quickly because, by the time of the 1988 tax classification rule, the need for them was well-recognized. In other words, the rapid spread of LLC statutes indicates the inefficiency not of the new rule, but rather of the pre-1988 tax rules that had constrained the passage of LLC statutes prior to that date.¹¹⁰ It also shows how a dynamic system is able to react to inefficiency by providing an opportunity for regulatory arbitrage.

2. Exhaustion of Firm Assets

Owner liability rules do not involve a choice simply between the extremes of vicarious and limited liability. One option is requiring creditors to sue the partnership and exhaust its assets before they can recover from partners. Under U.S. partnership law,

104. See J. William Callison, *Federalism, Regulatory Competition and the Limited Liability Movement: The Coyote Howled and the Herd Stampeded*, 26 J. CORP. LAW ___, ___ (2001).

105. For a discussion of the conflict of laws issue, see RIBSTEIN & KEATINGE, *supra* note 20, § 13.04.

106. The Westlaw search was "TI (limited liability company!)" in the "All Law Reviews and Journals" (TP-ALL) database.

107. See Goforth, *supra* note 82, at 1271-75, 1279-81.

108. See Bill Ainsworth, *Trial Lawyers Learn to Live with Limited Liability*, RECORDER, June 26, 1995, at 2.

109. See *supra* note 62 and accompanying text.

110. See Ribstein, *supra* note 62.

partners traditionally are directly liable only to tort-type creditors such as accident victims. However, several U.S. jurisdictions, including those adopting RUPA,¹¹¹ require both contract and tort creditors to exhaust partnership assets. The exhaustion rule is consistent with the so-called “dual priorities” rule of the UPA, which gives partnership creditors priority only in the assets of the partnership and not in those of individual partners.¹¹² This form of limited liability represents a compromise between full-fledged corporate-type limited liability and full-fledged vicarious liability. The U.S. rule contrasts with partners’ joint and several liability for all partnership debts in most other countries.¹¹³

These alternative rules raise the issue of which is best for partnership. The exhaustion rule obviously raises collection costs for creditors, while lifting partners’ burden of paying creditors and then seeking indemnity from the firm. Creditors’ costs arguably would exceed those of partners, who deal regularly with the firm.¹¹⁴ On the other hand, the exhaustion rule may be a reasonable compromise for some firms between vicarious and full-fledged limited liability where personal liability addresses moral hazard problems but creditors’ costs of suing the firm are not much higher than those of owners.

Because the efficiency of the exhaustion rule is unclear from the standpoint of pure theory, it should be tested in the laboratory of state laws. With NCCUSL’s promulgation of across-the-board exhaustion in RUPA, coupled with increased availability of contractual choice of law in general partnerships,¹¹⁵ states can accept or reject the RUPA rule, and firms can choose from among the various state rules. If states tend to adopt, say, the RUPA across-the-board exhaustion rule, and if firms tend to choose these statutes, this would indicate that this rule is efficient for most partnership-type firms.

The problem with a competition solution to these issues, however, is that federal bankruptcy law in the United States stifles full-fledged competition regarding the nature of limited liability. Bankruptcy law, among other things, overrules the dual priorities rule by providing for direct access by partnership creditors—through the bankruptcy trustee—to assets of bankrupt individual partners, and bankruptcy courts have enjoined creditors’ actions against nonbankrupt partners.¹¹⁶ All firms are subject to these rules in federal bankruptcy proceedings regardless of the otherwise applicable state law.¹¹⁷

111. See REV. UNIF. P’SHIP ACT § 307 (amended 1997), 6 U.L.A. 73-74 (Supp. 2001).

112. See UNIF. P’SHIP ACT § 40(i) (1914), 6 U.L.A. 902 (1995).

113. See Jacques Heenen, *Partnership and Other Personal Associations for Profit*, in 13 INTERNATIONAL ENCYCLOPEDIA OF COMPARATIVE LAW, 97, 140-44 (1975).

114. See Ribstein, *supra* note 62. Conversely, it has been argued that, because a universally available corporate form

captures all of the creditor-monitoring economies available under the old U.P.A. priority rules for partners’ creditors . . . 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.

▲ Hansmann & Kraakman, *supra* note 103, at 428 n.60.

115. See *supra* text accompanying notes 37-38.

116. For discussions and criticisms of these and other effects of bankruptcy law on partnerships, see Larry E. Ribstein, *Partner Bankruptcy and the Federalization of Partnership Law*, 33 WAKE FOREST L. REV. 795 (1998); Larry E. Ribstein, *The Illogic and Limits of Partners’ Liability in Bankruptcy*, 32 WAKE FOREST L.

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3. Limited Liability for Torts Only

Another possible approach to owner liability would be a rule of personal liability for contract but limited liability for torts. This approach would address the infeasibility of contracting out of vicarious liability as to tort creditors while providing by default for the liability that most contract creditors of closely held firms apparently want.¹¹⁸ On the other hand, vicarious liability may not be the efficient default rule for contract claims, and distinguishing two sets of creditors imposes extra transaction costs on the firm.¹¹⁹ Although the original Texas rule distinguished contract and tort claims,¹²⁰ less than a third of the LLP statutes now take this approach.¹²¹ Thus, the laboratory of state laws generally has rejected what appears to be an inefficient liability rule.

4. Limited Liability in Limited Partnerships and the Control Rule

A third approach to owner liability is the mixed liability rule for limited partnerships, in which general partners have vicarious liability but limited partners have limited liability unless they participate in control.¹²² This rule can be rationalized as a way to permit limited liability investments in an unincorporated firm, while minimizing the potential moral hazard problem with limited liability in closely held firms¹²³ by giving managers an incentive to act in creditors' interests.¹²⁴ The control rule no longer unduly restricts limited liability, as it did when firms had few other limited liability options, now that firms can combine separation of ownership and control and limited liability by forming LLCs.

The main counter-argument is that too few firms would opt for this approach to justify continuing to offer it. As with the other issues discussed in this paper, the best way to answer this question is through the laboratory of state competition. State law and contractual variations have made vicarious liability in limited partnerships vestigial. Limited partners' control liability under the existing version of the Revised Uniform Limited Partnership Act (RULPA) has been reduced—through an extensive safe harbor for permissible control acts—to a type of partnership by estoppel based on

REV. 31 (1997).

117. It has been argued that the transaction costs of entering into contracts regarding creditors' access to separate pools of owner and firm assets make legal default rules on such matters particularly important and binding. See Hansmann & Kraakman, *supra* note 102. But this does not preclude variation in these rules. Indeed, as transaction costs make legal default rules more valuable, they should also increase the value of competition and evolution regarding such rules in order to help ensure the rules' efficiency. Uniformity may be efficient if the rules are complex, entailing learning costs by third party creditors. See Kobayashi & Ribstein, *supra* note 81 (showing evidence that LLC rules regarding matters of this sort are, indeed, more uniform). However, the efficiency of uniformity does not necessarily follow from high costs of contracting around the default rule.

