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# Protecting LLC Owners While Preserving LLC Flexibility

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# More Ways to Protect LLC Owners and Preserve LLC Flexibility

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*This online companion to* Protecting LLC Owners While Preserving LLC Flexibility *considers several alternative approaches that might unify LLCs' twin goals of owner protection and governance flexibility. I examine self-regulation, private certification, investor-led market forces, lawyers in their gatekeeping capacity, and mandated disclosure systems. Ultimately, each of these alternatives proves less satisfying than a system that bifurcates LLC law based on the presumed sophistication of LLC owners.*

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## INTRODUCTION

In *Protecting LLC Owners While Preserving LLC Flexibility*,[1] I develop the case for bifurcating limited liability company ("LLC") law depending on LLC owners' projected sophistication. This bifurcation accomplishes the incompatible twin goals of giving LLC owners flexibility to set their internal governance rules while protecting relatively unsophisticated owners. In this online companion, I examine several additional ways to achieve this outcome, ultimately concluding that each is unsatisfactory. By analyzing the potential of self-regulation, private certification, investor-led market forces, lawyers as gatekeepers, and disclosure regimes, I make the case that the alternative "qualified LLC" solution developed in the accompanying Article has the most promise for enhancing long-term LLC efficiency.

## I. SELF-REGULATION

Industry self-regulation has achieved remarkable success in a variety of contexts. The American Bar Association ("ABA"), for example, promulgates and enforces ethics rules to govern the legal profession, in turn increasing the attractiveness of lawyers for clients.[2] The Financial Industry Regulatory Authority ("FINRA") regulates the broker-dealer industry, which protects investors and makes them more likely to patronize FINRA-affiliated broker-dealers.[3] Perhaps, then, we could similarly rely on LLCs to police themselves through self-regulation?

A reliance on LLC self-regulation would hope that LLCs would monitor one another to make sure that investors had a minimum, meaningful level of contractual protections, or that opportunism nevertheless did not occur in spite of a lack of protections. There are reasons to think this self-regulation might be attractive to LLCs. For one, self-regulation could head off more intrusive government regulation that might otherwise be enacted, preserving a

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[1] Peter Molk, *Protecting LLC Owners While Preserving LLC Flexibility*, 51 UC DAVIS L. REV. 2129 (2018) [hereinafter *Protecting LLC Owners*].

[2] *See, e.g.*, Jonathan Macey, *Occupation Code 541110: Lawyers, Self-Regulation, and the Idea of a Profession*, 74 FORDHAM L. REV. 1079 (2005); *cf.* Fred C. Zacharias, *The Myth of Self-Regulation*, 93 MINN. L. REV. 1147, 1153 (2009) (characterizing attorney self-regulation as only one piece of a broader attorney regulatory system).

[3] For analysis of FINRA's self-regulation, including skepticism about its effectiveness, see generally Andrew F. Tuch, *The Self-Regulation of Investment Bankers*, 83 GEO. WASH. L. REV. 101 (2014) [hereinafter *Self-Regulation*].

comparatively happy current state of affairs for existing LLCs.[4] Self-regulation could also protect the LLC "brand" from becoming tarnished by a few rotten apples, ensuring that the organizational form remained relatively attractive for investors' capital rather than scaring that capital away.[5] In other words, self-regulation could preserve trust and fend off more intrusive regulation for LLCs just as it has in other contexts.

Despite these advantages, the biggest impediment to LLC self-regulation may be the difficulty involved in achieving effective internal monitoring. Self-regulation requires that constituents regulate themselves, by monitoring what the others are doing. Yet monitoring presents a classic externalities problem. The benefits from a strong LLC brand accrue to all LLCs, while the costs are borne disproportionately by those LLCs actually doing the monitoring. As with any good with positive externalities, private forces will therefore underprovide LLC monitoring, which would lead self-regulation to unravel.

