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Statutory Forms for Closely Held Firms: Theories and Evidence from LLCs

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F. HODGE O'NEAL CORPORATE AND SECURITIES LAW SYMPOSIUM: LIMITED LIABILITY COMPANIES

STATUTORY FORMS FOR CLOSELY HELD FIRMS: THEORIES AND EVIDENCE FROM LLCs

LARRY E. RIBSTEIN*

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Business association statutes rarely are analyzed as ways to minimize transaction costs.¹ Economists have focused on the choice between organizing transactions within a firm or between firms,² and have paid no attention to questions concerning how these contracts are supplied. Lawyers tend to assume that statutory business forms are artifacts of tax law,³ and often fail to acknowledge transaction cost justifications for statutory standard forms. Accordingly, a firm's decision to form, for example, a limited partnership rather than a corporation has been of less interest to commentators than, for example, a firm's choice of control structure.

Yet business association statutes raise several interesting and important questions. Among other things, why do we observe the mix of business forms that we do? Why are there so many different kinds of business forms? Why are there not more, different types of forms? Is the current mix of business types efficient, or is it driven by regulatory pressures, interest groups, or market failures? Such questions are particularly apt for closely held firms. Where expected revenues from a transaction are relatively small, transaction costs, including those resulting from applicable legal rules, can have large effects on the choice of transaction form.⁴ But if the corporate form is unsuitable, why not substitute alternative unincorporated business forms? One reason may be that the development of such forms has been inhibited by tax and regulatory rules restricting the availability of limited liability.⁵

These formerly neglected issues concerning statutory standard forms have recently moved to prominence with the rapid emergence of the limited liability company (LLC) and the limited liability partnership (LLP).⁶

1 I have previously discussed one such business form. See Larry E. Ribstein, *An Applied Theory of Limited Partnership*, 37 EMORY L.J. 835 (1988).

2. The seminal works are those of Coase and Williamson, among others. See OLIVER E. WILLIAMSON, *MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS* (1975); Ronald H. Coase, *The Nature of the Firm*, in *THE NATURE OF THE FIRM: ORIGINS, EVOLUTION, AND DEVELOPMENT* 18 (Oliver Williamson & Sidney Winter eds., 1991).

3. See, e.g., Nancy J. Stara, *Has the Uniform Partnership Act Been Superseded by Subchapter A?*, 41 DRAKE L. REV. 461 (1992).

4. See Ian Ayres, *Judging Close Corporations in the Age of Statutes*, 70 WASH. U. L.Q. 365, 376-77 (1992) (arguing that the transaction costs of foreign incorporation for small firms, among other problems, have impeded competition to supply close corporation statutes). *But see* Larry E. Ribstein, *Delaware, Lawyers and Choice of Law*, 19 DEL. J. CORP. L. 999 (1994) (discussing lawyers' role in promoting competition regarding the law governing business associations and other contracts).

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

6. LLP statutes generally provide that partners are not liable for the malpractice of copartners as long as they register and provide for a minimal level of insurance.

During the relatively short period from early 1990 to mid-1994, forty-eight of the fifty-one U.S. jurisdictions adopted LLC statutes,⁷ and approximately half of the states have adopted LLP provisions.⁸ These adoptions occurred solely by the spontaneous actions of individual state legislatures, without the intervention of a uniform lawmaking body.⁹

A better understanding of the functions of statutory standard forms is made even more necessary by tax moves that are in the wind. The Internal Revenue Service and Treasury Department recently announced an initiative to drastically simplify tax classification rules by allowing domestic unincorporated business organizations to elect whether to be treated as partnerships for tax purposes.¹⁰ If adopted, this proposal would free business forms from their tax fetters and encourage the development of still more forms, possibly including corporate-like partnerships and all-purpose statutory business association “menus.”

The rapid rise of LLCs provides a laboratory in which to test theories concerning statutory business forms. This Article evaluates three hypotheses concerning closely held business association statutes. Part I discusses an *efficiency hypothesis* under which these statutes are shaped so as to minimize firms’ transaction costs. This Part develops a model of what

7. The only exceptions are Hawaii, Massachusetts, and Vermont. The statutes are included in full text, summarized in tabular form and analyzed in 2 LARRY E. RIBSTEIN & ROBERT R. KEATINGE, RIBSTEIN & KEATINGE ON LIMITED LIABILITY COMPANIES app. D (1992 & Supp. 1995).

8. These include, at the time this Article entered the final editing stage, Arizona (1994 Ariz. Legis. Serv. Ch. 196, S.B. 1012 (West)); Connecticut (1994 Conn. Legis. Serv. P.A. 94-218, S.S.B. 360 (West)); Delaware (Del. Code Ann. tit. 6, §§ 1502-1547 (Supp. 1994)); District of Columbia (1993 D.C. Legis. Serv. 10-34, Act 10-66 (West)) (codified in scattered sections of D.C. CODE § 41); 1995 Georgia Laws Act 4 (H.B. 1994); Illinois (1994 Ill. Legis. Serv. P.A. 88-573, S.B. 1448 (West) (codified in scattered sections of ILL. REV. STAT. ch. 805)); Iowa (IOWA CODE ANN. §§ 486.2-486.46 (West Supp. 1994)); Kansas (KAN. STAT. ANN. §§ 56-302 to 56-340 (Supp. 1994)); Kentucky (1994 Ky. Legis. Serv. ch. 389, S.B. 184 (West)); Maryland (1994 Md. Laws ch. 494, S.B. 513 (West)); Michigan (MICH. COMP. LAWS §§ 449.15-48 (Supp. 1994)); Minnesota (MINN. STAT. ANN. §§ 319A.02-12, 323.02-39 (West Supp. 1995)); New York (N.Y. LTD. LIAB. CO. LAW §§ 101-1403 (McKinney Supp. 1995)); North Carolina (1993 N.C. Sess. Laws ch. 354, H.B. 923); Ohio (1994 Ohio Laws File 103, S.B. 74); South Carolina (S.C. CODE ANN. § 33-43-101 to 33-43-1409 (Law. Co-op. 1995)); SD Legis. H.B. 1252 (1995). Texas (TEX. REV. CIV. STAT. ANN. arts. 6132b-1.01 to 6132b-10.04 (West Supp. 1995)); and Utah (UTAH CODE ANN. §§ 48-2b-101 to 48-2b-156) (1994)).

9. For an empirical test of the tendency of LLC statutes toward spontaneous uniformity, see Bruce H. Kobayashi & Larry E. Ribstein, *Evolution and Uniformity*, ECON. INQ. (forthcoming 1995 or 1996). After virtually all states had adopted or moved close to adoption of their LLC statutes, the National Conference of Commissioners on Uniform State Laws did promulgate a Uniform Limited Liability Company Act in the summer of 1994, which NCCUSL continued to rewrite into 1995. See UNIF. LTD. LIAB. CO. ACT (Reporter’s Draft Mar. 8, 1995).

10. See I.R.S. Notice 95-14 (Mar. 30, 1995).

efficient standard forms would look like based on an analysis of the economic function of business association statutes. The Article later uses this model to evaluate the actual LLC statutes that have been passed by the states.

Part II discusses a *tax/regulation hypothesis* under which tax and regulatory statutes shape business association statutes. This hypothesis is generally consistent with the efficiency hypothesis, in the sense that regulation is an important factor that legislators should take into account in crafting transaction-cost-minimizing standard forms. However, isolating the impact of regulation on the form of business association statutes helps in evaluating the secondary costs of tax and regulatory statutes.

Part III discusses an *inefficiency hypothesis* under which the public choice dynamics of legislatures, imperfect jurisdictional competition, and inherent constraints on the development of new standard forms prevent the development of efficient statutory standard forms.

Part IV then analyzes these theories of LLCs in light of the actual development of LLCs. It provides both an overview of the origins and evolution of LLC statutes and data concerning the structure of LLC statutes and firms' selection of the LLC form.

Part V concludes and discusses some public policy implications of the theories and evidence set forth in this Article. In general, the evolution of the LLC strongly supports both the existence of jurisdictional competition and the importance of tax and regulatory concerns in shaping state business association statutes.

I. THE EFFICIENCY HYPOTHESIS

Under the efficiency hypothesis, legislators and others who influence state legislation supply optimal statutory standard forms for closely held firms. Part III discusses details concerning legislators' incentives and interstate competition in the context of the inefficiency hypothesis. This Part presents a general model of statutory standard forms for business associations that can be used to test whether the actual development of the LLC is consistent with the efficiency hypothesis. It considers three questions concerning statutory standard form contracts: (1) what is the function of a *standard form*?; (2) why embody this standard form in a *statute*?; and (3) why develop a *new* standard form in addition to existing business forms that can be modified to closely resemble LLCs?

A. *The Role of Standard Forms*

Standard forms save the parties to firms the costs of devising customized terms for each contract. But how much do they save? Many firms vary statutory governance terms in their bylaws, operating agreement or certificate. Indeed, because most firms do not fit a single mold in important respects, they can benefit from some customized drafting. Drafting a comprehensive agreement does not necessarily cost much more than selecting a few customized terms. Nevertheless, the following subparts suggest five respects in which standard form terms can economize transaction costs.

1. *Default Terms for Firms Without Customized Contracts*

Standard forms are most valuable in reducing costs for firms that otherwise would not have any explicit contract. The marginal costs of drafting customized terms may exceed the marginal benefits where expected revenues from the transaction are relatively small. Accordingly, parties to these firms may prefer to go without an explicit agreement and risk having a dispute that is not covered by a contract. If a dispute occurs, the absence of a contract may make the outcome unpredictable which, in turn, may reduce the possibility of settlement and increase litigation costs. This analysis suggests that standard terms should be designed for the relatively small, informal firms that are least likely to be able to bear the costs of drafting customized terms.

Some firms that do not have customized contracts nevertheless may not need standard forms because their arrangements are so idiosyncratic that such forms are of relatively little value.¹¹ This may be the case for output and supply contracts, which are highly specialized to particular buyers and sellers.¹² But even standard forms that imperfectly suit idiosyncratic firms may reduce litigation and other costs that otherwise would result from the absence of well-defined rights.

11. See Roberta Romano, *State Competition for Close Corporation Charters: A Commentary*, 70 WASH. U. L.Q. 409, 413 (1992) (arguing that this characteristic explains the absence of competition to supply close corporation charters). As discussed below, this argument is questionable, and is cast in doubt by the rapid adoption and evolution of LLC statutes. See *infra* notes 138-40 and accompanying text.

12. However, as discussed *infra* text accompanying note 21, industries can and have developed their own forms. Accordingly, the main difference between these types of contracts and conventional business associations may concern the demand for *statutory* standard forms.

2. *Information Costs*

Standard forms also can reduce investors' and creditors' costs of learning the terms of each of the firms with which they contract. That is particularly true for shareholders in publicly held firms who commonly invest small portions of their portfolios in many firms. Although public securities markets discount governance differences in stock prices,¹³ market efficiency varies by company, security, market and information.¹⁴ Thus, the prices of relatively thinly traded stocks may reflect slowly, if at all, information about the details of contract terms that is costly for investors to acquire. Accordingly, standard forms may be particularly valuable in reducing information costs not only for closely held firms, but also for medium-sized publicly held firms that are not actively traded.

3. *End-Period Terms*

Many firms that have comprehensive agreements can gain from default terms on particular issues where the costs of customized contracting are likely to exceed the benefits. For example, it is more costly to include contractual provisions covering the many circumstances that ultimately may give rise to disagreement than it is to agree on the voting rules and other terms that will govern normal operations.¹⁵ Moreover, the discounted present benefit of rules governing disputes that are unlikely to occur for a long time may be relatively low. On the other hand, merely because such firms cannot deal practicably with these situations through customized contracts, it does not follow that the firms would be helped by statutory standard forms. Close corporations, whose disputes occur in nonrepeating end-game situations, may prefer flexible judicial decisionmaking to rigid legislative rules.¹⁶

4. *Terms Relating to Third Parties*

Standardization may assist trade creditors and others whose costs of learning the terms and entering into customized contracting may be high

13. For a summary of evidence of stock price reactions to governance changes, see ROBERTA ROMANO, *THE GENIUS OF AMERICAN CORPORATE LAW* 20-21 (1993).

14. See Jonathan R. Macey et al., *Lessons from Financial Economics: Materiality, Reliance, and Extending the Reach of Basic v. Levinson*, 77 VA. L. REV. 1017 (1991).

15. See WILLIAM A. KLEIN & JOHN C. COFFEE, JR., *BUSINESS ORGANIZATION & FINANCE* (5th ed 1993).

16. See ROMANO, *supra* note 13, at 27.

compared to the value of the transaction, but who, at the same time, cannot rely on efficient market pricing. This may explain the rules in corporate, limited partnership and limited liability company statutes dealing with such matters as distributions and registered agents for service of process.

5. *Interpretive Networks*

A statutory standard form potentially offers benefits similar to those of an on-line computer network or telephone network in the sense that other users of the network supply a complementary product. In the case of standard form "networks," the other users generate such benefits as judicial precedents, business practices and legal advice that help interpret and apply the standard form.¹⁷ This information can increase the clarity of contract terms by reducing errors of ambiguity, inconsistency and incompleteness.¹⁸ However, interpretive benefits may be limited in some situations. Case law and customs interpreting statutory terms may not be particularly useful for firms whose problems are likely to be idiosyncratic.¹⁹ Moreover, even in the absence of networks, statutes can provide clear rules on matters such as contents of filings and firm name that do not normally give rise to significant interpretive problems.

B. *Statutory Standard Forms*

Even if standard terms can reduce transaction costs, they need not be produced by legislatures. Private organizations can supply standard forms, such as the American Bar Foundation Model Debenture Indenture,²⁰ standard lease forms produced by associations of realtors, long-term output and supply contracts and joint venture agreements devised for use in the natural resources industry and informal codes of conduct or customs that substitute for more formal statutes or contracts.²¹ Firms such as franchi-

17. See Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. (forthcoming 1995).

18. See Charles J. Goetz & Robert E. Scott, *The Limits of Expanded Choice: An Analysis of Express and Implied Contract Terms*, 73 CAL. L. REV. 261, 286-89 (1985) (discussing the benefits produced by standardization of contract terms). For a discussion of the extent to which such benefits can be increased by creating links between two or more statutory forms, see Larry E. Ribstein, *Linking Statutory Forms*, 58 LAW & CONTEMP. PROB. (forthcoming 1995).

19. See ROMANO, *supra* note 13, at 26-27 (discussing idiosyncrasy of closely held firms as a reason why close corporation statutes were slow to develop).

20. See Churchill Rodgers, *The Corporate Trust Indenture Project*, 20 BUS. LAW. 551 (1965) (discussing history and goals of the project that developed this indenture).

21. See Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J. LEGAL STUD. 115 (1992).

sors that enter into similar contracts with many individuals may develop their own standard contracts.

In general, *statutes* may be necessary to supply standard terms where firms themselves cannot internalize the benefits of producing the standard term either on their own or through a private organization. But the fact that legislative action may be necessary to produce a standard form does not alone explain the existence of statutory standard forms. First, benefit-internalizing organizations are as necessary to create statutes as they are to create private forms. Under standard interest group theory, legislators will not necessarily legislate unless organizations and individuals pay them campaign contributions and other benefits for doing so.²² Indeed, it is not clear why organizations such as bar groups would pay to have legislators create what these groups could create for themselves. Second, specific industry groups need not internalize the benefits of drafting private codes since *lawyers* may be able to internalize these costs for their clients. Third, even if a well-designed statutory standard form might reduce transaction costs in some respects, the particular statute produced by a legislature may be unsuitable for many firms. The statute may even increase transaction costs if firms must incur costs to avoid application of the form.²³

Despite these considerations, the following discussion gives some respects in which statutes may be preferable to private standard forms.

1. *Information Costs*

The publicity generated by the legislative process, publication of statutes at state expense, and commentary on statutes by lawyers, academics and others, lowers the public's costs of learning about the standard form as compared with privately generated forms. This, in turn, reduces firms' costs of doing business under the form. In evaluating this benefit, however, it is important to note that a similar process can occur with respect to privately generated forms. For example, a "Prototype Limited Liability Company Act" promulgated by an ad hoc committee of the ABA quickly became as

22. See generally MANCUR OLSON, *THE LOGIC OF COLLECTIVE ACTION* (1965); ROBERT TOLLISON & ROBERT MCCORMICK, *POLITICIANS, LEGISLATION AND THE ECONOMY* (1981).

23. The Uniform Partnership Act (UPA) §§ 6-7 and the Revised Uniform Partnership Act (RUPA) § 202 provide that co-owned for-profit associations are partnerships and therefore subject to the statute. UNIF. PARTNERSHIP ACT §§ 6-7 (1914) [hereinafter UPA]; REVISED UNIF. PARTNERSHIP ACT § 202 (1993) [hereinafter RUPA]. Firms may shun "partnership characteristics" or may try to opt out of the form by contracting that they are not part of the statutory class. See 1 ALAN R. BROMBERG & LARRY E. RIBSTEIN, *BROMBERG & RIBSTEIN ON PARTNERSHIP* 2:30 (1988 & Supp.) (citing and discussing cases concerning effect of contracts providing that relationship is not a partnership).

widely known as any state LLC statute through distribution at ABA meetings and in private publications.²⁴

2. *Network Benefits and Statutory Forms*

If, as predicted above, statutory standard forms are used more heavily than equivalent private forms, they also will be more likely than their private analogs to generate network benefits such as judicial precedents, customs and practices that help in interpreting the terms.²⁵ To be sure, the value of judicial precedents in interpreting a particular term does not depend on whether the term is included in a statutory or in a private standard form. However, the number of precedents may depend on how many firms use a particular term which, in turn, may depend on whether the term is statutory or private. In other words, while potential network benefits are the same for statutory and nonstatutory forms, statutes may be able to create larger networks.

3. *Mandatory Rules and Credible Commitments: The "Control Rule"*

Mandatory rules in statutory standard forms can help the parties commit to particular contract terms or refrain from certain types of conduct for long periods.²⁶ These commitments are important for long-term contracts such as business associations. Enforcement costs and free rider problems may prevent third parties from enforcing contracts that bind the parties to particular governance terms. For example, changes in a management arrangement could affect creditors as a whole, but the damage would be difficult to quantify and may be slight for each creditor.