118. See *supra* text accompanying note 98.

119. See BROMBERG & RIBSTEIN, *supra* note 20, § 3.02; Larry E. Ribstein, *Possible Futures for Closely-held Firms*, 64 U. CIN. L. REV. 319, 329-31 (1996).

120. See BROMBERG & RIBSTEIN, *supra* note 20, §1.01(a).

121. See *id.* at tbl.3-1.

122. See REV. UNIF. LTD. P'SHIP ACT § 303 (amended 1985), 6A U.L.A. 144-45 (1995).

123. See *supra* text accompanying note 97.

124. See Larry E. Ribstein, *Limited Partnerships Revisited*, 67 U. CIN. L. REV. 953, 979 (1999).

misrepresentation of general partner status.¹²⁵ At the same time, general partners can avoid liability by the simple expedient of incorporating.

The advent of the LLP continued this evolutionary process. Several states explicitly permit limited partnerships to organize as limited liability limited partnerships (LLLPs) and thereby eliminate the vicarious liability of general partners and, in some cases, also of limited partners who participate in management.¹²⁶ LLLPs raise still further questions. On the one hand, now that limited partnerships can easily opt into full-fledged limited liability, the limited partnership statute arguably should tighten the control rule and general partner liability for the general partners that do not make the election, thereby preserving two distinct alternatives. On the other hand, because most limited partnerships will elect LLLP status if it is available, the statute arguably should eliminate vicarious liability for limited partnerships as simply a trap for the unwary, thereby making the LLLP in effect the default limited partnership. This issue was debated in the context of NCCUSL's revision of RULPA.¹²⁷ The final version of this provision provides for default personal liability of general partners.¹²⁸ However, the Reporter reflected the confused history of the revision on this issue in the following note to the April 2001 draft:

Having consulted severally with a majority of the Commissioners on the Drafting Committee, the Reporter believes that the Committee will vote to "flip" on the "flip"—i.e., to provide that, as a default rule, the general partner of a limited partnership is liable for the debts of the entity. If the Reporter's prediction is wrong (not an unprecedented event), the changes indicated above (and elsewhere) will simply be removed.¹²⁹

This suggests that uniform vicarious liability rule for limited partnerships was determined by how a particular committee felt at a particular time. But the laboratory of state legislatures considering whether to adopt the revision ultimately will, and should, determine the law on this issue.

5. Limited Liability as a Default Rule for All Partnerships

Limited liability in limited partnerships raises an additional question about the future of vicarious liability in general partnerships. If the state laboratory ultimately should decide that vicarious liability is simply a trap for limited partnerships, why not for general partnerships as well? One might respond that general partnerships are the default entity, unlike limited partnerships which the parties must commemorate by a state filing. But limited liability, like vicarious liability, can also be seen as a prescribed legal consequence of a particular relationship. The decision by the vast majority of firms to opt for limited liability arguably suggests that this is the efficient rule and that the legal consequence of forming a partnership should change accordingly. Full-fledged vicarious liability may not be an efficient default rule for a significant number of firms because the

125. See REV. UNIF. LTD. P'SHIP ACT § 303 (amended 1985), 6A U.L.A. 144-45 (1995).

126. See BROMBERG & RIBSTEIN, *supra* note 20, ch. 5.

127. See Ribstein, *supra* note 124, at 971.

128. See UNIF. LTD. P'SHIP ACT (2001) § 404(a).

129. NAT'L CONFERENCE OF COMM'RS OF UNIF. STATE LAWS, PROPOSED REVISIONS OF UNIFORM LIMITED PARTNERSHIP ACT (1976) WITH 1985 AMENDMENTS §404 note 9 (April 2001), at http://www.law.upenn.edu/bl/ulc/ulc_frame.htm.

collection costs of actions against individual partners and the increased monitoring costs of both partners and creditors under a vicarious liability rule probably exceed any benefits to creditors from the availability of a direct action.¹³⁰ Once again, this is a complex issue that is best decided in the laboratory of state law.

B. Partners' Financial Rights

There are several theoretically possible default rules for partners' shares in profits and losses, including equally (per capita), according to partners' financial contributions (pro rata), and per capita or pro rata by class of holder depending on their liability for the firm's debts and management responsibilities. As discussed below, these default rules reflect varying assumptions concerning firms' management and liability structures. As with the other issues discussed in this Article, the appropriate rule or mix of rules is difficult to determine as a matter of *a priori* theory.

U.S. partnership law provides that partners share equally in profits and losses after paying nonpartnership creditors.¹³¹ Indemnification by the partnership and contribution by individual partners reconciles partners' loss shares with their vicarious liability for all partnership debts. Partnership statutes also deny partners interest and rent in addition to their profit shares except where they specifically contract to loan or lease property to the firm.¹³² These rules contrast with the pro rata sharing rule for corporations and with the partnership rule in some non-U.S. jurisdictions.¹³³

The partnership equal sharing rule raises significant policy issues.¹³⁴ Fred C. Dobbs (Humphrey Bogart) observed in *The Treasure of the Sierra Madre* that "in any civilized place the biggest investor gets the biggest return."¹³⁵ The rule might be defended as based on the assumption that, in the absence of contrary agreement, the partners' profit share compensates them for all of their investments in the firm, including their credit contribution to a vicarious liability firm. This would explain why this default rule does not apply in limited liability firms and is so often varied by contract in firms where the equal-contribution assumption does not hold.¹³⁶ The default rule applies even to firms where the parties' contributions are not in fact equal but the parties have not contracted

130. See Ribstein, *supra* note 62, at 428-33.

131. UNIF. P'SHIP ACT § 18(a) (1914), 6 U.L.A. 526 (1995); REV. UNIF. P'SHIP ACT § 401(b) (amended 1997), 6 U.L.A. 77 (Supp. 2001).

132. See UNIF. P'SHIP ACT § 18(c), (f) (1914), 6 U.L.A. 526 (1995); REV. UNIF. P'SHIP ACT § 401(d), (h) (amended 1997), 6 U.L.A. 77 (Supp. 2001).

133. For example, German law provides for sharing on the basis of capital shares. See Heenen, *supra* note 113, at 108.

134. This markedly contrasts with one commentator's peculiar view, based on evolutionary biology, that the rule plays an essential role in partnership. See THOMAS A. SMITH, EQUALITY, EVOLUTION AND PARTNERSHIP LAW (University of San Diego Law and Economics Research Paper No. 11, University of San Diego Public Law Research Paper No. 20, 2001), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=262407. The paper ignores considerations underlying default rules as distinguished from actual contracts in particular firms, variations across types of partnership-like firms, cross-country differences and, in general, the adaptability of business forms.

