

## Agency and the Unincorporated Firm: Reflections on Design on the Same Plane of Interest

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Regardless of their legal form, all firms confront questions of governance, that is, the recurrence of situations that may not be resolved satisfactorily if their resolution is left solely to the discretion of individual actors. Two principal reasons explain the inevitability of governance questions within firms. First, the interests of persons involved with the firm may diverge. In particular, the interests of owners and managers, and of owners and creditors, do not always coincide. Even among themselves, owners' interests may well diverge. Second, the firm benefits over time through the existence of a structure that defines the ability of individual actors to take action that binds the firm and its owners, as well as some mechanism, whether direct or indirect, to control the conduct of people whose actions bear consequences for the firm and its owners. The law of agency provides a set of doctrines that underlie the mechanisms of firm governance.

My purpose in this Article is to illustrate recurrent aspects of unincorporated firms that generate governance problems, problems formally addressed by agency-law norms, but troublesome in practical respects nonetheless. Many unincorporated firms have internal governance structures that are insufficiently differentiated in function to resolve predictable difficulties with the clarity achieved by governance structures that differentiate more extensively among the functions of persons associated with the firm. Agency-law norms resolve these difficulties by providing formal answers to them, but the theoretical and practical challenges are often greater than in firms in which functions are more differentiated. In many unincorpo-

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rated firms, the same people occupy multiple roles — equity ownership, management, employment — rather than distinctive roles. Lack of differentiation in function often leads to instability in small firms. The legal consequences of incorporation themselves specify various differentiations in function,<sup>1</sup> some of which could be, but often are not, replicated in unincorporated firms. Lack of differentiation helps explain some of the distinctiveness in legal norms applicable to unincorporated firms. In a more speculative mode, I suggest that the persistence of such governance challenges in unincorporated firms may limit firm growth, particularly growth funded through external sources of equity investment.

My inquiry begins with a visual metaphor intended to reflect a baseline assumption about many unincorporated firms, which is that from the standpoint of issues relevant to agency, the design of many such firms places all actors on the same plane of interest. This feature is a defining visual quality in many works of art, in particular, work that preceded the Italian Renaissance or later work that does not evidence its influence. My specific illustration comes from Antonio Pisano, known as Pisanello, who worked in the first half of the fifteenth century. Consider the organization of visual experience in Pisanello's masterpiece, *The Vision of Saint Eustace*.<sup>2</sup> To be sure, the center of the painting depicts the Saint and his vision of Christ on the Cross. But there is so much else as well — a large stag with handsome antlers, a smaller stag with an even more impressive set of antlers, finely detailed equipment on the Saint's horse, elegant clothing on the Saint himself, a dog chasing a hare, other dogs awaiting their chance, what appears to be a bear, various birds, and much, much more. Each might capture the viewer's attention as readily as any other.

Of this painting in particular, and of Pisanello's style more generally, the influential art historian, Bernard Berenson, wrote:

The art of Pisanello, like that of the early Flemings, was too naive. In their delight in nature they were like children who, on making the first spring excursion into the neighbouring meadow and wood, pluck all the wild flowers, trap all the birds, hug all the trees, and make friends with all the gay-coloured creeping things in the grass. Everything is on the same plane of interest. . . .<sup>3</sup>

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1. See CHARLES R. O'KELLEY, JR. & ROBERT B. THOMPSON, CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS 499-501 (2d ed. 1996); Robert B. Thompson, *Unpacking Limited Liability: Direct and Vicarious Liability of Corporate Participants for Torts of the Enterprise*, 47 VAND. L. REV. 1, 2-3 (1994).

2. Figure 1. One can access this image through <http://www.yawp.com/cjackson>.

3. BERNARD BERENSON, THE ITALIAN PAINTERS OF THE RENAISSANCE 143-44 (1952).

In equally didactic terms, Berenson also articulated criteria by which to identify more mature artistic expression:

The larger part of human progress consists in exchanging naive conventionality for conscious law; and it is not otherwise with art. Instead of painting indiscriminately everything that appeals to him, the great artist, as with deliberate intention, selects from among the mass of visual impressions only those elements that combine to produce a picture in which each part of the design conveys tactile values, communicates movement, and uplifts with space-composition.<sup>4</sup>

In short, all is no longer on the same plane of interest: consciously constructed hierarchy and structure have been imposed, and the artistic work that results is more than, and apart from, a conscientious and undifferentiated replication of the artist's visual impressions.

I turn now to a series of examples of firms situated such that, in one respect or another, actors appear to be on the same plane of interest. Consider first the allocation of authority among partners within a general partnership. Under Section 9(1) of the Uniform Partnership Act (UPA), "[e]very partner is an agent of the partnership for the purpose of its business, and the act of every partner . . . for apparently carrying on in the usual way the business of the partnership . . . binds the partnership" unless the partner lacks actual authority to do the act in question and the person with whom the partner deals is aware of the partner's lack of actual authority.<sup>5</sup> Section 301 of the Revised Uniform Partnership Act (RUPA) is similar, with one exception not relevant for our present purposes.<sup>6</sup> In a general partnership, in short, ownership and authority are not differentiated from each other. Likewise, in a member-managed limited liability company (LLC), ownership and authority generally converge.<sup>7</sup>

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4. *Id.* at 145.

5. UNIF. PARTNERSHIP ACT (1914) (UPA) § 9(1), 6 U.L.A. 400 (1995).

6. REVISED UNIF. PARTNERSHIP ACT (1994) (RUPA) § 301, 6 U.L.A. 33 (1995). The exception concerns a partnership that has filed a statement of partnership authority with the state. Section 303 permits such statements to designate partners' authority and any limits upon it. The Section creates conclusive rights to rely on such statements in specified instances and deems a third party to have knowledge of a limitation on a partner's authority — when the person is not relying on a filed statement of authority — only as to limits on a partner's authority to transfer real estate and only when the limitation on authority is filed with real property records.