Creditors cannot easily overcome these problems by contract. Although they could contract for collective enforcement rights, as through an indenture trustee, creditors cannot easily collectivize different kinds of claims incurred in different types of transactions at different times. Alternatively, the creditors could contract for a penalty that would make

24. The Prototype Act was published as an appendix to 1 RIBSTEIN & KEATINGE, *supra* note 7. For data on the effect of the Prototype Act on LLC statutes, see Larry E. Ribstein & Bruce H. Kobayashi, *Uniform Laws, Model Laws and LLCs*, 66 U. COLO. L. REV. (forthcoming June 1995).

25. See *supra* Part I(A)(5).

26. Although statutory mandatory rules may reduce transaction costs in some circumstances, it does not follow that they are always efficient. Mandatory rules can impose unsuitable terms on firms or require them to choose an otherwise suboptimal form or to incur the costs of organizing under the law of a state other than their main place of business. Moreover, legislators may have perverse incentives to enact mandatory rules at the behest of a powerful interest group, such as trial lawyers, or to enhance their own power. See *infra* Part III(A).

enforcement by individual creditors cost-effective. For example, the equity owners could agree to give creditors special collection rights triggered by certain governance changes. Such terms might, however, be considered unenforceable “penalties” if they bear no relation to actual damages.²⁷

Statutes that provide rules for limited liability firms normally include unwaivable penalty rules that help solve these creditor enforcement problems. For example, the statute may prohibit the firm from making distributions under certain circumstances. Owners who do not comply risk losing their limited liability through “veil-piercing” or having to return excessive distributions.²⁸

The limited partnership “control rule,” which holds limited partners liable as general partners for taking part in the control of the business,²⁹ arguably is an example of a statutory creditor-protection penalty. The general partners’ personal liability helps align their interests with creditors. The control rule reinforces this alignment by assuring creditors that limited partners cannot initiate or approve transactions rejected by the general partners. The rule also assures the general partners, who have agreed to be personally liable for the firm’s debts, that the limiteds will not increase these debts without the generals’ consent. Without the control rule, the limited partners might be able to amend the agreement or otherwise remove the general partners and take over management functions. The limited partners may have a particularly strong incentive to take such action when the firm nears insolvency, because owners who have no equity stake can shift the entire cost of the failure of risky investments to creditors and general partners.³⁰

27. See generally *Lake River Corp. v. Carborundum Co.*, 769 F.2d 1284, 1290 (7th Cir. 1985); Charles J. Goetz & Robert E. Scott, *Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach*, 77 COLUM. L. REV. 554 (1977). This reasoning suggests that statutes are only a second-best solution to simply providing for enforcement of liquidated damage clauses whether or not they amount to “penalties.”

28. See, e.g., REVISED UNIF. LTD. PARTNERSHIP ACT § 304 (1985) [hereinafter RULPA] (liability of partners in noncomplying partnerships); *id.* §§ 607-608 (liability for excessive distributions). This is not to suggest that all such rules are optimal. See Ribstein, *supra* note 1, at 888-89 (arguing that rules limiting distributions are unnecessary and inefficient).

29. See UPA § 7 (1914); RULPA § 303 (1985). Note that the Revised Act provides that only creditors who are misled about the limited partners’ status can recover. RULPA § 303(a). This dilutes the control rule so that it merely duplicates the “partner-by-estoppel” theory of UPA § 16 rather than providing assurances concerning who will exercise control.

30. This conflict of interest is well illustrated in the corporate context by *Credit Lyonnais Bank v. Pathe Communications Corp.*, Civ. A. No. 12190, 1991 WL 277613 (Del. Ch. Dec. 30, 1991). The court held that members of an executive committee that was running a very heavily leveraged firm under a corporate governance agreement did not breach their duty to defendant, a 98% shareholder, by,

Other contracting devices could not easily accomplish the same results. The alternative of imposing creditor-protection duties on managing limited partners raises intractable issues concerning the types of obligations this would entail, given the inherent conflict of interest between owners and creditors and the fact that courts generally have refused to recognize such a duty.³¹ Although the limited partnership agreement could forbid the limited partners from managing and from amending the agreement to remove this prohibition, this restriction could expose the limited partners to the risk of mismanagement by undisciplined general partners. Moreover, sufficiently desperate limited partners and insolvent general partners might agree unanimously to ignore a prohibition. A later court decision that the partners lacked the power to change the management structure would give little comfort to creditors whose debts became uncollectible as a result of the owners' risky maneuvers or questionable conveyances.

The statutory control rule, therefore, solves a difficult contracting problem. It provides some protection to creditors and general partners from the potentially severe agency costs that arise in connection with insolvency by ensuring that the controlling partners remain personally liable for the firm's debts. At the same time, it protects the limited partners from potentially large agency costs vis-à-vis the general partners by giving the limiteds the power to take over management. In light of this explanation, it makes sense that the control rule imposes liability only on limited partners who manage, and not on nonowners: only residual claimants would have a perverse incentive to run the firm contrary to creditors' interests.³²

C. Differences Among Statutory Standard Forms

A final issue concerning statutory standard business association forms is the circumstances that give rise to *different* statutes. Because the statutes include mostly default terms that can be varied by contrary agreement,

among other things, refusing to sell certain assets. *Id.* at *21. Chancellor Allen discussed at length the potential conflict of interest between creditors and owners. *Id.* at *34 n.55.

31. *See, e.g., Katz v. Oak Indus., Inc.*, 508 A.2d 873, 879 (Del. Ch. 1986). In the *Credit Lyonnais* case, discussed *supra* note 30, Chancellor Allen, who also decided *Katz*, reasoned that managers did not breach their duty in refusing to engage in an asset sale that would have benefited the shareholders, because the managers "owed their supervening loyalty to . . . the corporate entity." *Credit Lyonnais*, 1991 WL 277613, at *34. However, Chancellor Allen did not suggest that the managers would have breached their duty to creditors if they *had* sold the assets. For a good discussion of the problems in this context of recognizing a general duty to the "corporate entity," see C. Robert Morris, *Directors' Duties in Nearly Insolvent Corporations: A Comment on Credit Lyonnais*, 19 J. CORP. L. 61 (1993).

32. *See Ribstein, supra* note 1, at 885.

different types of firms can adapt the statutes to their needs. Although it may be appropriate to provide alternative default terms for each aspect of a business association to suit different types of firms, statutes could meet this demand by offering a “Chinese menu” of terms. For example, states could let firms choose a transfer provision from Category A and a dissolution provision from Category B. Also, rather than enacting LLC statutes, legislatures could offer an apparent equivalent to an LLC statute by allowing limited partnerships to opt out of the control rule.³³ Alternatively, legislatures could create LLCs out of partnerships simply by allowing partnerships to adopt limited liability.³⁴ The following subparts suggest answers to these questions and explain why a new LLC statutory form is the desired alternative.

1. *Coherent Sets of Terms*

Although the “Chinese menu” approach could work for firms that have customized contracts, such firms probably have little need for standard forms. For firms that use standard forms in order to avoid excessive customizing costs, selecting among menu items also may not be cost-justified. This is because selecting menu items for a business association, unlike a restaurant meal, involves complex interactions among choices in order to produce a *coherent* set of terms.

Constructing a coherent set of terms involves trade-offs at the margin. For example, it is inefficient to combine two or more costly monitoring devices where the marginal cost of each additional device exceeds its marginal benefit. Accordingly, regulatory considerations aside,³⁵ providing for limited liability and direct management in a separate statute may be more efficient than allowing general partnerships to adopt limited liability, as has been done through LLP statutes.³⁶ Some provisions of general partnership statutes may be efficient when combined with individual liability of the partners, but not if the partners have limited liability. For example, giving each partner the power to liquidate the firm at will may involve excessive costs if liquidation is unnecessary to free dissociating

33 Legislatures could even allow “limited partnerships” to opt out of the requirement that the partnership have at least one general partner. States already allow something close—the incorporated general partner. See Ribstein, *supra* note 1, at 868-71.

34. For a list of “limited liability partnership” statutes which have done that, see *supra* note 8.

35 See *infra* Part II.

36 These statutes probably are better explained by regulatory considerations than under the efficiency hypothesis. See *infra* Part II(C).

partners from continued exposure to predissociation liabilities.³⁷

The efficiency of combining terms into coherent sets also explains why a separate business form for limited-liability, closely held firms is more efficient than adapting the corporate form to closely held firms. Even if corporation statutes allow complete flexibility, closely held firms must still attempt to anticipate the potential impact of each element of the corporate form and draft around inappropriate terms. This negates an important function of standard forms, to provide defaults for split-ups and other circumstances that are costly to anticipate and draft for on formation.³⁸ Since firms are unlikely to draft customized terms for these situations, courts would have to supply judicial buyout and dissolution remedies. This can increase unpredictability and litigation costs.

2. *Gap-Filling*

Separate business association statutes let firms adopt not only particular terms but also a general structure. This helps courts decide cases that are not resolved by the statute or by the firms' customized contracts. For example, a firm's decision to incorporate, even if the resulting form adopts several partnership features, indicates that courts should fill gaps in situations not expressly provided for in the statute or the certificate by defaulting back to such corporate features as continuity of life, free transferability and centralized management. It follows that courts should be reluctant to order a buyout of owners of a close corporation in the absence of a showing that the statutory grounds have been met.³⁹

3. *Combining Flexibility and Mandatory Rules*

Offering different statutory standard forms facilitates the combination of desirable mandatory rules⁴⁰ and customized contracting. Firms could choose either to bind themselves to mandatory rules such as the limited partnership "control rule," or to avoid the rule by selecting an alternative business form. The rule would be mandatory in the sense of inhibiting firms from making midstream changes without dissolving and paying off

37. See Larry E. Ribstein, *The Revised Uniform Partnership Act: Not Ready for Prime Time*, 49 BUS. LAW. 45, 69-75 (1993) (noting that partners' personal liability may justify liquidation at will, but arguing that this remedy is unnecessary even in light of partners' liability).

38. See *supra* Part I(A)(3).

39. See FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 238-39 (1991); Charles R. O'Kelley, Jr., *Filling Gaps in the Close Corporation Contract: A Transaction Cost Analysis*, 87 NW. U. L. REV. 216 (1992).

40. See *supra* Part I(B)(3) (discussing reasons for mandatory statutory rules).

creditors.⁴¹ On the other hand, if the control rule were part of a Chinese menu-type statute the firm could change the rule without the consent of third parties simply by choosing another term.⁴²

D. Efficiency Implications for Statutory Design

This Part has outlined the economic functions of statutes for various types of business associations. In general, *standard* terms can reduce firms' contracting and information costs as compared with fully customized contracts; *statutory* terms can be superior to privately drafted forms in some circumstances by supplying efficient mandatory rules, reducing information costs and providing a base for developing judicial gap-filling rules; and *discrete* statutes can provide signaling and offer coherent sets of terms for firms that would not incur the costs of choosing such terms from a master "menu."

It follows from this general analysis that there is an efficiency justification for a business association statute that is distinct from general partnership in providing for limited liability, and from other limited liability forms (i.e., corporation and limited partnership) in providing for direct member participation in management. The history of close corporations demonstrates that some firms do, in fact, demand this combination of features.⁴³ This Part has shown that the features should be offered in a distinct, internally consistent statute rather than simply being made available as a menu item or customized term. Under the principle of internal consistency, such a statute would build on the concept of direct management by restricting transferability of shares and offering liquidity in the form of easy dissolution. Providing for a distinct and internally consistent business form would assist courts in filling gaps by signaling that the owners intended to rely on direct participation in management and easy

41. Note that this efficiency justification for mandatory rules is based on problems associated with midstream changes. Where midstream switching is not a concern, mandatory rules are harder to justify. As long as the firm discloses its terms at the outset of any deal, the parties presumably can contract accordingly. As discussed *infra* Part III, many mandatory rules are more consistent with the inefficiency hypothesis than with the limited efficiency justification for mandatory rules discussed here.

42. The differences between menus and separate statutes regarding mandatory rules may blur in this respect. A separate statute could let firms escape mandatory terms midstream by converting or merging into a different standard form without paying off minority owners or creditors, while a menu statute could provide that firms cannot drop the "control rule" without a dissolution-type procedure.

43. Limited liability has been explained primarily in the context of publicly traded firms. See EASTERBROOK & FISCHER, *supra* note 39, at 40-41. However, there are also strong reasons to believe that limited liability can be an efficient contract term in closely held firms. See Larry E. Ribstein, *Limited Liability and Theories of the Corporation*, 50 MD. L. REV. 80, 101-06 (1991).

exit rather than on other devices, such as fiduciary duties, for controlling manager discretion. In general, this approach would eliminate the awkwardness that has resulted from trying to adapt the corporate form to closely held firms.

As discussed in Part IV, the LLC as it has evolved in state statutes is, in fact, consistent with this general model of an efficient statute for closely held firms. This provides evidence supporting the efficiency hypothesis.

II. THE TAX/REGULATION HYPOTHESIS

Under the tax/regulation hypothesis, statutes for closely held firms are designed to some extent with a view toward helping firms obtain favorable treatment under tax and regulatory statutes. Most importantly, firms that adopt statutory partnership features are taxed as partnerships on a flow-through basis rather than as separate entities like corporations. The data on the evolution of LLC statutes shows that tax classifications have affected LLC statutes, particularly with respect to the minimum number of members, limitations on transfer, and continuity of the firm.⁴⁴ Indeed, the most recent LLC statute explicitly provides that it should be applied so as to “permit a limited liability company to qualify for taxation as an entity that is not an association taxable as a corporation under the Internal Revenue Code of 1986.”⁴⁵

Subpart A discusses the efficiency of the underlying tax classification scheme. Subpart B shows that, irrespective of the efficiency of the classification scheme, designing business association statutes in light of tax considerations may be consistent with the efficiency hypothesis, in the sense that an efficient statute would minimize firms’ transaction costs *in light of* their tax and regulatory needs. Subpart C discusses analogous regulatory considerations in designing business association statutes.

A. *Efficiency of Tax Classification*

A business is taxed as a partnership under Subchapter K of the Internal Revenue Code (i.e., on a “flow-through” basis, with income taxed directly to the owners and losses deductible against owners’ income) if it is not a “corporation.” The Code defines this term to include “association.”⁴⁶ In

44. See *infra* Parts IV(C)(2), (4) and (8).

45. 15 PA. CONS. STAT. § 8915 (Supp. 1994).

46. See I.R.C. § 7701(a)(3) (1988) (definition of “corporation”); *id.* § 7701(a)(2) (definition of “partnership”).

Morrissey v. Commissioner,⁴⁷ the Supreme Court approved a test to determine "association" status based on an entity's "resemblance" to corporations.⁴⁸ The current "resemblance" test adopts the IRS' interpretation set forth in the "Kintner regulations,"⁴⁹ and provides that a business organization is a corporation and not a partnership if it has at least three of the following characteristics: continuity of life, centralized management, limited liability, and free transferability of interests.⁵⁰

These tax classification provisions are inefficient to the extent that they rely on an inherent distinction between partnerships and corporations. The characteristics that define "associations" (i.e., nonpartnerships) for tax purposes are neither immutably associated with particular types of business associations nor rationally related to the way the firm ought to be taxed.⁵¹ More importantly, requiring firms to have particular characteristics in order to be taxed as partnerships could perversely cause firms to adopt terms that increase transaction costs solely in order to reduce tax costs.⁵² For example, rigid restrictions on continuation of the firm after member dissociation and on transferability of shares, while helpful for tax classification purposes, may impose extra transaction costs on most limited liability firms.

Commentators have struggled to find a more defensible basis for the one-tier/two-tier tax distinction. They have proposed tests based on liquidity of interests⁵³ and on member participation in management,⁵⁴ or have

47. 296 U.S. 344 (1935).

48. *Id.* at 357.

49. The name refers to the case that prompted the regulations, *United States v. Kintner*, 216 F.2d 418 (9th Cir. 1954), in which the IRS unsuccessfully sought to characterize a professional corporation as a partnership. *Id.* at 428.

50. See Treas. Reg. § 301.7701-2(a) (as amended in 1993). For leading cases interpreting the Kintner regulations, see *Zuckman v. United States*, 524 F.2d 729 (Ct. Cl. 1975); *Larson v. Comm'r*, 66 T.C. 159 (1976).

51. See Ribstein, *supra* note 5, at 451-56.

52. *Id.* at 456-67. Statutory terms could serve a tax function without significantly increasing transaction costs. Statutes could be used simply to reduce the costs of identifying classes of transactions for different tax consequences by providing a mechanism for grouping the firms with partnerships, rather than with corporations, for tax purposes. In other words, firms could be allowed to choose their tax treatment by organizing under such statutes. This approach would not give firms complete freedom to reduce taxes as long as the statute imposes drafting and other transaction costs on firms that are not suited to the statutory defaults. For example, a publicly traded corporation would have to draft around transfer, dissolution and management provisions of statutes designed for closely held firms. Even with such a contract, the firm still would risk application of inappropriate default terms to situations not covered by the express contract.