135. THE TREASURE OF THE SIERRA MADRE (Metro-Goldwyn-Mayer 1948).

136. Indeed, courts may often assume a contrary agreement in this situation. See, e.g., *Warren v. Warren*, 784 S.W.2d 247 (Mo. Ct. App. 1989) (holding that partners who provided substantial time and vital services deserved extra compensation).

around the rule. But to what extent should this result prevail even in the face of clear expectations to the contrary in particular firms? For example, should partnership law provide for a different default rule in LLPs where the assumption of credit contributions does not hold?¹³⁷ A rigid default rule would encourage costly contrary agreements, seemingly inconsistent with the transaction-cost-reducing function of default rules. On the other hand, a flexible rule, or applying many different default rules, imposes information costs on firms.¹³⁸

Again, the laboratory of state laws should resolve these issues through horizontal and vertical competition. States can offer hybrid or variant business forms that provide alternatives to some of the general partnership default rules, including those regarding allocation of financial rights, without increasing general partners' information costs or uncertainty. For example, limited partnership statutes¹³⁹ and most LLC statutes¹⁴⁰ provide for pro rata financial rights.

C. Management and Control

Management and control default rules theoretically vary on a continuum according to their flexibility or rigidity, from rules providing for equality among partners with fixed categories of authority, to those creating classes of owners and managers with particular levels of authority. The more flexible the members' default authority, the greater the uncertainty costs associated with determining that authority and the need to allocate those costs between the firm and third parties.

Default partnership rules treat all partners equally regarding management and control: partners participate directly in management;¹⁴¹ each partner has one vote rather than apportioning votes by the value of money contributions as under corporate law;¹⁴² and all partners vote on the firm's decision, with a majority vote required to approve all ordinary decisions and unanimity required for extraordinary decisions, including amendment of the agreement and admission of new partners.¹⁴³

Equality rules for management, like those for financial rights discussed above, suit very closely held firms in which the partners' combinations of capital, service, and credit contributions can be assumed to equalize. At the same time, majority-vote rules avoid the high coordination costs of requiring unanimity on ordinary decisions.¹⁴⁴ The rules regarding a partner's power to bind the firm in transactions with third parties reflect this

137. See BROMBERG & RIBSTEIN, *supra* note 20, § 4.04(a).

138. Moreover, the "linkage" of general partnership default rules with LLPs is arguably an advantage of LLPs. See generally Ribstein & Kobayashi, *supra* note 86.

139. See REV. UNIF. LTD. P'SHIP ACT § 503 (amended 1985), 6A U.L.A. 209-10 (1995).

140. See RIBSTEIN & KEATINGE, *supra* note 20, app. 5-1 (tabulating statutes).

141. See UNIF. P'SHIP ACT § 18(e) (1914), 6 U.L.A. 526 (1995); REV. UNIF. P'SHIP ACT § 401(f) (amended 1997), 6 U.L.A. 77 (Supp. 2001).

142. See UNIF. P'SHIP ACT § 18(e) (1914), 6 U.L.A. 526 (1995); REV. UNIF. P'SHIP ACT § 401(f) (amended 1997), 6 U.L.A. 77 (Supp. 2001).

143. See UNIF. P'SHIP ACT § 18(h)-(i) (1914), 6 U.L.A. 526 (1995); REV. UNIF. P'SHIP ACT § 401(i)-(j) (amended 1997), 6 U.L.A. 77-78 (Supp. 2001).

144. See generally JAMES BUCHANAN & GORDON TULLOCK, *THE CALCULUS OF CONSENT* (1962) (describing optimal voting rules). Armour and Whincop argue that decisions should be made by at least a majority vote. See Armour & Whincop, *supra* note 17, at _____. However, the parties might decide to reduce the costs of consensus through sub-majority voting and delegation.

equal allocation of power. Under U.S. law any partner normally can bind the firm in ordinary business transactions with third parties.¹⁴⁵ Similarly, because the default rules assume that partners are full-time co-managers, their acts in the ordinary course of business trigger partnership tort liability, as do acts by full-time employees of other types of firms.

But even many closely held firms do not fit the model of active worker-management. For example, larger partnerships need to centralize authority to minimize decisionmaking costs. Because of the basic partner equality assumption, the firm bears the burden of notifying third parties of limitations on partners' authority to bind the firm.¹⁴⁶ RUPA makes only a slight concession to this problem by providing a mechanism for binding third parties in real estate transactions where third parties can easily check a central record.¹⁴⁷

There is, therefore, a need for default rules that suit centralized management even in partnership-type firms. The limited partnership was once the only alternative set of default rules that U.S. law offered for closely held firms. The traditional limited partnership form clearly delineates classes of managing general partners, who have vicarious liability for the debts of the firm and can bind the firm in transactions with third parties, and non-managing limited partners, who have limited liability—unless they participate in control¹⁴⁸—and no power to bind the firm.¹⁴⁹

The traditional limited partnership does not, however, suit the many closely held firms in which investor-employees want substantial say even if they do not exercise day-to-day control. State statutes initially accommodated this need by diluting the limited partnership control rule and permitting limited partners to participate more actively in management without losing their limited liability. These state statutory developments were reflected in 1976 and 1985 versions of the Uniform Limited Partnership Act (ULPA), which offered increasing levels of management flexibility.¹⁵⁰ The recent revision of ULPA has now completely eliminated the “control rule.”¹⁵¹ However, eliminating the clear demarcation between general and limited partners simultaneously raises general partnership type problems of third party uncertainty in determining member authority.

The LLC offers a compromise form of “chameleon” management: the firm can choose either direct partnership-type control by the members or centralized control by managers that is closer to, but not as rigid as, the limited partnership format.¹⁵² With this

145. See UNIF. P'SHIP ACT §§ 9-13 (1914), 6 U.L.A. 400-44 (1995); REV. UNIF. P'SHIP ACT §§ 301-305 (amended 1997), 6 U.L.A. 60-68 (Supp. 2001).

146. See UNIF. P'SHIP ACT § 9 (1914), 6 U.L.A. 346 (1995); REV. UNIF. P'SHIP ACT § 301 (amended 1997), 6 U.L.A. 60 (Supp. 2001).

147. REV. UNIF. P'SHIP ACT § 303 (amended 1997), 6 U.L.A. 63-64 (Supp. 2001).

148. See UNIF. LTD. P'SHIP ACT § 7 (1916), 6A U.L.A. 336 (1995); REV. UNIF. LTD. P'SHIP ACT § 303 (amended 1985), 6A U.L.A. 144-45 (1995).

149. See REV. UNIF. LTD. P'SHIP ACT § 403(a) (amended 1985), 6A U.L.A. 177 (1995) (providing that a general partner in a limited partnership has the same rights and powers as a general partner in a general partnership).