On top of the externalities problem is the massive cost of monitoring the more than two million LLCs currently in existence, with more forming every day.[6] These companies are diffusely spread around the country; their operating agreements are usually nonpublic, non-standardized, and difficult to discern;[7] and their investors' and managers' conduct is generally private. Monitoring in these

[4] Jerrold G. Van Cise, *Regulation — By Business or Government?*, HARV. BUS. REV. (Mar. 1966), https://hbr.org/1966/03/regulation-by-business-or-government ("It is of course true that, with 'a little bit of luck,' industry may enjoy the happiness of self-regulation without the harassment of any government participation whatever.").

[5] *See, e.g.*, Mary Kay Gugerty, Mark Sidel & Angela L. Bies, *Introduction to Minisymposium: Nonprofit Self-Regulation in Comparative Perspective — Themes and Debates*, 39 NONPROFIT & VOLUNTARY SECTOR Q. 1027, 1035-36 (2010) (discussing this incentive in the nonprofit sector).

[6] *See Table 8: Domestic General Partnerships, Limited Partnerships, and Limited Liability Companies: Selected Items, by Selected Industrial Group, Tax Years 2013-2014*, IRS (April 2016), https://www.irs.gov/pub/irs-soi/14pa08.xls [hereinafter *Table 8*] (over 2.4 million LLCs existing in 2014); Rodney D. Chrisman, *LLCs Are the New King of the Hill: An Empirical Study of the Number of New LLCs, Corporations, and LPs Formed in the United States Between 2004-2007 and How LLCs Were Taxed for Tax Years 2002-2006*, 15 FORDHAM J. CORP. & FIN. L. 459, 460 (2010) (describing the rate of new LLC formation).

[7] Leo E. Strine, Jr. & J. Travis Laster, *The Siren Song of Unlimited Contractual Freedom*, *in* RESEARCH HANDBOOK ON PARTNERSHIPS, LLCS AND ALTERNATIVE FORMS OF BUSINESS ORGANIZATIONS 1, 2-3 (Mark Lowenstein & Robert Hillman eds., 2015) ("[LLC] governing instruments — which contain unique provisions that lead to *ad hoc* judicial decisions interpreting specific provisions that provide no predictability in future cases — are often poorly drafted and unclear . . . .").

circumstances amounts to a herculean task, even without the externalities issue.

Of course, self-regulation does work in some instances, even where the self-regulated entities are spread out and numerous as would be the case for LLCs. Both lawyers and broker-dealers have achieved apparent success with self-regulation, despite their large and diffuse numbers. They do so by delegating monitoring responsibilities to a relatively concentrated single entity (the ABA or FINRA, respectively), relying on that entity to do the self-regulatory work.[8] But it is important to recognize that this solution merely shifts problems around. Who, for example, makes sure that the single monitor is actually doing a good job? The same forces that make self-regulated entities ineffective monitors of one another will also make them ineffective monitors of the monitor. Indeed, some have argued that self-regulation works among lawyers and broker-dealers only because of the meaningful state oversight layered on top;[9] without this external oversight, some have argued self-regulation does not work well at all.[10]

## II. PRIVATE CERTIFICATION

Closely related to self-regulation is the idea of private certification, in which private certification groups shoulder the monitoring duties. Proponents might point to the success that private certification systems have achieved in solving some of self-regulation's coordination failures and wonder if LLCs could similarly benefit from a certification regime.[11] Certification provides a useful signal of quality in circumstances ranging from organic food[12] to sustainable forestry products.[13] Perhaps a certifier could certify LLCs suitable for everyday investors, or only sophisticated investors, providing similar value to

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[8] *See supra* notes 2-3 and accompanying text.

[9] *See* Zacharias, *supra* note 2, at 1147 (discussing lawyers); Tuch, *Self-Regulation*, *supra* note 3, at 170 (discussing broker-dealers).

[10] *See* Zacharias, *supra* note 2, at 1150-51; Tuch, *Self-Regulation*, *supra* note 3, at 170 (discussing broker-dealers).

[11] *See, e.g.*, Peter Molk, *Do We Need Specialized Business Forms for Social Enterprise?*, *in* CAMBRIDGE HANDBOOK OF SOCIAL ENTERPRISE LAW 13-19 (Benjamin Means & Joseph Yockey eds., 2017) [hereinafter *Specialized Business Forms*] (analyzing private certification in the context of social enterprise).

