January 1992

The Deregulation of Limited Liability and the Death of Partnership

Larry E. Ribstein

Follow this and additional works at: http://openscholarship.wustl.edu/law_lawreview

Part of the Business Organizations Law Commons

Recommended Citation
Available at: http://openscholarship.wustl.edu/law_lawreview/vol70/iss2/9
THE DEREGULATION OF LIMITED LIABILITY
AND THE DEATH OF PARTNERSHIP

LARRY E. RIBSTEIN*

The popularity of the partnership form of business1 indicates that an organizational form in which some owners can be held personally liable for the firm’s debts2 is efficient for many firms. This could be because, for many firms, individual liability reduces the firm’s credit costs more than it increases owners’ risk-bearing, monitoring, or other costs. This Article, however, suggests an alternative explanation: the partnership form is attractive for many firms on the margin only because of the regulatory costs of limited liability, including double corporate taxation and limitations on organizational form.3

Recent developments provide a valuable opportunity to test this explanation. Many lawyers and legislators have become interested in a new limited liability business form, the “limited liability company” (LLC), that lets firms adopt limited liability without many of the tax and other costs that once attended limited liability. If this Article’s regulatory explanation of partnership is correct, the partnership form of business will greatly diminish in importance. After a transitional period, partnership will survive, if at all, as a residual form for firms that have no customized agreement.

This Article discusses three principal aspects of the story of the death of partnership. Sections I and II show why tax and regulatory concerns

---

1. There were approximately 1.7 million general and limited partnership federal tax returns filed in 1989. See 1990 I.R.S. ANN. REP. 30 (July 1991). As discussed in Section I(B)(2) infra, limited partnerships usually are limited liability firms because often the general partners are corporations. For a brief discussion of the implication of this Article’s analysis on limited liability forms, including limited partnership, see infra Section V.

2. This refers to the owners’ liability in excess of their investments in the firm, normally for debts remaining unpaid after the firm’s assets are exhausted. It is alternatively referred to in this Article as “unlimited” or “individual” liability.

3. For other evidence of how regulation rather than efficiency shapes organizational form, see Mark J. Roe, A Political Theory of American Corporate Finance, 91 COLUM. L. REv. 10 (1991) (showing how regulation has inhibited monitoring by large shareholders); Mark J. Roe, Political Elements in the Creation of a Mutual Fund Industry, 139 U. PA. L. REv. 1469 (1991) (mutual fund industry developed in accordance with regulatory framework established early in its history).
may be primarily responsible for firms’ adoption of the partnership form. Section I discusses the regulatory costs of limited liability and how the development and tax recognition of the LLC only recently have relaxed impediments on limited liability. Section II discusses the other side of the regulatory explanation: why firms would be expected to reject unlimited liability of owners in the absence of regulatory incentives.

Sections III and IV discuss why, as a normative matter, regulatory constraints on limited liability should be lifted. Section III demonstrates that the interests of involuntary creditors do not justify inhibiting the emergence of LLCs. Section IV shows that the partnership form should not be maintained as a way to classify business forms for tax purposes. Finally, Section V includes a speculation on the near-term future of LLCs, partnerships, and other business forms.

I. A Regulatory Theory of Unlimited Liability

This Section shows how general partnership has been sustained as a popular business form by regulatory inhibitions on adopting limited liability.

A. Pre-LLC Restrictions on Limited Liability

Until recently, firms had four general methods of adopting limited liability: (1) incorporating; (2) forming a limited partnership; (3) forming a noncorporate, nonlimited partnership type of limited liability business; and (4) forming a partnership and entering into nonrecourse contracts. As reviewed below, each of these alternatives involves significant costs.

1. Incorporation

Incorporation is, of course, the traditional route to limited liability. Although not necessarily a feature of the early corporation, limited liability has come to be regarded as the feature that most clearly distinguishes corporations from other business forms—that is, as the most distinctively “corporate” feature. But there are two types of costs associated with seeking limited liability through incorporation.