7. See LARRY E. RIBSTEIN & ROBERT R. KEATINGE, LIMITED LIABILITY COMPANIES § 8.06 (1996). In some states the position is not entirely clear. For example, Delaware's LLC statute provides that in an LLC, "[u]nless otherwise provided in a limited liability company agreement, each member and manager has the authority to bind the limited liability company." DEL. CODE ANN. tit. 6, § 18-402 (1993 & Supp. 1996). This provision would

That each owner has at least apparent authority to bind a general partnership and a member-managed LLC creates an evident risk for all owners and for the firm's creditors. Agency law, of course, enables the other members to sue the rogue member who acts in excess of his actual authority, or who commits an unauthorized tort or crime while acting in partnership business,<sup>8</sup> but success in that suit does not vitiate the liability incurred on behalf of the firm. Moreover, owners of firms are not equally talented, or necessarily talented at all, in running the firm's business. Thus, the risk is not simply that the firm will be bound to a transaction entered into by an agent not actually authorized, but that the firm will be disadvantaged through a transaction that an appropriately skilled agent would not have undertaken.

In contrast, incorporating a firm differentiates as a baseline matter between ownership and authority to act on the firm's behalf.<sup>9</sup> Shareholders may undertake to act as the firm's agents, but the baseline rules contributed by legal form do not accredit all of them with the appearance of authority. Statutory specification and agency-law doctrines together allocate authority to bind a corporation. Authority to bind the corporation typically resides in its officers, who usually are appointed by its directors,<sup>10</sup> but directors' assent

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appear to make restrictions on authority controlling on third parties. Read in its entirety, this Section of the statute leaves one a bit uncertain about the consequences of transactions undertaken by a member who is apparently authorized to act, but who lacks authority under the LLC agreement when the other party is unaware of the limitation in the agreement. Earlier language in the Section states that:

Unless otherwise provided in a limited liability company agreement, the management of a limited liability company shall be vested in its members in proportion to the then current percentage or other interests of members in the profits of the limited liability company owned by all of the members, the decision of members holding more than 50 percent of the said percentage or other interest in the profits controlling . . . .

*Id.* Does this initial "unless otherwise provided" refer only to the prospect of changing the managerial prerogatives created by the statute, or does it additionally make any specification of authority in the agreement (including limitations on authority) conclusive against all third parties, including ones who lack knowledge of the limitation? If the initial proviso in the section is read narrowly, so might the later proviso be read only to validate an election to allocate management exclusively to a manager. *See also* Mitchel Hampton Boles & Susan Pace Hamill, *Agency Powers and Fiduciary Duties Under the Alabama Limited Liability Company Act: Suggestions for Future Reform*, 48 ALA. L. REV. 143, 148-51 (1996) (identifying possible disputes over authority in LLCs).

8. Any agent owes the principal a duty to act only as authorized. *See* RESTATEMENT (SECOND) OF AGENCY § 383 (1958). The agent is liable to the principal for loss caused by the breach of any duty. *Id.* § 401.

9. Moreover, a corporation is not the agent of its sole or majority shareholder simply on the basis of the fact of share ownership. *Id.* § 14 M.

10. *See, e.g.*, DEL. CODE ANN. tit. 8, § 142 (1991). The Delaware statute does not

may be required for major transactions. Depending on the size of the corporation, the nature of its business, and the nature of the transaction, nonofficer managers may have authority to transact. Fundamental transactions by statute require a resolution adopted by directors followed by shareholders' assent. Details aside, the picture is one of centralization and hierarchy in the allocation of authority.

Firms in which authority to act is broadly allocated to all owners — like general partnerships and member-managed LLCs — present greater challenges to control mechanisms than do firms structured to differentiate between ownership and authority.<sup>11</sup> In the absence of hierarchy imposed by legal form, more of the work of control turns on the efficacy of internal systems to monitor agents' activities. Individual owners have a greater stake in the efficacy of these systems when they are individually liable for the firm's obligations, and they have a lesser stake when their risk is limited to their ownership interest in the firm itself.<sup>12</sup>

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foreclose the possibility of having officers chosen by shareholders if the corporation's bylaws so provide. *Id.* § 142(b). In contrast, the New York statute requires that shareholder selection of officers be authorized in the corporation's certificate of incorporation. N.Y. BUS. CORP. LAW § 715(b) (McKinney 1986). The Revised Model Business Corporation Act does not explicitly resolve the question. *See* REVISED MODEL BUS. CORP. ACT (RMBCA) § 8.40(a) (1986) (providing that corporation "has the officers described in its bylaws or appointed by the board of directors in accordance with the bylaws").

11. A related point has been made in the realm of political theory. Within a social relationship, if each member's actions may be ascribed to all other members, "we have not representation but 'solidarity,' as exemplified in vendettas, blood feuds, or reprisals." HANNA F. PITKIN, *THE CONCEPT OF REPRESENTATION* 40 (1967) (drawing on work of Max Weber to distinguish condition of solidarity from representation, in which only select members of group have authority to act for it).

12. Individual liability also enhances incentives to insure, *see* Thompson, *supra* note 1, at 37, and the past and prospective efficacy of internal control mechanisms should bear on the level of insurance premiums, *cf.* FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 54 (1991) (noting that firms engaging in risky activities will pay higher insurance premiums).

The relative novelty of the LLC as an organizational form means that the strength of members' limited liability has yet to be fully tested in litigation. Consider the consequences of the partnership origins of the LLC for liability questions that arise once an LLC dissolves. Like a partnership agreement, an LLC's operating agreement may provide for automatic dissolution upon the happening of a specified event. UNIF. LIMITED LIABILITY COMPANY ACT (ULLCA) § 801(b)(1), 6A U.L.A. 481 (1995). Thereafter, although the LLC "continues" only for the purpose of winding up, the LLC is bound on nonwinding-up transactions that would have been binding on it prior to the dissolution, unless the other party to the transaction has notice of the dissolution. Although a dissolved and wound-up LLC may file articles of termination with the state, dissolution may occur much earlier. *See id.* § 805. The consequence is a classic instance of the lingering apparent authority of the now-dissolved LLC's agents, in particular its managers or members. In contrast, a corporation's dissolution is not effective until articles of dissolution are filed with the state. *See* RMBCA § 14.03(b).

