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ARE PARTNERS AGENTS?

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Abstract

Partners have been characterized as agents of the partnership. But this is wrong to the extent that it implies that the law of agency should be applied to partnership. In fact, agency is a distinct set of default rules that apply to a particular type of relationship. Each business association has its own set of default rules that apply to a specific type of relationship. It follows that the commentary of the Restatement (Third) of Agency may be misleading to the extent that it implies otherwise by purporting to deal with partnership-type firms. Moreover, the Revised Uniform Limited Liability Company Act is particularly misguided in dispensing with agency rules and implicitly importing the law of agency into the law of limited liability companies. Similar principles apply to corporate law and the relationship among the shareholders, the corporation and the board of directors.

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Partnership statutes provide that a partner is an agent of the partnership,¹ and this is indeed the common understanding. This principle applies to other types of partnership-type unincorporated entities. Limited liability company statutes generally provide that managers of manager-managed LLCs and all members of member-managed firm are agents of the LLC.² Limited partnership statutes provide that general partners in limited partnerships are subject to partnership rules.³ By contrast, corporation statutes do not take a position on whether shareholders or executives are agents of the firm.⁴

¹ See UPA §9(1) (1914); RUPA §301(a) (1997).

² See ULLCA §301(a)(1).

³ See RULPA §403 (1985) (providing that a general partner of a limited partnership has the rights and powers of a general partner in a general partnership); ULPA (2001) §402 (a) ("general partner is an agent of the limited partnership for the purposes of its activities").

⁴ See, e.g., *Lee v. Jenkins Bros*, 268 F.2d 357 (2d Cir.), cert. denied, 361 U.S. 913 (1959) (applying agency principles in determining the authority of corporate executive to bind the corporation).

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These rules create an opportunity for confusion. If general partners and managing members are agents, does this mean that the law of agency applies to those parties? If so, what is the role of partnership and LLC statutory and case law, which provides potentially different and conflicting results? Does the absence of special corporate statutory provisions defining the agency role of corporate actors mean that those actors are agents in some purer sense than their counterparts in partnerships? If so, why?

This conceptual puzzle has recently taken on particular importance with the promulgation of the Revised Uniform Limited Liability Company Act ("RULLCA"). RULLCA provides:

(a) A member is not an agent of a limited liability company solely by reason of being a member.

(b) A person's status as a member does not prevent or restrict law other than this [act] from imposing liability on a limited liability company because of the person's conduct.⁵

The RULLCA official comments suggest that existing agency law answers the question formerly answered by the statute, and indicate the results under agency law in some illustrative cases, referring to the Restatement (Third) of Agency.⁶ Because RULLCA both removes specific statutory provisions dealing with agency-type issues and suggests that agency law may apply in determining these issues, RULLCA will require lawyers, courts and commentators to confront the relationship between agency and partnership.

This article provides a first cut at the necessary analysis. It shows that, contrary to accepted wisdom, partnerships and partnership-type relationships are *not* in themselves agency relationships in the sense of being subject to the standard form provided by agency law. The laws relating to these business associations, like corporate laws, define relationships that are distinct from the agency relationship outlined in Restatement (Third) of Agency. While these standard forms all address the same basic issues of power, duty and liability, they provide different answers.

To be sure, the law of agency potentially *applies to* partnership-type business associations just as it does to all individuals and legal entities in determining the relationships between firms and third parties. In the absence of statutory provisions defining the power of particular parties to bind the firm, background agency rules would provide the applicable rules. But these statutes generally do, in fact, provide rules governing members' and partners' power to bind the firm. And this is the appropriate result since the rules should be designed for the specific business association rather than for the agency relationship.

It follows that RULLCA is fundamentally flawed in suggesting that other rules, including agency, should determine members' powers to bind the firm as such and as managers. Because a limited liability company differs from a common law agency relationship, the rules that RULLCA omits ought to play an important role in defining the

⁵ Revised Uniform Limited Liability Company Act (2006), §301, available at http://www.law.upenn.edu/bll/archives/ulc/ullca/2006act_final.htm.

⁶ See *id.* Comments to §§301 and 407.

power of LLC members and managers. By leaving a gap for agency to fill, RULLCA in effect inappropriately combines what should be the distinct standard forms of the agency relationship and the limited liability company.

The implications of this analysis extend beyond the agency power of partners and LLC members. They also relate, among other things, to partners' vicarious liability for their co-members' acts, the fiduciary relationship among partners and members, and dissolution of the partnership. The analysis also relates to corporate issues for which courts and commentators have drawn mistakenly on agency, including the power of corporate directors and piercing the veil.

The article proceeds as follows. Part I discusses the central theory that motivates this analysis – that of the function of statutory and common law standard forms. Part II discusses the range of distinct standard forms and the need for specific rules relating to each. Parts III through VI relate this paper's analysis to the business association issues discussed immediately above. Part VII extends the analysis to issues relating to corporations.