The first cost is the extra tax burden associated with “two-tier” taxa-
tion of corporate income—at the corporate level when income is earned, and again at the shareholder level when it is distributed as dividends. Under the current tax structures—a corporate-level tax rate comparable to the individual-level rate and no reduced rate for capital gains—most firms and holders suffer a tax penalty from incorporation whether income is retained by the corporation or paid out as dividends as soon as it is earned.6

Corporate shareholders can avoid double taxation by electing to be taxed under Subchapter S of the Internal Revenue Code. However, the Subchapter S election imposes many organizational restrictions on the firm. For example, the Code prohibits more than thirty-five shareholders,7 restricts who may own stock,8 forbids an allocation of dividend and liquidation rights that creates more than one “class” of stock,9 and prohibits the S Corporation from owning a corporate subsidiary.10 A corporation may lose its Subchapter S status, potentially creating substantial additional tax liabilities, if at any time it stops meeting these qualifications, as when stock is transferred to a nonqualifying holder.11

S Corporation treatment also has several operational drawbacks compared to partnership: S Corporation shareholders must allocate income, loss, deduction, and credit in direct proportion to their interests in the corporation;12 the shareholders’ basis for purposes of limiting losses and deductions they can take in a given year does not include their share of the firm’s debts as in a partnership;13 and a shareholder contributing property to an S Corporation can avoid recognizing gain only if the transferor controls the corporation and takes stock in return.14

These tax drawbacks of incorporation do not explain the long preva-
lence of partnership prior to 1909 when the corporate tax was instituted. Partnership may have developed originally as a method of avoiding legal and religious prohibition of usury.\textsuperscript{15} Partnership survived the rise of the corporation prior to 1909 because of state-law impediments to incorporation. At first, firms could incorporate only by, in effect, purchasing special charters from state legislatures. Incorporation became more widely available under general incorporation statutes, beginning with New Jersey’s in 1875, and general incorporation was prevalent by the turn of the century.\textsuperscript{16} Indeed, the institution of the corporate tax may be explained partly as a method of controlling the corporate form after it had been freed from state legislative control.\textsuperscript{17}

Despite the introduction of general incorporation laws, state statutory inhibitions on incorporation persist today. Corporation statutes typically prescribe rules that may not be optimal for the parties to closely held firms.\textsuperscript{18} These include centralized management,\textsuperscript{19} extensive fiduciary duties of directors and shareholders,\textsuperscript{20} and nondiscrimination within classes of stock.\textsuperscript{21} Shareholders cannot always effectively draft around these

\begin{itemize}
\item \textsuperscript{17} See Richard B. Goode, The Corporation Income Tax 37 (1951) (quoting President Taft’s speech introducing the corporate tax law). These regulatory explanations for partnership answer Saul Levmore’s question as to why partnership flourished prior to 1909 when incorporation was a “tax bargain.” See Saul Levmore, Partnerships, Limited Liability Companies, and Taxes: A Comment on the Survival of Organizational Forms, 70 Wash. U. L.Q. 489, 490 (1992).
\item \textsuperscript{18} For a discussion of why state legislatures do not compete for chartering business by optimizing provisions for close corporations, see Ian Ayres, Judging Close Corporations in the Age of Statutes, 70 Wash. U. L.Q. 365, 393-95 (1992). Cf. Larry E. Ribstein, Limited Liability and Theories of the Corporation, 50 Md. L. Rev. 80, 123-24 (1991) (showing why there is no state competition for statutory terms that facilitate contracting for limited liability).
\item \textsuperscript{20} See, e.g., Del. Code Ann. tit. 8, § 144 (1991) (fairness and procedural rules for director conflict-of-interest transactions); Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985) (directors held liable for recommending sale of company without following requisite procedure to determine adequacy of price).
rules. Some corporate statutes let parties to closely held firms enter into certain types of agreements, such as opting out of management by a board of directors, if the firms qualify as close corporations and comply with procedural requirements. An agreement that does not comply with these requirements and that is inconsistent with the statutory norms may not be enforced even if all shareholders are parties.