My second example of lack of differentiation is related but distinctive. In many unincorporated firms, especially those providing professional services, ownership and work (or employment) are not differentiated. The investment risk that an ownership interest in a firm represents is not differentiated from the context in which the professional-as-owner practices her profession. This combination of roles within the firm can have untoward consequences separate from the illiquidity of the investment itself.<sup>13</sup> Courts' willingness to articulate and apply a stringent form of fiduciary duty in such firms may well be a response to the enhanced risk created by a lack of differentiation. Like Mr. Beasley, formerly of Cadwalader, Wickersham & Taft, a partner expelled from such a firm as a result of his partners' breach of fiduciary duty has been deprived not just of the fruits of a financial investment, but of an accustomed professional setting as well.<sup>14</sup>

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The salient question is whether members in a dissolved but not yet terminated LLC are individually liable on pretermination transactions when the LLC does nothing to give notice of its dissolution. A third party might well argue that when the LLC dissolved without notice to the public, the members' shield against partnership-style individual liability evaporated. After all, the limited liability firm in which the members invested has dissolved! The LLC itself may not have "terminated," *see* ULLCA § 805(b), but the third party might argue that its nontermination only establishes the LLC's liability and does not address the members' individual liability. Statutory provisions stating that the obligations of an LLC are "solely" those of the company, *see id.* § 303(a), do not address members' liability that arguably arises once the LLC itself, in some legally relevant sense, no longer exists. Moreover, these issues are even more pressing in jurisdictions with LLC statutes that define dissolution and create the prospect of automatic or nonpublic dissolution but do not differentiate between dissolution and termination. *See, e.g.,* N.C. GEN. STAT. § 57C-6-01 (1993). That is, if the LLC is organized under a statute that specifies circumstances under which it will dissolve, but does not specify a separate condition of termination, members' individual liability for postdissolution acts is a substantial risk.

13. A minority investment interest in a small firm may be illiquid when the investor is otherwise passive. *See, e.g.,* Donahue v. Rodd Electrotype Co., 328 N.E.2d 505, 518 (Mass. 1975).

14. *See* Beasley v. Cadwalader, Wickersham & Taft, No. CL-94-8646 "AJ," 1996 WL 438777 (Fla. Cir. Ct. July 23, 1996). The Cadwalader partnership agreement did not contain a mechanism to expel a partner without cause. In the absence of such a mechanism in the agreement, an alternative route for an at-will partnership is dissolution, followed by reformation as a partnership consisting of prior members save those being excluded. This alternative has been characterized as "at best, cumbersome and, at worst, laden with risk." *See* ROBERT W. HILLMAN, HILLMAN ON LAWYER MOBILITY § 5.4.1, at 5:19 (1994). In cases like *Beasley*, when the partnership agreement contains no relevant provision, dissolution entitles the expelled partner to a judicial forum in which to contest the valuation of his interest. By statute, the excluded partner has a right to an accounting of his interest in the partnership, that is, to his proportionate share of its assets net of liabilities. *See, e.g.,* Dawson v. White & Case, 672 N.E.2d 589, 592-94 (N.Y. 1996) (finding that agreement

In short, the relative stringency of member-to-member fiduciary duties in this context reflects the enhanced risks that follow lack of differentiation in function. Corporate norms, in contrast, presuppose that the shareholder-to-shareholder relationship is an atomistic one, in which shareholders are not understood to represent each other as agents. Shareholders owe each other no duties, at least in the absence of a controlling shareholder who exercises control over the firm's operation or who self-deals with the firm. Such a shareholder, though, is not simply a shareholder; the exercise of operational control ventures beyond the differentiated role of an equity investor defined by corporate law.

To be sure, the same lack of differentiation can occur just as readily in closely held corporations. Shareholders in small corporations, like partners in professional service firms, often have employment as well as investment relationships with the corporation. Case law addressing this fact reflects disagreement over the normative significance properly ascribed to the formal fact of incorporation. In particular, leading cases indicate that courts fundamentally disagree about whether fiduciary constraints apply to limit the discretion of controlling shareholders to cause the corporation to terminate the employment of a minority shareholder. A recent Delaware case, *Riblet Products Corp. v. Nagy*,<sup>15</sup> completely severs employment-related issues from the duties that a corporation's controlling shareholders owe a minority shareholder.<sup>16</sup> In contrast, several Massachusetts cases hold controlling shareholders to a duty of utmost good faith and fair dealing that extends to decisions to terminate the employment of minority shareholders.<sup>17</sup> In Delaware case law, the formal fact of incorporation trumps any normative significance that might be ascribed to the functional similarity between the minority shareholder's situation and that of a member of a partnership.<sup>18</sup>

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among partners excluded goodwill as distributable asset; future payments under unfunded pension plan were not liability of firm in dissolution, but were properly characterized as profitability-contingent expenses of successor firm).

15. 683 A.2d 37 (Del. 1996).

16. *Riblet Prods. Corp. v. Nagy*, 683 A.2d 37, 37-40 (Del. 1996).

17. See, e.g., *King v. Driscoll*, 638 N.E.2d 488, 494 (Mass. 1994); *Wilkes v. Spring-side Nursing Home, Inc.*, 353 N.E.2d 657, 662 (Mass. 1976). This principle applies in Massachusetts even when the termination of a shareholder's employment occurred pursuant to the terms of an agreement mandating sale of the stock when employment ends. See *King*, 638 N.E.2d at 494.

18. Cf. *Nixon v. Blackwell*, 626 A.2d 1366, 1380 (Del. 1993) (declining to differentiate between legal norms applicable to closely and publicly held corporations, especially when parties did not elect to be classified as statutory close corporation). The preference that Delaware case law exhibits for form-based answers is a relatively consistent theme

One virtue of formalism in this connection is that it obviates the inevitable and difficult inquiry into the content of rules specifically applicable to closely held corporations or other corporations in which functions are less differentiated than in a publicly held corporation. Consider a corporation in which the shareholders, all farmers, sell their grain output to the corporation and receive production financing from it. This scenario conflates equity ownership with debtor-creditor and commercial buyer-seller relationships. Does the fact that the shareholders' position is undifferentiated or undiversified change the nature of the directors' fiduciary duty of care? In *Brane v. Roth*,<sup>19</sup> the court held that the directors breached their duty of care by failing to hedge against price changes in the commodity outputs sold to the corporation by its shareholders.<sup>20</sup> From the standpoint of modern financial theory, it is odd to think that directors are under a duty to hedge against such risks because shareholders themselves could hedge or diversify against them.<sup>21</sup> The outcome in *Brane* is also surprising in light