53. See Rebecca S. Rudnick, *Who Should Pay the Corporate Tax in a Flat Tax World?*, 39 CASE W. RES. L. REV. 965 (1989).

54. See Joseph A. Snoc, *Entity Classification Under the Internal Revenue Code: A Proposal to Replace the Resemblance Model*, 11 J. CORP. L. 647 (1990).

suggested that two-tier taxation may reduce owner-manager agency costs by removing managers' incentives to time asset dispositions.⁵⁵ The liquidity test is based on the suspect assumption that such a test will not have implications for the choice of organizational form.⁵⁶ The agency-cost test questionably assumes that a costly tax rule is an efficient way of constraining agency costs.⁵⁷ In any event, none of these arguments defends the current multifactor approach, although the liquidity approach comes closest to describing the closely-held/publicly-held distinction that is emerging in practice.⁵⁸

The current approach is not only difficult to defend on efficiency grounds, but from at least one perspective seems particularly perverse. Traditionally, the double tax is a tax on limited liability.⁵⁹ Yet, by permitting *closely held* firms to adopt the single-level tax, the current tax classification scheme encourages firms to distribute assets precisely in the situation in which this is most likely to hurt creditors—in relatively small-capitalization firms, where those who make the distribution decisions are themselves owners who would have the most to gain from externalizing risk.⁶⁰

Distinguishing closely held and publicly held firms might be justified on the public interest ground that the agency costs inherent in an entity-level tax are highest where owners can neither control distribution decisions nor create “homemade dividends” by selling or easily borrowing against their interests.⁶¹ Alternatively, the distinction might be explained on public choice grounds as resulting from pressure by manager-owners for tax rules

55. See Hideki Kanda & Saul Levmore, *Taxes, Agency Costs, and the Price of Incorporation*, 77 VA. L. REV. 211 (1991); see also Joseph A. Snoe, *The Entity Tax and Corporate Integration: An Agency Cost Analysis and a Call for a Deferred Distributions Tax*, 48 U. MIAMI L. REV. 1, 29 (1993) (discussing alternative agency cost implications of single- and two-tier taxation).

56. See Ribstein, *supra* note 5, at 471-73.

57. *Id.* at 469-71.

58. *Id.* at 471-72. Kanda and Levmore's agency-cost test assumes that the parties can choose the tax rule that applies, which is not the case. The IRS has implicitly rejected a participation-in-management test by permitting partnership-type taxation of centrally managed LLCs on the basis of the four-factor test. See Rev. Rul. 93-6, 1993-1 C.B. 229 (ruling that an LLC formed under the Colorado Limited Liability Company Act would be treated as a partnership for federal tax purposes despite having centralized management mandated by the Colorado Act, because it lacked continuity of life and free transferability of interests).

59. See Ribstein, *supra* note 5, at 453-56. For a criticism of this basis of the tax classification system, see *id.* at 467-69.

60. See *supra* text accompanying note 30 (discussing this point as part of creditor-protection rationale of the control rule).

61. See Snoe, *supra* note 55, at 34-39.

that allow them to take earnings from the firm without an additional tax penalty.⁶²

If a particular tax classification rule cannot be defended, perhaps a *clear* rule, even if it rests arbitrarily on choice of business form, can be defended on efficiency grounds. Such a rule may reduce litigation and uncertainty costs as compared with a more open-ended definition.⁶³

Whatever the justification or explanation for the tax classification rules, they cannot be evaluated fully without considering the extent to which they encourage statutory provisions and contracts that would be suboptimal in the absence of the tax rules. The tax/regulation hypothesis articulated in the next subpart provides an approach to measuring these costs.

B. Tax Effects on Business Association Statutes

Given the current tax classification rules, there may be a public interest justification for designing a business association statute to ensure that firms using the statute lack at least two of the corporate characteristics identified in the Kintner regulations. If partnership tax consequences dwarf transaction cost considerations, there is a public interest justification for providing tax-oriented terms even if perverse tax motivations would not exist in a perfect world. The tax/regulation hypothesis also suggests a reason for separate business association statutes as opposed to letting firms choose from a menu of provisions. Providing a coherent set of interrelated terms helps characterize a firm for tax purposes in the same way that it helps courts to characterize the firm for purposes of filling contractual gaps.⁶⁴

On the other hand, a business association statute should not be designed to help firms minimize tax liability if the transaction costs of a tax-oriented statute can be expected to overwhelm any tax-related advantages.⁶⁵ In particular, tax rules may not justify mandatory business association statutory provisions that prevent firms from trading off tax advantages and nontax transaction costs. Such rules may be explained by political

62. See Jennifer Arlen & Deborah M. Weiss, *The Political Economy of Double Corporate Taxation* (1994) (unpublished manuscript, on file with author).

63. 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, 829-30 (1994).

64. See *supra* Part I(C)(2).

65. Note that the transaction cost tradeoffs inherent in tax-oriented terms may be hard to determine because the design of the business association statute may affect the design of the tax statute—i.e., where the tax rule borrows from the business associations rule or new business forms lead to the formation of interest groups that lobby for tax flexibility.

considerations and are consistent with the inefficiency hypothesis.⁶⁶

C. Regulatory Considerations

Business association statutes may be designed to serve regulatory as well as tax functions. Most importantly, a decentralized-management default statutory term justifies characterizing firms organized under such statutes as non“securities” for state and federal securities law purposes. General partnerships have been characterized as virtually per se nonsecurities⁶⁷ because partners’ direct participation in management tends to negate the “efforts-of-others” prong of the basic test in *SEC v. Howey*⁶⁸ for the definition of a security. A similar analysis would be appropriate for LLCs if they are generally recognized as a decentralized-management form.⁶⁹

66. See *infra* text accompanying note 82.

67. See *Williamson v. Tucker*, 645 F.2d 404 (5th Cir.) (leading case recognizing the very heavy presumption against “security” in the general partnership context), *cert. denied*, 454 U.S. 897 (1981); Larry E. Ribstein, *Private Ordering and the Securities Laws: The Case of General Partnerships*, 42 CASE W. RES. L. REV. 1, 47-54 (1992) (discussing cases supporting “per se” approach).

68. 328 U.S. 293, 297 (1946).

69. See 1 RIBSTEIN & KEATINGE, *supra* note 7, § 14.02; Ribstein, *supra* note 63, at 816-23. For similar conclusions concerning LLC interests as “securities,” see Carol Goforth, *Why Limited Liability Company Membership Interests Should Not Be Treated as Securities and Possible Steps to Encourage the Result*, 45 HASTINGS L.J. 1223 (1994); Mark A. Sargent, *Are Limited Liability Company Interests Securities?*, 19 PEPP. L. REV. 1069 (1992). For a contrasting approach, concluding that LLCs are generally nonsecurities, see Marc L. Steinberg & Karen L. Conway, *The Limited Liability Company as a Security*, 19 PEPP. L. REV. 1105 (1992).

Some states have chosen to clarify the characterization of LLCs by revising the definition of a “security” in their securities statutes. See ALASKA STAT. § 45.55.990(12) (Supp. 1994) (defining LLC interest as security); CAL. CORP. CODE § 25019 (West Supp. 1995) (providing that LLC interest not a security if LLC can prove that all of its members are actively engaged as managers); IND. CODE § 23-2-1-1 (k) (iii) (Burns Supp. 1994) (defining LLC interest as security unless person claiming it is not a security can prove that all of the members are actively engaged in management); OHIO REV. CODE ANN. § 1707.01 (Anderson Supp. 1994) (defining LLC interests as securities); 1994 Pa. Legis. Serv. 1994-126 (H.B. 2075) (Purdon’s) (providing that LLC interests are “securities” unless the LLC is not managed by managers, the purchaser of the membership interest enters into a written commitment to be engaged actively and directly in the management of the company and the purchaser of the membership interest, in fact, does participate actively and directly in the management of the company); WIS. STAT. § 551.02(13)(c) (Supp. 1994) (presuming LLC interest to be a “security” if the right to manage the LLC is vested in one or more managers or if the LLC has more than 35 members).

There are analogous problems in determining whether an LLC should be treated as a “corporation” under the Bankruptcy Code, 11 U.S.C. § 101(9) (Supp. V 1993) (defining “corporation”). See 1 RIBSTEIN & KEATINGE, *supra* note 7, § 14.04. Decentralization is significant in this context in determining whether partnership rules should control initiation of the proceeding. See 11 U.S.C. § 301 (1988) (requiring unanimity for initiation of voluntary partnership bankruptcy). In this respect, the actual form of management adopted by the LLC—i.e., whether it is managed by members or managers—rather than the default provision should be controlling. However, the limited liability of an LLC may justify

Regulatory considerations can arise unexpectedly. For example, a firm was forced to change from an LLC to a corporate structure when questions were raised whether it was structured by one of its owners to circumvent foreign ownership laws and regulatory limits on how many television stations one company can own.⁷⁰

Regulatory considerations are particularly important in explaining the development of LLPs.⁷¹ Partnerships with limited liability seem perverse from a pure transaction-cost standpoint because limited liability fits poorly with other elements of the partnership form.⁷² Moreover, under most LLP statutes the firm might forgo the complete limitation of owner liability that it otherwise would have adopted solely to maximize the chance that it will be characterized as a partnership for regulatory purposes. However, LLPs' function becomes clearer in the light of regulatory considerations. The application of many types of regulation potentially turn on whether a firm is formally a "partnership." These include not only the securities laws, as discussed immediately above, but also employment discrimination statutes.⁷³

As with the effect of tax rules, even if regulation that forces firms to make perverse transaction-cost choices is itself inefficient, statutory terms such as LLP provisions may be an efficient way to help firms adapt to this regulation.

treating even a member-managed LLC as a "corporation" under bankruptcy law because of the importance of limited liability to the handling of the bankrupt estate.

70 Elizabeth Jensen, *SF Broadcasting Acts to Speed FCC Clearance*, WALL ST. J., Oct. 17, 1994, at B9.

71. See *supra* note 8 (listing statutes). See generally Larry E. Ribstein, *Possible Futures for Unincorporated Firms*, 64 U. CIN. L. REV. (forthcoming 1995) (discussing regulatory, tax and other considerations underlying the development of the LLP form).

72. See *supra* text accompanying notes 35-37.

73. See *Hishon v. King & Spalding*, 467 U.S. 69, 80 (1984) (Powell, J., concurring) (stating that partnership was "employer" for purposes of age discrimination laws but that those laws did not regulate relationship among law partners); *Wheeler v. Hurdman*, 825 F.2d 257, 277 (10th Cir.) (refusing to apply antidiscrimination law to partner in large accounting firm), *cert. denied*, 484 U.S. 988 (1987); 1 BROMBERG & RIBSTEIN, *supra* note 23, at 1:33.

Recent courts have refused to adopt a "per se" test, holding instead that the test as to the application of the discrimination laws is whether the person is a "bona fide" partner. See *Simpson v. Ernst & Young*, 850 F. Supp. 648, 663 (S.D. Ohio 1994) (holding that plaintiff should be treated as an employee rather than a "bona fide" partner under age discrimination laws); *Ehrlich v. Howe*, 848 F. Supp. 482, 489 (S.D.N.Y. 1994) (holding that plaintiff was a nonemployee partner because he shared profits and losses, was jointly and severally liable for firm debts, voted as a partner, had a sufficient voting interest to block partnership decisions in combination with one other partner, participated in hiring decisions and could be terminated only by unanimous vote of the other partners). Although these cases suggest that the LLP vs. LLC strategy may not be completely effective, technical partnership status may create enough of a presumption against "employee" treatment to make the strategy pay off for many firms.

D. Implications

The tax/regulation hypothesis implies that the presence or absence of competition among business forms depends critically on tax and regulatory rules that bear on the costs and benefits of competing forms rather than on inherent defects in the market for business forms. Thus, the evolution of business association statutes for closely held firms may have been limited by tax classification rules that constrained the development of flexible forms. This observation is confirmed by the fact that active state development of LLCs began the instant the IRS signaled a new flexibility by sanctioning partnership tax treatment for LLCs.⁷⁴

The tax/regulation hypothesis may be tested empirically if the IRS follows through on a recent tentative proposal to allow certain unincorporated firms to elect whether to be treated as partnerships for tax purposes.⁷⁵ Under the tax/regulation hypothesis, this proposal should further encourage the growth of unincorporated firms by increasing the significance of the state law classification of the firm as a corporation or a partnership. At the same time, it should eliminate tax-classification reasons for structuring unincorporated firms in particular ways. Thus, tax-oriented but otherwise inefficient rules in limited liability company statutes will be eliminated.

III. THE INEFFICIENCY HYPOTHESIS

This Part examines reasons why legislators might pass inefficient statutory standard form rules. Subpart A considers the extent to which political forces are likely to cause adoption of inefficient provisions. Subpart B discusses network externalities as an explanation for inefficient LLC terms. Subpart C focuses on herding and limited information as a cause of inefficiency. Finally, subpart D shows how inefficient statutes may be constrained by jurisdictional competition.

A. Rent-Seeking and Interest Groups

This subpart discusses two groups whose interests may be important in shaping LLC legislation—legislators and lawyers.

74. See *infra* Parts IV(A), IV(B)(2).

75. See *supra* note 10 and accompanying text. Note that the proposal would not affect tax treatment under rules applicable to certain types of firms, such as the rule which taxes publicly traded partnerships as corporations. See I.R.C. § 7704 (1988).

1. Legislators

Legislators may act as brokers who pass laws in return for “rents” from interest groups, including contributions, political support and potential future employment. They also may serve their own interests in adopting legislation that maximizes their future rent-seeking ability. Accordingly, legislators may resist adopting LLC or other statutory provisions that are consistent with the public interest criteria discussed in Part I because such provisions would reduce their expected rents from future laws relating to closely held firms. For example, legislators might seek to maximize both the number of mandatory rules in business association statutes and the complexity of default provisions. As legislators pass more mandatory statutory rules, parties to firms must rely increasingly on legislators’ help to adjust their relationships. For example, consider a statute that lets members transfer their management power only by unanimous consent of the nonassigning members and does not allow members to vary the statutory rule. If changes in LLC practice made consent requirements particularly costly, LLC members would have to apply for legislative approval of provisions allowing transfers with a lower vote.⁷⁶ This is analogous to legislators’ sale of corporate charters in the early history of corporate law.⁷⁷

Even statutory default rules can impact legislators’ power. Complex and detailed default provisions increase legislators’ opportunities to change existing contracts by changing default rules. This, in turn, invites contracting parties to pay rents to legislators rather than investing in private renegotiation of contracts. Elaborate formal requirements for changing statutory defaults, such as detailed amendment and merger procedures, similarly lend themselves to legislative manipulation.

Mandatory rules may be efficient. The discussion of the limited partnership “control rule,” for example,⁷⁸ suggests that there may be an efficiency justification for a mandatory rule that prevents firms from opportunistically opting out of rules in midstream when parties’ incentives

76. Although contracting parties might want to change default rules, it will usually be more cost-effective for them to simply bargain around the rule rather than to pursue a statutory change.

77. For accounts of the sale of charters and how jurisdictional competition ultimately broke down this practice, see Henry N. Butler, *Nineteenth-Century Jurisdictional Competition in the Granting of Corporate Privileges*, 14 J. LEGAL STUD. 129 (1985).

78. See *supra* Part I(B)(3).

change. But, in many situations, prohibiting firm-specific contracting could impose burdens on LLCs that exceed the rules' benefits. For example, requiring LLCs to disclose the details of all member contributions would impose significant burdens on LLCs and perhaps channel the parties to otherwise less suitable transaction forms. At the same time, third party creditors probably would derive little benefit from such disclosures, since member contributions are only a small part of the firms' general creditworthiness.

2. Lawyers

Lawyers may be the most powerful interest group that would demand LLC statutory provisions.⁷⁹ Because lawyers are well organized into bar groups, they can overcome free rider problems that impede small business owners in collectively seeking legislation. Moreover, lawyers can provide politicians not only with campaign funds and votes, but also with drafting services and jobs for legislators who are also lawyers.

Lawyers may gain from the adoption of new limited liability business forms such as LLCs and LLPs in ways that are adverse to their clients' interests. For example, lawyers can reduce their risk-bearing costs by using the LLC form in their own practices. Although lawyers and other professionals are subject to ethical and legal restrictions on limitation of liability that apply irrespective of the form of organization,⁸⁰ they could use an additional partnership-type limited liability business form as an opportunity to press for a relaxation of restrictions on limited liability.

Lawyers also may seek adoption of provisions in business association statutes that reduce their exposure to malpractice liability. One possible source of malpractice liability is the attorney's failure to achieve the flow-through partnership-type taxation the clients expected. The characteristics

79. For a discussion of lawyers' influence on corporate law, see Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporation Law*, 65 TEX. L. REV. 469 (1987).

80. With respect to legal restrictions on limiting lawyer liability, see generally ROBERT W. HILLMAN, HILLMAN ON LAWYER MOBILITY 6:6-6:20 (1994). With respect to ethical restrictions on limiting lawyer liability, see MODEL CODE OF PROFESSIONAL RESPONSIBILITY DR 6-102, EC 6-6 (1983); MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.8(i) (1992). With respect to accountants, the American Institute of Certified Public Accountants (AICPA) amended its Rule 505 in 1991 to expand the forms of business in which accountants could practice. AICPA CODE OF PROFESSIONAL CONDUCT Rule 505 (1994). The rule as amended has been interpreted as permitting accountants to practice as LLCs, subject to state law. See Memorandum from Helene Kennedy, Director, Communications and Public Relations of the AICPA, to State Society Executive Directors and Communications Directors (June 13, 1991).

that determine whether LLCs and other firms are taxed as partnerships—i.e., continuity of life, centralized management, limited liability and free transferability of interests—are not always easy to determine.⁸¹ For example, it may not be clear what level of consent to transfer of management rights is enough to remove the corporate characteristic of free transferability. Lawyers may bear the costs of an adverse tax ruling without receiving the transaction-cost benefits of suitable terms. Moreover, nontax lawyers might have to acquire some expertise in tax law or refer cases to tax specialists. Accordingly, lawyers might advocate mandatory statutory provisions that reduce the possibility of adverse tax consequences even if their clients would prefer to be able to adapt the statutes to their needs.

Lawyers also may advocate mandatory provisions that force clients to seek legal advice in drafting their agreements. For example, the parties need legal advice to navigate intricate restrictions on fiduciary duty waivers.⁸² They would also need legal advice to ensure that they have complied with formalities that are prerequisites to limited liability and to avoid restrictions on distributions. Moreover, any change in complex default terms and mandatory rules requires review and change of existing agreements.

These lawyer-benefit explanations for statutory rules do not require that lawyers actually dominate the drafting process. To be sure, lawyers acting as statutory drafters might press for such provisions irrespective of whether firms generally would want them in the statutes. But nonlawyer drafters may recognize that lawyers ultimately will make self-interested decisions for clients on whether to adopt the statute, just as corporate managers can influence corporations' choice of chartering state.

Several factors limit the perverse effects of lawyer influence on business association statutes. First, prolawyer provisions in business association statutes do not necessarily hurt clients. For example, limited liability would not necessarily significantly reduce client protection.⁸³ The firm's assets and reputation, as well as partners' individual assets, would continue to

81. For a discussion of the uncertainty inherent in applying these classification factors, see Ribstein, *supra* note 5, at 461-65.