Even firms that successfully qualify for close corporation status do not have complete flexibility. The security of close corporation agreements is jeopardized by statutes and case law providing for close corporation dissolution and buyout remedies in the event of "oppression" of minority shareholders, irrespective of the presence or absence of specific agreements. Although close corporation statutes do allow some types of agreements, corporations cannot opt out of liability for some fiduciary

378 A.2d 121 (Del. 1977) (permitting discrimination among shareholders within class by original charter provision).

22. See, e.g., DEL. CODE ANN. tit. 8, §§ 343, 350 (1991) (permitting certain agreements in firms that elect close corporation status by certificate provision); MODEL BUSINESS CORPORATION ACT § 7.32 (1991) (permitting certain agreements in nonpublicly traded corporation if agreement is set forth in articles of incorporation and bylaws, or is in writing and "made known to the corporation," in either event only if approved by all those who are shareholders at the time). Ian Ayres says that these provisions may be useful in preventing close corporation precedents from spilling over into, and causing uncertainty in, general corporation cases. See Ayres, supra note 18, at 395. This raises the question whether the uncertainty costs from spillover effects exceeds those from the risk of invalidating noncomplying contracts.

23. One leading case did enforce the agreement in these circumstances. See Zion v. Kurtz, 405 N.E.2d 681 (N.Y. 1980). However, there was a vigorous dissent, and the majority opinion noted specific circumstances that justified enforcement:

Since there are no intervening rights of third persons, the agreement requires nothing that is not permitted by statute, and all of the stockholders of the corporation assented to it, the certificate of incorporation may be ordered reformed, by requiring Kurtz to file the appropriate amendments, or more directly he may be held estopped to rely upon the absence of those amendments from the corporate charter.

Id. at 685 (footnote omitted).

For a discussion of how the courts have nullified statutes that are unresponsive to the needs of close corporations, but that criticizes Zion for upsetting an arguably rational legislative judgment to compartmentalize close corporation cases, see Ayres, supra note 18, at 383-88.


breaches, creating costly uncertainty as to what is not included. 26 By contrast to corporation law, partnership statutes broadly permit the partners to agree to any form of management 27 and to waive fiduciary duties. 28

2. Limited Partnership

The parties can adopt limited liability without incorporation by forming a limited partnership. Although a limited partnership must have at least one general partner who has unlimited liability, 29 the parties effectively can obtain complete limited liability by incorporating the general partner.

The principal problem with using the limited partnership form is that the parties are restricted in their form of organization if they wish to achieve complete one-tier partnership taxation. The business is a corporation for tax purposes if it has three or four of the "corporate" characteristics: limited liability, centralized management, free transferability, and continuity of life. 30 As discussed in more detail below, 31 this classifi-

26. See, e.g., DEL. CODE ANN. tit. 8, § 102(b)(7) (1991) (permitting corporations to opt out of damage liability for director fiduciary breach, but not for acts that involve a breach of the "duty of loyalty," that are "not in good faith," that involve "intentional misconduct or a knowing violation of law," or "from which the director derived an improper personal benefit."). None of the relevant terms is defined in the statute. For discussions of the statutes that permit opt out from the liability for fiduciary breach see Deborah A. DeMott, Limiting Directors' Liability, 66 WASH. U. L.Q. 295 (1988); Harvey Gelb, Director Due Care Liability: An Assessment of the New Statutes, 61 TEMPLE L. REV. 13 (1988); Dennis R. Honabach, All That Glitters: A Critique of the Revised Virginia Stock Corporation Act, 12 J. CORP. L. 433 (1987).

27. See UNIFORM PARTNERSHIP ACT § 18 (1914) (the rights and duties of the partners determined "subject to any agreement between them"); 2 ALAN R. BROMBERG & LARRY E. RIBSTEIN, BROMBERG & RIBSTEIN ON PARTNERSHIP § 6.03 (1988 & Supp. 1991).

28. See UNIFORM PARTNERSHIP ACT § 21 (1914) (partner has duty to account for self-dealing only with respect to transaction that is "without the consent of the other partners"). For cases recognizing the validity of fiduciary duty waivers in the partnership, see Jerman v. O'Leary, 701 P.2d 1205 (Ariz. Ct. App. 1985) (self-dealing); Singer v. Singer, 634 P.2d 766 (Okla. Ct. App. 1981) (partnership opportunities). For a discussion of the scope of the opt-out power in the partnership, see 2 BROMBERG & RIBSTEIN, supra note 27, § 6.07(h).