[12] *Becoming a Certified Operation*, U.S. DEP'T OF AGRIC., https://www.ams.usda.gov/services/organic-certification/becoming-certified (last visited Mar. 1, 2018).

[13] *Why Should I Become FSC Certified?*, FOREST STEWARDSHIP COUNCIL, https://ic.fsc.org/en/for-business/business-benefits/becoming-fsc-certified (last visited Jan. 25, 2018).

the investing public that the organic certification provides to the eating public.

Instead of relying on market players to monitor one another as in self-regulation, certification relies on one or more certification groups to do the monitoring, which reduces coordination difficulties that otherwise arise with a pure self-regulation system.[14] Yet for certification to succeed, two conditions must be satisfied: the investing public would need to attach some additional value to the certification mark, *and* the certifier needs to be trustworthy.[15] The first of these conditions has not yet been satisfied in the LLC-space, but perhaps investors would appreciate the governance predictability that a certifier's approval could offer if it only existed.[16] There are reasons to be skeptical: different LLC governance arrangements are more suited to different types of investors, and whether investors could accurately sort themselves into types recognized by the certifier, and therefore whether a certification signal would provide any real value, is questionable.

Satisfying the second condition would also be challenging. The same forces that make self-regulation monitoring difficult will also lead to apathetic monitoring of the certifier, and a poorly monitored certifier risks undermining certification's value.[17] Preventing some of these breakdowns can be accomplished with creative legislative solutions.[18] All require a significant investment of resources, in turn increasing the costs of doing business as an LLC and making this solution less attractive.

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[14] *See* Molk, *Specialized Business Forms*, *supra* note 11.

[15] *See id.*; Stephen Choi, *Market Lessons for Gatekeepers*, 92 NW. U. L. REV. 916, 936 (1998).

[16] Indeed, this is often cited as one reason that investors favor the corporate form with its mandatory protections for public investing, as opposed to less predictable alternative entities. STEPHEN J. CHOI & A.C. PRITCHARD, SECURITIES REGULATION 403 (4th ed. 2015) ("[I]nvestors in the public capital markets typically prefer a simple corporate structure — the entire business held by one formally incorporated entity — and a simple capital structure: one class of common stock.").

[17] *See* Molk, *Specialized Business Forms*, *supra* note 11, at 20; Gabriele Jahn et al., *The Reliability of Certification: Quality Labels as a Consumer Policy Tool*, 28 J. CONSUMER POL'Y 53, 61-63 (2005) (discussing conditions necessary for a successful certification system). *See generally* Frank Partnoy, *What's (Still) Wrong with Credit Ratings?*, 92 WASH. L. REV. 1407 (2017) (discussing the failures of credit rating systems).

[18] *See, e.g.*, Brian Galle, *Self-Regulation of Social Enterprise*, *in* RESEARCH HANDBOOK ON SOCIAL ENTERPRISE LAW (Benjamin Means & Joseph Yockey eds., forthcoming 2018) (advocating random assignment of government-approved certifiers).

## III. INVESTOR-LED MARKET FORCES

Instead of counting on LLCs to solve the problem internally or through certification, we might instead look to investors to provide their own solution. There are two ways this might work. First, LLCs that want to maximize the price that investors pay will be deterred from inefficiently minimizing those investors' governance protections. Investors are presumed to price governance protections and should pay less money when they have poor governance protections.[19] Second, LLCs that repeatedly need to raise funds from investors will be deterred from opportunism even if operating agreements might otherwise allow it, since mistreating investors will make raising future funds more expensive.

Let us first consider the role of pricing governance protections. In an efficient market, governance terms are incorporated into the price at which investment interests are sold.[20] Consequently, value-reducing terms that permit opportunism by management will reduce the price at which investment interests will sell. When firms raise money, they typically want to maximize the selling price of investment interests. Market forces, therefore, will deter them from including value-reducing terms.