82. See Ribstein, *supra* note 37, at 60-61. (criticizing such restrictions in the Revised Uniform Partnership Act). Lawyers' advocacy of complexity in this regard is not inconsistent with their advocacy of mandatory tax-characterization rules. Advising on compliance with complex and mandatory business association-type rules does not involve the same problem of crossover expertise as advice on tax characterization, and consequently does not pose an equivalent risk of malpractice liability.

83. For a general discussion of the policy arguments favoring limited liability of professionals, see Ribstein, *supra* note 5, at 434-36.

serve as a bond against partner misconduct. Monitoring by other professionals remote from the work being done for the client is often less useful than monitoring by the clients themselves, particularly through corporate legal and accounting departments.⁸⁴

Second, competition in the professional services market can mitigate the potential impact of prolawyer statutory provisions. Clients theoretically can adjust the fees they are willing to pay based on whether the firm has limited liability and on indicia of the firm's future performance. Thus, statutes permitting lawyers to limit their personal liability may help rather than hurt clients by opening up competition in the legal services market. Indeed, smaller firms might advocate mandatory personal liability to increase the cost of capital and decrease the potential size of their larger competitors.⁸⁵

Third, lawyers and clients have common interests in important respects. For example, a statute that furthers client interests by providing a better organizational form also generates legal fees for lawyers as clients seek to further their interests by switching to the new form.

B. Network Externalities

Even if legislators have incentives to supply statutes that parties to firms want, the parties themselves may lack incentives to adopt new standard forms. This is an aspect of the "network benefits" point discussed in Part I.⁸⁶ The extent and number of these networks may be suboptimal because each user gains only part of the benefit she confers by joining the network⁸⁷—i.e., networks may involve positive externalities. This

84. See Jack L. Carr & G. Frank Mathewson, *The Economics of Law Firms: A Study in the Legal Organization of the Firm*, 33 J.L. & ECON. 307, 322-23 (1990).

85. See Jack L. Carr & G. Frank Mathewson, *Unlimited Liability as a Barrier to Entry*, 96 J. POL. ECON. 766 (1988). This may explain the recent tentative move in the American Law Institute to mandate personal liability of attorneys irrespective of the form of organization. See RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS, tentative draft 7, § 79 cmt. C (Apr. 7, 1994). Under the analysis in the text, a *uniform* rule would insulate small firms from competition by larger firms operating under more flexible statutes.

86. See *supra* Parts I(A)(5), I(B)(2).

87. See Michael L. Katz & Carl Shapiro, *Systems Competition and Network Effects*, J. ECON. PERSP., Spring 1994, at 93; Michael L. Katz & Carl Shapiro, *Technology Adoption in the Presence of Network Externalities*, 94 J. POL. ECON. 822 (1986); Michael L. Katz & Carl Shapiro, *Network Externalities, Competition, and Compatibility*, 75 AM. ECON. REV. 424 (1985). Farrell & Saloner have identified analogous externalities of "excess inertia" (reluctance to switch from existing technology or standard) and "excess momentum" (switching that strands "installed base" of users of existing technology). See Joseph Farrell & Garth Saloner, *Standardization, Compatibility, and Innovation*, 16 RAND J. ECON. 70, 71-72 (1985) (excess inertia); Joseph Farrell & Garth Saloner, *Installed Base and*

“network externalities” problem may inhibit the formation of new networks, and so cause existing networks to become too large. In the business associations context, new standard forms may never become successful unless they borrow ill-fitting terms from existing forms solely in order to have the benefits of case law and other interpretive materials that have been developed in connection with these forms.⁸⁸

There are several issues concerning the extent of any network externality problem regarding statutory business forms. First, as discussed above,⁸⁹ the existence of network *benefits* is questionable for statutory standard forms. Second, any network *benefits* may not involve an *externalities* problem in this context. State legislators and lawyers can encourage the development of networks in ways that are not readily available to private firms attempting to start technological networks. Lawyers can hold continuing legal education programs on the use of a new standard form even before any firms join the network. Lawyers earn general reputational benefits from these efforts and can capture a share of any market for these forms that should develop. Lawyers’ marginal time costs of presenting and attending these programs may be relatively low because all states require lawyers to participate in continuing legal education.⁹⁰

C. Herding and Limited Information

State lawmakers may engage in “herd behavior” in enacting LLC or other new business associations statutes by ignoring their private information and applying terms from earlier statutes or from other standard forms.⁹¹ This practice inhibits formation even of those new statutory “networks” that firms would be willing to join. The main question

Compatibility: Innovation, Product Preannouncements, and Predation, 76 AM. ECON. REV. 940 (1986) (excess momentum). Liebowitz & Margolis argue that network externalities may not be as widespread as these authors suppose. See S.J. Liebowitz & Stephen E. Margolis, *Network Externality: An Uncommon Tragedy*, J. ECON. PERSP., Spring 1994, at 133; S.J. Liebowitz & Stephen E. Margolis, *The Fable of the Keys*, 33 J.L. & ECON. 1 (1990).

88 See Rubstein, *supra* note 18 (discussing this reason for linking statutory forms).

89 See *supra* Part I(A)(5).

90 Although these efforts may encourage firms to adopt the new form, older forms may still remain valuable because of their existing sets of interpretive materials. See Rubstein, *supra* note 18.

91 For theoretical treatments of herd behavior, see Abhijit V. Banerjee, *A Simple Model of Herd Behavior*, 107 Q.J. ECON. 797 (1992); Sushil Bikhchandani et al., *A Theory of Fads, Fashion, Custom, and Cultural Change as Informational Cascades*, 100 J. POL. ECON. 992 (1992); David S. Scharfstein & Jeremy C. Stein, *Herd Behavior and Investment*, 80 AM. ECON. REV. 465 (1990). For an application of this theory to judicial lawmaking, see Jason Johnston, Notes on the Economic Theory of Legal Evolution (Mimeo, Vanderbilt University, 1993).

regarding herding is whether legislators are irrationally disregarding information or are acting rationally in view of their limited initial information. It is not surprising that early-enacting lawmakers would be uncertain about what types of new statutory forms to adopt. As more information becomes available about the nature of the form, how firms are using it and potential problems, later-adopting legislators may reach different conclusions than their predecessors about the types of terms that are appropriate. In this way, inputs from many jurisdictions will cause efficient rules to evolve through innovation.⁹²

Whether the herd hypothesis or the limited-information hypothesis best describes the enactment of LLC statutes depends on whether later LLC statutes evolve different approaches than the earlier laws. Part IV includes data that sheds light on this issue.⁹³

D. *The Impact of Jurisdictional Competition*

The power of particular groups to enact self-interested legislation, as well as the impact of network externalities, limited information and herding, ultimately depends on the extent to which jurisdictions compete to provide LLC legislation. Jurisdictional competition provides new information about LLCs and gives legislators incentives to do something more than play follow-the-leader. More importantly, any attempt by legislators and lawyers to reap selfish gains from LLC statutes could meet the same fate as special chartering—that is, erosion of inefficient rules by competition among the states.⁹⁴ The earliest general incorporation statutes may have resulted from high potential gains by interest groups and relatively low lobbying costs.⁹⁵ Even where these circumstances did not exist, legislators had an incentive to stem the loss of incorporations to general incorporation states, and the consequent loss of revenues⁹⁶ and legislative control over local firms, by

92. See Martti Vihanto, *Competition Between Local Governments as a Discovery Procedure*, 148 J. INST. & THEO. ECON. 411, 415-17 (1992). For an illustration of how such a process worked in the context of federal procedural rules, see Bruce H. Kobayashi, Jeffrey S. Parker and Larry E. Ribstein, *The Process of Procedural Reform: Centralized Uniformity vs. Local Experimentation* (1994) (unpublished manuscript, on file with *Washington University Law Quarterly*).

93. See *infra* Part IV(C).

94. See Butler, *supra* note 77.

95. See William F. Shughart II & Robert D. Tollison, *Corporate Chartering: An Exploration in the Economics of Legal Change*, 23 ECON. INQ. 585, 593 (1985).

96. Revenues from incorporations accrue generally to taxpayers, who are a relatively uncoordinated, and therefore weak, interest group. But these fees can be valuable to legislators because they can be tapped to fund projects for powerful constituents without legislators' having to levy unpopular taxes. I thank William Carney for this insight.

enacting competing general incorporation statutes.⁹⁷ In short, the statutes relating to closely held firms and other private contracts emerge from a combination of political forces and jurisdictional competition.⁹⁸

It is not clear, however, to what extent jurisdictional competition constrains political rent-seeking with regard to LLC statutes. The demand side of jurisdictional competition requires, among other things, that actors be mobile,⁹⁹ while the supply side requires that legislators have incentives to compete for formation business.¹⁰⁰ Academics have debated whether and to what extent jurisdictional competition generally leads to efficient results regarding public corporation statutes. William Cary claimed that state competition for corporate charters was a vigorous “race to the bottom” because the chartering choice was made by self-interested managers.¹⁰¹ But Ralph Winter showed that, because efficient capital markets gave managers incentives to choose the most efficient governance terms, the competition for corporate charters is a “race to the top.”¹⁰²

Even if jurisdictional competition generally leads to efficient public corporation law, it may not operate effectively with regard to closely held firms. First, Ian Ayres argues that close corporations’ relative immobility affects the demand for close corporation legislation.¹⁰³ Foreign incorporation imposes registration costs, exposes firms to suits in remote jurisdictions and makes unavailable intrastate financing that is exempt from the federal securities laws. Close corporations ordinarily lack incentives to incur these costs because they can get most of what they want by adapting the default provisions of their residence-state’s law. Large multistate firms,

97. See Shughart & Tollison, *supra* note 95, at 591.

98. See Larry E. Ribstein, *Efficiency, Regulation and Competition: A Comment on Easterbrook & Fischel’s Economic Structure of Corporate Law*, 87 NW. U. L. REV. 254 (1992) (discussing generally this dynamic perspective on corporate law).

99. See Frank H. Easterbrook, *Antitrust and the Economics of Federalism*, 26 J.L. & ECON. 23, 34 (1983); Charles M. Tiebout, *A Pure Theory of Public Expenditures*, 64 J. POL. ECON. 416 (1956).

100. For a detailed discussion of these factors, see Ronald J. Daniels, *Should Provinces Compete? The Case for a Competitive Corporate Law Market*, 36 MCGILL L.J. 130 (1991).

101. See William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L J 663 (1974).

102. See RALPH K. WINTER, JR., *GOVERNMENT AND THE CORPORATION* (1978); Ralph K. Winter, Jr., *State Law, Shareholder Protection and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977).

103. See Ayres, *supra* note 4, at 375-76. Roberta Romano has argued that legislators might not actively supply statutes for closely held firms because there is no transaction-cost justification for such statutes. See *supra* note 11 and accompanying text. In this situation, the *absence* of statutes would be consistent with the efficiency hypothesis, and the presence of such statutes would be consistent with either the regulatory or inefficiency hypotheses.

on the other hand, pay these costs anyway in all but one state in which they transact business and have scale economies that can absorb the costs.

Second, Ayres argues that, even if close corporations could move their incorporation state relatively cheaply, legislators would have little incentive to supply close corporation statutes because judicial decisions on close corporation issues could reduce the value of the state's corporate precedents for public corporations. Among other problems, the meanings of statutory provisions may be clouded by applying the same provisions to the different public and close corporation contexts.¹⁰⁴

Third, even if state legislators do compete to supply statutes for closely held firms, there will not necessarily be a race to the top. No active stock market provides an efficient pricing mechanism to discipline the close corporation charter market. But this may not be a problem because owners are actively involved in managing closely held firms, and therefore need not rely on a public market to discount governance information in share prices. On the other hand, the choice might be determined by lawyers who, as discussed above,¹⁰⁵ may have self-interested reasons for selecting particular types of LLC statutes.

The following discussion of specific conditions for competition in the context of closely held firms shows that, despite the concerns raised above, there are reasons to believe that there will be a race to the top in this context.

1. Firms' Mobility and the Conundrum of Fees

In arguing that there is less jurisdictional competition for close corporations than for public corporations, Ayres relies on close corporations' high regulatory and tax costs of foreign incorporation. But it does not necessarily follow that competition will be limited or nonexistent. To see this, it is helpful to delineate the factors firms will consider in choosing foreign incorporation. A firm's decision to incorporate outside its residence state (i.e., the state in which its principal place of business is located) depends on (a) the fees and other charges or penalties the residence state imposes on foreign firms operating in the state; (b) the incorporation

104. For example, in *Whetstone v. Hossfeld Manufacturing Co.*, 457 N.W.2d 380, 382-83 (Minn. 1990), the court applied an appraisal right provision to permit a close corporation minority shareholder to dissent from an amendment of the articles of incorporation. This case raises the question whether a public corporation shareholder would be able to dissent in the same situation, and increases the uncertainty of the appraisal right for public corporations.

105. See *supra* text accompanying note 82.

fees and taxes charged by the nonresidence state; (c) the transaction and other costs of foreign incorporation; (d) the transaction cost advantage of organizing under the other state's law; (e) the incorporation fees and taxes charged by the residence state; and (f) the costs of avoiding foreign incorporation. A firm will choose foreign incorporation if $(a + b + c) < (d + e + f)$. This simple formula clarifies that firms will organize elsewhere if the nonresidence state can offer a transaction cost advantage or lower organization costs and fees.¹⁰⁶ In short, state competition can explain why legislators do not exploit close corporations' captivity by increasing their franchise taxes.

Ayres' suggested limits on state competition overlook the availability not only of better corporation statutes, but also of alternative types of business forms. Ayres suggests that states could limit this form of competition by charging more for these other forms.¹⁰⁷ But firms might respond by adopting nonstatutory contracts, such as partnership agreements with nonrecourse provisions.¹⁰⁸ While these contracts are more costly and less reliable than adopting statutory limited liability forms, if the organization fees were high enough, the savings would offset these additional costs. Also, as illustrated by the development of LLCs and LLPs, states could compete for out-of-state business with noncorporate statutory forms. To be sure, these forms are relatively risky for interstate business in the absence of an entrenched "internal affairs" rule that applies the law of the incorporating state. But common law choice-of-law rules and constitutional rules may provide some protection.¹⁰⁹ Moreover, LLCs might have statutory protection as foreign corporations and limited partnerships¹¹⁰ or

106. See Ayres, *supra* note 4, at 374-75. The loss of the federal intrastate securities exemption probably is not a significant factor in light of the availability of other securities exemptions for closely held firms. See, e.g., S.E.C. Regulation D, 17 C.F.R. §§ 501-508 (1994).

107. See Ayres, *supra* note 4, at 374-75.

108. See generally Ribstein, *supra* note 43.

109. See generally Larry E. Ribstein, *Choosing Law by Contract*, 18 J. CORP. L. 245 (1993) (discussing general choice-of-law and constitutional issues); Ribstein, *supra* note 4 (discussing impact on contractual choice of law of recent statutes in Delaware, New York and Texas providing for enforcement of choice-of-law clauses).

110. This was apparently an impetus for the first post-tax-ruling statute, in Colorado. According to a Colorado lawyer active in the development of LLCs in that state:

Many thought that the LLC should attempt to comply with the foreign corporation certificate of authority or registration law of the non-LLC state. The Secretary of State (Corporation Commission or whatever) would then say either (a) that the LLC could not file which would tend to prove they were not required to file and could transact business without registration or (b) that the LLC could file as a foreign corporation, which would tend to show compliance with the corporation code of the state involved and give the LLC a basis to do business, take title, claim limited liability like a corporation.

may be able to move their operations to states that have or will enforce favorable law.

Finally, factor (f) in this formula indicates that some closely held firms may be more likely to choose foreign state organization if, like national firms, they have independent business reasons for operating in more than one state. For example, even a relatively small firm that is based in Kansas City, Missouri, and competes in a market that extends into Kansas may be more likely to organize in Kansas than a firm with a similar-sized market in the middle of the state—for example, in Independence, Missouri.

In short, states do not have natural monopolies over the business of chartering closely held firms. A state that has no LLC statute, or whose statute is clearly unsuitable for closely held firms, perhaps because it includes a large number of cumbersome formalities and mandatory rules, may lose fees and legal business to a state with a more hospitable statute.¹¹¹

2. *Lawyers as Suppliers and Demanders of Legislation*

Ayres' argument for limited interstate competition for close corporation charters assumes that only the parties to these firms would demand such legislation and only state legislators would supply it. This ignores, however, the central role of the practicing bar in both demanding and supplying legislation.¹¹² Lawyers have an interest in attracting and retaining transactional and litigation business by having state-of-the-art business association statutes in their state. Lawyers also may gain both from statutory provisions that help lawyers at the expense of their clients¹¹³ and from provisions that serve both lawyers' and clients' interests. For example, if statutory

111. One indication of this competition is that California inserted a provision in its LLC statute noting the urgency of competing for business with the vast majority of states that had already adopted LLC statutes. This provision states:

This act is an urgency statute necessary for the immediate preservation of the public peace, health, or safety within the meaning of Article IV of the Constitution and shall go into immediate effect. The facts constituting the necessity are: Limited liability companies may presently do business in at least 43 of the United States. It is essential to the California economy that the state provide an attractive business environment, which includes provision for limited liability companies. In order to help stem the flow of business and jobs from California, protect the rights of Californians dealing with limited liability companies, and improve California's business climate and tax base, it is necessary that this act go into effect immediately.

1993 Cal. Legis. Serv. 1200 (West).

112. For a discussion of lawyers' role in jurisdictional competition, see Ribstein, *supra* note 4.

113. See *supra* Part III(A)(2).

standard terms reduce lawyers' costs of forming firms, at least some of the reductions would be passed to the client in the form of lower fees. On the supply side, these laws are often written by bar groups whose members can earn general reputational benefits and specific client referrals by being associated with the legislation.