Saul Levmore views the persistence of incorporation as "striking" in light of my discussion of the regulatory and tax advantages of partnership. Levmore, supra note 17, at 490-91. This misses a central point of my Article. For the reasons discussed infra in Part II, most firms would choose to incorporate or form other limited liability business forms but for these tax and regulatory considerations. The "striking fact," therefore, is not that firms incorporate, but rather that they choose to form partnerships.

29. See REVISED UNIFORM LTD. PARTNERSHIP ACT § 101(7) (1985) (defining "limited partnership").

cation system can impose significant governance costs.

Even apart from tax-related organizational burdens, the limited partnership form imposes costly restrictions on obtaining limited liability. The most important is the "control rule," which provides that limited partners may be held liable as general partners if they take part in the control of the business.\textsuperscript{32} Although this rule has been eroded by a wide "safe harbor" of acts that do not constitute taking part in control,\textsuperscript{33} the rule still effectively inhibits some limited partner actions, such as taking over a failing or mismanaged firm. Limited partnership statutes also impose strict remedies for distributions even by solvent firms that may, in effect, force the firms to retain earnings that are nevertheless being taxed directly to the partners.\textsuperscript{34}

3. Other Limited Liability Business Forms

The states have promulgated limited liability business forms that eliminate some of the cumbersome restrictions of corporations and limited partnerships, including business trusts\textsuperscript{35} and limited partnership associations.\textsuperscript{36} The Delaware business trust statute, in particular, contains no restrictions on the form of business.\textsuperscript{37}

There are, however, two serious problems with these business forms that inhibit their use. First, there is a question whether the Internal Revenue Service (I.R.S.) recognizes these forms as partnerships for tax purposes.\textsuperscript{38} Although parties may be able to obtain private I.R.S. rulings favoring partnership classification,\textsuperscript{39} acquiring these rulings is costly.\textsuperscript{40}

\textsuperscript{31} See infra § IV(B).
\textsuperscript{32} See Revised Uniform Ltd. Partnership Act § 303 (1985); Uniform Ltd. Partnership Act § 7 (1916).
\textsuperscript{33} See Revised Uniform Ltd. Partnership Act § 303(b) (1985).
\textsuperscript{34} See Uniform Ltd. Partnership Act § 17(4) (1914); Revised Uniform Ltd. Partnership Act § 608(a) (1985). These provisions are criticized in Larry E. Ribstein, \textit{An Applied Theory of Limited Partnership}, 37 Emory L.J. 835, 888-89 (1988).
\textsuperscript{37} See Ribstein, supra note 18, at 125.
\textsuperscript{38} For rulings classifying limited partnership associations as corporations for tax purposes, see Rev. Rul. 71-434, 1971-2 C.B. 430, 431-32 (Ohio association); Rev. Rul. 71-277, 1971-1 C.B. 422, 423 (Pennsylvania association); Giant Auto Parts, Ltd. v. Comm'r, 13 T.C. 307 (1949). These rulings are discussed in Gazur & Goff, supra note 36, at 394.
\textsuperscript{39} There is one private ruling recognizing partnership classification of a Michigan partnership
Accordingly, these forms cannot be viable alternatives to partnership until the I.R.S. issues rulings generally classifying them as partnerships.

A second problem inhibiting use of these forms is that they are not clearly recognized by states other than the state of formation. Under general conflict-of-law principles, forum states ordinarily recognize corporate liability limitations and internal governance rules of the state of formation. The same rule probably applies to limited partnerships. In any event, the states have specific statutory provisions concerning recognition of foreign corporations and limited partnerships. But a state might not recognize the limited liability or other features of a partnership association or business trust formed in another state. This limits not


40. See infra notes 217-19 and accompanying text.

41. See RESTATEMENT (SECOND) CONFLICT OF LAWS § 302 (1971) (law of state of incorporation ordinarily governs as to corporate “internal affairs” unless another state has more significant interests); Id. at § 307 (law of state of formation governs as to extent of shareholder's liability to creditors). See also Bank of Augusta v. Earle, 38 U.S. 519 (1839) (although corporations not constitutionally protected as “citizens,” Court presumed that states would grant comity to foreign corporation law by recognizing foreign corporations).