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throughout its corporate jurisprudence, regardless of transactional or relational context. Consider Delaware's treatment of fundamental corporate transactions. Delaware rejects the "de facto merger" doctrine, which enables a court to characterize as a merger a transaction that the parties have structured through an alternative mode available under the corporate statute. See, e.g., *Hariton v. Arco Elecs., Inc.*, 188 A.2d 123, 125 (Del. 1963). As a result, transactions carrying identical economic consequences have disparate consequences for shareholders, depending on the transactional vehicle chosen by the directors and managers who structured the transaction. Under the Delaware statute, for example, merger transactions may trigger appraisal rights for shareholders, whereas sales of assets never do. See DEL. CODE ANN. tit. 8, §§ 251, 262, 271 (1991 & Supp. 1996). On occasion, Delaware's formalism has the effect of expanding rather than contracting shareholders' entitlements. In a recent — and controversial — opinion, the Delaware Supreme Court defined minority shareholders' entitlements in the context of a two-step negotiated acquisition transaction, one in which a cash tender offer was followed by a cash-for-shares merger, both at the same price. See James C. Freund & Edward F. Greene, *Substance over Form S-14: A Proposal to Reform SEC Regulation of Negotiated Acquisitions*, 36 BUS. LAW. 1483, 1499-1505 (1981). In *Cede & Co. v. Technicolor, Inc.*, 684 A.2d 289, 298 (Del. 1996), the court held that minority shareholders who dissented from the second-step merger and sought appraisal of their shares were entitled to their proportionate share of the value of the enterprise as a going concern as of the date of the merger. This rule enabled minority shareholders to receive a proportionate share of elements of provable value added prior to the merger by the corporation's majority shareholder, who achieved that position through the tender offer that constituted the first step of the acquisition plan. The rule gives operative legal effect to the formal distinction between the tender offer and the merger, even though both were undertaken as steps in the same plan of acquisition.

19. 590 N.E.2d 587 (Ind. Ct. App. 1992).

20. *Brane v. Roth*, 590 N.E.2d 587, 590-92 (Ind. Ct. App. 1992).

21. See Henry T.C. Hu, *Hedging Expectations: "Derivative Reality" and the Law and Finance of the Corporate Objective*, 21 J. CORP. L. 3, 30 (1995).



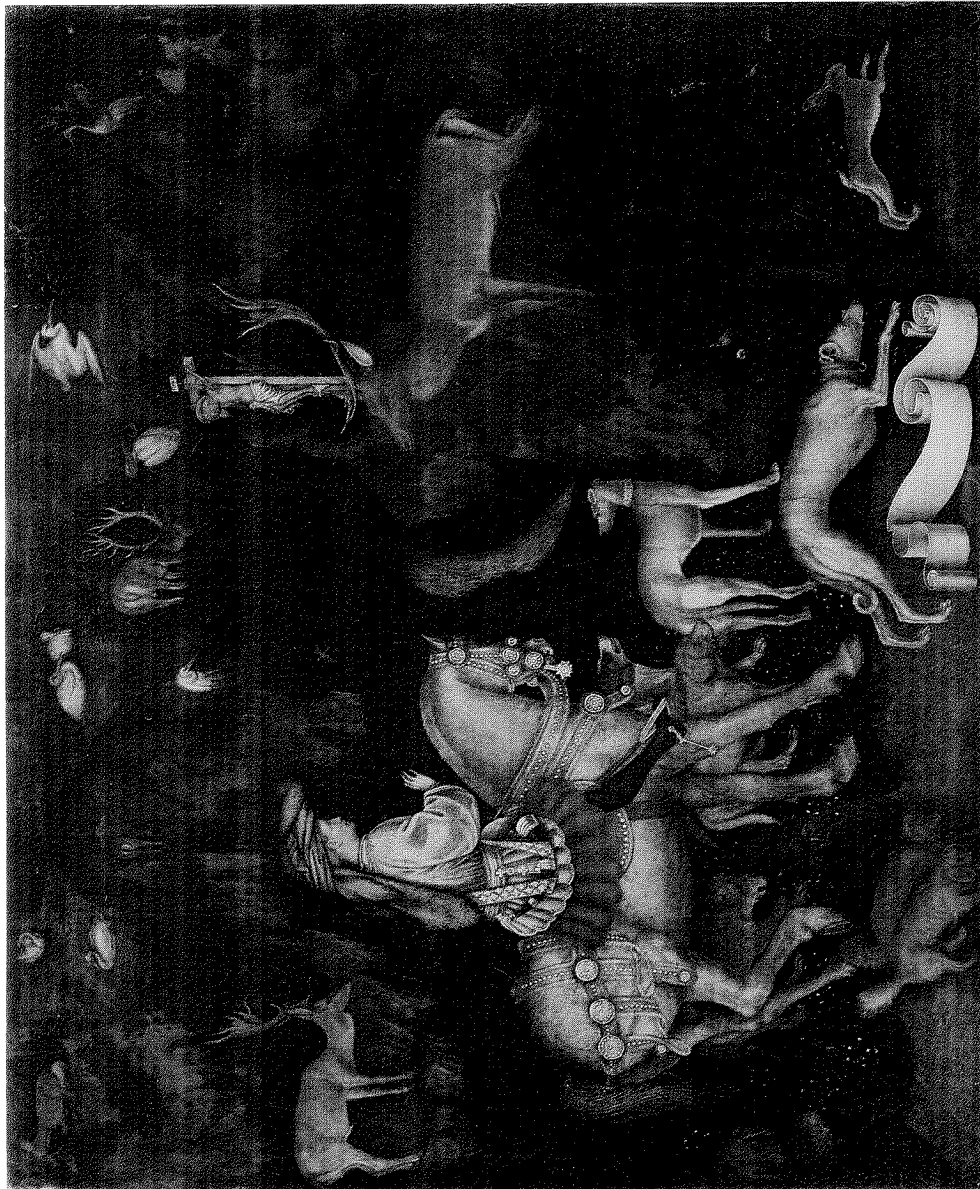


Figura 1. Antonio Picanello *Vision of Saint Eustace*



of the breadth of the contemporary business judgment rule, which protects directors from liability for the consequences of decisions made in good faith on an informed basis, so long as the directors do not have a conflict-of-interest.<sup>22</sup> Nonetheless, it is unsurprising that a court might impose a duty to hedge when, as in *Brane*, the conflation of relationships enhances shareholders' risks well beyond conventional risks of equity investment.