There is a potential tension between lawyers' roles as demanders and suppliers of statutes. Lawyers' incentive to supply legislation depends partly on whether they are compensated in the form of increased fees. At the same time, if lawyers benefit at their clients' expense, this decreases the demand for the statute by the parties to firms. As a result of this tension, the intensity of jurisdictional competition may depend to some extent on whether it is driven by franchise tax revenues as well as by lawyers.¹¹⁴

3. Rewards for Competing

Jurisdictional competition depends partly on whether legislators or lawyers can capture enough benefits from supplying legislation to at least offset the costs in terms of time and other resources devoted to drafting and the risk of losing political or client support because of failed experiments. Legislative innovators may not be able to capture all of the benefits because other jurisdictions easily can free-ride on their efforts by copying successful legislation.¹¹⁵ Yet much of the work is done by lawyers who can capture general reputational benefits and specific client referrals from their committee work even if their work product is copied by other states.¹¹⁶

4. Effect on Incorporations of Publicly Held Firms

Ayres argues that legislators may refuse to adopt close corporation legislation in order to protect their business from incorporations of publicly held firms.¹¹⁷ But Ayres also notes that the undesirable "spillover" effect of close corporation legislation on public corporation statutes could be

114 See Ribstein, *supra* note 4 (elaborating this point).

115. See Susan Rose-Ackerman, *Risk Taking and Reelection: Does Federalism Promote Innovation?*, 9 J. LEGAL STUD. 593 (1980).

116. See *supra* Part III(D)(2). William Carney suggests that, because lawyers do not internalize the benefits of drafting corporate law, they have relied on the Model Business Corporation Act and only engaged in sporadic corporate law reform. See William J. Carney, *Federalism and Corporate Law: A Non-Delaware View of the Results of Competition* (1994) (unpublished manuscript, on file with author). However, Delaware's first mover advantage and the presence of the MBCA may have discouraged innovation in corporate law. Neither of these factors plays a role in LLC law.

117. See Ayres, *supra* note 4, at 395.

contained by forcing closely held firms to organize under wholly separate statutes.¹¹⁸ Ayres says legislators are reluctant to provide such forms because courts would nullify such an extreme limit on private ordering.¹¹⁹ But the states do compete to provide *noncorporate* business forms precisely in order to avoid “spillover.” This is an example of the “coherence” and “gap-filling” justifications for separate statutory standard forms.¹²⁰

5. *The Race to the Top*

Even if states actively compete to provide statutes for closely held firms, they will not necessarily “race to the top.” For example, lawyers might guide their clients toward statutes with complex, litigation-maximizing rules that serve the lawyers’, but not the clients’, interests.¹²¹ Clients’ private benefits from being informed about statutes may be lower than their private costs, and there is no efficient securities market that would discount experts’ judgments in the price. Yet clients can rely to some extent on reputational signals of lawyers’ skill and loyalty and lawyers may compete to some extent on overall price.

E. *Summary and Implications*

This Part has shown that statutory standard forms for closely held firms may not be developed consistently with either the efficiency or regulatory hypotheses. Inefficient terms may result from a combination of imperfect legislator incentives, interest group activity, defects in the market for state laws, or externalities inherent in firms’ demand for standard forms.

One possible implication of the inefficiency hypothesis is that statutory standard forms should be produced by “superlegislatures” such as the American Law Institute, the American Bar Association or the National Conference of Commissioners on Uniform State Laws. These bodies might be able to overcome the inertia that prevents the promulgation of these standard forms, to mute interest group activity, and to stimulate the development of networks of standard form users. However, these bodies respond to their own sets of misincentives¹²² and could encourage the

118. *Id.* at 395 n.124.

119. *Id.*

120. *See supra* Part I(C)(1) & (2).

121. *See supra* text accompanying note 82.

122. *See* Kathleen Patchel, *Interest Group Politics, Federalism, and the Uniform Laws Process: Some Lessons from the Uniform Commercial Code*, 78 MINN. L. REV. 83, 120-25, 126-32 (1993) (criticizing banks’ influence on Articles 3 and 4 of the Uniform Commercial Code); Larry E. Ribstein

adoption of inefficient laws.¹²³ In any event, there is evidence that state legislatures tend to widely adopt uniform law proposals only in certain situations in which uniformity is particularly appropriate.¹²⁴ This suggests that proposed uniform statutes for closely held firms would not be widely adopted, because closely held firms have diverse needs and these firms normally operate in only one state and so do not risk having to comply with inconsistent state laws.

A second implication of the inefficiency hypothesis is that courts should pick up the slack left by statutes by taking an active role in providing rules for closely held firms. They would, among other things, nullify restrictions on use of the statutes¹²⁵ and ignore statutory limitations on remedies such as dissolution on petition by minority holders. The problem with this course of action is that, if the efficiency or tax/regulation hypothesis is correct, the judicial nullification of statutes would be inefficient.¹²⁶

Since their actions could produce perverse results, courts and policymakers should act on the inefficiency hypothesis only if it is supported by strong evidence. The following Part discusses data produced by the recent evolution of the LLC.

IV. EVIDENCE FROM THE DEVELOPMENT OF THE LLC

This Part discusses the rapid adoption and evolution of LLC statutes in the wake of a tax ruling that reduced the costs of limited liability. This Part also examines the implications of this development for the theories of statutory forms discussed in Parts I-III. Subpart A gives a general historical

& Bruce H. Kobayashi, *An Economic Analysis of Uniform State Laws*, 25 J. LEG. STUD. (forthcoming 1996); Ribstein & Kobayashi, *supra* note 22 (discussing disincentives concerning promulgation of uniform LLC act); Edward Rubin, *Efficiency, Equity and the Proposed Revision of Articles 3 and 4*, 42 ALA. L. REV. 551 (1991) (same); Alan Schwartz & Robert E. Scott, *The Political Economy of Restatement-Type Lawmaking Processes: An Analysis of the UCC and the Proposed Revisions to Article 2*, 143 U. PA. L. REV. 595 (1995) (analyzing the work of the American Law Institute and NCCUSL, focusing on the Uniform Commercial Code).

123. See Ribstein & Kobayashi, *supra* note 122.

124. *Id.*

125. See Ayres, *supra* note 4, at 395.

126. Although a statute that is shaped by tax and regulatory considerations may increase transaction costs in other respects, a court cannot correct this problem without compromising the statute's tax and regulatory objectives. For example, if a statute provides for dissolution at will for tax classification reasons, a court that attempted to reduce the transaction costs of this provision by interpreting the statute to provide for continuity of life would thereby insert the very feature the statute's drafters deliberately and rationally sought to avoid.

overview, while subpart B discusses the process in more detail. Subparts C and D provide data on the terms of LLC statutes and on firms' adoption of the LLC form. In general, the history of the LLC tends to support the efficiency hypothesis. State legislatures rapidly have evolved statutes for closely held firms that match what would be predicted under the efficiency hypothesis—that is, internally consistent sets of provisions combining limited liability and decentralized management. The pace of statutory innovation tends to support the existence of jurisdictional competition. Moreover, the speed with which firms have switched to the LLC form tends to suggest that network externalities are not a strong impediment to the development of new statutory business forms. At the same time, the history of LLCs, the timing of adoption by firms of the LLC form, and the structure of LLC statutes support the tax/regulation hypothesis.

A. *Historical Overview*

Prior to the advent of the LLC, owners of closely held firms were forced to choose from among several not completely satisfactory alternatives.¹²⁷ In particular, corporate default rules such as centralized management, free transferability and dissolution only by majority vote are ill-suited to many closely held firms whose owners want to participate directly in control but also to retain the option of exiting the firm. Also, corporations are subject to costly double taxation on income at the firm level and at the distribution level. Partnership offered favorable organizational rules and tax treatment, but at the significant cost of unlimited liability.

Courts and commentators long ago recognized the need for a limited liability business form that was better suited than the corporation to the needs of closely held businesses.¹²⁸ Closely held firms could obtain partial limited liability through limited partnerships. However, the limited partnership “control rule” can be quite costly for the typically active owners of closely held firms. Judicial changes in corporation law¹²⁹ followed by legislative adoption of special close corporation provisions¹³⁰ facilitated use of the corporate form. But relatively few firms formed statutory close

127. These problems are reviewed in more detail in Ribstein, *supra* note 5, at 418-25.

128. For a leading early article, see Edwin J. Bradley, *Toward a More Perfect Close Corporation—The Need for More and Improved Legislation*, 54 GEO. L.J. 1145 (1966).

129. See Ayres, *supra* note 4, at 378-88 (tracing and analyzing judicial nullification of legislative restrictions on adaptation of the corporate form for use by closely held firms).

130. For a comprehensive review of these provisions, see Dennis S. Karjala, *A Second Look at Special Close Corporation Legislation*, 58 TEX. L. REV. 1207 (1980).

corporations.¹³¹ That may have been for one or more of several reasons: the statutes included unnecessary formalities and restrictions;¹³² close corporations remained at least partly subject to unsuitable corporate default rules; firms perceived strong interpretive benefits in the case law and customs that were associated with the existing corporate and partnership “networks”;¹³³ or firms would have to incur costs in the form of filing fees and legal costs of examining and revising existing agreements. In any event, the close corporation statutes apparently did not offer enough of a benefit over current forms to offset the costs of making the switch.

Firms and legislators were constrained from innovating new types of limited liability firms because of uncertainties about whether these firms would be characterized as corporations under the tax classification rules¹³⁴ and about whether the firms’ limited liability would be recognized outside the formation jurisdiction. A state that does not explicitly authorize “foreign” firms to transact business locally may, under general choice-of-law principles, refuse to apply the law of a state the parties have chosen in their contract if the chosen law lacks significant contacts with the contract or conflicts with the forum’s policies.¹³⁵ Applying these principles, a state might not recognize the limited liability or other features of new business forms.¹³⁶

Wyoming adopted the first LLC statute in 1977 in response to a request by an oil firm that had used Panamanian limited liability companies and wanted to use a U.S. entity for an international oil and gas exploration venture.¹³⁷ During the next eleven years, only one other state—Florida, in 1982—followed Wyoming’s lead.

In 1988 the Internal Revenue Service (IRS) decided to classify an LLC as a partnership for tax purposes.¹³⁸ By the fall of 1994 all but three states had adopted LLC statutes. All of these statutes provide for limited

131. See I F. HODGE O’NEAL & ROBERT B. THOMPSON, O’NEAL’S CLOSE CORPORATIONS § 1.18 (3d ed. 1986); Mike Harris, Comment, *Assessing the Utility of Wisconsin’s Close Corporation Statute: An Empirical Study*, 1986 WIS. L. REV. 811.

132. See Karjala, *supra* note 130, at 1267-68.

133. See *supra* Part I(B)(2) (discussing these network benefits).

134. See *supra* Part II(A).

135. See RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 187(2) (1971).

136. See, e.g., *Means v. Limpia Royalties*, 115 S.W.2d 468, 474 (Tex. Civ. App. 1938) (refusing to recognize the limitation of liability of an Oklahoma business trust).

137. See William D. Bagley, *The History of the LLC in the USA*, 8 PUBOGRAM no. 3, at 15 (July 1994).

138. See Rev. Rul. 88-76, 1988-2 C.B. 360-61 (1988). The tax administrative history leading up to this ruling is briefly reviewed in Ribstein, *supra* note 5, at 425-26.

liability¹³⁹ and the vast majority provide for a default rule of direct management by members.¹⁴⁰ Thus, soon after the lifting of tax constraints the states adopted a discrete business association for closely held firms that combines limited liability and direct management.

The roles of the efficiency and other hypotheses of closely held business forms discussed in Parts I-III emerge more clearly from the history and data on LLC provisions discussed in the next two subparts.

B. Factors Motivating LLC Legislation

This subpart discusses in more detail the history of LLCs and its implications for the hypotheses concerning statutory forms discussed in Parts I-III. It shows that some history, including the rapid evolution of LLC statutes, tends to support the efficiency hypothesis, while other history supports the tax and inefficiency hypotheses. This ambiguity makes more important the data presented in subparts C and D on the terms of LLC statutes and on LLC formations.

1. The Effect of the Change in Tax Rules

The timing of the adoption of LLC statutes strongly suggests that it was provoked by the change in tax rules announced by the Revenue Ruling on the Wyoming statute. The initial Wyoming statute had been in existence for eleven years when the IRS changed the tax status for LLCs. It is potentially significant that states waited until the tax ruling rather than achieving the same thing in effect in other ways. For example, Georgia passed something very similar to an LLC act by dropping the “control rule” from its limited partnership statute in 1988, but this move was not followed by any other states. One reason may be that Georgia’s statute did not receive the IRS’ ruling ensuring partnership classification until 1991, after the evolution of the LLC was well underway.¹⁴¹

139. See generally 1 RIBSTEIN & KEATINGE, *supra* note 7, ch. 12.

140. The exceptions, of those statutes which include a default rule, are MINN. STAT. § 322B.606 (West Supp. 1995); N.D. CENT. CODE § 10-32-69 (Supp. 1993); OKLA. STAT. tit. 18, § 2013 (Supp. 1995); TEX. REV. CIV. STAT. ANN. art. 1528n, art. 2.12 (West Supp. 1995). The Minnesota and North Dakota statutes permit members to take action that otherwise must be taken by managers, and permit members to enter into member control agreements. See MINN. STAT. §§ 322B.37, 322B.606(2), 322B.67; N.D. CENT. CODE §§ 10-32-50, 10-32-69(2).

141. See Rev. Rul. 91-51, 1991-2 C.B. 434; Ribstein, *supra* note 5, at 465 n.220. On the other hand, the states’ failure to accept the dropping of the control rule may be attributable to the control rule’s importance from a transaction-cost standpoint. This would support the efficiency rather than the regulatory hypothesis.

The relationship between tax rules and statutory form may, however, be more complex than the direct timing link suggests because it is necessary to explain why the Wyoming Revenue Ruling occurred when it did. One possible explanation is that the tax reform of the mid-1980s, by causing top corporate-level tax rates to exceed top individual rates and eliminating the lower "capital gains" rate on gains on the disposition of stock, made corporate-type double taxation costly for more firms.¹⁴² As a result, firms stood to gain more by pressing at the IRS level for a tax change that provided for partnership-type taxation on limited liability investments.¹⁴³

2. *Enforcing Jurisdictional Choice*

The IRS' approval of LLCs as pass-through entities quickly spurred legislative activity in several states. The new statutes included provisions which clarified that the law of the formation state would be applied to "foreign" LLCs. This quickly solved the problem of interstate acceptance of this new form of limited liability.¹⁴⁴

3. *Changes in Limited Liability Rules*

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

First, state courts extended the requirement that partnership creditors exhaust partnership assets before proceeding against individual partners. The exhaustion requirement defers partners' personal liability pending an unsatisfied judgment against the partnership or a determination of partnership insolvency. Partners gain the time value of this delay, particularly if there is a below-market statutory interest rate. They also shift to creditors the costs of pursuing individual partners, since without exhaustion partners must pay judgments and seek indemnification or contribution from their copartners. Creditors may have trouble obtaining an

142. See Merton H. Miller, *The Modigliani-Miller Propositions After 30 Years*, J. ECON. PERSP., Fall 1988, at 99, 117-18.

143. It is not clear that there was an onslaught of requests for rulings. However, the IRS might have foreseen increased pressure for a tax change and acted to protect its bureaucratic power by ensuring that the process would be under its control, rather than that of Congress or the courts. In effect, the IRS by bureaucratic action expanded the scope of Subchapter S of the Internal Revenue Code. Normally, such expansion would be the prerogative of Congress. Indeed, LLCs have given rise to a large number of revenue rulings and private letter rulings.

144. See Part III(D).

unsatisfied judgment against the partnership or proving that the partnership is insolvent. Claims against the partnership therefore can be settled by the partnership or partners for somewhat less if exhaustion prevails than if it does not.¹⁴⁵

The traditional rule requires exhaustion only for joint (i.e., contract-type) liabilities¹⁴⁶ and not for joint and several liabilities.¹⁴⁷ Several states have modified the Uniform Partnership Act rule distinguishing joint and joint and several liability¹⁴⁸ to prescribe joint and several liability of partners for all partnership obligations.¹⁴⁹ Some courts have applied the exhaustion requirement even to joint and several liability, particularly where the applicable statute lets plaintiffs sue partnerships in the firm name along

145. Some recent New York cases have delineated what the plaintiff must do in order to pursue a partner's individual assets. In *U.S. Trust Co. v. Bamco* 18, 585 N.Y.S.2d 186 (App. Div. 1992), the court held that the plaintiff need not actually pursue partnership assets, including a judgment owed the partnership, as a prerequisite to reaching the partner's assets unless he seeks to dispense with joining the partnership. *Id.* at 188. It is enough that the partnership cannot or will not satisfy the judgment. *Id.* at 189. The court reasoned that partners, who have a right of indemnity and a right to participate in the management and conduct of the partnership business and to inspect the books and to demand an accounting, are in a superior position to creditors. *Id.* Similarly, in *British Land (B of C), Inc. v. 43 West 61st Street Associates*, 576 N.Y.S.2d 554 (App. Div. 1991), the court held that plaintiff's obligation to marshal the partnership's assets was satisfied by the six executions it delivered to the sheriff. *Id.* at 555.

146. See *Moseley, Hallgarten, Estabrook & Weeden, Inc. v. Ellis*, 849 F.2d 264, 271 (7th Cir. 1988) (Illinois law); *Wisnouse v. Telsey*, 367 F. Supp. 855, 858-60 (S.D.N.Y. 1973) (New York law); *In re Stanfield*, 6 B.R. 265, 267 (Bankr. D. Nev. 1980) (Nevada law); *In re Peck*, 99 N.E. 258, 259-60 (N.Y. 1912); *Ira Rubin, P.C. v. A. C. Kluger & Co.*, 383 N.Y.S.2d 828, 831 (Civ. Ct. 1976); *Diamond Nat'l Corp. v. Thunderbird Hotel, Inc.*, 454 P.2d 13, 15 (Nev. 1969); 2 BROMBERG & RIBSTEIN, *supra* note 23, § 5.08. Section 15(b) of the UPA makes partners jointly liable for "debts and obligations of the partnership" other than those specified in UPA §§ 13 (wrongful acts, e.g., torts) and 14 (breaches of trust), for which the liability is joint and several by UPA § 15(a). The obligations for which UPA § 15 creates joint liability include contracts and the obligations to perform them. See *Hartford Fin. Sys., Inc. v. Florida Software Servs., Inc.*, 550 F. Supp. 1079, 1088 (D. Me. 1982) (Maine law) (obligation to arbitrate pursuant to agreement); *Bank of Commerce v. DeSantis*, 451 N.Y.S.2d 974, 978 (Civ. Ct. 1982).