42. See RESTATEMENT (SECOND) CONFLICT OF LAWS § 295(3) cmt. d (1971).


44. See REVISED UNIFORM LTD. PARTNERSHIP ACT §§ 901-08 (1985).

45. UNIFORM PARTNERSHIP ACT § 6(2) (1914) provides that an association that otherwise falls within the general definition of partnership (see id. §§ 6-7) is not a partnership if it is formed under any other statute, including a statute of another state. Accordingly, a state may treat a foreign non-statutory business form such as a business trust as a partnership even if the organizing state's law provides for limited liability. Beneficiaries of a business trust have been held entitled to limited liability only if they do not participate in management. See Greco v. Hubbard, 147 N.E. 272, 275 (Mass. 1925); ALAN R. BROMBERG, CRANE & BROMBERG ON PARTNERSHIP 174 (1968); WARREN, supra note 5, at 384-98. See also Thompson v. Schmitt, 274 S.W. 554 (Tex. 1925) (business trust holders did not have limited liability because this vehicle illegally circumvented the limited partnership, which was the statutory vehicle for noncorporate limited liability).

Under conflict-of-law principles, a forum state does not have to recognize the limited liability of a firm formed under another state's law. RESTATEMENT (SECOND) CONFLICT OF LAWS § 6(2)(b) (1971) provides for consideration in selecting the applicable law of “the relevant policies of the forum. . . .” In Means v. Limpia Royalties, 115 S.W.2d 468 (Tex. Civ. App. 1938), the court refused to recognize the limitation of liability of an Oklahoma business trust, citing Texas policy similar to that articulated in Thompson.

Full faith and credit and due process constrain application of forum rules, but probably only where the forum lacks minimum contacts with the transaction. See Allstate Ins. Co. v. Hague, 449 U.S. 302 (1981). The Commerce Clause might be interpreted to bar states from applying their partnership laws to foreign-state limited liability firms. In CTS Corp. v. Dynamics Corp., 481 U.S. 69 (1987), the Supreme Court held that the Commerce Clause did not bar states from applying their own corporate laws to regulate interstate tender offers, emphasizing that the statutes did not subject
only the usefulness of these hybrid limited liability forms to business people who adopt them, but also the benefits to state bar groups and others who innovate hybrid forms.

4. **Limited Liability by Nonrecourse Contract**

Parties to firms could obtain limited liability, governance flexibility, and flow-through tax treatment by forming general partnerships or sole proprietorships and agreeing with creditors to limit their liability to the amount of their investments in certain assets. The problem with this approach is that, in the absence of incorporation or other statutory recognition, it is costly to contract with individual creditors either separately or by informing them of limited liability terms that apply to all the firm’s creditors. Moreover, state statutes increase these costs, even beyond those that are logistically necessary, by imposing personal liability on parties who signal limited liability by posing as corporations or limited partnerships.

B. **Development of Limited Liability Companies**

Beginning with Wyoming in 1977, several states now have statutes providing for LLCs. Although these statutes vary, virtually all share some characteristics: limited liability for all members without regard to corporate activities to inconsistent regulation and that the states had the power to regulate the internal affairs of locally incorporated firms. This reasoning might be turned around to invalidate legislation that interferes with other states’ attempts to create limited liability interstate firms. Indeed, some post-CTS cases have invalidated on Commerce Clause grounds antitakeover statutes that applied to foreign corporations. See Tyson Foods, Inc. v. McReynolds, 865 F.2d 99 (6th Cir. 1989); Hyde Park Partners, L.P. v. Connolly, 839 F.2d 837 (1st Cir. 1988); Campeau Corp. v. Federated Dep’t Stores, 679 F. Supp. 735 (S.D. Ohio 1988). For some modern examples of the large literature bearing on constitutional constraints on application of forum rules, see Symposium: Choice-of-Law Theory After Allstate Insurance Co. v. Hague, 10 Hofstra L. Rev. 1 (1981); Harold W. Horowitz, The Commerce Clause as a Limitation on State Choice-of-Law Doctrine, 84 Harv. L. Rev. 806 (1971); Frederic L. Kirgis, Jr., The Roles of Due Process and Full Faith and Credit in Choice of Law, 62 Cornell L. Rev. 94 (1976); James A. Martin, Constitutional Limitations on Choice of Law, 61 Cornell L. Rev. 185 (1976).