My final example is the failure of many unincorporated firms to differentiate a distinctive monitoring function from either ownership or operational management. Limited partnerships, or LLCs organized as investment vehicles, are intriguing in this respect. Limited partnership statutes differentiate between ownership and authority to bind the firm by allocating to the general partner all of a partner's rights and powers, subject to any contrary or restrictive provision in the statute or the limited partnership agreement.<sup>23</sup> Although comparable rights of limited partners are not specified by statute, limited partners are not liable for the firm's obligations unless they participate in the control of its business.<sup>24</sup>

On the governance front, and in contrast to corporate statutes,<sup>25</sup> limited partnership statutes do not impose any requirement of periodic election on the general partner's continuity as manager.<sup>26</sup> Moreover, because the general partner itself is the manager, limited partnership statutes do not create the structural possibility of differentiating the function of operational management from the function of monitoring management's efficacy and probity. In particular, limited partnership statutes do not permit the partnership agreement to reduce the liability to third parties borne by a general partner, thereby foreclosing the possibility of variations in such liability among general partners.<sup>27</sup> As a consequence, the general partner whose duties were restricted to monitoring other general partners would confront

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22. See AMERICAN LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01(c) (1992).

23. REVISED UNIF. LIMITED PARTNERSHIP ACT (RULPA) § 403(a) (1976), 6A U.L.A. 177 (1995).

24. *Id.* § 303(a). Subsection (b) specifies a number of actions that do not constitute participation in control. *Id.* § 303(b). Even a limited partner who participates in control is, under subsection (a), liable only to third parties who transact with the firm "reasonably believing, based upon the limited partner's conduct, that the limited partner is a general partner." *Id.* § 303(a).

25. See, e.g., DEL. CODE ANN. tit. 8, § 211(b) (1991) (requiring annual stockholder meeting to elect directors).

26. Limited partnership statutes leave to the partnership agreement the specification of circumstances that would require a general partner to withdraw. See RULPA § 603.

27. See *id.* § 403(b). In contrast, a general partner's liability to the partnership and its other members may be addressed in the agreement. *Id.*

the same degree of liability to third parties. Corporation statutes, by mandating a shareholder-elected board of directors, create a structure in which it is at least theoretically possible to distinguish a monitoring function from management and to invest that function in directors who are not themselves corporate officers or employees involved in operational management, and who, unlike general partners, do not bear the risk of liability on all of the firm's obligations to third parties simply by virtue of their position as directors. In addition, directors are authorized and obligated by statute to intervene when the circumstances warrant. Although this institution has flaws — individual outside directors may not always be exemplary in their service as monitors — the point is that the governance structure implicit in limited partnership statutes does not differentiate monitoring from managing.<sup>28</sup>

Likewise, the great majority of LLC statutes do not compel or explicitly contemplate a division between managing and monitoring,<sup>29</sup> a pattern to which the Minnesota statute is a noteworthy exception.<sup>30</sup> Even the

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28. Case law recognizes this point, at least implicitly. Consider the body of cases addressing issues incident to derivative actions brought by limited partners on behalf of limited partnerships. *See id.* §§ 1001-1004. If the limited partner makes a demand on the general partner prior to filing the action, Delaware does not treat the making of the demand as a concession of the general partner's independence. *See Seaforth Funding Ltd. Partnership v. M & M Assocs. II, L.P.*, 672 A.2d 66, 71 (Del. Ch. 1995). In the parallel corporate context, a consequence of making a demand is conceding the directors' independence to address the content of the demand. *See Spiegel v. Buntrock*, 571 A.2d 767, 775-76 (Del. 1990). This rule presupposes "a reasoned vote of a majority of individuals constituting a board of directors." *Seaforth Funding*, 672 A.2d at 71.

29. In the Delaware LLC statute, for example, an LLC that is not managed by its members would be managed by a manager "who shall be chosen by the members in the manner provided in the limited liability company agreement." DEL. CODE ANN. tit. 6, § 18-402 (Supp. 1996). An LLC may have more than one manager. *See id.*

30. The Minnesota LLC statute expressly differentiates a monitoring function from operating management unless members of the LLC elect by unanimous vote to have member-management. MINN. STAT. ANN. § 322B.606 (West 1995). In a number of respects, its salient provisions resemble those of a corporation statute. The corporate-like characteristics of this statute and of the structure it mandates for LLCs would reduce its attractiveness to parties who desire the simpler and flatter structure mandated by partnership statutes and contemplated by most LLC statutes. Unless all the members elect member-management, the Minnesota statute invests in a board of governors the authority to manage or direct the management of the LLC's business and affairs. *Id.* A majority of governors present at a meeting may remove a manager at any time. *Id.* § 322B.686(2). The board of governors may have one or more members, as fixed in the LLC's articles of organization or operating agreement. *Id.* § 322B.61. Governors must be natural persons and must be elected in accordance with provisions in the articles or operating agreement. *Id.* § 322B.613. Fixed terms specified for governors may not exceed five years; governors may

Delaware LLC statute, which explicitly embodies a policy "to give the maximum effect to the principle of freedom of contract and to the enforceability of [LLC] agreements,"<sup>31</sup> appears to contemplate only an undifferentiated management function.<sup>32</sup> Monitoring in such firms, then, tends to be an incident of ownership; a prospective equity investor monitors before investing by choosing to invest in a particular firm with a particular set of managers and monitors thereafter on the basis of available information, with the possibility of seeking after-the-fact remedies against perceived misconduct.<sup>33</sup> The absence of an ongoing mechanism to monitor and intervene on behalf of investors would be a basis on which courts, examining managers' behavior after the fact, might justify the imposition of stringent fiduciary standards. These justifications are weakened — or at least called into question — by agreed-to advance specifications of actors' roles and entitle-

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be selected to fill vacancies by a majority of the remaining governors, but a governor so selected serves until the members select a qualified successor at their next annual or special meeting. *Id.* §§ 322B.616, 322B.64. The statute specifies a standard of conduct for governors and provides that a governor is not liable if that standard of conduct has been met. *Id.* § 322B.663. In substantive respects, this Section of the LLC statute tracks the counterpart language in Minnesota's Business Corporation Act, *see id.* § 302A.251, including language permitting directors to consider the interests of nonshareholder constituents in considering the corporation's best interests, *see id.* § 302A.251(5). It is unlikely that sophisticated equity investors would be attracted to a structure that, by statute, permitted LLC governors to prefer the interests of nonequity holder constituents to those of LLC members, unless these investors were comfortable with the composition of the board of governors.

31. *See* DEL. CODE ANN. tit. 6, § 18-1101(b) (1993).