I. THE FUNCTION OF STANDARD FORMS

Agency is best viewed as a particular type of standard form relationship. This means that the rules governing agency are designed to fit the types of relationships that the law defines as agency. As discussed below in Part II, corporations and partnership-type firms can be viewed as alternative types of standard forms. Before exploring the specifics of these alternatives, it is useful to consider the functions of specific standard forms.⁷

In general, standard forms provide sets of default terms that suit different types of firms. With many different types of standard forms from which to choose, parties can pull a set of standard form rules off the shelf that fits their relationship. This, in turn, enables the parties to reduce costs otherwise spent on customized contracts.

It follows from this transaction-cost-reducing function of standard forms that the value of a standard form depends on whether it includes a *coherent* set of rules – that is, terms that complement each other rather than being redundant or conflicting. For example, owners' strong management rights are consistent with giving these owners the power to bind the firm in transactions with third parties. These rights may be consistent with giving members the unilateral power to dissolve their relationship to free themselves from co-members they no longer trust. Also, strong fiduciary duties may not be necessary if the members have the power to protect themselves.

A coherent standard form can serve several functions in addition to reducing the parties' contracting costs. First, it can assist courts and regulators in interpreting the parties' contract and in applying regulatory statutes. A court may be able to infer the parties' expectations from the nature of the standard form they have selected. For example, given general partners' strong powers and vicarious liability, a court may not be willing to assume that the partners have contracted away management and control powers

⁷ See generally, Larry E. Ribstein, *Statutory Forms for Closely Held Firms: Theories and Evidence from LLCs*, 73 Wash. U. L. Q. 369 (1995).

if the agreement is unclear. However, the court may reach a different conclusion under similar facts in a limited partnership. Also, there may be different consequences for standard form partnerships than for corporations under regulatory statutes such as securities⁸ and employment discrimination laws.⁹

Second, multiple standard forms can assist the evolution of legal rules. The availability of multiple forms enables parties and firms to, in effect, "arbitrage" among forms by choosing the applicable regulation or tax. For example, the availability of both limited partnership and LLC statutes helped parties break down artificial tax barriers among entities embodied in the classification rules. The parties can experiment with various types of provisions and entities and observe which emerge as the most widely used, and how different approaches suit different needs.

In light of the benefits of multiple standard forms, courts and legislatures should be careful about linking two or more forms.¹⁰ Although linkage may have the advantage of increasing the pool of cases and other interpretive materials available to each form, it also carries the drawback of reducing the distinctiveness of each form, and thereby its ability to perform the functions discussed above.

The value of distinct standard forms means that even if an agency relationship is analogous to and performs the same functions as other business associations, the relationships should be kept separate.

II. THE AGENCY STANDARD FORM

This part discusses the important differences between agency and partnership-type firms that have been loosely, and incorrectly, referred to as agency relationships.

An agency relationship is defined as "the fiduciary relationship that arises when one person (a "principal") manifests assent to another person (an "agent") that the agent shall act on the principal's behalf and subject to the principal's control, and the agent manifests assent or otherwise consents so to act."¹¹

There are four important aspects of this definition:

1. Agency is *defined* as a "*fiduciary relationship*." Thus, it is not merely the case that agents *may* be fiduciaries, but that if they are *not* fiduciaries they are also not agents.

2. An agent by definition acts *on the principal's behalf*. It follows that an agent does not, as such, act on her own behalf.

⁸ See Larry E. Ribstein & Robert Keatinge, RIBSTEIN & KEATINGE ON LIMITED LIABILITY COMPANIES, §§14.02-14.03; See Larry E. Ribstein, *Form and Substance in the Definition of a "Security": The Case of Limited Liability Companies*, 51 WASH. & LEE L. REV. 807 (1994); Larry E. Ribstein, *Private Ordering and the Securities Laws: The Case of General Partnerships*, 42 CASE WEST. RES. L. REV. 1 (1991).

⁹ *Id.* §14.05.

¹⁰ See Larry E. Ribstein, *Linking Statutory Forms*, 58 J. Law & Contemp. Prob. 187 (Spring, 1995) (discussing the costs and benefits of linkage).

¹¹ Restatement (Third) of Agency, §1.01.

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3. The agent acts "*subject to the principal's control.*" Although the agent likely has significant management power, which is what makes the agent a fiduciary, this power is ultimately subject to the principal's control.

4. Agency arises only when the agent "*manifests assent or otherwise consents so to act.*" In other words, one who manifests assent or otherwise consents to a relationship in which she will act to some extent on her own behalf or in which she is not ultimately subject to another's control is not an agent.

There are important differences between agency under this definition and partnership or partnership-type relationships:

1. The relationship between partners is not necessarily, and indeed often is not, fiduciary in character.¹²

2. Partners are by definition *co-owners*.¹³ As an owner, the partner acts on her own behalf. While this does not entitle the partner to disregard the other partners' interests, this is not, like agency, a relationship in which one party dedicates her efforts to another's interests.