150. Compare REV. UNIF. LTD. P'SHIP ACT § 303 (1976), 6A U.L.A. 144-45 (1995), with REV. UNIF. LTD. P'SHIP ACT § 303 (amended 1985), 6A U.L.A. 144-45 (1995).

151. See NAT'L CONFERENCE OF COMM'RS OF UNIF. STATE LAWS, *supra* note 128, § 303.

152. See RIBSTEIN & KEATINGE, *supra* note 20, app. 8-1 (summarizing and tabulating state statutes).

greater flexibility comes greater uncertainty for third party creditors than in limited partnerships as to whether particular individuals have authority to bind the firm. For example, limited partnership statutes generally provide that the certificate is notice to third parties that those designated therein as general partners are such.¹⁵³ LLC statutes generally do not have comparable provisions.¹⁵⁴ Thus, under most statutes courts would apply agency rules that would require the firm to notify third parties which non-managing members lack binding authority.¹⁵⁵ However, some states, particularly including Delaware, make the operating agreement binding as to members' and managers' authority, thereby effectively requiring third parties to check this agreement when dealing with the firm.¹⁵⁶

The main point is that the laboratory of state law, and not uniform law drafters, has produced governance structures that efficiently reflect the variety of firms' needs. Even where rules are embodied in NCCUSL's uniform partnership, limited partnership, and LLC acts, NCCUSL generally has followed rather than led the process.¹⁵⁷ For example, the LLC chameleon management structure had evolved in many state statutes before being included in ULLCA.¹⁵⁸

D. Partner's Property Rights in the Firm

Partners have the right to sell or otherwise alienate their rights to distributions, unlike corporate shareholders, however, they cannot transfer their rights to participate in control without their co-partners' consent.¹⁵⁹ Like the other partnership default rules, this assumes that each partner is a co-manager and therefore is not fungible with other investors, as are corporate shareholders.

These rights raise at least two important issues. First, to what extent should partners be able to protect their interests in the firm from their individual creditors? The rights of partners' creditors must be balanced against those of the nondebtor owners to continue to exercise their substantial management rights free from creditors' interference. These owner and creditor rights may collide in partnerships. Unlike in a publicly held firm, an individual partner may be able to exercise significant control over the partnership and thereby restrict distributions that creditors otherwise would be able to reach by levying on the partner's interest. Moreover, unlike in a corporation, the creditor who levies on, or "charges," a partnership interest cannot, by foreclosure, take over the voting power of the stock because the charging creditor is no more than a transferee of the partner's financial rights.¹⁶⁰ Instead, the creditor's rights are subject to those of the owner, including the debtor himself.

153. See REV. UNIF. LTD. P'SHIP ACT § 208 (amended 1985), 6A U.L.A. 134 (1995).

154. See RIBSTEIN & KEATINGE, *supra* note 20, app. 4-1.

155. See *id.* § 8.05.

156. See *id.* app. 8-1 (summarizing state statutory provisions).

157. See Ribstein & Kobayashi, *supra* note 91.

158. See Ribstein, *supra* note 66, at 2.

159. See UNIF. P'SHIP ACT § 27 (1914), 6 U.L.A. 736 (1995); REV. UNIF. P'SHIP ACT § 503 (amended 1997), 6 U.L.A. 91 (Supp. 2001).

160. See UNIF. P'SHIP ACT § 28 (1914), 6 U.L.A. 744 (1995); REV. UNIF. P'SHIP ACT § 504 (amended 1997), 6 U.L.A. 92-93 (Supp. 2001).

The laboratory of state law has dealt with this issue. State general partnership statutes vary as to whether a charging creditor can foreclose on the debtor's partnership interest.¹⁶¹ This is a significant issue under general partnership law because foreclosure permits the creditor to obtain a judicial dissolution and liquidation of a partnership without an unexpired term.¹⁶² Foreclosure and dissolution rights may or may not carry over from general to the limited partnership statutes under current law. Although these statutes do not explicitly provide for dissolution by members' creditors,¹⁶³ they incorporate general partnership terms to the extent that these are not inconsistent with the limited partnership statute.¹⁶⁴ This raises the question whether the general partnership provision on the assignee's right to compel dissolution is "inconsistent,"¹⁶⁵ as one leading case has held.¹⁶⁶ The ULPA revision clarifies that issue through a special limited partnership provision that permits judicial dissolution actions only by a partner.¹⁶⁷ On the other hand, ULLCA provides both for foreclosure of LLC interests and for judicial dissolution on application by transferees of interests.¹⁶⁸ These variations set the stage for evolution and competition among both states and business forms on this issue.

The second issue regarding partner property rights concerns free transferability of management rights. Because restricted transferability assumes that members are co-managers, it arguably follows that the default rule should differ in firms where that assumption does not hold. Partnership-type statutes that include rules based on centralized management arguably should provide for free transferability of management rights for non-managing members. Yet restricted transferability of management rights is still the rule for all interests in partnership-type firms. This may be because such transferability is the tax and regulatory dividing line between corporate-type and partnership-type firms.¹⁶⁹ This may also be an example of tax and regulation trumping efficient state law evolution of business forms. On the other hand, a transferability-based distinction among business forms may be more efficient than other bases because it is less likely to induce firms to make inefficient tax or regulation-induced adjustments in form.¹⁷⁰

161. See BROMBERG & RIBSTEIN, *supra* note 9, § 3.05(d)(3)(v); see also *id.* § 3.05(d)(3)(i) (discussing whether charging order is creditor's exclusive remedy).

162. See UNIF. P'SHIP ACT § 32 (1914), 6 U.L.A. 803 (1995); REV. UNIF. P'SHIP ACT § 801(6) (amended 1997), 6 U.L.A. 108-09 (Supp. 2001). This means that a partnership's creditors, unlike those of a corporation, do not have the type of "affirmative asset partitioning" that gives them "liquidation protection" against owners' creditors. See Hansmann & Kraakman, *supra* note 103, at 394.

163. See REV. UNIF. LTD. P'SHIP ACT § 801 (amended 1985), 6A U.L.A. 240-41 (1995).

164. See *id.* § 1105, 6A U.L.A. 302 (1995).

165. See Larry E. Ribstein, *Linking Statutory Forms*, 58 J.L. & CONTEMP. PROBS. 187 (1995) (discussing general linkage issue).

166. *Baybank v. Catamount Constr., Inc.*, 693 A.2d 1163 (N.H. 1997).

167. See UNIF. LTD. P'SHIP ACT (2001) § 802.

168. See UNIF. LTD. LIAB. CO. ACT § 504(b), §801(5) (amended 1996), 6A U.L.A. 107 (Supp. 2001) (discussing foreclosure and dissolution, respectively).