32. The statute does not forbid an attempt to differentiate monitoring from management in the LLC agreement. The agreement could specify different duties for different managers, a prospect the statute does not expressly permit, but does not prohibit. *See, e.g., id.* § 18-1101(c)(2) (providing that "the member's or manager's . . . duties and liabilities may be expanded or restricted" in LLC agreement); *id.* § 18-402 (providing that "[t]he manager shall . . . hold the offices and have the responsibilities accorded to him by the members and set forth" in LLC agreement). Likewise, on the same reasoning, the agreement could specify different selection mechanisms for different managers. *See id.* (providing that in manager-managed LLC, management to extent provided in LLC agreement "shall be vested in the manager who shall be chosen by the member in the manner provided" in LLC agreement). It is interesting nonetheless that the lengthy sample operating agreement in the leading treatise on the subject does not attempt such a differentiation in function. *See* RIBSTEIN & KEATINGE, *supra* note 7, at app. A-31 (providing that "[e]ach member-manager has the power to bind the Company.").

33. Commentators suggest that in a manager-managed LLC, members retain authority "to amend the articles of organization or take other important actions without the managers' approval" unless the LLC agreement provides otherwise. *See* RIBSTEIN & KEATINGE, *supra* note 7, at 8-35. Such retained authority would not, however, support interference in ongoing business decisions made by the manager.

ments of the sort contained in many partnership and LLC agreements. By restricting individual actors' discretion, such specifications structure the relationship in a fashion not identical to the formal consequences of incorporation, but sufficiently similar to ground arguments for the relaxation of fiduciary norms.

Consider now one of the leading puzzles raised by choices among available organizational forms, which is the predominant use of the corporate form by high-tech start-ups that receive venture capital funding. The puzzle, explored at length by Joseph Bankman in a 1994 article, is that this choice is an expensive one on the tax front for venture capital firms because it forgoes predictable tax savings that could be realized were the recipient of the investment organized as a partnership.<sup>34</sup> Such tax savings likely exceed the costs of converting a partnership or an LLC to corporate form prior to an initial public offering of the firm's stock.<sup>35</sup> Professor Bankman's article examines several possible explanations for the organizational structure of start-ups that comprise portfolio investments for venture capital firms and finds no single answer to the pattern.<sup>36</sup> The puzzle is especially intriguing because venture capital investors may safely be assumed to be sophisticated, to be able to retain highly skilled legal and financial advisors, and to be in a strong position to bargain for an organizational form that best achieves their interests as investors. One possible explanation that is not considered in Professor Bankman's article is the formally undifferentiated governance structure contemplated by partnership and LLC statutes. Observed patterns in venture capital investing support this hypothesis. Most venture capital firms in the United States are structured as limited partnerships with a management company as general partner.<sup>37</sup> The terms of a stock purchase agreement define the relationship

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34. Joseph Bankman, *The Structure of Silicon Valley Start-Ups*, 41 UCLA L. REV. 1737, 1738-39 (1994). In particular, choosing the corporate form sacrifices pass-through tax treatment of the firm's losses.

35. *Id.* at 1749-50.

36. *See id.* at 1749-66. The explanations discussed include the special tax circumstances of corporations that make venture capital investments an uncommon occurrence in the United States, the unattractiveness to some investors of the benefits provided by investments that yield tax losses, the prospect that venture capitalists are innately optimists with gamblers' mentalities, and the impact of tradition on both venture capitalists and managers in portfolio firms.

37. *See* Curtis J. Milhaupt, *The Market for Innovation in the United States and Japan: Venture Capital and the Comparative Corporate Governance Debate*, 91 NW. U. L. REV. (forthcoming 1997) (manuscript at 30-31, on file with author); *see also* Paul Gompers & Josh Lerner, *The Use of Covenants: An Empirical Analysis of Venture Partnership Agreements*, 39 J.L. & ECON. 463, 469 (1996). The structure of venture capital funds resembles

between the venture capital firm and the recipient of its investment. Most stock purchase agreements structure the venture capital investment as a purchase of convertible preferred stock;<sup>38</sup> a part of the deal is the venture capitalist's right to participate in the governance of the portfolio company by electing one or more directors to its board.<sup>39</sup> Indeed, the number of

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that of funds that finance leveraged buyouts. The fund's general partner receives a percentage of its profits, which typically has been 20% in venture capital agreements. Some funds recently have demanded a higher percentage share, which alienated some pension fund investors. See *From Labs to Riches*, *ECONOMIST*, Nov. 9, 1996, at 87. Over 80% of the investment into venture capital funds now comes from institutional investors. *Id.*

The identity of investors in venture capital funds suggests additional tax-related explanations for the observed pattern. The partnership structure of a venture capital firm should make the tax situation of its investors a significant factor in how the firm structures the businesses in which it invests. Under current tax law, it is not attractive for a tax-exempt investor or a foreign investor to receive a distributive share of the income of an unincorporated firm, including an LLC. See Susan Pace Hamill, *The Limited Liability Company: A Catalyst Exposing the Corporate Integration Question*, 95 *MICH. L. REV.* 393, 425 (1996). The Internal Revenue Code taxes the receipt of such income as unrelated business income for the tax-exempt investor, see I.R.C. §§ 512-513 (1994), while a tax-exempt investor would pay no taxes at all on dividends on corporate stock. Tax treaties between the United States and foreign countries generally result in lower tax rates for dividends on corporate stock than for business income from other sources. See Hamill, *supra*, at 425. As a consequence, concludes Professor Hamill, "growing businesses that find it necessary to raise significant capital from the equity markets for the first time will be forced to use the corporate form in order to reach the tax-exempt and foreign investors." *Id.*