3. Partners, by default, have "*equal rights*" in managing the business¹⁴ rather than, like agents, being "subject to the principal's control."

4. One who agrees to these terms is obviously not agreeing to be subject to the rules of agency.

Other partnership-type firms that involve co-ownership and co-management also are not agency relationships. Limited partners and the typical member of a manager-managed LLC have no management rights and therefore are clearly not fiduciaries, at least when they are acting as limited partners or members. General partners and managing members may be fiduciaries vis a vis the limited partners or non-managing members, but they have the above characteristics of general partners among themselves.

III. APPARENT AND ACTUAL AUTHORITY

This Part discusses the implications of the above analysis for the immediate issue in the agency characterization of partnerships raised by the RULLCA approach – that is, the application of the law of agency in determining the power of partners and LLC members and managers to bind the firm.

A. GENERAL CONSIDERATIONS

The power of a partner to bind the partnership has been described as follows for at least the last century:

Every partner is an agent of the partnership for the purpose of its business, and the act of every partner. . . for apparently carrying on in the usual way the business of the partnership of which he is a member binds the partnership, unless the partner

¹² See Larry E. Ribstein, *Are Partners Fiduciaries?* 2005 Illinois Law Review 209.

¹³ UPA §6(1) (1914); RUPA §101(6), 202(a) (1997).

¹⁴ UPA §18(e) (1914); RUPA §401(f) (1997).

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so acting has in fact no authority to act for the partnership in the particular matter, and the person with whom he is dealing has knowledge of the fact that he has no such authority.¹⁵

Conversely, "[a]n act of a partner which is not apparently for the carrying on of the business of the partnership in the usual way does not bind the partnership unless authorized by the other partners."¹⁶ Similar provisions are in RUPA¹⁷ and LLC statutes.¹⁸ This also describes the power of a general partner in a limited partnership¹⁹ and the manager of a manager-managed LLC.²⁰

Deborah DeMott has said that "Section 9(1) combines two basic concepts of agency law, actual and apparent authority."²¹ The Restatement defines these terms as follows:

An agent acts with actual authority when, at the time of taking action that has legal consequences for the principal, the agent reasonably believes, in accordance with the principal's manifestations to the agent, that the principal wishes the agent so to act.²²

Apparent authority is the power held by an agent or other actor to affect a principal's legal relations with third parties when a third party reasonably believes the actor has authority to act on behalf of the principal and that belief is traceable to the principal's manifestations.²³

An agent's power under these provisions depends on an efficient allocation of costs between the principal and the third party. Where the principal's manifestations cause an agent (actual authority) or third party (apparent authority) to act, the costs of any mistake are best placed on the principal as the cheaper cost avoider. Conversely, the principal is not the cheaper cost avoider and therefore does not bear the loss where it has not made such a manifestation either to the agent or the third party.

A similar notion underlies the partnership formulations. If a partner is apparently carrying on the partnership business, a third party reasonably can assume the partner's act binds the firm, and it should be up to the firm as the cheaper cost avoider to communicate any limitations. The converse is true if the act is not apparently for carrying on the partnership business.

¹⁵ UPA §9(1).

¹⁶ *Id.* §9(2).

¹⁷ See RUPA §301.

¹⁸ ULLCA §301(a)(1).

¹⁹ See RULPA §403 (1985); ULPA (2001) §__.

²⁰ ULLCA §301(b)(1).

²¹ Deborah A. Demott, *Our Partners' Keepers? Agency Dimensions of Partnership Relationships*, 58 *Law and Contemporary Problems* 109, 111 (Spring 1995).

²² Restatement (Third) of Agency, §2.01.

²³ Restatement (Third) of Agency, §2.03.

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While the Restatement and UPA formulations have similar foundations, they differ in application. A partner who acts apparently in the usual partnership business *necessarily* binds a partnership whether or not she reasonably believed that the partners wished her so to act, whether or not a third party reasonably believed that the partner had authority, and whether or not any such belief was "traceable to the principal's manifestations." Under the UPA the partner's act may be binding even if the third party had facts alerting a reasonable person that the co-partners did not authorize the act as long as the third party did not *know* the partner lacked authority.²⁴ RUPA only partly closes the gap between partnership and agency by providing that the act is not binding if the third party "received a notification that the partner lacked authority."²⁵ This makes authority turn on the specific act of giving a notification that is received,²⁶ instead of all of the circumstances that contribute to a third party's reasonable belief under the Restatement.

A partner's power to bind the firm is really "inherent authority" – that is, power that inheres in the position of being partner. As Professor DeMott explains, inherent agency power "imputes the agent's acts to the principal even when the plaintiff's reasonable belief in the agent's authority is in some sense mistaken." She cites *Croissant v. Watrud*,²⁷ in which an accounting firm was bound by the acts of a partner in collecting and disbursing funds notwithstanding its argument that accountants generally did not offer such services to their client, so that this was not apparently usual for an accounting business. Under this approach, the position itself, and not the specific circumstances, creates the requisite manifestation.