Moreover, efficient pricing also ensures that even if the operating agreement allows for opportunism, investors originally pay a compensatory discount for those investment interests. This effectively eliminates their damages; they buy into a poor investment, but they pay a low price to do so. In a robust, efficient market, LLC reform might thus be unnecessary because of the deterrent and remedial effects that market forces already provide.[21]

While there is evidence to support this argument in public capital markets,[22] there is little reason to think that market forces will provide

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[19] Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735, 1736 (2006) ("The mechanism by which securities are priced 'ensures that the price reflects the terms of governance and operation' offered by the firm. If these governance terms are unfavorable, investors will discount the price they are willing to pay for that firm's securities." (footnote omitted)).

[20] *Id.*

[21] *See* Mohsen Manesh, *Equity in LLC Law?*, 44 FLA. ST. U. L. REV. (forthcoming 2018) (manuscript at 59) (arguing that "market-based considerations associated with [publicly-traded LLCs] weigh against the judicial use of equitable discretion to protect investors").

[22] *See, e.g.*, Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 254 (1977) (arguing that market forces imply a "race to the bottom" in corporate law). *See generally* ROBERTA ROMANO, THE ADVANTAGE OF COMPETITIVE FEDERALISM FOR SECURITIES REGULATION (2002)

a deterrent in the vast majority of problematic LLC waivers. Most LLCs are not publicly traded, and instead are bought and sold among a narrow group of private buyers.[23] Privately traded interests among a select group of individuals bear little similarity to the efficient market characteristics of public markets; indeed, little or no trading volume easily severs the requisite link between investment prices and governance terms upon which a market forces solution relies.[24] Once that link has been cut, there is no longer a market check against the problem of investors' underpricing governance interests, leaving this fundamental LLC issue unaddressed. Consequently, while market forces might make reform unnecessary for LLC interests that are traded on efficient public markets,[25] they will not solve the governance problems inherent with unsophisticated investors buying interests in private companies.

Next, let us examine the deterrent effect posed by LLCs' repeated need to raise new funds over time from investors. This need may arise for a variety of reasons. It is not unusual for companies to require additional capital infusions as they expand later operations. Other companies might be structured to have finite lifespans, after which they must distribute their assets and raise new ones.[26] Still others might have controlling serial entrepreneurs who might want to embark on a new venture with new funding. In any of these situations, it is difficult to imagine a greater roadblock to raising funds than recent mistreatment of investors. Repeat trips to the capital markets will deter opportunism even if an operating agreement otherwise permits undesirable behavior, giving it the potential to solve the LLC opportunism problem.

However, this deterrent acts only upon those LLCs and entrepreneurs who will (or think they might) actually engage in

(summarizing these arguments).

[23] *Compare* Manesh, *supra* note 21, at 54 (finding approximately 150 publicly traded LLCs or limited partnerships), *with* IRS, *Table 8*, *supra* note 6 (estimating 2.4 million LLCs); *see also* Peter Molk, *How Do LLC Owners Contract Around Default Statutory Protections?*, 42 J. CORP. L. 503, 538 (2017) [hereinafter *Contracting Around Default Statutory Protections*] (finding three-quarters of a sample of privately held LLCs to have transfer restrictions).

[24] *See, e.g.*, Basic Inc. v. Levinson, 485 U.S. 224, 248-49 (1988) (discussing the link between efficient securities markets and market prices).

[25] Manesh, *supra* note 21. *But see* Strine & Laster, *supra* note 7, at 5 (recommending mandatory duties of loyalty for publicly traded LLCs and limited partnerships).

[26] *See, e.g.*, Larry E. Ribstein, *Partnership Governance of Large Firms*, 76 U. CHI. L. REV. 289, 292 (2009).

repeated funding rounds. And while this deterrent may undoubtedly be effective in some areas — private equity is a prominent example[27] — many firms have perpetual lifespans with no intention of raising more capital and an entrepreneur with no immediate plans to start new projects.[28] For these firms, there is little reason to refrain from opportunism, since existing investors are already locked into the firm and cannot retroactively decrease their buy-in price.[29]

Finally, for repeat funding to provide a meaningful constraint, reputations for past opportunism must also spread to potential new investors, so that those new investors discount their buy-in price appropriately. These signals are likely to be noisy, because what constitutes opportunism is a fact-specific inquiry whose interpretation likely differs across individuals. Moreover, the signals also may have difficulty in spreading, given the large number of LLCs, the even larger number of potential investors, and the relatively small number of investors in any particular LLC who must be relied upon to spread the company's reputation.[30] Investor-led constraints, therefore, appear to provide only a very partial solution to opportunism, in the context of the very few publicly traded LLCs that exist.