38. See Milhaupt, *supra* note 37, (manuscript at 32).

39. Aspects of venture capital investing, including this one, may present conflicts of interest between the venture capital firm and other equity holders. Directors elected by the venture capital firm, like all directors, owe fiduciary duties to the corporation itself and to all of its shareholders, but these specially chosen directors may press hard on behalf of the interests of the venture capital firm, even when its interests diverge from those of other equity holders. The venture capital firm may, for example, wish to retrieve its investment so that it may invest in another prospect that is more promising. It is common to make the preferred stock issued to the venture capital firm subject to mandatory redemption, see Milhaupt, *supra* note 37, (manuscript at 33), a feature that would increase in value when the start-up's prospects appear shakier. To protect its receipt of assets from the start-up when redemption occurs, it is in the interest of the venture capital firm that the shaky-looking start-up not undertake risky projects prior to the redemption. Even when those projects have a high payoff potential, if their failure would lead to the start-up's insolvency in temporal proximity to the redemption, the redemption would be in jeopardy of being voidable as an impermissible distribution of assets to an equity holder. The venture capital agreement may also include a "drag along" clause, which enables the venture capital investor to compel the other shareholders to sell their interests if the venture capital firm has received an offer acceptable to it. See FREDERICK D. LIPMAN, *VENTURE CAPITAL AND JUNK BOND FINANCING* 45 (1996). A "drag along" clause enables the venture capital firm to sell to a purchaser that insists on acquiring all outstanding equity interests in the corporation. It contemplates a forced sale, and thus a situation in which the interests or desires of the

venture capitalists who serve on the board of a portfolio company tends to increase during times of crisis, as manifested by turnover in the portfolio company's chief executive officer.<sup>40</sup> Thus, the governance elements in the venture capital deal appear to be significant. This conclusion is unsurprising given the degree of industry concentration present in most venture capital firms' portfolios and their lack of market liquidity prior to a public offering of portfolio companies' stock. Governance issues are especially salient when an investment is relatively illiquid, even in deals that, like the quintessential venture capital deal, are structured to facilitate the venture capital firm's exit as an investor.<sup>41</sup>

Considerable ingenuity could be expended on attempts to replicate the governance structure created by corporate law in an unincorporated firm in order to place the venture capitalist in an authoritative and informed position to monitor management and to intervene when warranted without itself undertaking the burdens — and liabilities — of direct operational management. A differentiated monitoring function is not an expressly stated option for the structures created under partnership statutes and under most LLC statutes.<sup>42</sup> Much less ingenuity is required to avail oneself of the predictable governance pattern embraced by the corporate form. It is also a less risky choice for the investor's legal advisors. Attempting to create a differentiated monitoring function in an LLC without the benefit of explicit statutory guidance is a riskier endeavor for the investor's lawyer than using the more predictable governance structure created by a corporate statute.<sup>43</sup>

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venture capital firm diverge from those of other equity holders. Likewise, the venture capital firm's interest in exiting from its investment through an initial public offering of the start-up's stock or a sale of the start-up might lead its directors on the start-up's board to press for such a transaction sooner rather than later, even when a later transaction might be advantageous to all holders of equity in the start-up. To be sure, the venture capital firm's interest in its reputation may serve as an effective constraint on its pursuit of interests in conflict with other equity holders.

40. See Josh Lerner, *Venture Capitalists and the Oversight of Private Firms*, 50 J. FIN. 301, 302 (1995).

41. See JACK S. LEVIN, *STRUCTURING VENTURE CAPITAL, PRIVATE EQUITY, AND ENTREPRENEURIAL TRANSACTIONS* 18 (1994).

42. The Minnesota LLC statute is an intriguing exception. See *supra* note 30.

43. Marcel Kahan and Michael Klausner explain that, for a variety of reasons, lawyers who draft contractual and organizational documents may prefer to use standardized terms over customized terms whose import is less certain. Marcel Kahan & Michael Klausner, *Path Dependence in Corporate Contracting: Increasing Returns, Herd Behavior and Cognitive Biases*, 74 WASH. U. L.Q. 347 (1996). Even when the lawyer accurately anticipates future contingencies and drafts language that addresses them appropriately, a court may misinterpret or misapply the contractual provision. Moreover, the magnitude of the negative impact on the lawyer's reputation as a drafter may exceed the magnitude of the



To be sure, venture capital investing seems a relatively unlikely context for parties to be locked into suboptimal organizational choices as a consequence of lawyers' risk aversion. The business setting itself is one that should induce innovation, not discourage it. Indeed, it is common for lawyers who do venture capital work to agree to provide services initially for very low cash fees, or no fees at all, in exchange for stock in the company<sup>44</sup> or in anticipation of providing well-paid services later on if the firm succeeds.<sup>45</sup> To the extent participants in this market continue to choose the corporate form over theoretically available LLC structures, it may be because innovation may not promise sufficient advantages over the customary structure.<sup>46</sup> Moreover, if the customary structure works well enough in facilitating the investment objectives of venture capital firms, it is plausible that those firms would not themselves have identified the reasons why the customary structure works as well as any likely alternative.<sup>47</sup>

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negative impact on the client, in particular because the lawyer's career risk is undiversifiable. *Id.* at 354-55. A good reputation as a drafter is more easily destroyed than created; "[l]ike a reputation for ethical behavior, a reputation as a contract lawyer may have to be built on many successful contracts, while it may be ruined with only one failure." *Id.* at 358. A separate but related phenomenon is the reputed preference of transactional lawyers for solutions to clients' needs that are less rather than more likely to eventuate in litigation. Edward Rubin reports that within law firms, transactional lawyers often regard themselves as having failed when one of their "matters" becomes a "case" to be referred to the firm's separate litigation department. See Edward L. Rubin, *The Nonjudicial Life of Contract: Beyond the Shadow of the Law*, 90 NW. U. L. REV. 107, 111-12 (1995). Moreover, if an innovation in contractual or organizational structuring succeeds, it is not protectible as intellectual property by the transactional lawyer. These arguments do not, of course, establish that such innovation never occurs — manifestly it does — just that its occurrence may be inhibited.

44. Lisa Bernstein, *The Silicon Valley Lawyer as Transaction Cost Engineer?*, 74 OR. L. REV. 239, 247 & n.37 (1995). In Professor Bernstein's assessment, this contingent fee structure enhances the entrepreneur's reputation in the eyes of venture capital firms.

45. *Venture Capitalists: A Really Big Adventure*, ECONOMIST, Jan. 25, 1997, at 20, 21.

46. In particular, current tax law makes noncorporate structures unattractive for many investors who presently fund venture capital pools. See *supra* note 37. Organizational innovation is unlikely to occur unless venture capital firms wish to attract additional types of investors.