The cheaper cost avoider analysis does not entirely explain a partner's positional power under this rule. Even if the mistaken partner acted within the usual scope of the business, the third party rather than the partnership may be the cheaper cost avoider if she knows facts that indicate the action was unauthorized. Thus, it is not clear why the presumption of authority should be conclusive. Conversely, the partnership is not bound by acts that are not apparently within the scope of the business unless the co-partners have given actual authority, even if the third party had information indicating that the partners authorized the act.

Indeed, the Second Restatement clarified the conceptual basis of such liability along different lines from the usual rationale for apparent and actual authority. The Second Restatement provides:

Inherent agency power is a term used in the restatement of this subject to indicate the power of an agent which is derived not from authority, apparent authority or

²⁴ See UPA §9(1) (1914) (providing that the act is not binding if the third party "has knowledge of the fact that [the partner] has no such authority").

²⁵ RUPA §301(1).

²⁶ See *id.* §102.

²⁷ 432 P.2d 799 (Or. 1967).

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estoppel, but solely from the agency relation and exists for the protection of persons harmed by or dealing with a servant or other agent.²⁸

A comment to the section explains:

Partnerships and corporations, through which most of the work of the world is done today, depend for their existence upon agency principles. The rules designed to promote the interests of these enterprises are necessarily accompanied by rules to police them. It is inevitable that in doing their work, either through negligence or excess of zeal, agents will harm third persons or will deal with them in unauthorized ways. It would be unfair for an enterprise to have the benefit of the work of its agents without making it responsible to some extent for their excesses and failures to act carefully. The answer of the common law has been the creation of special agency powers or, to phrase it otherwise, the imposition of liability upon the principal because of unauthorized or negligent acts of his servants and other agents. These powers or liabilities are created by the courts primarily for the protection of third persons, either those who are harmed by the agent or those who deal with the agent. In the long run, however, they enure to the benefit of the business world and hence to the advantage of employers as a class, the members of which are plaintiffs as well as defendants in actions brought upon unauthorized transactions conducted by agents.²⁹

In other words, the firm should bear the liability as a repeat player because it benefits over the course of many transactions from the reliance of third parties on the acts of the firm's agents, even if the particular act generating liability in the instant case did not benefit the firm. The problem with this rationale is that it is overbroad in that it can justify holding the firm liable for everything its agents do. More likely the cheaper cost avoider idea will constrain inherent agency power liability at the edges. But it remains the case that an agent's inherent power might extend beyond the actual or apparent authority of an agent who lacks inherent power.

General dissatisfaction with the inherent authority concept and its uncertain status in the courts has led the drafters of the Third Restatement to junk the concept. A Note to the Restatement states:

[T]his Chapter, like the remainder of this Restatement, does not use the concept of inherent agency power stated in Restatement Second, Agency § 8 A. Situations that inherent agency power is said to govern are covered by other doctrines, as explained specifically where relevant.³⁰

Thus, *agency* principles for binding a firm are limited to actual and apparent authority as defined in agency law. Other bases for setting the limits of a person's power to bind the firm in transactions with third parties must come from other bodies of law, including other business association standard forms.

²⁸ Restatement (Second) of Agency, §8A.

²⁹ *Id.* Comment a.

³⁰ Restatement (Third) of Agency, Chapter 2, Introductory Note.

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There are several reasons why the internal structure of a firm set forth in the standard form should determine a member or manager's power to bind the firm, and in particular why a partner should have inherent power to bind the firm within the apparent scope of the business. First, the member's status as an owner affects the member's costs and benefits of transactions entered into on behalf of the firm. The greater the member's incentives as co-owner to avoid improvident transactions, the lower the potential agency costs from separating ownership and control. The lower the agency costs, the more likely that the principal will be in a better position than a third party to protect against harm caused by an errant agent. This supports holding the firm liable for all acts within the apparent scope of the partnership even in the absence of apparent authority.

Second, the firm's liability may depend on members' ability to terminate their direct or indirect responsibility for the acting member's contracts and torts. A principal generally can terminate at will the acting member's agency power under the general law of agency. The principal's power to protect herself from an errant agent is a factor to be taken into account in determining the cheaper cost avoider as between the principal and third party. A firm's internal governance determines the extent to which the owners can terminate their responsibility for acts of owners and non-owner agents. A partnership may not be able to unilaterally terminate a partner's power to bind the firm by expelling the partner in the absence of an expulsion power in the agreement. A partner theoretically can terminate her individual direct or indirect responsibility for a co-partner's act by dissociating from the firm. By extension, all of the partners could dissociate from the firm. However, partners' power to dissociate is constrained by their ability to get paid for their interests and by the potential costs of terminating the firm. Accordingly, the partners' practical ability to terminate mutual agency power ultimately depends on the internal rules of the business association and on the balance these rules strike between continuity and exit.³¹ Given the potential costs of terminating the firm's responsibility for members' acts, it arguably follows that partners and the partnership should be bound only by a partner's acts within the scope of the business the partners undertook to join, and not for acts outside that scope that are nevertheless apparently authorized under general agency law.