169. See 26 U.S.C. § 7704 (1994) (providing that partnerships with freely transferable shares are subject to double corporate taxation). Prior to check-the-box, transferability also was one of the attributes that distinguished corporations from partnerships under the classification rules. See Treas. Reg. § 301.7701-2(a)(2) (1994).

170. See Ribstein, *supra* note 62, at 469-70.

E. Fiduciary Duties

Because fiduciary duties minimize agency costs associated with the separation of ownership from management rights, they arguably should apply only when partners act as agents.¹⁷¹ Indeed, imposing fiduciary duties when partners act as owners to protect their interests—for example, by voting on partnership transactions, selling their ownership interests, exiting the firm, or expelling other partners—actually could increase agency costs by inhibiting partners from monitoring managers. It follows that fiduciary duties should not apply, or at least not strictly require unselfish conduct, when partners act as owners rather than as managers or agents. Apart from optimal default rules, fiduciary duties are part of the contract among the partners and therefore should be subject to contrary agreement.¹⁷² Finally, the statutes should provide some mechanism for enforcing fiduciary duties, again subject to contrary agreement. The following Subsections raise issues concerning fiduciary duties that can be, and have been, addressed in the laboratory of state laws.

1. Managers vs. Owners

To what extent should default duties reflect degrees of centralization of management? This issue mirrors those regarding financial rights, agency, and transferability discussed above. Given the model of co-equal ownership in the general partnership, it would seem to follow that partners would not have default fiduciary duties when they are acting solely as owners rather than as managers. That is, in this situation, partners would be able to act selfishly, subject to general contract and good faith principles. This is consistent with UPA section 21, titled “Partner Accountable as a Fiduciary,” which requires partners to “account to the partnership for any benefit and hold as trustee for it any profits derived by him without the consent of the other partners” from partnership transactions.¹⁷³ Despite its title, this provision simply forbids a partner from taking more from the partnership than the partners have agreed. To be sure, the classic statement of partners’ fiduciary duties, by Justice Cardozo in *Meinhard v. Salmon*,¹⁷⁴ seems to go much further:

Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the “disintegrating erosion” of particular exceptions. [citation omitted] Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd. It will not consciously be lowered by any judgment of this court.¹⁷⁵

171. See Larry E. Ribstein, *Are Partners Fiduciaries?* 2005 Illinois Law Review 209

172. See Frank Easterbrook & Daniel Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425 (1993); Ribstein, *supra* note 23.

173. UNIF. P’SHP ACT § 21 (1914), 6 U.L.A. 608 (1995)

174. 164 N.E. 545 (N.Y. 1928).

175. *Id.* at 546.

But close analysis of partnership cases reveals that courts, consistent with the language of UPA section 21, attend to the nature of specific contracts in applying fiduciary duties.¹⁷⁶

RUPA confuses the law by generally characterizing partners as fiduciaries and then ambiguously qualifying this characterization. RUPA section 404 defines “general standards of partner’s conduct,” to include an explicit “duty of loyalty” and a “duty of care.”¹⁷⁷ In order to deal with the many cases referred to above in which partners were held not to be acting as fiduciaries, RUPA section 404 qualifies these general duties as follows:

- (e) A partner does not violate a duty or obligation under this [Act] or under the partnership agreement merely because the partner’s conduct furthers the partner’s own interest.
- (f) A partner may lend money to and transact other business with the partnership, and as to each loan or transaction, the rights and obligations of the partner are the same as those of a person who is not a partner, subject to other applicable law.¹⁷⁸

These provisions are unclear.¹⁷⁹ At their broadest, they can be taken to negate the general “standards” elsewhere in section 404. The most straightforward interpretation is that partners are not subject to a fiduciary duty when they are not acting as fiduciaries. This can be reconciled with the remainder of section 404, which does not impose a fiduciary duty on all partners, but literally only defines the “only fiduciary duties a partner owes to the partnership”¹⁸⁰—that is, when one is owed.

Because of its ambiguity, RUPA section 404 eliminates whatever advantage might otherwise have been derived from statutory definition of partners’ duties. This problem is exacerbated by the limited waivability of fiduciary duties under RUPA discussed below. Unfortunately, many of the states that have adopted RUPA, which now exceed a majority of U.S. jurisdictions, are taking along with it these undesirable features. This illustrates the potential harm that can be caused by promulgation of uniform law proposals.¹⁸¹

Horizontal and vertical choice and statutory and common law evolution, however, mitigate the harm caused by RUPA. In particular, many LLC statutes clearly separate the fiduciary duties of managing members from the looser, good faith duties of non-managing members.¹⁸² A similar rule is emerging in limited partnership case law¹⁸³ and is included in the revised ULPA.¹⁸⁴ Statutory provisions explicitly authorizing fiduciary

176. See Ribstein, *supra* note 23.

177. REV. UNIF. P’SHP ACT § 404 (amended 1997), 6 U.L.A. 83 (Supp. 2001).

178. *Id.*

179. See Larry E. Ribstein, *The Revised Uniform Partnership Act, Not Ready for Prime Time*, 49 BUS. LAW. 45, 54-55 (1993).

180. REV. UNIF. P’SHP ACT § 404 (amended 1997), 6 U.L.A. 83 (Supp. 2001).

181. See Ribstein & Kobayashi, *supra* note 5, at 146-48 (discussing the potential of uniform law proposals to spur adoption of inefficient statutes).

182. See RIBSTEIN & KEATINGE, *supra* note 20, app. 9-1 (describing and tabulating statutes).

183. See BROMBERG & RIBSTEIN, *supra* note 9, § 16.07(a).

184. See UNIF. LTD. P’SHP ACT (2001) § 305 (describing limited duties of limited partners). The Comment to section 30 makes clear that “[t]he obligation of good faith and fair dealing is *not* a fiduciary duty, does not command altruism or self-abnegation, and does not prevent a partner from acting in the partner’s own self-interest.” *Id.*

duty contracts, discussed in the next Subsection, further mitigate problems under standard form provisions.