## IV. LAWYERS AS GATEKEEPERS

If LLCs or investors are not the solution, perhaps the lawyers who draft LLC operating agreements are. If we could be sure that lawyers

[27] *See id.* at 299 (describing the role of limited terms).

[28] *See* Molk, *Contracting Around Default Statutory Protections*, *supra* note 23, at 545 (finding eighty-three percent of a sample of Delaware LLCs to have indefinite lifetimes).

[29] In fact, the problem may also arise even for many firms with plans to visit the capital markets repeatedly. From a game-theoretical perspective, even a future need for new capital will not act as a deterrent unless the firm will need to raise capital into the indefinite future. If capital needs have a finite end point, then the rational firm (or those who control it) will engage in opportunism after that final investment round. Investors, anticipating this last-period opportunism, will offer a lower buy-in price for the final investment round. The firm, anticipating this lower price, will therefore engage in opportunism in the second-to-last investment round as well, since there is nothing to be gained from good behavior. Investors, anticipating this, will pay less in the second-to-last investment round. The cycle eventually unravels so that the firm initially attracts investors at a low price and engages in opportunism after the first funding round, with all future rounds following the same pattern. *See generally* ANDREU MAS-COLELL ET AL., MICROECONOMIC THEORY 268-82 (1995) (describing this process of backwards induction).

[30] *Compare* IRS, *Table 8*, *supra* note 6 (finding 2.4 million LLCs in 2014), *with* Molk, *Contracting Around Default Statutory Protections*, *supra* note 23, at 520 (finding ninety-three percent of a sample of Delaware LLCs to have twenty or fewer members).

had the incentive to guarantee efficient protections for investors, then lawyers might solve the problem that other forces cannot.

There is reason to be optimistic. Lawyers have conventionally assumed the role of business law "gatekeepers" who keep certain bad activities out of the marketplace. Securities lawyers, for example, are thought to serve a gatekeeping role for undesirable private placement and initial public offering sales.[31] Perhaps lawyers could perform a similar function when it comes to LLCs. After all, the core governance document for LLCs — their operating agreement — is often drafted by lawyers, putting them in an admirable gatekeeping position to screen out "bad" operating agreements while allowing only "good" operating agreements through. If lawyers faced legal liability or private financial repercussions for sanctioning inappropriate operating agreements, perhaps they would act as desired.

Yet there is also reason to doubt this potential solution. Others have suggested that operating agreements are generally drafted by lawyers representing exclusively sponsors of the LLC.[32] These lawyers owe no duties to LLC investors, so they face no legal liability if the operating agreements ultimately allow opportunistic conduct against investors.[33] Many lawyers also face little meaningful private financial consequences if they allow poor operating agreements. Reputations matter when value is placed on a good reputation and reputation spreads easily,[34] such as with a limited pool of players. The securities underwriting process, for example, thrives on players' desire to preserve good reputations, but it features a limited pool of well-known underwriters who must preserve their reputation for bringing good

[31] *See* Ronald J. Gilson, *The Devolution of the Legal Profession: A Demand Side Perspective*, 49 MD. L. REV. 869, 883 (1990) (unregistered securities); Andrew F. Tuch, *Multiple Gatekeepers*, 96 VA. L. REV. 1583, 1589-90, 1634-35 (2010) (describing the role of lawyers in selling registered securities, while raising doubts about their ability to be held legally liable for failure). *See generally* Frank Partnoy, *Barbarians at the Gatekeepers? A Proposal for a Modified Strict Liability Regime*, 79 WASH. U. L. REV. Q. 491 (2001) (discussing limitations with existing gatekeeper liability regimes).