Third, the rules in the business association affect third party expectations. Given the significant role of each member in a general partnership, a third party may expect that member to be able to bind the firm. Specific facts as to the member's power in the particular firm must be weighed against that general expectation. The third party's expectation may be lower in centrally managed general partnerships, limited partnerships, and manager-managed LLCs, but there may be variations among these forms as well. Also, the statutory rules regarding the relevant firms explicitly deny limited partners and members of manager-managed LLCs the inherent power to bind the firm. Again, these results follow from the structure of the particular business associations as provided in the statutory default rules, rather than from the general law of agency. The structure provides a way for the firm to signal limitations on authority to third parties.

In short, the nature and default rules of the firm determine the scope of a member's power to bind it, not the transaction-specific facts emphasized in the rules on

³¹ See *infra* Part VI.

apparent and actual authority. In other words, a firm's member binds the firm in transactions with third parties as a member of a type of business association, not as an agent in the more generic relationship defined by the law of agency. To be sure, not all of the nuances suggested by the above analysis are reflected in the statutory rules. But the firm-specific statutory rules invite courts to take the context of the particular business association into account in defining partners' and members' authority rather than applying rules from other contexts. That is why it is misleading to label these as "agency" rules.

B. RULLCA

The observations in subpart A point to RULLCA §301's central problem. After correctly clarifying that members are not agents by virtue of their membership, RULLCA leaves the law in limbo regarding the extent of members' apparent authority to bind the firm. An LLC member is not an agent – she is a member. As such, she should have some inherent power to bind the LLC. It is up to the statute to specify how much power, perhaps by analogizing to partnerships as do most LLC statutes and ULLCA.³² By omitting default rules like those in general and limited partnership and LLC statutes, RULLCA gives the courts no guidance on how to proceed. They cannot draw on agency law because a limited liability company is a particular type of firm whose rules are provided by the governing statute and not by agency law. Agency law provides the questions but not the answers.

As discussed in subpart A, the statute also may deny agency power in situations where apparent authority otherwise might exist. Consider an LLC whose operating agreement provides for management by managers and that the manager is A.³³ Suppose another member, B, purportedly acts on behalf of the LLC in a particular transaction. The circumstances might support apparent authority under general agency law because the transaction is in the apparent scope of the firm's ordinary business and the member has acted on behalf of the firm in similar prior transactions. However, recognizing apparent authority here would undercut the statute's goal to permit the firm to centralize management power by denying authority to non-managing members.³⁴

The tension between general agency law and the LLC standard form might be resolved by looking to a reasonable third party's understanding of the limitations of non-managing members' authority in a manager-managed LLC. But what is the third party supposed to know? Suppose that although the LLC was operated as a manager-managed firm, its operating agreement did not include the appropriate manager-management

³² See ULLCA §301; Ribstein & Keatinge, *supra* note 8, App. 8-5 – 8-6.

³³ Note that it may not be obvious what the operating agreement provides. RULLCA does not require a written agreement and therefore permits oral or even implied operating agreements. See RULLCA, *supra* note 5, §102(13); Larry E. Ribstein, *An Analysis of the Revised Uniform Limited Liability Company Act*, U Illinois Law & Economics Research Paper No. LE07-027, available at <http://ssrn.com/abstract=1003805>, forthcoming 2008 Va. L. & Bus. Rev. Yet RULLCA §407(a) states that an LLC is manager-managed only if the operating agreement "expressly provides" that the operating agreement includes "manager-managed," "managed by managers," "vested in managers" or "includes words of similar import," whatever that means.

³⁴ *See id.*

language.³⁵ Now in order to align agency and LLC law it is necessary to make the statute say that anything that looks like a manager-managed LLC creates the requisite apparent authority. But then the third party would have to assume away the legislative intent to define distinct member-managed and manager-managed LLC governance structures.

To further complicate things, suppose, as RULLCA permits,³⁶ the operating agreement is oral. RULLCA, of course, does not formalize the choice of manager-managed or member-managed format by requiring designation in the filed articles because the designation supposedly does not matter in that agency law applies in either case. But merely by providing for a designation, RULLCA suggests that the designation matters. So we have a choice that may matter but is buried in an unwritten operating agreement. RULLCA's ambivalence about the role of centralized management accordingly may frustrate planning and increases litigation costs.

In short, having created a particular type of governance structure in which LLCs can choose between centralized and decentralized management, RULLCA needs to clarify how this structure determines a member's or manager's power to bind the firm. RULLCA cannot leave this task to agency law because the structure is inherent in LLCs, and is not a part of the general law of agency.