147. See *Catalina Mortgage Co. v. Monier*, 800 P.2d 574, 577 (Ariz. 1990) (en banc); *Phillips v. Cook*, 210 A.2d 743, 746-47 (Md. 1965); *Foster v. Daon Corp.*, 713 F.2d 148, 151 (5th Cir. 1983) (Texas law).

148. See UPA § 15 (1914).

149. See, e.g., ALA. CODE § 10-8-52 (1994) ("except as may be otherwise provided by law"); ARIZ. REV. STAT. ANN. § 29-215 (Supp. 1994); COLO. REV. STAT. § 7-60-115 (1990); GA. CODE ANN. § 14-8-15 (Supp. 1994); KAN. STAT. ANN. § 56-315 (Supp. 1993); MISS. CODE ANN. § 79-12-29 (1989); MO. REV. STAT. § 358.150 (Supp. 1994); N.C. GEN. STAT. § 59-45 (1989); OR. REV. STAT. ANN. § 68.270 (1988); TENN. CODE ANN. § 61-1-114 (1989); TEX. REV. CIV. STAT. ANN. art. 6132b, § 15 (West Supp. 1995).

with some or all the partners.¹⁵⁰ The courts can reach a similar result by narrowly drawing the category of cases involving joint and several liability.¹⁵¹ The exhaustion requirement can be burdensome for the creditor. Some New York cases even hold that fewer than all the partners cannot be *sued* individually unless the plaintiff first obtains a judgment against the partnership or shows that partnership property is insufficient.¹⁵² In other words, a complaint against individual partners fails to state a claim unless it alleges partnership insolvency.¹⁵³ This forces the

150 See ILL. CODE CIV. PROC. § 2-411(b) (by implication from ILL. ANN. STAT. ch. 735, para. 5/2-411(b) (Smith-Hurd 1992) (authorizing unsatisfied judgment creditor of partnership to enforce liability of a partner)); *Koppers Co. v. Mackie Roofing & Sheet Metal Works*, 544 So. 2d 25, 26 (La. Ct. App. 1989) (by implication from LA. CIV. CODE arts. 2817 (partnership as principal obligor is primarily liable for its debts) and 737 (partners may not be sued unless partnership is joined)); *Leger v. Townsend*, 257 So. 2d 761, 763 (La. Ct. App. 1972); *Security State Bank v. McCoy*, 361 N.W.2d 514, 515 (Neb. 1985) (NEB. REV. STAT. § 25-316 requires judgment against partnership and insufficiency of its assets before execution against individual assets); *Horn's Crane Service v. Prior*, 152 N.W.2d 421, 423 (Neb. 1967); *Hall v. Oldfield*, 158 N.E. 191, 192-93 (Ohio 1927). For other cases reaching the same conclusion under firm-name statutes without discussing whether the statute negates the exhaustion requirement, see *Sargeant v. Grimes*, 70 F.2d 121, 122 (10th Cir.) (Colo. law), *cert. denied*, 293 U.S. 568 (1934); *Heiden v. Beuttler*, 11 F. Supp. 290, 291 (N.D. Iowa 1935) (Iowa law); *Leach v. Milburn Wagon Co.*, 15 N.W. 232, 233 (Neb. 1883) (Iowa judgment creditor failed to show no partnership assets in Nebraska); *Young v. Mayfield*, 316 P.2d 162, 165 (Okla. 1957) (dictum); *Fowler v. Brooks*, 146 P.2d 304, 307 (Okla. 1944).

151. See *Arbor Village Condominium Ass'n v. Arbor Village Ltd.*, 642 N.E.2d 1124 (Ohio App. 1994) (holding that, where the partnership, through agent, failed to disclose repairs in a condominium sale, it was a partnership breach of duty, not partner breach, under UPA § 13, so that the creditor had to exhaust remedies).

152. *Wisnouse v. Telsey*, 367 F. Supp. 855, 859 (S.D.N.Y. 1973) (New York law); *Helmsey v. Cohen*, 391 N.Y.S.2d 522, 523 (App. Div. 1977).

153. *Owen Steel Co. v. George A. Fuller Co.*, 563 F. Supp. 298, 300 (S.D.N.Y. 1983) (dismissing contract breach complaint against partners); *Pine Plains Lumber Corp. v. Messina*, 435 N.Y.S.2d 381, 384 (App. Div. 1981) (same); *Cunard Line Ltd. v. Abney*, 540 F. Supp. 657, 660 (S.D.N.Y. 1982) (same); *Whittaker Corp. v. Calspan Corp.*, 810 F. Supp. 457, 466 (W.D.N.Y. 1992) (New York law); *Baker v. Latham Sparrowbush Assocs.*, 808 F. Supp. 992, 1003-04 (S.D.N.Y. 1992) (applying New York law and declining to reinterpret New York rule despite argument that it was based on misinterpretation of *Wisnouse v. Telsey*); *Nate B. & Frances Spingold Found. v. Wallin, Simon, Black & Co* 585 N.Y.S.2d 416 (App. Div. 1992) (holding that a cause of action for breach of contract does not lie against an individual partner absent an allegation that the partnership is insolvent or otherwise unable to pay its obligations, and error to permit plaintiff to amend complaint to allege the partnership's insolvency since the mere possibility of insolvency is insufficient to hold the individual partners liable). For cases allowing suits to proceed against individual partners pending a later determination whether the partnership assets are insufficient, see *Propoco, Inc. v. Birnbaum*, 550 N.Y.S.2d 901, 902 (App. Div. 1990); *Midwood Dev. Corp. v. K 12th Assocs.*, 537 N.Y.S.2d 237, 239 (App. Div. 1989) (affirming judgment against partnership and partner but noting that it "does not alter the longstanding rule that a judgment creditor generally must look to partnership property first"); *Bank of Commerce v. DeSantis*, 451 N.Y.S.2d 974, 978 (Civ. Ct. 1982).

creditor at an early stage of the proceeding to establish facts concerning the ultimate collection of the judgment, at the risk of later being forced to sue the partners separately.

The expansion of the exhaustion requirement in state partnership law works together with recent cases under federal bankruptcy law that also tend to block creditors' direct access to partners' assets. Several cases have enjoined actions by creditors of bankrupt partnerships against nonbankrupt partners.¹⁵⁴ This in effect relegates creditors to a collective proceeding unless they can preemptively strike solvent partners prior to the partnership's bankruptcy.

Finally, the Revised Uniform Partnership Act (RUPA) endorses the exhaustion rule by requiring creditors, except in certain situations, to exhaust partnership assets before proceeding against the assets of individual partners.¹⁵⁵ This is reinforced by a rule providing that partners' contribution obligations are enforceable by "a person appointed by a court to represent creditors of a partnership."¹⁵⁶ This suggests that the contribution obligation is property of the estate, and therefore that actions by creditors of the partnership against the individual partners may be stayed under bankruptcy law.¹⁵⁷ Although the RUPA has not yet been widely adopted, it arguably reflects the current trends.

These changes in the law of personal liability reduced the impact on firms' cost of credit of adopting limited liability. At the same time, they may not equally decrease the costs to partners of personal liability, since partners still have to incur the costs of monitoring the firm and their copartners' wealth to guard against potentially disastrous personal liability. Thus, expansion of the exhaustion requirement increases firms' incentives to adopt a limited liability business form. To the extent that the development of LLC statutes has responded to these changes in firms' transaction costs, the development is consistent with the efficiency hypothesis.

4. *Lawyers' Role*

Lawyer groups have initiated proposals for LLC legislation and urged the

154. See generally Paul R. Glassman, *Third-Party Injunctions in Partnership Bankruptcy Cases*, 49 BUS. LAW. 1081 (1994).

155. See RUPA § 307(d) (1993).

156. *Id.* § 807(f).

157. See 11 U.S.C. § 362(a)(3) (1988).

proposals through the legislatures.¹⁵⁸ This indicates that legislators' efforts are not critical in producing jurisdictional competition. The bar's role does not, however, clearly support either the efficiency or inefficiency hypotheses of statutory standard forms, since the drafting lawyers could be serving their own interests in increasing fees and fostering litigation rather than the interests of their clients.

5. *Changes in Demand for Limited Liability*

The rapid spread of LLC and LLP statutes could be viewed as a response to an increased demand for limited liability. To the extent that LLC statutes respond to an underlying demand for limited liability, they are consistent with the efficiency hypothesis. The increased demand for limited liability could be attributable to greater exposure of accountants and lawyers to securities law,¹⁵⁹ malpractice and other forms of liability, particularly in savings and loan cases.¹⁶⁰ This expanding liability raised doubts about the adequacy of traditional means, such as liability insurance, of protecting professional partners' personal assets.¹⁶¹ Moreover, partners cannot easily protect themselves through monitoring from liability caused by a sudden shift in the law.

158. The anecdotal evidence supporting this is the author's own work on LLC statutes and statements made at meetings of the American Bar Association Section on Business Law, Partnership Committee, Subcommittee on Limited Liability Companies.

159. For a review of the expanding securities law liability of lawyers, see Marc I. Steinberg, *Attorney Liability Under the Securities Laws*, 45 Sw. L.J. 711 (1991).

160. See Lisa Isom-Rodriguez, *Limiting the Perils of Partnership*, AM. LAW., July-Aug. 1993, at 30 (noting that large settlements in savings and loan cases by law firms such as Kaye, Scholer and Jones, Day spurred interest in limited liability partnerships, and quoting one lawyer as saying that the Kaye, Scholer case was a "clarion call to action" on limited liability). Although securities law liability is imposed directly on participants, it impacts on limited liability by reducing the firm's assets available to pay other debts, including malpractice liabilities. This shift in demand is unlikely to be affected by the Supreme Court's recent decision eliminating aiding and abetting liability under Rule 10b-5 and § 10(b) of the Securities and Exchange Act of 1934. See *Central Bank of Denver v. First Interstate Bank of Denver*, 114 S. Ct. 1439, 1448 (1994). Firms still face potential direct liability under the securities laws, as well as both direct and aiding and abetting liability under banking and other laws. For discussions of the implications of *Central Bank*, see *Symposium on the Central Bank Decision: The Demise of Aiding and Abetting?*, 49 BUS. LAW. 1429-87 (1994).

161. See Dan L. Goldwasser, *Damage Control for Professional Liability*, CPA J., July 1991, at 16 (noting accountants' concern about expanding liability, particularly in the wake of the collapse of liability insurer Lavanthol & Horwath). These concerns have been cited as an important reason for the development of the limited liability partnership. See Robert Hamilton, *Registered Limited Liability Partnerships: Present at the Birth (Nearly)*, 66 COLO. L. REV. (forthcoming 1995).

C. *Data on LLC Statutory Terms*

This subpart analyzes the provisions of LLC statutes for evidence concerning the efficiency, tax and inefficiency hypotheses discussed in Parts I-III. The data discussed in this subpart tend to support the efficiency hypothesis. Once some states adopted LLC statutes, other states could have taken no action, copied another statute (such as the Wyoming statute that was the subject of the 1988 IRS ruling), or enacted statutes that let foreign LLCs operate locally.¹⁶² But the data on adoptions demonstrate that LLC provisions have evolved toward provisions that are consistent with the efficiency hypothesis and away from earlier less efficient models. Newer statutes and amendments to older statutes have tended to eliminate undesirable mandatory rules,¹⁶³ and to replace rules that are appropriate for centralized-management firms—the earlier model for limited liability—with partnership-type rules that appropriately reflect the LLC’s decentralized-management default rule. The constant change itself suggests the influence of jurisdictional competition. The evolution toward more efficient provisions reflects the use of new learning about the LLC form and is inconsistent with the notion that legislators are “herding” and ignoring new information.

1. *Management by Members*

Virtually all LLC statutes have combined the features of direct management¹⁶⁴ and limited liability.¹⁶⁵ The efficiency of combining direct management and limited liability has already been discussed.¹⁶⁶ The pattern of adoption in this regard tends to refute the proposition that state legislators are blindly following the leader. The first state to pass an LLC statute after the Wyoming Revenue Ruling, Colorado in 1990, adopted a mandatory centralized management rule.¹⁶⁷ Not only was this approach rejected by every later statute, but Colorado itself recently changed its rule

162. Three states, Georgia, Indiana and Mississippi, did so. *See* GA. CODE ANN. § 14-11-1 to -19 (Supp. 1993); IND. CODE ANN. § 23-16-10.1-4 (Burns Supp. 1990); MISS. CODE ANN. §§ 79-29-1001 to 1010 (Supp. 1994). All have been replaced by domestic LLC statutes.

163. The distinction between inefficient mandatory rules and mandatory rules that appropriately restrict midstream opt-outs is discussed *supra* text accompanying notes 76-78.

164. *See supra* note 140 and accompanying text.

165. *See supra* note 139 and accompanying text.

166. *See supra* Part IV(A).

167. *See* COLO. REV. STAT. ANN. § 7-80-401(1) (Supp. 1994).

to make centralized management merely optional.¹⁶⁸

The one common element of LLC statutes that raises questions under the efficiency hypothesis is their “menu” feature—that is, the ability to choose between the decentralized management default and an alternative centralized management form. By providing for two types of management forms in the same statute, this approach raises potential coherence and gap-filling problems.¹⁶⁹ Many of the statutes attempt to address the coherence problems by providing alternative sets of rules, concerning such matters as agency power, for each of the management defaults.¹⁷⁰ However, these statutes inevitably include some provisions, such as fiduciary duty rules, that must do “double duty” by applying to both centrally managed and member-managed firms. Moreover, courts must be careful to interpret the statutes to fill gaps depending on whether the centralized-management or member-management default rule applies.

Legislatures could adopt other types of menus that accomplish similar results and raise similar problems. For example, some LLP statutes let limited partnerships become LLPs, thereby giving them the option of adopting one of two rules regarding the liability of the general partner.¹⁷¹ This option raises the same coherence and gap-filling problems as does providing for alternative defaults within the LLC form. In light of these inherent defects in the menu approach, it might be preferable to provide distinct statutes for each of the default management rules. This could entail the creation of a new statutory standard form that is, in effect, a centrally managed LLC. This form would resemble a limited partnership except that it would provide for default rules that both limit the liability of the general partner and eliminate the “control rule.”

168. See 1994 Colo. Legis. Serv. S.B. 94-107 (West) (amending COLO. REV. STAT. §§ 7-80-204(e) (requiring statement in articles disclosing if LLC is managed by managers) and 7-80-401(1) (providing for rules that apply if LLC is managed by managers)).

169. See *supra* Parts I(C)(1) & (2).

170. For example, most statutes provide that members have agency power only in member-managed firms. See 1 RIBSTEIN & KEATINGE, *supra* note 7, at 8-14 (tabulating provisions).

171. See, e.g., DEL. CODE ANN. tit. 6, §§ 1553, 17-214 (Supp. 1994); 15 PA. CONS. STAT. § 8201(a) (Supp. 1994); TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 2.14 (West Supp. 1995); *id.* art. 6132b-3.08(8); VA. CODE ANN. §§ 50-43.12, 50-73.78 (Michie 1993).

2. Number of Members Required to Form

Some LLC statutes require the LLC to have at least two members.¹⁷² The requirement is arguably consistent with the tax/regulation hypothesis, since an LLC with one member may not be entitled to pass-through tax treatment.¹⁷³ The IRS, however, has ruled that the requirement is satisfied for two-member *firms* organized under statutes that permit one-member firms.¹⁷⁴ The requirement may also serve a regulatory function under bankruptcy law, because it is not clear whether a one-member LLC may be a debtor in bankruptcy.¹⁷⁵ Requiring two members therefore helps firms avoid inadvertent consequences under tax and bankruptcy law.

The two-member requirement also is arguably consistent with the efficiency hypothesis. A coherent LLC statute is well suited only to deal with issues arising in associations of two or more members. For example, unlike in a corporation, the death of the sole member probably would trigger the uncertain consequences of dissolution.

The important question is whether the statute should allow a sole proprietor to adopt the LLC form despite these transaction cost, tax and regulatory problems. Mandating two members may be inefficient because it denies sole owners the choice between the corporate form and the somewhat more flexible LLC form. It also exposes LLCs to the risk of loss of the limited liability shield or to inadvertent dissolution when a member leaves or if there is a defect in membership.¹⁷⁶ Consistent with the inefficiency hypothesis, mandating two members might be motivated by lawyers' seeking to avoid potential malpractice resulting from inadvertent loss of flow-through tax treatment.

172. See 1 RIBSTEIN & KEATINGE, *supra* note 7, § 4.03. Statutes are listed *id.* at 4-47. Some of these statutes permit the firm to be *formed* by a single member, but require the formed LLC to have more than one member. 1 *id.* at 4-4.

173. See Rev. Proc. 95-10, 1995-3 I.R.B. § 4.01, at 21.

174. See Priv. Ltr. Ruls. 92-10-019 (Dec. 6, 1991), 92-18-078 (Jan. 31, 1992) (determining that association with two members entitled to partnership tax treatment although organized under Texas statute that requires only one member). The IRS recently clarified that it will consider a request for a ruling that an LLC is a partnership for tax purposes if, among other requirements, the LLC has two members. See Rev. Proc. 95-10, 1995-3 I.R.B. § 4.01, at 21.

175. A one-member LLC may not be an individual, partnership or corporation, and therefore not a "person" under 11 U.S.C. § 101(41) eligible for relief under *id.* § 109(b), (d) or (f).

176. See Marshall B. Paul & Stuart Levine, *One-Member LLCs Pose Often-Overlooked State Law Issues*, 1 J. LTD. LIABILITY CO. 162 (1995) (discussing problems under statutes that do not clearly permit one-member LLCs).

The following table summarizes states' adoption of two-member requirements.