Questions concerning the consequences of centralization of management also arise regarding disclosure duties. It has been argued that, when ownership and management are separated, the non-managing owners should have relatively weak access to information to reflect their weak fiduciary duties regarding use of the information they obtain.¹⁸⁵ But it also could be argued that isolation from control creates a greater need for information and therefore justifies stronger information rights. Indeed, courts follow this approach when determining the applicability of the U.S. securities laws.¹⁸⁶

These questions are best resolved through firm-specific contracts that reflect variations concerning the potential for member abuse of information and through evolution of statutory default provisions in different states and business forms. For example, perhaps the information rights of limited partners, who are completely locked out of control by the limited partnership “control rule,” should differ from those of non-managing LLC members who are not similarly impeded. Even within a given business form there is room for several different approaches. Reflecting these uncertainties concerning the optimal rule, U.S. jurisdictions have shown remarkable variability regarding members’ information rights in LLC statutes.¹⁸⁷

2. Waiver of Fiduciary Duties

Whatever the statutory rules concerning fiduciary duties in partnership-type firms, they clearly should be, and essentially are, subject to contrary agreement.¹⁸⁸ There are strong policy reasons for permitting contractual tailoring of duties to particular relationships. Among other things, there may be considerable costs associated with empowering partners to sue under broad and ambiguous fiduciary duty rules.¹⁸⁹ The arguments against enforcement of fiduciary duty waivers are based mainly on the contracting parties’ inability to protect themselves against oppressive contracts or to foresee potential harm. These arguments should have no more traction in business association contracts than in contracts generally.¹⁹⁰

In any event, because partnerships, like other business associations, clearly are voluntary relationships, contracts inevitably will hold sway. If a state forbids waivers in one or more forms, the parties can contract for a different business form or type of

185. J. William Callison & Allan W. Vestal, “*They’ve Created a Lamb with Mandibles of Death*”: *Secrecy, Disclosure, and Fiduciary Duties In Limited Liability Firms*, 76 IND. L.J. 271 (2001).

186. These laws apply to the offer or sale of a “security,” the existence of which has been held to depend significantly on whether the investor’s participation in management was significant in producing the expected return. See generally Larry E. Ribstein, *Private Ordering and the Securities Laws: The Case of General Partnerships*, 42 CASE W. RES. L. REV. 1 (1991) (discussing the application of this case law to partnerships).

187. For a summary of LLC statutory variations, see Callison & Vestal, *supra* note 184, at 287-91. Callison and Vestal demonstrate significant jurisdictional variation despite the existence of a uniform law and condemn that law’s approach. *Id.* at 279-80. Oddly enough, they nevertheless advocate that this issue be dealt with in uniform laws. *Id.* at 291-92.

188. See Ribstein, *supra* note 23.

189. See Larry E. Ribstein, *Law v. Trust*, 81 B.U. L. REV. 553, 577-79 (2001).

190. See generally Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 WASH. L. REV. 1 (1990); Easterbrook & Fischel, *supra* note 171.

relationship, or for application of the law of another state. The issue, therefore, is not whether the law forbids fiduciary duty waivers, but how costly it makes them.

Delaware has taken the lead in enacting legislative provisions that explicitly permit contracting around partnership-type fiduciary duties. These provisions first entered Delaware's limited partnership act,¹⁹¹ and now are also found in Delaware's LLC¹⁹² and general partnership¹⁹³ acts. Several LLC statutes provide for broad power to waive fiduciary duties.¹⁹⁴ Courts have interpreted these provisions expansively to give full range to freedom of contract, subject to reasonable interpretation of fiduciary duty provisions, including general contractual good faith duties.¹⁹⁵ A few other states also permit full waiver of fiduciary duties in partnership-type limited liability firms.¹⁹⁶

Should statutes give parties the same freedom to waive fiduciary duties in all types of partnership-type firms? One might argue that there should be more stringent limits on contracting in general partnership—which is the default form for very informal firms—than in LLCs and limited partnerships that require a filing and are usually done with the advice of counsel. On the other hand, because fiduciary duties may be inappropriate for closely held, owner-managed general partnerships,¹⁹⁷ restrictions on waiver may be most costly for such firms. Again, these issues arguably are appropriate for resolution in the state law laboratory. If, despite competition among forms, firms continue to form partnerships that are subject to anti-waiver rules, this provides some evidence that firms forming general partnerships prefer to be bound by restrictions on waiver.¹⁹⁸

A corollary to the point that partnership fiduciary duties are essentially contractual and subject to testing and evolution through competition and variation in state laws is that any excessive or inadequate fiduciary duties are attributable to restrictions on competition and variation. For example, attorney ethical rules in the United States are not subject to competitive forces.¹⁹⁹ In particular, ethical rules constrain law firms from restricting opportunistic exit and competition,²⁰⁰ thereby leading to the sort of conduct Professor Hillman condemns in his article for this Symposium.²⁰¹

3. Enforcement of Duties

Partners have rights against the partnership for their shares of profits or other compensation and indemnification, and against individual partners for contribution toward partnership losses or for damages for breach of fiduciary duty. U.S. law

191. See *supra* note 59 and accompanying text; see also Ribstein, *supra* note 60.

192. DEL. CODE ANN. tit. 6, § 18-1101 (1999).

193. See *id.* § 15-103(b)(8).

194. See RIBSTEIN & KEATINGE, *supra* note 20, app. 9-1.

195. See BROMBERG & RIBSTEIN, *supra* note 9, § 16.07(h)(5); RIBSTEIN & KEATINGE, *supra* note 20, § 9.04, at 11 (Supp. 2001).

196. See BROMBERG & RIBSTEIN, *supra* note 20, § 8.103 (discussing general partnership provisions); RIBSTEIN & KEATINGE, *supra* note 20, app. 9-1 (tabulating LLC provisions).

197. See *supra* Part IV.E.1.

198. However, an informal firm that a court deems to be a partnership may not realistically be said to be choosing its business form or applicable law.

199. See Ribstein, *supra* note 94.

200. See Larry E. Ribstein, *Ethical Rules, Agency Costs and Law Firm Structure*, 84 VA. L. REV. 1707, 1735-38 (1998) (discussing how these restrictions may injure clients).

201. See Hillman, *supra* note 94, at ____.

traditionally held that partners could not enforce these rights except in an action called an “accounting,” generally brought on dissolution, that resolves all of the partner’s rights and obligations in a single proceeding.²⁰² However, some cases recognized partners’ rights to sue without an accounting,²⁰³ and RUPA explicitly permits partners to use nonaccounting actions to enforce partnership rights.²⁰⁴

Although the RUPA approach seems sensible, it is not free from doubt. Given the potential for litigation to disrupt the partnership relationship, the partnership default rule arguably should restrict such suits until global resolution on dissolution and winding up, when there is no more relationship to preserve.²⁰⁵ That seems particularly logical in the very closely held general partnership. However, in firms with centralized management, partner suits may be needed as a way to police the firm’s agents. Once again, this issue is appropriate for resolution in the laboratory of state laws. There is, in fact, variation among the states, particularly regarding explicit recognition of derivative suits in LLCs.²⁰⁶

F. Dissociation and Dissolution

As with other partnership issues, there is a range of policy choices regarding partner exit from the firm. On the one hand, given the restricted transferability of and limited market for partnership interests, partners need to be able to either dissolve the firm or sell interests back to the firm (or the other partners) in order to have a viable ability to exit the firm. Partner exit rights give partners control over their investments and thereby constrain co-partners’ opportunism more effectively than the weaker powers to vote or to sue for co-partner misconduct.²⁰⁷ Moreover, the stronger the partners’ ownership rights in the firm’s assets, the stronger their incentives to participate in developing these assets.²⁰⁸ On the other hand, partner exit rights invite opportunistic conduct in the form of withdrawing property that is the product of joint investment, or threatening to do so in order to extort a payoff from their co-partners. This risk of opportunism, in turn, dilutes the partners’ incentives to invest in the firm.²⁰⁹ In general, the problem is one of finding the appropriate balance between these costs of exit and of continuity.