IV. VICARIOUS LIABILITY

General partners' personal liability for partnership debts seems to reinforce the agency nature of partnership to the extent that it makes partners analogous to principals as well as agents of the partnership and their co-partners. However, vicarious liability complicates rather than supports the agency characterization.

First, under modern partnership law, partners are not liable for partnership acts in the same sense that principals are. Most partnership statutes are modeled after the Revised Uniform Partnership Act, which provides that partners usually are personally liable only after the creditor has exhausted partnership assets.³⁷ Partners therefore are better characterized as guarantors of the firm's debts than as principals. The agency analogy is further diluted by the fact that partners' liability among themselves takes the form of a duty to contribute to the *firm* to make up any shortfall between the firm's assets and liabilities – *not* a duty to pay co-partners directly.³⁸ Thus, the partners do not resemble co-principals. This structure is consistent with the analysis in Part III that partners' power to bind the firm derives from the structure of particular business associations rather than from the general law of agency.

Second, to the extent that vicarious liability is consistent with the agency analysis, the argument is undercut by the application of limited liability not only to partnership-derived firms like LLCs and limited partnerships, but to partnerships themselves under LLP statutes.

³⁵ *See id.*

³⁶ *See* RULLCA §102(13).

³⁷ *See* RUPA §307.

³⁸ *See* UPA §40; RUPA §807.

Third, and more generally, these qualifications of and departures from vicarious liability in partnership undermine the application of agency norms to partnership relationships. Professor DeMott identifies the principle of "qui facit per alium, facit per se (one who acts through another acts through himself)" as a justification for vicarious liability that is "analytically more elegant" than other justifications that have been suggested.³⁹ She argues that "[t]he maxim supports the derivative liability of individual partners to the extent that partnership norms identify all partners with the acts of all fellow partners," and that the maxim's "power is its usefulness as a figurative or heuristic device to help understand an agency relationship."⁴⁰ But then it arguably should follow that the *non-application* of the maxim to partnerships for the reasons discussed above suggests that partnerships are *not* agency relationships.

V. FIDUCIARY RELATIONSHIP

An analysis of fiduciary duties in partnerships and partnership-type firms provides important insights into the application of agency law to these and other firms. It is important to begin this discussion by returning to the definition of agency as "the fiduciary relationship that arises when one person (a "principal") manifests assent to another person (an "agent") that the agent shall act on the principal's behalf and subject to the principal's control, and the agent manifests assent or otherwise consents so to act."⁴¹ In other words, an agency is *defined* in part as a "fiduciary relationship."

It is commonly said that partners owe fiduciary duties to each other and the partnership.⁴² However, while partners *may* owe such duties, unlike agents they are not *necessarily* in a fiduciary relationship either among themselves or with the partnership.⁴³ This follows from the nature of a fiduciary relationship and how this relationship applies in the partnership context.⁴⁴

Properly understood, fiduciary duties apply *only* where an "owner" (that is, one who controls and derives the residual benefit from property) delegates open-ended management power over property to someone else.⁴⁵ This is the classic situation in which the person who exercises delegated power has an incentive to enrich herself at the owner's expense. Because the principal faces difficulty in controlling the agent's self-

³⁹ See Demott at 121-22.

⁴⁰ *Id.*

⁴¹ Restatement 1.01.

⁴² See Alan R. Bromberg & Larry E. Ribstein, BROMBERG & RIBSTEIN ON PARTNERSHIP (1988 and supp), §6.07(a), n. 1 (citing numerous cases).

⁴³ The same may be true of corporate directors. See Douglas G. Baird & M. Todd Henderson, *Other People's Money*, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1017615, forthcoming 60 Stan. L. Rev. __ (2008) (showing how imposing fiduciary duties on directors may be contrary to the parties' bargain and suggesting recognizing liability only where directors violate a contractual obligation owed to shareholder, creditor, or other investor).

⁴⁴ See Larry E. Ribstein, *Are Partners Fiduciaries*, 2005 ILL. L. REV. 209.

⁴⁵ *Id.* at __.

Ribstein, *Are Partners Agents?*

dealing, a strong fiduciary duty of loyalty⁴⁶ is justified in the absence of contrary agreement to protect the owner despite the potentially high costs associated with enforcement of the duty.⁴⁷ The type of relationship in which this strong duty is justified differs from non-fiduciary delegations of power, such as that by a creditor to a debtor,⁴⁸ and from the vulnerability of one party to another that does not involve any delegation of power.⁴⁹

It follows that the relationship among partners and members of partnership-type firms is not a fiduciary relationship to the extent that the members are acting only as such.⁵⁰ Rather, partners are agents only to the extent that they exercise a management role vis a vis the firm or the other partners.⁵¹ An example of the latter scenario is the classic case of *Meinhard v. Salmon*,⁵² the strong language of which has created a misapprehension of the extent of fiduciary duties in partnerships. The member's inherent agency power to bind the firm is not the sort of power that justifies the application of strong fiduciary duties. Indeed, a reason for giving partners the power to bind is that the co-partners are in a position to control the acting partner, which is why the partners do not need the protection of fiduciary duties.