47. Venture capital relationships in Silicon Valley, and lawyers' roles in facilitating them, may have distinctive qualities that may not be prevalent elsewhere. In Silicon Valley, lawyers serve the financial brokerage function of bringing client entrepreneurs together with venture capital firms. See Bernstein, *supra* note 44, at 245. One law firm alone controls access to 40%-60% of available capital. *Id.* at 246. Most lawyers in Silicon Valley encourage the parties to use one of three standardized agreements. *Id.* at 248. Finally, it appears not to be unusual for the same lawyer to represent both the venture capital fund and the entrepreneur. *Id.* at 248-49 n.43. Whatever implications should be drawn from a

The significance of corporate governance rights to venture capital investors also helps to explain the use of convertible preferred stock, as opposed to convertible debt, as the basic financing vehicle. As an equity investment, convertible preferred stock affords less protection against downside risk than would convertible debt, but it is a preferable vehicle to generate rights to achieve participation in corporate governance through the election of directors.<sup>48</sup> Negotiated covenants in privately placed debt securities can enable a lender to monitor the debtor's financial condition and review major business decisions; tightly drawn financial and business covenants may enable the lender to veto transactions and thus facilitate negotiations between the lender and the borrower's management over elements of business decisions that are relevant to the risks borne by the lender. These contractually based rights, significant though they may be in many instances, are not equivalent to an internal role in firm governance.<sup>49</sup> Only internal participants may initiate transactions that bind the

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pattern of dual representation, one is not that the standard agreements underserve the interests of venture capital funds.

48. Debt securities that carry voting rights also carry the risk of subordination in the event their issuer enters bankruptcy, as well as the risk that the creditor will be perceived to have exercised such control over the debtor's management that it becomes liable to other creditors as the principal on whose behalf the debtor incurred obligations. *See* RESTATEMENT (SECOND) OF AGENCY § 14 O (1958). Additionally, using an equity structure for the venture capital investment does not result in debt reflected on the books of the start-up firm, which might make it more attractive to prospective lenders and to prospective purchasers of common stock. The preferred equity structure is also desirable if the start-up firm is not expected to generate significant earnings in its early years because the dividend preference does not create any contractual obligation to pay a dividend. Debt securities with a fixed coupon — a fixed obligation to pay interest at periodic intervals — create a contractual obligation to make the payments when due. Zero-coupon debt, in contrast, does not create such an obligation, but it generates taxable income for the debtholder on imputed interest over the lifetime of the obligation. *See* I.R.C. §§ 1272-73 (1994). Finally, an equity-based structure presents fewer conflicts than does a debt-based investment between the venture capital firm and the portfolio company's management, whose compensation typically includes a significant equity component consisting of stock options. Apart from these analytically separable factors, experienced commentators explain the predominance of equity structures by reference to the risk preference or investing style of venture capital firms. They seek "geometric returns when the portfolio company is successful" and "would not purchase debt interests simply to obtain an interest yield." *See* LEVIN, *supra* note 41, at 19. Returns on venture capital investing are highly variable. Last year, the average venture capital fund returned an average of 54.2% to its investors, whereas the average return over the past decade was 13.5%. *From Labs to Riches*, *supra* note 37.

49. A lender that achieved such a position would incur the risks associated with holding de facto equity. *See supra* note 48. Consider a lender that conditions its willingness to lend on the borrower's acceptance of the lender's provision of pervasive management consulting services under a contract that, one way or another, has been structured to make

firm. Even holders of debt securities convertible into equity are in an external position until they convert or until the firm defaults.<sup>50</sup> Factors apart from governance may explain the observed pattern of venture capital investing, but the governance choices of sophisticated investors able to negotiate for terms that best serve their interests warrant reflection. In particular, these choices prompt tentative skepticism about the wisdom of organizational statutes that facilitate organizational agreements with terms that provoke wonder that any rational person could, knowing the terms, nonetheless decide to invest.

### *Conclusion*

Bernard Berenson's assessment aside, the *Vision of St. Eustace* continues to hold our interest. For one thing, it leads us to wonder what might happen next. Will the dog catch the hare? Will the other dogs mobilize themselves? Will St. Eustace's instincts for the hunt overtake his immediate religious experience? The relative sizes of the stag and the religious vision suggest that the Saint's interests as a hunter soon may dominate. Similarly, unincorporated firms demonstrate the intrinsic interest of human unpredictability. With functions undifferentiated, and in the absence of a formal centralizing hierarchy that might constrain behavior, much can happen that would be less likely in a more structured organization.

It remains to be seen whether the governance characteristics heretofore typified by the corporate form can successfully be replicated in a noncorporate structure. These characteristics help explain the investment choices of venture capital firms, which invest in portfolio firms organized as corporations (not partnerships) and which mostly invest in preferred equity securities, not debt. LLC statutes, formally inviting as they are to contractual innovation, create the theoretical possibility of replicating the corporate-style differentiation of a monitoring function from operational management. Venture capital firms structure investment relationships through legal forms that create significant rights in firm governance. If these rights are valuable, sophisticated investors are not likely to experiment with organizational innovations that carry uncertain governance consequences.

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it highly unattractive for the borrower to breach the contract or decline to follow the advice. If the management consulting advice is "advice" that the borrower cannot refuse, the lender appears to have departed from a contractually grounded external posture and to have become an internal participant in firm governance.

50. See Alexander J. Triantis & George G. Triantis, *Conversion Rights and the Design of Financial Contracts*, 72 WASH. U. L.Q. 1231, 1252-53 (1994).

Theoretically plausible though my account may be, caution warrants this final concluding point. Berenson's critique of the *Vision of Saint Eustace* illustrates a pitfall of scholarly self-confidence, which the critique manifests to a degree that some might perceive as hubris. Berenson's work reflects a scholarly and aesthetic paradigm that would strike many contemporary observers as woefully dated and narrow. Much contemporary art is, in its own way, just as flat and unhierarchical as Pisanello's, and many contemporary audiences value primitive as well as contemporary works for precisely that quality of untutored and unstructured enthusiasm which Berenson so firmly disparaged. Berenson's work as an art historian brought new rigor to attribution and had an enduring impact on the profession's standards and practice.<sup>51</sup> It has proven less vulnerable over time than have his aesthetic judgment and taste. Styles of explanation in legal scholarship, like styles of art criticism, inevitably reflect their era and its dominant explanatory paradigms, and accordingly, such styles are vulnerable to subsequent shifts in taste as well as to subsequent evolutions in knowledge. The choice among available organizational structures implicates complex patterns of human interactions; custom, past practice, and interpersonal relationships may explain many such choices to a degree that eludes capture by tightly drawn theoretical models.

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51. See ERNEST SAMUELS, *BERNARD BERENSON: THE MAKING OF A CONNOISSEUR* (1979).