[32] Strine & Laster, *supra* note 7, at 2 ("[T]hese governing instruments seem to be drafted unilaterally by the sponsors and proposed on a take-it-or-leave-it basis to the investors.").

[33] This is particularly true when the drafting attorneys disclose their interests in the operating agreement. *See, e.g.*, Second Amended and Restated Limited Liability Company Agreement for Quorum Realty Fund IV, LLC, Art. 14, Sec. 14.1. Of course, if minority investors were represented by attorneys who commit malpractice in approving an operating agreement, investors might have legal actions against *those* attorneys. Malpractice, however, is a high bar; moreover, much of the opportunism problem arises when minority investors are not represented by legal counsel.

[34] *See* Choi, *supra* note 15, at 919-20.

companies to the public among a restricted pool of repeat sophisticated investors, to get more business in the future.[35] On the other hand, there is a diverse array of non-repeat LLC business, and a diverse array of investors who probably know little about most lawyers or their firms, making law firm reputation relatively unimportant to many customers. Therefore, the firm that drafts a weak LLC operating agreement loses little business if that operating agreement later leads to opportunistic conduct. Unhappy investors will likely never be dealing with that firm or lawyer again, and information about that firm's or lawyer's role will have difficulty spreading to prospective investors in new LLCs counseled by that firm or lawyer.[36]

Without imposing some new liability on lawyers, there are insufficient deterrents for them to fill a meaningful gatekeeping role. Nor would imposing new liability necessarily be a good idea, as it would be difficult to identify ahead of time how to define a "bad" operating agreement to which liability should attach.[37] Other options may, therefore, make more sense.

## V. "SMARTER" DISCLOSURE

With these bottom-up approaches not working, perhaps we could rely on a top-down government-initiated disclosure approach.[38] LLCs

[35] *See* John C. Coffee, Jr., *Re-Engineering Corporate Disclosure: The Coming Debate Over Company Registration*, 52 WASH. & LEE L. REV. 1143, 1169 (1995); Merritt B. Fox, *Regulating Public Offerings of Truly New Securities: First Principles*, 66 DUKE L.J. 673, 689 (2016).

[36] *Cf.* John F. Coyle & Joseph M. Green, *Startup Lawyering 2.0*, 95 N.C. L. REV. 1403, 1417-18 (2017) (finding lawyers to serve no screening function in North Carolina startups). This does not necessarily mean that certain law firms will not specialize in providing "high quality" LLC operating agreements to some portion of LLC investors, particularly for very large investments for which they could charge a substantial premium.

[37] This is particularly true given the noncontractual dynamics that many LLCs use to deter opportunism. *See, e.g.*, Ribstein, *supra* note 26, at 298-99 (analyzing these dynamics in the context of private equity firms). These dynamics, of course, would never appear in the operating agreement, and assessing their relative strength after the fact could be fraught with hindsight problems.

[38] We might also think that LLCs might derive standardized operating agreement forms if left to their own devices, as has occurred in the venture capital space. *See* Robert P. Bartlett, III, *Commentary*, 51 ARIZ. L. REV. 47, 54-55 (2009) (describing the origins of these documents); Coyle & Green, *supra* note 36, at 1412-15 (describing the importance of these forms). But until the number of law firms working on LLC formations reduces to a manageable number so that they can feasibly coordinate, and until investors recognize value from uniformity, achieving standardization from the ground up across LLCs as a whole seems unlikely. *Cf.* Jonathan G. Rohr, *Freedom of*

already have disclosure of governance terms — as creatures of contract law, operating agreement terms generally do not bind investors unless those investors have access to and agree to those terms.[39] But the terms are not disclosed in an easily digestible format, varying from agreement to agreement in documents that regularly span one hundred pages of legalese.[40] One term is typically given no priority over another, making their relative importance difficult to identify and assess. Given investors' finite ability to process disclosure terms,[41] perhaps a system of "smarter" mandatory disclosure would better lead investors to identify and appropriately price modifications to traditional owner protections.