The application of fiduciary duties is an important respect in which characterizing a partnership as an agency relationship has created mischief. If a partnership is an agency relationship, it would follow from the inherent fiduciary character of agency that a partnership relationship is necessarily fiduciary, contrary to the considerations discussed above. On the other hand, making a partnership an agency but not a fiduciary relationship casts doubt on the fiduciary character of agency. This lack of clarity, in turn, would dilute fiduciary law's norm-creation function.

Moreover, characterizing a partnership as an agency creates confusion on the important issue of the extent to which partners can contractually modify or eliminate fiduciary duties. Extending the inherent fiduciary character of agency to partnership relationships suggests that it is appropriate to constrain fiduciary contracts in partnerships and in other business associations derived from partnership. Yet such modifications of fiduciary duties may make sense. Partners ought to be able to clarify their obligations in situations where the existence of a default duty is not clear. These contracts are also valuable even in situations where partners have fiduciary-like management powers but

⁴⁶ This duty must be distinguished from more limited duties of care or to refrain from misappropriating property, as well as from the contractual obligation of good faith and fair dealing. See *id.* at 220-23.

⁴⁷ These costs include direct litigation costs, the costs of contracting around open-ended rules, and the need for clear rules to serve as the basis for creating extra-legal norms and standards of conduct. See *id.* at 235-36.

⁴⁸ *Id.* at 224-27.

⁴⁹ *Id.* at 227-28.

⁵⁰ *Id.* at 238-40.

⁵¹ *Id.* at 240-41.

⁵² 164 N.E. 545 (N.Y. 1928)

where their ability to act in their self-interest may be constrained more cost-effectively than by applying fiduciary duties.⁵³

VI. TERMINATION AND DISSOLUTION

The dissolution of a partnership by partner dissociation from the firm has been analogized to the terminability at will of an agency relationship. Thus, Restatement (Third) of Agency comments that "[t]he power to revoke or renounce actual authority, notwithstanding the terms of an agreement, is comparable in this respect to a partner's power under the Uniform Partnership Act (1914) to cause dissolution of a partnership by express will but in contravention of the partnership agreement."⁵⁴

In fact, the comparison between agency and partnership regarding termination is less straightforward than this comment indicates. It is important to distinguish, on the one hand, between the termination of the agency relationship between a partner or member and the firm and, on the other hand, the dissolution of the relationship among the non-dissociating members. As the Restatement notes at several points,⁵⁵ the dissociation of a partner or other member of a partnership-type firm often does not necessarily terminate a partnership. Under traditional general partnership law, there is only a technical dissolution and continuation of the underlying business following a partner's dissociation where the dissolution is wrongful (in general, prior to expiration of an agreed term or undertaking) and all of the non-dissociating partners agree to continue.⁵⁶ RUPA provides for continuation of the partnership in this situation unless half or more of the non-dissociating partners agree to wind up.⁵⁷ ULPA (2001) provides for dissolution after general partner dissociation only if at least a majority of the partners consent to dissolution.⁵⁸ LLCs typically do not dissolve merely on dissociation of a member.⁵⁹

Many partnership-type firms also differ from agency regarding the causes and consequences of member dissociation. While a general partner can dissociate at will from a general or limited partnership even if this is contrary to the partnership agreement,⁶⁰ a limited partner does not have a default power to dissociate from a limited partnership.⁶¹ Under ULPA (2001), limited and general partners have the power to dissociate, but the dissociation may simply turn the partner into an assignee.⁶² RULLCA

⁵³ These alternative constraints include high-powered incentives and partner rights to exit the firm. See Larry E. Ribstein, *Big Partnerships*.

⁵⁴ See Restatement (Third) of Agency, §3.10, cmt b.

⁵⁵ See *id.* §3.07, cmt d (death of a partner); 3.08, cmt (loss of capacity).

⁵⁶ UPA §38(2)(b) (1914).

⁵⁷ RUPA §801(2) (1997).

⁵⁸ ULPA (2001), §801(3).

⁵⁹ ULLCA §801 (1996); Revised ULLCA §801 (2006).

⁶⁰ UPA §31(2) (1914); RUPA §602(1) (1997); RULPA §602 (1985); ULPA (2001), §604 (a).

⁶¹ RULPA §603 (1985) (limited partner may withdraw at the time or upon events specified in agreement).