Table 1: Minimum number of owners: one member

Enacted by	# adopting	# not adopting	% adopting
1/91	0	4	0
1/92	2	6	25
7/92	2	12	14
1/93	2	16	11
4/93	4	17	19
7/93	7	25	22
1/94	8	28	22
12/94	14	34	29

As shown in Table 1, only two of eighteen LLC statutes permitted one-member firms as of the beginning of 1993. As of the end of 1994, however, fourteen statutes, more than a quarter of the total, permitted sole-proprietorship LLCs. This rise may be partly due to increased tax acceptance of the LLC, particularly the IRS rulings concerning two-member LLCs under "one-member" statutes.¹⁷⁷ Thus, the tax purpose of the two-member requirement has receded. Alternatively, under the efficiency hypothesis, the need for flexibility in this regard became evident and overcame lawyers' risk aversion. On the other hand, as explained above, the two-member requirement is not clearly inefficient in light of tax and regulatory considerations. This could explain why states have not rejected the two-member requirement to the same extent as they have other tax-related mandatory rules.¹⁷⁸

3. Formalities of Organization

Central filings that notify third parties of the firm's identity and its owners' limited liability are cost-effective ways of providing important information.¹⁷⁹ Nevertheless, there is no efficiency-based reason to make this rule mandatory by denying limited liability to firms that contract for limited liability with third parties but do not comply with the filing requirement. In other words, LLC statutes are misguided to the extent that

177. See *supra* note 174 and accompanying text.

178. See *infra* Parts IV(C)(4) (discussing contracts allowing free transferability of management rights), IV(C)(8) (discussing contracts allowing continuity following a member's dissociation).

179. See Ribstein, *supra* note 43, at 107-08.

they deny limited liability to firms that “assum[e] to act” as LLCs but do not comply with the statute.¹⁸⁰ Such provisions in corporate statutes¹⁸¹ are better explained as politically motivated restrictions on limited liability than on public interest grounds.¹⁸² The only possible efficiency justification for the rules is to ensure that firms comply with corporate governance and other rules as a condition of obtaining limited liability.¹⁸³ This justification makes no sense as applied to a flexible LLC statute. In short, the rules are explained either by legislators’ preferences for mandatory formalities¹⁸⁴ or as blind application of corporate rules in an inappropriate context.

Similar considerations apply to liabilities for erroneous certificates. Third parties are sufficiently protected from misrepresentations by fraud law that they do not need additional protection from erroneous certificates. Nevertheless, limited partnership law generally requires members to amend certificates that have become inaccurate.¹⁸⁵ Even if such requirements are justified in limited partnerships,¹⁸⁶ LLCs differ critically from limited partnerships with regard to the need for such a disclosure, since a limited partnership certificate discloses the important fact of the identity of the general partners who manage the firm and are personally liable for its debts. Despite these considerations, several LLC statutes provide for liability for erroneous certificates or for a duty to amend inaccurate certificates.¹⁸⁷ These requirements arguably are consistent with the inefficiency hypothesis.

180. See 1 RIBSTEIN & KEATINGE, *supra* note 7, § 4.15 (describing the provisions); 1 *id.* at 4-66 (tabulating state provisions).

181. See REVISED MODEL BUSINESS CORP. ACT § 2.04 (1984).

182. See Ribstein, *supra* note 43, at 121-25.

183. *Id.* at 110-11.

184. See *supra* text accompanying note 76.

185. See RULPA § 202(c) (1985).

186. Even in limited partnerships, liability for inaccurate disclosures is of dubious value. Estoppel and lingering partner liability provided for under the partnership laws for misidentification of general partners in certificates is probably adequate, and additional liability is a potential trap for the unwary. See Ribstein, *supra* note 1, at 879. Thus, the Georgia version of the RULPA has deleted the duty to amend, see GA. CODE ANN. § 14-9-202 (Supp. 1994), and does not include liability for inaccurate statements.

187. See 1 RIBSTEIN & KEATINGE, *supra* note 7, § 4.14; 1 *id.* at 4-65 (tabulating state provisions).

The following tables summarize states' adoptions of the provisions described above:

Table 2: Penalties for noncompliance with formalities

Enacted by	# adopting	# not adopting	% adopting
1/91	3	1	75
1/92	6	2	75
7/92	9	5	64
1/93	10	8	56
4/93	11	10	52
7/93	15	17	47
1/94	16	20	44
12/94	17	31	35

Table 3: Liability for erroneous certificates

Enacted by	# adopting	# not adopting	% adopting
1/91	4	0	100
1/92	5	3	62.5
7/92	8	6	57
1/93	9	9	50
4/93	10	11	48
7/93	13	19	41
1/94	14	22	39
12/94	21	27	44

These tables show that LLC statutes have evolved away from prescribing unnecessary formalities, consistently with the efficiency hypothesis.

4. *Transferability*

Limited transferability of LLC interests is internally consistent with other elements of the LLC form. Under a decentralized management default, transfer of management (as distinguished from financial) rights, can be costly because of the risks of conferring management responsibility on strangers. Transferees of management rights not only would have a say in the day-to-day business but presumably also would have partner-like agency power to bind the firm. Consistent with this analysis, all LLC statutes provide for a default rule of restricted transferability.¹⁸⁸

Many LLC statutes go further and limit the members' ability to contract

¹⁸⁸ See *id.* § 7.04, *id.* at 7-35 (tabulating state provisions).

for free transferability of management rights.¹⁸⁹ These limitations are inconsistent with the efficiency hypothesis. Restrictions on transferability necessitate costly negotiations for consent¹⁹⁰ and the potential that members may opportunistically withhold consent.¹⁹¹ Moreover, the costs of restricting exit may be particularly high if the members have given up voice by opting for centralized management.

One explanation for mandatory restrictions on transferability is that waiver might jeopardize partnership tax characterization. Yet, because the transaction cost advantages of free transferability might sometimes outweigh the tax advantages of restricting transferability, firms might prefer statutory flexibility. Moreover, the IRS has ruled that the "corporate" characteristic of free transferability is lacking in firms that restrict transferability even if they are organized under flexible statutes.¹⁹² Thus, mandatory restrictions on transferability cannot be explained by the tax/regulation hypothesis alone.

The following table reflects the evolution of mandatory transferability restrictions.

Table 4: Prohibiting contracts for transferability of management rights

Enacted by	# adopting ¹⁹³	# not adopting	% adopting
1/91	3	1	75
1/92	5	3	62.5
7/92	7	7	50
1/93	7	11	39
4/93	8	13	38
7/93	13	19	41
1/94	15	21	42
12/94	19	29	40

189. 1 *id.* § 7.04.

190. In *Frandsen v. Jensen-Sundquist Agency, Inc.*, 802 F.2d 941 (7th Cir. 1986), Judge Posner reasoned that the rule against restricting transfer in close corporations was based on the higher costs of securing agreements to transfer. He expressed these costs mathematically in terms of an n-member set as $n(n-1)/2$. *Id.* at 946.

191. For an example of a case in which the court refused to enforce a consent restriction on share transfer where the nonconsenting member may have been withholding consent opportunistically in order to obtain the shares cheaply himself, see *Rafe v. Hindin*, 288 N.Y.S.2d 662, 666 (App. Div.), *aff'd mem.*, 244 N.E.2d 469 (N.Y. 1968).

192. See Priv. Ltr Ruls. 92-19-022 (Feb. 6, 1992), 92-18-078 (Jan. 31, 1992). More recently, the IRS increased tax flexibility of LLCs by adopting a Revenue Procedure which provides, among other things, that an LLC does not have corporate-type free transferability if transfer must be approved by at least a majority in interest of the members, or of the member-managers in a manager-managed LLC.

Rev. Proc. 95-10, 1995-3 I.R.B. § 5.02, at 23.

193. These numbers do not include statutes that require consent to be in writing.

Table 4 shows that the percentage of LLC statutes allowing free transferability of management rights has remained relatively constant but has gradually dropped. Most of the flexible statutes were adopted after the IRS rulings classifying as partnerships firms formed under flexible statutes.¹⁹⁴ The downward shift may also reflect the impact of jurisdictional competition in overcoming lawyers' concerns about flexibility.¹⁹⁵

The persistence of mandatory restrictions on transferability might be explained on the ground that such provisions protect lawyers from exposure to malpractice claims arising out of inadvertent tax mischaracterization.¹⁹⁶ Yet this does not explain why a higher percentage of states has allowed contracts for continuing the LLC after member dissociation despite the risk that this could create corporate-type "continuity of life" for tax purposes.¹⁹⁷

Another possible reason for the persistence of restrictions on free transferability may be legislators' concern that LLCs will use their freedom to create publicly traded LLCs. Restricted transferability provides a straightforward and easily applied method of separating publicly traded and closely held firms for tax purposes, thereby cabining application of the double corporate tax.¹⁹⁸ Invading the corporate double-tax realm would invite counterpressure from powerful interest groups that favor preservation of the double tax¹⁹⁹ that might jeopardize LLCs' tax status. This explanation is consistent with the tax/regulation hypothesis.

5. *Allocation of Management and Financial Rights*

Equal (per capita) allocation of member voting and financial rights correlates better with other elements of the LLC standard form than allocating rights pro rata according to member financial contributions. Per capita allocation is appropriate in a general partnership in which the owners are personally liable for debts. Partners' personal liability gives them a stake in the firm that can exceed their capital contributions and a commen-

194. See *supra* note 192 and accompanying text.

195. Some evidence of the role of lawyers' concerns about flexibility is provided by a recent Wyoming amendment which increased flexibility concerning transferability and other matters but added a Governor's note that cautions lawyers concerning the possible tax implications of adopting such provisions. See 1995 Wyo. Sess. Laws ch. 79 (H.B. 79) (approved Feb. 20, 1995).

196. See *supra* text accompanying note 81.

197. See *infra* Part IV(C)(8).

198. See Ribstein, *supra* note 5, at 472.

199. See Arlen & Weiss, *supra* note 62.

surate incentive to monitor, and therefore to contribute services to the firm.

Per capita sharing also may be an appropriate default rule for LLCs despite their limited liability. First, it correlates with the direct-management default of most LLC statutes.²⁰⁰ Under this default, the members ordinarily make service contributions for which a pro rata rule would not adequately compensate them. Although service and credit contributions might be compensated through pro rata sharing by defining contributions on which the sharing is based to include promised or rendered services, expanding the definition of contributions beyond conventional types of property further complicates the valuation problems described below. Firms that adopt centralized management can be expected to customize the firm in other respects, including changing to a pro rata sharing rule.

Second, per capita sharing correlates with the restricted transferability of LLC shares. By contracting out of the exit option, members rely more heavily on active participation in governance. This, in turn, makes it more likely that the members will be making service contributions for which they would expect to be compensated.

Third, per capita sharing avoids valuation and record-keeping problems in closely held firms. For example, distributions complicate pro rata sharing. Whether a distribution amounts to a return of a contribution, and therefore a reduction of the member's share, may require a determination of whether the distribution reduced the value of the firm below that of the value of the contributions. This may not be a problem among existing members as long as all distributions are pro rata. But it complicates apportionment among new members and existing members who have depleted capital accounts. Also, basing members' shares on the value of their nonreturned contributions increases the need for accurate records of contributions and distributions.

To be sure, LLCs' limited liability means that many LLC members will be passive capital-contributors for whom pro rata sharing would be appropriate. But the statutory default rule should be designed for informal firms that are least likely to have customized agreements and careful records. Accordingly, LLC statutes should provide for per capita sharing unless the members provide both for contribution-based sharing and for the maintenance of records from which members' contributions can be accurately determined.

200. See *supra* text accompanying note 140.

The following table summarizes states' positions on this issue.²⁰¹

Table 5: Per capita allocation of voting rights

Enacted by	# adopting	# not adopting	% adopting
1/91	2	2	50
1/92	2	6	25
7/92	3	11	21
1/93	4	14	22
4/93	6	15	29
7/93	11	21	34
1/94	13	23	36
12/94	21	27	44

Table 5 shows that the statutes have evolved toward the per capita rule, consistent with the efficiency hypothesis. Statutes began by carrying over the pro rata rule from the corporate and limited partnership statutes. This model may be more appropriate for corporations and limited partnerships which provide for default centralized-management structures. As firms, legislators and bar committees learned more about the inherent difference in this respect between LLCs and other limited-liability forms, states adopted LLC voting rules that reflect these differences. This is inconsistent with the "herding" aspect of the inefficiency hypothesis.²⁰²

The tax/regulation hypothesis may, however, have the last word regarding allocation of voting rights. The IRS has taken the position that requiring consent to transfer by holders of a majority of the financial interests, rather than unanimous consent, does not amount to corporate-type free transferability,²⁰³ and that majority-in-interest, rather than unanimous, consent to avoid dissolution after member dissociation does not constitute corporate-type continuity of life.²⁰⁴ The RUPA incorporates the "majority-

201. See 1 RIBSTEIN & KEATINGE, *supra* note 7, at 8-49 (tabulating state statutory provisions).

202. See *supra* Part III(C).

203. See Rev. Proc. 95-10, 1995-3 I.R.B. § 5.02, at 23; 1 RIBSTEIN & KEATINGE, *supra* note 7, § 16.11, at 15-25 (reviewing earlier rulings).

204. See Rev. Proc. 95-10, 1995-3 I.R.B. § 5.01, at 23; 1 Ribstein & Keatinge, *supra* note 7, at 18-28 to 29 (reviewing earlier rulings); see also Treas. Reg. § 301.7701-2(b)(1) (as amended in 1993) (providing that corporate-type "continuity of life does not exist for a limited partnership notwithstanding the fact that a dissolution of the limited partnership may be avoided, upon . . . an event of withdrawal of a general partner, by at least a majority in interest of the remaining partners agreeing to continue the partnership"). The IRS also has provided a safe harbor definition of "majority in interest" for purposes of voting on the continuation of a limited partnership. See Rev. Proc. 94-46, 1994-28 I.R.B. 129 (defining "majority in interest" for purposes of Treas. Reg. § 301.7701-2(b)(1) as majority of profit

in-interest” rule for continuation of a general partnership.²⁰⁵ Some recent LLC statutes also include this language.²⁰⁶ Because, as discussed above, pro rata default rules increase transaction costs in the absence of tax considerations, these provisions tend to support the tax/regulation hypothesis. They do not strongly support the inefficiency hypothesis, however, since the voting rules are not mandatory.

6. Adoption of Partnership-Type Agency Power

Because LLC statutes provide by default for partnership-type member management, it follows that LLC members, like partners, should be able to bind the firm if they are acting in the ordinary course of business.²⁰⁷ Nevertheless, many early LLC statutes either include no provision for members’ agency power, or provide simply that a member’s act binds the firm.²⁰⁸ The evolution of LLC statutory provisions is described in the following table.

Table 6: Adoption of partnership-type agency power

Enacted by	# adopting	# not adopting	% adopting
1/91	0	4	0
1/92	0	8	0
7/92	5	9	36
1/93	6	12	33
4/93	8	13	38
7/93	17	15	53
1/94	19	17	53
12/94	29	19	60

The evolution of LLC statutes toward a partnership-type rule on member agency power arguably reflects new learning by state legislators and bar committees about the partnership-like characteristics of LLCs. It therefore tends to support the efficiency hypothesis and refute the proposition that

interests and of capital interests).

205. See RUPA § 801(2)(I) (1994).

206. See N.Y. LTD. LIAB. CO. LAW §§ 602(b)(2), 604(a) (McKinney Supp. 1995) (transfer of management rights); *id.* 701(d) (continuation); S.C. CODE ANN. § 33-43-901(c) (Law Co-op. Supp. 1995) (continuation). This trend can be expected to accelerate with the Revenue Procedure cited above in notes 202 and 203.

207. For the partnership rule, see UPA § 9(1) (1914); RUPA § 301 (1993).

208. See 1 RIBSTEIN & KEATINGE, *supra* note 7, at 8-51 (tabulating state statutory provisions).

legislators are engaging in “herding.”²⁰⁹

7. *Fiduciary Duties and Remedies*

Fiduciary duties and remedies should be designed so that they are internally consistent with the other default terms of LLC statutes discussed above. Because fiduciary duties are intended to reduce agency costs arising out of owners’ delegation of management responsibilities, their benefits depend on how much management power members delegate to a subset of owners or to nonowner managers. Without such delegation, owner-managers presumably ought to be able to act selfishly and negligently.²¹⁰ Even if members do delegate power, the benefits of fiduciary duties depend on the existence of other constraints on managers’ conduct, particularly dissolution and buyout remedies. As other constraints reduce the marginal benefits of fiduciary duties, these benefits are likely to be outweighed by the costs of fiduciary duties, including direct litigation costs and indirect costs of making managers more risk-averse than owners would prefer.²¹¹

It arguably follows from these general considerations that LLC statutes should provide for a partnership level of fiduciary duties rather than a higher corporate level,²¹² because the LLC default terms of decentralized management, free transferability and dissociation at will minimize the benefits of fiduciary duties and make corporate-type director duties inappropriate. Moreover, given the members’ flexibility to vary the form of management, LLCs are likely to differ significantly regarding the level of fiduciary duties that suits each firm. Accordingly, this is not an appropriate area either for nonwaivable fiduciary duties or for specific statutory defaults. The statute instead should leave the courts free to deal with alleged fiduciary breaches on a case-by-case basis under a very

209. See *supra* Part III(C).

210. See Ribstein, *supra* note 37, at 52-55.

211. As to potential costs from fiduciary duties and remedies, 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); Daniel R. Fischel & Michael C. Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 71 CORNELL L. REV. 261 (1986); Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?* 7 J.L. ECON. & ORGANIZATION 55 (1991).

212. For a discussion asserting that partners’ duties are lower than those of corporate managers, see Ribstein, *supra* note 37, at 53-55.

general statutory default like that applied to partnerships under the UPA.²¹³

The following tables present data on LLC statutory provisions concerning members' consent to interested transactions and waiver of fiduciary duties.²¹⁴ With regard to interested transactions, some statutes provide for a partnership model allowing members to appropriate partnership property for their personal benefit with comembers' consent, at least where the firm is managed by members.²¹⁵ Other statutes include language similar to that in corporate-type interested-director provisions. The partnership-type language encourages courts to fill gaps by applying more appropriate partnership precedents based on a model of decentralized management, while the corporate-type language encourages courts to apply inappropriate corporate precedents based on a centralized-management model. With regard to waiver, Table 8 distinguishes between statutes that permit the partners to contract fully regarding fiduciary duties and those that include corporate-type limitations on waiver.