For instance, LLCs might be required to include a summary cover page with their operating agreements, consisting of a listing of traditional owner protections that most investors expect followed by indications of whether and on what pages of the agreement those

*Contract and the Publicly Traded Uncorporation*, 14 N.Y.U. J. L. & BUS. (forthcoming 2018) (developing an argument for a ground-up standardization of governance terms among publicly traded LLCs and limited partnerships). *See generally* Matthew Jennejohn, *The Architecture of Contract Innovation*, 59 B.C. L. REV. (forthcoming 2018) (studying deterrents to standardization in M&A deal contracts).

39 This is not to say that each investor must always agree to every term in the operating agreement. However, initial investors must at least agree to the operating agreement as a whole (explicitly by signing it, or implicitly by investing), with the terms of those agreements disclosed to investors. Note that if an agreement does not require unanimous consent for amendment, investors may later find themselves subject to terms to which they did not explicitly agree. Nevertheless, these investors would have consented to the original operating agreement, including the non-unanimous consent requirement. *See* Molk, *Contracting Around Default Statutory Protections*, *supra* note 22, at 537 (finding many LLCs to allow amendment without unanimous consent); *but see* Shapiro v. Ettenson, No. 00442, slip op. at 650 (N.Y.S. Jan. 24, 2017) (allowing LLC to adopt operating agreement without unanimous consent two years after formation). *See* George S. Geis, *Ex-Ante Corporate Governance*, 41 J. CORP. L. 609, 612 (2016) (grappling with these latecomer losses). *See generally* Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1442-44 (1989) (describing non-efficiency one-time "latecomer" losses that can arise from amending governance agreements).

40 Strine & Laster, *supra* note 7, at 12-13 ("[A]lternative entity agreements typically contain 90-plus pages of dense, complex, and heavily cross-referenced legalese. To digest the contractual prose, the reader must decode multi-layered sentences, incorporate the meaning of defined terms, and be constantly on the watch for more specific provisions elsewhere in the agreement or language that applies 'notwithstanding anything to the contrary.' Even when language appears familiar, it often departs subtly from the precise terms interpreted in earlier judicial opinions — and intentionally so.")

41 *See, e.g.*, OMRI BEN-SHAHAR & CARL E. SCHNEIDER, MORE THAN YOU WANTED TO KNOW: THE FAILURE OF MANDATED DISCLOSURE (2014) (studying consequences from this limited processing and attempts to manage it).

protections are varied.[42] Or, if that is too much for investors to process, perhaps the first page of each operating agreement would be required to have a smiley face of varying degrees of happiness, depending on the overall strength of owner protections.[43] Disclosures of this sort would not only make investors more aware of what they are getting into and more likely to price those investments accurately, but also facilitate comparison-shopping by investors across potential investments, a practice currently inhibited by today's lack of standardization.

Yet the problems with disclosure-based solutions have been well documented. As summarized by Omri Ben-Shahar and Carl Schneider, "[m]uch evidence suggests that people often overlook disclosures, ignore them when they notice them, treat them perfunctorily when they read them, forget and misinterpret much they have read, and incorporate little of their learning into decisions."[44] This presents a troubling picture when applied to LLCs. LLCs' problem stems from investors' failure to notice and value accurately governance eliminations. While more digestible disclosure may address the failure to notice issues (although evidence on even this is mixed[45]), it does little to address investors' failure to value accurately those governance modifications. To be sure, some investors who failed to notice governance modifications will now value them accurately once those modifications are brought to their attention. Yet many others will still undervalue reductions even after they become aware of those reductions' existence. Assessing the finer nuances of, for example, a business opportunity waiver or indemnification agreement is no easy

[42] Disclosure regulation often aims to simplify complex documents into standardized forms that can be digested and compared by consumers. *See, e.g.*, TILA-RESPA Integrated Disclosure Rule Implementation, CONSUMER FIN. PROT. BUREAU, https://www.consumerfinance.gov/policy-compliance/guidance/implementation-guidance/tila-respa-disclosure-rule/ (last visited July 25, 2017) (collecting resources for standardized mortgage disclosure rules). *See generally* Leonard J. Kennedy, Patricia A. McCoy & Ethan Bernstein, *The Consumer Financial Protection Bureau: Financial Regulation for the Twenty-First Century*, 97 CORNELL L. REV. 1141, 1160-75 (2012) (describing the genesis of these rules).