⁶² *Id.* §602(a)(3) (limited partners); 605(a)(5) (general partners).

includes a similar provision for LLC members,⁶³ and many LLC statutes give LLC members no default power to dissociate at will.⁶⁴

The distinction between dissolution of the partnership relationship and termination of agency is based on differences between the standard forms, particularly regarding vicarious liability. Each standard form involves a particular tradeoff between the costs and benefits of continuity of the firm and members' power to exit at will. Continuing the firm despite a member's dissociation protects the partners from potentially high costs of disrupted business plans and opportunism by exiting owners. On the other hand, owner power to unilaterally dissolve the firm protects members from self-interested conduct by co-members. This is particularly important for general partners, who are vicariously liable for the firm's debts. The law must balance the benefits of allowing departure at will against the costs of allowing partners to take their ownership interests out of the firm. In firms without vicarious liability, the balance swings toward limiting the members' ability to extricate themselves from the firm.

In short, because the terminability of the relationship among partners and members of partnership-type firms is intricately related to the other elements of these standard forms, the rules regarding terminability should differ between agency and partnership, and across different partnership-type standard forms. And as discussed above in subpart III.A., the degree of terminability should affect partners' and members' power to bind the firm. This is another respect in which it is a mistake to throw all of these relationships into the same agency bag.

VII. CORPORATIONS

This paper has focused on the nature of partnership and partnership-type firms as agency relationships. This Part generalizes the point by looking beyond partnerships to corporations. In this context as well, the rules are based on the particular business association rather than the general law of agency. Subpart A considers the anomalous relationship between the directors and the shareholders or corporation. Subpart B looks at the relationship between the corporate entity and the shareholders.

A. THE BOARD OF DIRECTORS

Directors may seem to be agents of the shareholders. After all, the shareholders elect the directors and the directors owe fiduciary duties. However, the Restatement recognizes that directors are not the shareholders' agents.⁶⁵ This makes sense because the shareholders do not actually control the directors. For example, if a majority, or even all, of the shareholders want the directors to take some action, there may be a serious question whether they can compel this action. The directors may not owe a fiduciary or other duty to particular shareholders, or even to the shareholders as a whole as

⁶³ RULLCA §603(a)(3) (1996).

⁶⁴ See Ribstein & Keatinge, *supra* note 8, App. 11-3 (listing 18 statutes so providing).

⁶⁵ See Restatement (Third) of Agency, §1.01, cmt f. While corporate directors have a special statutory role, non-directors officers and employees do not. In the absence of special corporate statutory provisions, their role would be defined by agency law. See, e.g., *Lee v. Jenkins Bros.*, 268 F.2d 357 (2d Cir.), cert. denied, 361 U.S. 913 (1959) (interpreting corporate president's power to bind the firm to a substantial employment agreement).

distinguished from other corporate constituencies.⁶⁶ And it is clear that a single director may not act on behalf of the shareholders.

Nor is it clear who the principal is – that is, whether it is the “corporation” or the shareholders. The most elaborate theory of the role of corporate directors, Stephen Bainbridge's concept of “director primacy,”⁶⁷ conceives of the board of directors as a contracting nexus which hires the various contributors to corporate wealth. Bainbridge characterizes the board as “a sui generis body – a sort of Platonic guardian--serving as the nexus for the various contracts comprising the corporation.”⁶⁸ In other words, the board of directors is more like a collective principal than agents. But the board is not quite a principal either, because directors do not act on their own behalf and are to some extent accountable to the corporation. Thus, as with the other rules discussed in this paper, the role of the board is defined by the relevant business association rather than by agency law.⁶⁹

B. VEIL-PIERCING

Courts commonly pierce the corporate veil when they decide that the corporation acted as the shareholder's “agent.” However, this analysis is misleading. The corporate entity always acts as the agent of its owners in the sense that it acts on the owners' behalf and subject to their control. But the function of limited liability in corporations and other business entities is to *negate* this consequence of agency. Thus, the arguable existence of agency cannot justify the liability. Again, the nature of the relationship, like that between managers and owners, flows from the law of the relevant business association and not from the general law of agency.

VIII. CONCLUDING REMARKS

The old saw that partnerships or corporations are agency relationships does more to obfuscate than to enlighten. Agency law serves the same functions and sometimes gets to similar results as analogous law in specific business associations. Moreover, agency law provides background rules to the extent they are not supplanted by specific business association rules. But it is significant that business association statutes commonly *do* supplant agency. In these situations the application of agency rules and analysis leads to confusion. At best, the agency analogy is a starting point for analysis in business associations. To use it as the finish point – as does RULLCA, for example – is to end up nowhere.

⁶⁶ See Baird & Henderson, *supra* note 43.

⁶⁷ See Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 Nw. U. L. Rev. 547 (2003).

⁶⁸ *Id.* at 550-51 (footnote omitted).

⁶⁹ Note that, although corporate directors might seem to be more distinct from agents than partners or members of unincorporated firms, it is not obvious why the general concept of “director primacy” should not apply to the managers of other centrally managed firms. The differences would be mainly in terms of degrees of accountability. For a discussion of the different roles of directors in corporations and partnerships, see Ribstein, *supra* note 53.