Table 7: Partnership rule for member consent to interested transactions

Enacted by	# adopting	# not adopting	% adopting
1/91	0	4	0
1/92	0	8	0
7/92	1	13	7
1/93	2	16	11
4/93	2	19	10
7/93	7	25	22
1/94	7	29	19
12/94	10	38	21

213. See UPA § 21(1) (1914) (providing that partners may not benefit from partnership property without copartner consent). RUPA § 404 (1993) incorporates the UPA rule on self-dealing, but adds a duty of care, an obligation of good faith, and specific rules on the duty of loyalty. For criticism of this additional specificity as unnecessary and confusing, see Ribstein, *supra* note 37, at 52-55, 57-61.

214. See 1 RIBSTEIN & KEATINGE, *supra* note 7, § 9.04 (discussing consent and waiver); *id.* at 9-49 to 9-50 (tabulating state provisions). The table does not reflect statutes that do not include a provision on this topic because noninclusion probably reflects the absence of a legislative judgment on the issue. However, noninclusion is arguably efficient because it permits courts flexibly to fill in fiduciary duties based on the specific contract.

215. The Pennsylvania statute provides for a partnership-type model in member-managed firms and a corporate-type model in manager-managed firms. See 15 PA. CONS. STAT. § 8943 (Supp. 1994).

Table 8: Permitting waiver of fiduciary duties

Enacted by	# adopting	# not adopting	% adopting
1/91	1	3	25
1/92	1	7	12.5
7/92	1	13	7
1/93	2	16	11
4/93	3	18	14
7/93	7	25	22
1/94	9	27	25
12/94	11	37	23

The evolution indicated by these tables supports the efficiency hypothesis, although the trend is much clearer for the default fiduciary duties than for the waiver rule. With respect to the default consent rule, as with other aspects of LLC law, the evolution may reflect learning by state legislators and bar committees about the partnership-like nature of LLCs. The different history of waiver rules may reflect the fact that, while *default* fiduciary duties should vary among business forms, there is no reason to distinguish LLCs from other business forms regarding waiver of fiduciary duties. Accordingly, there is no efficiency basis for expecting a distinct rule on this issue to evolve for LLCs. Any apparent evolution may simply reflect the fact that late-enacting states provided for waivers elsewhere in their business associations laws.

8. *Dissociation and Dissolution*

LLC statutes provide that members can dissociate at will and, in the absence of contrary agreement, can obtain at least a buyout of their interests.²¹⁶ All states' statutes also provide that a member's dissociation dissolves the LLC subject to the members' consenting to continue the firm.²¹⁷ These means of providing liquidity are internally consistent with the limited transferability of LLC interests. LLC statutes should not condition members' exit on grounds such as deadlock and oppression that apply to close corporation shareholders. Courts and legislatures devised

216. See 1 RIBSTEIN & KEATINGE, *supra* note 7, §§ 11.02-11.03; 1 *id.* at 11-67 (tabulating statutes on members' power to withdraw).

217. 1 *id.* § 11.05; 1 *id.* at 11-73 (tabulating statutes on continuation after member dissociation); Larry E. Ribstein, *Statutory and Planning Considerations for Withdrawal from an LLC*, 1 J. LTD. LIABILITY CO. 64, 65 (1994).

these theories to mitigate the problems of applying corporate-type continuity to closely held firms for which the standard corporate form is inappropriate. By providing a clear alternative to close corporations in the form of a default power to freely dissociate, LLC statutes signal courts to fill gaps in statutes and agreements consistent with the partnership model of free exit rather than with the corporate model of continuity.

Buyout and liquidation rights can, however, be costly. Among other problems, these rights give each member the opportunity to appropriate some of the value of the firm and are inconsistent with members' expectations that assets would be committed indefinitely to the firm.²¹⁸ As a result, *liquidation* at will may not be appropriate even in general partnerships, where the right has long been recognized.²¹⁹ *Dissociation* at will remains an appropriate default provision for the smaller, more informal firms that would be most likely to operate without customized agreements. The buyout right gives members some liquidity and thereby reduces the risk that a controlling faction will take advantage of a "frozen-in" minority. A statutory buyout right would eliminate the need for the sort of vague and uncertain common law and statutory oppression and buyout remedies that plague close corporations. Nevertheless, LLC members at least should be able to contract around default dissolution and liquidation provisions.

Despite these considerations, the following table shows that many LLC statutes do not allow LLCs to contract around the default rules.²²⁰ These provisions arguably support the tax/regulation hypothesis in that they ensure against corporate-type continuity of life for tax purposes. But for the transaction-cost reasons just discussed, firms probably would prefer to be able to contract for continuity. Accordingly, mandatory dissolution arguably is consistent with the inefficiency hypothesis.²²¹

218. See Ribstein, *supra* note 37, at 70.

219. See *id.*; Larry E. Ribstein, *A Mid-Term Assessment of the Project to Revise the Uniform Partnership Act*, 46 BUS. LAW. 111, 143-44 (1990); Larry E. Ribstein, *A Statutory Approach to Partner Dissociation*, 65 WASH. U. L.Q. 357, 373-75 (1987).

220. See 1 RIBSTEIN & KEATINGE, *supra* note 7, § 11.07; 1 *id.* at 11-74 (tabulating statutes on members' power to vary statutory continuation right).

221. One possible explanation for such provisions is that they protect lawyers from potential malpractice liability for misdrafting agreements that trigger unexpected tax consequences. See *infra* text accompanying note 81.

Table 9: Prohibition of continuation agreements

Enacted by	# adopting	# not adopting	% adopting
1/91	0	4	0
1/92	1	7	12.5
7/92	3	11	21
1/93	3	15	17
4/93	3	18	14
7/93	3	29	9
1/94	3	33	8
12/94	3	45	6

Table 9 indicates an evolution toward flexibility that supports the efficiency hypothesis rather than the tax or inefficiency hypotheses. Although there were never many statutes providing mandatory rules for continuation agreements, the number of mandatory states has remained steady even with the rapid increase in the total number of LLC statutes. Note that, contrary to the tax/regulation hypothesis, this development proceeded despite the Internal Revenue Service's initial failure to sanction explicitly statutory provisions that permit flexibility in this regard. Indeed, the IRS suggested that it might treat LLC continuation agreements more stringently from the standpoint of corporate-type continuity than it has treated limited partnership continuation agreements.²²²

There is further evidence against the tax/regulation hypothesis in the fact that LLC statutes continue to provide for default buyout rights despite the risk this poses of causing higher estate tax valuations for family limited partnership interests.²²³ The Internal Revenue Code provides that, in valuing such an interest, contractual limitations on liquidation (which otherwise would reduce the value of the interest) are ignored if they are more restrictive than the statute.²²⁴ Assuming these rules will be applied

222. See I RIBSTEIN & KEATINGE, *supra* note 7, at 1s-28. Recently, the IRS mitigated this problem by setting forth specific guidelines for when continuation provisions in an LLC's operating agreement will be deemed not to constitute corporate-type continuity of life for purposes of obtaining a ruling that a firm will be classified as a partnership for tax purposes. See Rev. Proc. 95-10, 1995-3 I.R.B. § 5.01, at 23.

223. See Ribstein, *supra* note 217, at 69.

224. See I.R.C. § 2704(b) (1988). This provision was passed primarily to reverse the result in Estate of Harrison v. Commissioner, 42 T.C.M. (CCH) 1306 (1987) and Estate of Watts v. Commissioner, 51 T.C.M. (CCH) 60 (1985), *aff'd*, 823 F.2d 483 (11th Cir. 1987), which held that the interest could be

to LLCs, an operating agreement that precludes withdrawal would be considered to be more restrictive than state law if the LLC was formed under a statute that provides for a default exit on designated notice. Notably, in this situation it is the *statute*, and *not* the contract, which matters for tax purposes.

The reason why LLC statutes have not eliminated this tax problem may be that the family business problem is not important enough in the LLC context to justify sacrificing transaction costs for regulatory objectives.²²⁵ The limited partnership may be more appropriate for this type of business because the limited partnership control rule helps lock passive members out of control. Rather than undertaking a drastic elimination of the default power to withdraw in all firms, one LLC statute has addressed the problem in a more limited way by including a special provision that applies to a firm that elects to be a "family controlled limited liability company."²²⁶ These facts suggest that legislatures, perhaps motivated by jurisdictional competition, are acting as faithful agents for firms by efficiently trading off tax and transaction-cost objectives.

D. Data on Formation of LLCs

The following chart shows the numbers and times of formations of LLCs, limited partnerships and corporations in five states.²²⁷ The data

discounted for estate tax purposes if there was a decline in the value of the interest as a result of the death that did not result in a transfer of the value to someone else. I.R.C. § 2704(b) provides that an "applicable restriction" on liquidation rights can be disregarded in valuing the estate for tax purposes even in the absence of a transfer of value. *Id.* Section 2704(b)(3)(B) provides that an "applicable restriction" does not include "any restriction imposed, or required to be imposed, by any Federal or State law." Treasury Regulations define "applicable restriction" as one that is "more restrictive than the limitations that would apply under the State law generally applicable to the entity in absence of the restriction." Treas. Reg. § 25.2704-2(b) (1994). See generally S. Stacy Eastland, *Valuation Planning with Respect to Transfers of Partnership Interests Under Chapter 14; Transfer Tax Consequences of Selected Partnership*, ALI-ABA COURSE OF STUDY PLANNING TECHNIQUES FOR LARGE ESTATES, C819 ALI-ABA 109, 154-72 (1993).

225. Alternatively, lawyers may have mistakenly interpreted LLC statutes as restricting exit whenever they provide for a fixed duration. See Ribstein, *supra* note 217, at 70. The statutes may be amended to restrict exit if this interpretation is revised.

226. See ARIZ. REV. STAT. ANN. § 29-707(C) (Supp. 1994).

227. The filings have been determined through a search on the Westlaw Prentice-Hall database. Accordingly, the numbers are not official counts. A cross-check is provided by the facts that the Colorado data corresponds closely with data obtained from the Colorado Secretary of State, and that data for all of the states is comparable with data the states supplied for INTERNATIONAL ASSOCIATION OF CORPORATION ADMINISTRATORS, ANNUAL REPORT OF THE JURISDICTION (1994). The states

show that in all states examined there was a relatively rapid move to LLCs. Moreover, since the numbers of new limited partnership and corporate formations have remained relatively constant, the rapid increase in LLCs probably represented conversions from these forms as well as from general partnerships.²²⁸

The pattern of adoptions tends to refute the existence of significant "network externalities."²²⁹ It is significant that a considerable number of firms switched from or avoided business forms with well-entrenched uniform statutes and interpretive networks of case law, customs and expertise. The rate of growth is similar in all states irrespective of when in the general history of LLCs the state's statute was adopted. During this period of rapid acceptance of the LLC form, there remained many uncertainties concerning the rules that would be applied to LLCs. LLCs represent both a novel combination of direct management and limited liability and a novel hybrid of direct and centralized management for which there were no developed internal governance and agency rules.²³⁰ Moreover, there were additional uncertainties concerning the tax treatment of LLCs that did not quite fit the initial Wyoming Revenue Ruling,²³¹ and concerning LLCs' ability to operate outside their formation states.²³² Nevertheless, firms apparently were willing to incur uncertainty costs and the costs of pressing for more statutes and for tax rulings that would clarify

examined were those in which current numbers for LLCs, limited partnerships and corporations could be determined, and where LLC statutes have been in effect long enough to yield significant numbers of formations. LLCs were first formed on the following dates in these states: Wyoming, 1977; Colorado, April 1990; Iowa, July 1992; Oklahoma, September 1992; Texas, June 1991. Limited partnership and corporate figures are given for the years during which LLC filings occurred in each state.

228. Conversions to LLC form do not necessarily trigger tax consequences. *See* 1 RIBSTEIN & KEATINGE, *supra* note 7, § 17.13, at 17-58, 1S-46.

229. *See supra* Part III(B).

230. It should be noted, however, that LLC statutes are drafted with significant linkages to existing forms in order to mitigate their novelty and carry over interpretive materials associated with existing standard forms. *See* Ribstein, *supra* note 18.

231. *See generally* 1 RIBSTEIN & KEATINGE, *supra* note 7, ch. 16.

232. LLCs had little guidance as to what law would apply to foreign LLCs in the absence of explicit statutory provisions. A recent case illustrating the uncertainty in the case law is *Abu Nassar v. Elders Futures Inc.*, No. 88 Civ. 7906 (PKL), 1991 U.S. Dist. LEXIS 3794 (S.D.N.Y. Mar. 28, 1991). In that case, the court held that foreign law should be applied to the requirements of the status of a Lebanese "limited liability company," and local law may be applied as to a veil-piercing issue. *Id.* at *14. Thus, the court looked to both the law of Lebanon (the formation state) and of New York (the operation state and the state whose law was designated by the parties to an agency contract). *Id.* *See generally* 1 RIBSTEIN & KEATINGE, *supra* note 7, § 13.03.

the law. This evidence strongly suggests that the failure of special close corporation statutes cannot be attributed simply to network externalities.

	Co-LLC	Co-LP	Co-Corp	Ia-LLC	Ia-LP	Ia-Corp
1988						
1989						
1990	164	668	13,990		91	4,592
1991	488	707	14,991		100	4,837
1992	989	896	16,362	147	101	5,060
1993	2,828	992	17,365	603	107	5,206
1994	4,815	1,079	17,908	860	130	5,290

	Ok-LLC	Ok-LP	Ok-Corp	Tx-LLC	Tx-LP	Tx-Corp
1988						
1989						
1990					2,855	39,826
1991				269	3,010	38,944
1992	222	309	951	1,861	3,967	38,563
1993	941	304	946	3,033	4,989	41,280
1994	1,431	354	1,034	4,465	5,971	42,047

	Wy-LLC	Wy-LP	Wy-Corp
1988	12	28	1,078
1989	23		
1990	69	22	1,391
1991	234	38	1,645
1992	840	37	1,991
1993	1,026	41	2,014
1994	958	30	1,933

V. CONCLUSION AND IMPLICATIONS

The development of the LLC suggests questions and gives some tentative answers relating to statutory standard forms for closely held firms. First, LLCs provide insights into the functions that are served by these statutes. This Article has shown that establishing alternative statutory standard forms can provide an efficient contracting mechanism.

Second, the rapid evolution of the LLC demonstrates that jurisdictions

compete for formations of closely held firms. Not only have the states rushed to enact these statutes and firms rushed to organize as LLCs, but over a very short period there has been a remarkable evolution of statutory terms.

Third, the evolution of the LLC strongly suggests that the failure of special close corporation legislation did not result from problems inherent in state competition to provide statutes for closely held firms, or from firms' reluctance to break away from established forms and interpretive networks. Rather, the recent story of the LLC suggests that the failure of special close corporation legislation prior to 1988 was attributable to inflexible tax classification rules and questions about interstate recognition of limited liability. Indeed, the LLC phenomenon could spell the end of the close corporation business form. Close corporations temporarily accommodated the corporate form to closely held firms while alternative forms were unavailable for tax and interstate recognition reasons. This accommodation has been imperfect in many ways. In particular, grafting close corporation governance arrangements onto a form with limited transferability of interests and no right of dissolution at will has forced the courts and legislatures to adopt an awkward and ad hoc oppression remedy in order to provide a right of exit. The LLC has made these makeshift devices unnecessary.

The analysis and evidence in this Article has several important implications beyond LLCs. Evidence of efficient jurisdictional competition generally supports enforcing contractual choice of law. This evidence also counsels caution about intervention in the law of closely held firms by judges or by law reformers. If statutes define efficient standard form contractual terms, judicial nullification can inefficiently abrogate contracts. Moreover, the tables in Part IV(C) demonstrate graphically how pointless and counterproductive it is for one set of uniform lawmakers to attempt to write a "uniform" law of LLCs that improves on what can be produced by the organic process of state competition. In short, allowing statutes of different types and from different states to compete is preferable to a priori judgments by regulators or reformers as to what rules should govern business associations.

Additional implications concern the future of business forms for closely held firms. It may be the case that LLCs, like close corporations, are a transitional form. The next step toward increased recognition of limited liability has been to include limited liability in the basic partnership form by allowing general partnerships to register for limited liability as under

LLP provisions.²³³ Beyond this, it may be that limited liability will become a default term of the partnership form. The efficiency hypothesis suggests that limited liability should be segregated into a separate standard form and integrated with such features as filings and disclosures which are appropriate only for firms that adopt limited liability. However, the development of the LLP suggests that there may be tax and regulatory reasons why limited liability would be incorporated into the partnership form.

The latest tentative proposal by the IRS to make partnership tax treatment available to all unincorporated firms²³⁴ signals that still more changes are in the wind. This Article suggests that tax law has had important effects on business forms. Freed from some of the current tax constraints, statutory business forms could proliferate further. This proposal could signal the beginning of a new corporate-type partnership, accelerate the demise of the close corporation, or have other effects on statutory standard forms that cannot now be predicted.

Finally, this Article suggests that it is time that data started playing more of a role in prescriptions concerning closely held firms. More empirical work remains to be done. Among other things, once LLCs have been in use for some time it may be possible to test this Article's theory of the functions of standard forms by identifying differences between the types of firms that choose to organize as LLCs. For example, firms that manage real estate and other properties may continue to organize as limited partnerships even though the same tax advantages and more flexible management are available through the LLC form. This would suggest that the control rule and other mandatory limited partnership rules are, indeed, efficient for such firms.

The data so far suggests that there is a "race to the top" in creating statutory law for closely held firms, but the "top" is determined to some extent by the tax and regulatory context in which these firms must operate. It follows that the way to improve the law of closely held firms lies not in more uniform laws, but in avoiding unnecessary tax and regulatory constraints on the shape of firms.

233. See *supra* text accompanying note 8; Ribstein, *supra* note 71.

234. See *supra* text accompanying note 10.