[43] For an example of the power of smileys, see Leslie Kaufman, *Utilities Turn Their Customers Green, With Envy*, N.Y. TIMES (Jan. 30, 2009), http://www.nytimes.com/2009/01/31/science/earth/31compete.html (describing efforts made by several electric utilities). There is, of course, a question of whether one smiley face standard could be uniformly applied to all investors, who vary in their protection needs and desires. For simplicity, I will assume that such a standard could be developed.

[44] BEN-SHAHAR & SCHNEIDER, *supra* note 41, at 67.

[45] *Id.* at 43 (summarizing several studies that suggest many individuals ignore disclosed information).

task, even for investors who are aware of its presence. And still other investors will ignore the governance disclosures no matter how obvious they are to concentrate on the more salient features like capital contribution repayments or dividend payout priorities, again resulting in underpriced governance modifications.

Nevertheless, disclosure could still indirectly achieve its intended effects, even if it has little direct effect on investors. In other contexts, disclosure succeeds by making private information available to government actors, watchdog organizations, academics, and sophisticated players, who process this information to effect change that ultimately affects disclosure's intended target.[46] Disclosure of insurance company practices, for example, may improve insurance contracts for everyday consumers, even if those consumers never read the disclosed information, because of the pressure from various advocates who now have access to the information.[47]

For this solution to work for LLCs, LLC operating agreements must be made generally available to the public. Yet most LLCs are private entities that have strong, legitimate interests in keeping their operating agreements private.[48] Making these operating agreements publicly available will impose significant costs. This does not mean it should necessarily be avoided but does mean that the benefits must be significant and that alternative approaches would not be better. Unfortunately, there is reason to think the potential benefits from full disclosure may be small. As already discussed, unsophisticated LLC investors may ignore disclosure-based information, whether it comes from the disclosure itself or indirectly through an information processor. Further, unlike other markets, different LLC investors often pay different prices for identical ownership interests in the same company. This means that unsophisticated parties could be charged one investment price by an opportunistic LLC, while sophisticated parties, or those who pay attention to disclosure processors, are charged a lower price, defeating the market check that processors of disclosure have provided in other circumstances.[49] And finally, there is

[46] *See* Daniel Schwarcz, *Transparently Opaque: Understanding the Lack of Transparency in Insurance Consumer Protection*, 61 UCLA L. REV. 394, 409-13 (2014) (discussing several successful implementations of full disclosure regimes).

[47] *See id.*

[48] *See supra* note 23 and accompanying text.

[49] *E.g.*, John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717, 723-37, 751-53 (1984) (discussing disclosure in the context of securities markets); Schwarcz, *supra* note 46, at 401-02 (collecting several examples). *See generally* Alan Schwartz & Louis L. Wilde, *Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis*, 127 U. PA.

a less intrusive way with lower costs that could tackle the same problem. That intervention is the subject of the corresponding Article.[50]

## CONCLUSION

Although a variety of alternatives exist that have successfully solved opportunism in other contexts, these alternatives are not satisfactory when applied to LLCs. As long as LLCs are used by both sophisticated and unsophisticated investors and entrepreneurs, they seem destined to either risk leaving unsophisticated investors unprotected, which generates inefficiencies and capital costs, or risk restricting governance flexibility, which keeps some investors from setting the optimal internal governance rules for their unique situations.

The accompanying Article takes up a new and creative solution to this problem.[51] Instead of applying a uniform set of rules to LLCs regardless of investor type, I propose bifurcating the system, much as securities law has done with securities registration requirements.[52] Doing so will ensure LLCs continue to be appealing and appropriate for both the very sophisticated parties who can fend for themselves as well as everyday investors who seek a simple tax-efficient form with limited liability.

L. REV. 630, 643-45 (1979) (analyzing the circumstances under which a group of informed market participants can generate efficient prices for all).

[50] Molk, *Protecting LLC Owners*, *supra* note 1 (developing a "qualified LLC" solution).

[51] *Id.* at 2151.

[52] *Id.* at 2159.