Partnership law in the United States began with the single UPA rule that each partner can dissolve the firm at will, even if contrary to the partnership agreement.²¹⁰ This sort of strong exit rule is appropriate for very closely held firms that consist of particular individuals making unique contributions and that change fundamentally when

202. See BROMBERG & RIBSTEIN, *supra* note 9, § 6.08(c) (discussing accounting “exclusivity” rule).

203. The leading case is *Sertich v. Moorman*, 783 P.2d 1199 (Ariz. 1989).

204. REV. UNIF. P’SHIP ACT § 405 (amended 1997), 6 U.L.A. 87-88 (Supp. 2001).

205. See Saul Levmore, *Love It or Leave It: Property Rules, Liability Rules, and Exclusivity of Remedies in Partnership and Marriage*, 58 LAW & CONTEMP. PROBS. 221 (1995).

206. See RIBSTEIN & KEATINGE, *supra* note 20, app. 10-1 (tabulating statutes).

207. See Levmore, *supra* note 204, at 237-39.

208. See generally Stephan J. Grossman & Oliver D. Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, 94 J. POL. ECON. 691 (1986).

209. For discussions of the opportunism problem in closely held firms, see Larry E. Ribstein, *A Statutory Approach to Partner Dissociation*, 65 WASH. U. L.Q. 357 (1987); 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).

210. See UNIF. P’SHIP ACT §§ 31, 38 (1914), 6 U.L.A. 771, 880 (1995).

one individual leaves. However, the rule probably does not suit many partnerships that want rules that encourage the partners to stay.²¹¹ Partners always have been able to contract around the UPA default rule by entering into a partnership agreement in which they agree to continue the firm notwithstanding a partner's exit.²¹² The UPA also provides a kind of default continuation agreement for partners who agree to a partnership for a particular term or undertaking, pursuant to which the leaving partner must pay damages and is not entitled to share in the goodwill of the continuing firm.²¹³ Under either type of agreement, partner dissociation would cause only a technical dissolution after which the business of the firm would continue. But these agreements may not provide enough continuity for many firms because strong default exit rules may be traps lying in wait for partners who have neglected to provide for continuity in a particular situation. Moreover, even a technical dissolution may raise questions concerning the continuity of the partnership's rights and obligations in contracts with third parties.²¹⁴

RUPA eliminates even technical dissolution in the event of certain types of partner dissociation, as where the partner dissociates wrongfully or by death or bankruptcy²¹⁵—the sorts of sudden departure where forcing buyout or liquidation can wreak the most havoc. Thus, the states now offer a choice between UPA and RUPA exit rules.²¹⁶

Even more importantly, states have developed additional variations through LLC and limited partnership statutes. In particular, some statutes have eliminated not only default dissolution upon member dissociation, but also the right to dissociate, meaning that members can take their services elsewhere, but may not be able to remove their investments from the firm.²¹⁷ This evolution was driven to some extent by the federal tax law changes that allowed much more flexibility in the types of firms that are entitled to elect partnership-type taxation.²¹⁸ It has also been affected by estate tax laws that impose higher taxes on interests in firms governed by state laws that provide by default for liquidation on partner dissociation.²¹⁹

Has state competition produced an optimal mix of exit rules? Eliminating partners' default exit right swings the pendulum toward permitting oppression of locked-in partners. Indeed, close corporations were long plagued by such problems, which triggered complex and unpredictable judicial remedies to relieve minority oppression.²²⁰ The application of estate tax rules irrespective of the rights provided for in the agreement may have encouraged legislatures to provide for a higher level of default continuity than would have been the case apart from tax considerations. State competition and evolution arguably produced an optimal mix of rules if tax considerations are taken into account.

211. See Ribstein, *supra* note 209.

212. See BROMBERG & RIBSTEIN, *supra* note 9, § 7.13.

213. UNIF. P'SHIP ACT §§ 31, 38 (1914), 6 U.L.A. 771, 880 (1995).

214. See BROMBERG & RIBSTEIN, *supra* note 9, § 7.14(b) (discussing effect of dissolution on partnership's executory contracts).

215. REV. UNIF. P'SHIP ACT § 801 (amended 1997), 6 U.L.A. 108 (Supp. 2001)

216. See BROMBERG & RIBSTEIN, *supra* note 20, ch. 8 (summarizing state variations on RUPA provisions).

217. See BROMBERG & RIBSTEIN, *supra* note 9, § 17.01(c) n.19 (listing limited partnership provisions); RIBSTEIN & KEATINGE, *supra* note 20, app. 11-1 (tabulating LLC statutes).

218. See *supra* Part III.C.2.

219. See RIBSTEIN & KEATINGE, *supra* note 20, ch. 18.

220. See generally RIBSTEIN & LETSOU, *supra* note 57, § 5.05(c).

G. Switching and Changing Forms

The many new forms that have been developed, and the changes within forms discussed above, raise problems as well as benefits. The basic issue is how to balance the benefits of legal evolution against the need to protect the rights of parties who are caught up in the changes.²²¹

To begin with, the proliferation of standard statutory forms creates a need for procedures that simplify the task of moving from one form to another. The traditional method in a general partnership was to dissolve and liquidate the firm, triggering tax and other costs of discontinuity. But the states have reduced switching costs by providing merger and conversion procedures that allow partnerships to combine with or become other types of entities without dissolving.²²² This promotes legal evolution by encouraging existing firms to move to the new forms. On the other hand, the ability to switch easily into limited liability forms may hurt third party creditors of the original business, among others.

This raises the broader topic of the effect of changes within statutory forms. Again, while these changes are an inherent part of the beneficial evolution described above, they may frustrate the expectations of those who have relied on the existing rules. For example, members or partners may have relied on dissolution and dissociation at will, and therefore may be hurt by changing the rules to restrict these rights.

Case law applying common law creditor-protection rules or the contract clause of the U.S. Constitution²²³ may protect parties' expectations. The problem with these approaches, however, is that they are applied ex post by courts, and therefore may frustrate the expectations of some parties while attempting to protect those of others. Here, too, it is worth considering what the laboratory of state laws might accomplish regarding, for example, rules specifying prospective application of changes in dissociation and dissolution provisions.

H. The Limits of Variation in Business Forms

How many different business forms should there be? Here, too, important policy choices lie along a spectrum and are best addressed through state law competition and variation. There are costs to "linking" business forms or adopting "unified" business entity laws and thereby foregoing the advantages of facilitating regulatory arbitrage and providing different business rules to suit different types of firms.²²⁴

On the other hand, linkage does have the important benefit of permitting firms to use case law, customs, and forms associated with both of the linked forms that aid in the application and interpretation of the statute and private agreement, thereby encouraging the development and use of new business forms.²²⁵ The greater the number of forms, the greater are owners' and third parties' information costs of selecting and dealing with firms, and the less the potential for standardization and development of private forms and

221. See Larry E. Ribstein, *Changing Statutory Forms*, 1 J. SMALL & EMERGING BUS. L. 11 (1997), reprinted in 39 CORP. PRAC. COMMENTATOR 703 (1998).

222. See RIBSTEIN & KEATINGE, *supra* note 20, § 11.16.

223. See *supra* note 14 and accompanying text.

224. See Larry E. Ribstein, *Making Sense of Entity Rationalization*, 58 Business Lawyer 1023 (2003).

225. See Ribstein & Kobayashi, *supra* note 86; Ribstein, *supra* note 165.

case law interpretations. This suggests that standard forms should not provide every feasible combination of default rules.

Because the current menu of choices has emerged from substantial state competition and evolution over the past few years, there is reason to believe that it efficiently reflects firms' needs. However, from a theoretical standpoint there is an additional option the states might consider—an open-ended “contractual entity” that enables firms to have the advantage of limited liability without having to confine themselves to an existing set of default rules.²²⁶ This device might “incubate” new standard forms by encouraging parties to enter into new types of contracts.

V. IMPLICATIONS OF THE ANALYSIS

The above analysis holds lessons for statutory law development, including those underway in Europe. Most importantly, this Article demonstrates the benefits of “horizontal” jurisdictional competition to facilitate market-testing, variety, and evolution of laws. In this respect, the United States may have an inherent advantage over individual European countries where there are no significant subordinate political entities. 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.”²²⁷ In other words, federal systems are likely to beat unitary jurisdictions in international competition.

The U.S. model also might work for Europe as a whole. The disappearance of international trade barriers may reduce the significance of whether countries are allied in a U.S.-style federal system. This suggests that the best path for Europe is to facilitate competition regarding business association laws rather than eliminating competition through “harmonization.” To the extent that centralizing law-drafting functions is desirable, it can be best accomplished through promulgation of “model” laws rather than by compelling uniformity through federal mandates.²²⁸

There may be, however, significant differences between Europe and the United States that prevent the development of U.S.-style competition in Europe. This difference is not constitutional, because there may be a firmer constitutional basis for jurisdictional competition in post-*Centros* Europe than in the United States.²²⁹ Rather, inherent legal, cultural, language, historical and other differences among European countries may play a greater role in constraining firms' ability to choose from among different jurisdictions. Also, jurisdictional competition in Europe must overcome the “real seat” choice of law rule, which *Centros* has not necessarily displaced.²³⁰ Moreover, lawyers may not be able to take the lead in law reform in Europe as they have in the United States²³¹ because of differences between lawyers' role and the structure of the bar in the two contexts. All of

226. See generally Larry E. Ribstein, *Limited Liability Unlimited*, 24 DEL. J. CORP. L. 407 (1999).

227. Barry Weingast, *The Economic Role of Political Institutions: Market-Preserving Federalism and Economic Development*, 11 J.L. ECON. & ORG. 1, 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), in FRIEDRICH HAYEK, *INDIVIDUALISM AND THE ECONOMIC ORDER* ch. 12 (1948).

228. See Ribstein & Kobayashi, *supra* note 91.

229. See *supra* Part III.A.

230. See text accompanying *supra* note 3.

231. See *supra* text accompanying note 47.

this is not to say that jurisdictional competition cannot arise in Europe. For example, LLP legislation in England apparently was provoked by competition from Jersey.²³² Moreover, the *Centros* line of cases may bring the end of the real seat rule as new firms establish in the United Kingdom to avoid the rule.²³³ However, jurisdictional competition in Europe may never take the full-fledged U.S. form.

These differences suggest that it may be appropriate to design legal rules to compensate for the reduced feasibility of competition in the European context. These rules might mimic competition by providing for menus of business features within individual statutes.²³⁴ Although a menu offered by a single lawmaker is not equivalent to jurisdictional choice, menus may be a viable, second-best alternative to facilitate adaptation and variation given inherent constraints on jurisdictional competition.

Europe may differ from the United States not only in terms of the competitive dynamic, but also in terms of the optimal rules and, therefore, the likely outcome of an efficient competition. In particular, there may be less need for limited liability for small firms given the reduced threat of tort liability in Europe as compared to the United States. The growth of limited liability in the United States may be partly attributable to the revolution in tort liability.²³⁵ In Europe, by contrast, limited liability in small firms arguably adds little protection because owners of small firms would be liable for their own acts in any case, and most of their remaining business and personal liability would be insurable or subject to limitation by contract.²³⁶

VI. CONCLUDING REMARKS

As this Article shows, enforcing jurisdictional choice can have profound benefits for the evolution of business law. Because humans cannot accurately foresee and provide for the future, a market-oriented evolutionary process is preferable to government-imposed rules. Markets, not governments, have the wisdom necessary to guide firms in an uncertain world. Thus, policymakers should be wary of top-down planning and the hegemony of theory untested in the markets. Policy reform should focus on the mechanisms of legal evolutions and markets for law rather than on the substantive provisions of business law. These lessons have important implications for Europe as it enters the post-*Centros* age.

232. See McCahery & Vermeulen, *supra* note 55, at ___ n.63.

233. See Marco Becht, Colin Mayer & Hannes F. Wagner, *Corporate Mobility and the Costs of Regulation*, ECGI - Law Working Paper No. 70/2006, available at <http://ssrn.com/abstract=906066> (finding an increase in UK incorporations of firms not physically located in the UK, mostly coming from other EU countries subject to the *Centros* rule).

234. A menu approach has been recommended for the American system to deal with the supposed problems created by network externalities. See Klausner, *supra* note 50. However, network externalities probably do not impede jurisdictional competition in the United States sufficiently to justify reliance on this method there. See *supra* note 86 and accompanying text.

235. See *supra* Part IV.A.1.

236. See *Williams v. Natural Life Health Foods Ltd.*, 1 W.L.R. 830, 2 All E.R. 577 (1998), in which the House of Lords held that an employee of a limited company was not personally liable for his own negligent misstatement because, under *Hedley Byrne & Co Ltd. v. Heller & Partners Ltd.*, there was an absence of reliance sufficient to create a special relationship between plaintiff and defendant that would justify liability for negligent misrepresentation. This is a contract-type privity argument that may not have held up against wide-open tort theories in the United States.

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