47. *Id.* at 113-14.
48. *See* Revised Uniform Ltd. Partnership Act § 304 (1985) (providing for liability of persons who invest in a business erroneously believing it is a limited partnership); Revised Model Business Corp. Act § 2.04 (1984) (providing for liability of persons purporting to act for a corporation they knew had not been formed); Ribstein, *supra* note 18, at 121-24 (criticizing liability on this ground).
their participation in control, recognition of LLCs formed in other jurisdictions, and freedom from other restrictions on form of governance.\textsuperscript{50}

After a tortuous history, the I.R.S. decided in 1988 to classify a Wyoming LLC as a partnership for tax purposes.\textsuperscript{51} The Service's imprimatur on limited liability companies indirectly may have solved the other principal impediment to flexible, noncorporate limited liability companies. Because the tax ruling has spurred rapid legislative activity in several states, the problem of interstate acceptance of limited liability companies\textsuperscript{52} is being solved rapidly.

The advent of the LLC means that many of the restrictions that formerly hampered adoption of limited liability are disappearing. Although many impediments remain,\textsuperscript{53} the reduction in the tax and regulatory costs of limited liability still provides an opportunity to test firms' preference for limited liability in the absence of regulatory and tax constraints.\textsuperscript{54}


It is beyond the scope of this article to develop a political theory of why tax barriers to limited liability without incorporation only now are being lowered. However, it seems likely that pressure for such a decision increased with the Tax Reform Act of 1986, when for the first time top corporate tax rates rose above top individual rates, the lower tax on "capital gains" was eliminated and, because of the repeal of General Utilities, corporations no longer could avoid corporate-level recognition of gain on assets they sold or distributed to shareholders.

\textsuperscript{52} \textit{See} supra note 45 and accompanying text.

\textsuperscript{53} \textit{See infra} Subpart IV(B) (discussing the costs of complying with the tax classification factors) and \textit{infra} text accompanying notes 246-47 (discussing how tax rules effectively limit pass-through treatment to closely held firms).

\textsuperscript{54} The evidence so far indicates significant but not overwhelming interest in this new statutory form. Information from the secretaries of state of six of the eight states that have enacted LLC statutes shows that approximately 1000 LLCs had formed in those states as of October 7, 1991. Three of the statutes had been effective only since July 1, 1991, and another since July 1, 1990.
II. Survival of Voluntary Unlimited Liability

Most firms that now organize as general partnerships probably will not continue to do so once restrictions on limited liability have been loosened through recognition of the LLC form. For most such firms, cost savings under limited liability are likely to outweigh any additional cost of credit as compared with unlimited liability. Section A deals with non-professional firms, while Section B discusses the special case of professional firms.

A. Non-Professional Firms

A firm's owners would elect to accept unlimited liability only if their costs of doing so were less than their savings in credit costs. The higher credit costs under limited liability reflect the potential agency costs creditors bear. In a highly leveraged firm, limited liability owners receive all the benefits from success while creditors bear most of the cost of failure. As a result, owners may make investments that are excessively risky from the creditors' standpoint and thus fail to exercise the amount of care creditors would prefer in monitoring and selecting the firm's agents. Limited liability owners who do not "cheat," but who cannot cheaply signal and bond their intention not to do so and who do not gain other advantages from limited liability, may end up paying more in increased credit charges than they gain from not having to bear all losses. Whether this is actually the case depends on the advantages of limited liability to the firm and the advantages of unlimited liability to creditors.

The advantages of limited liability may be worth the increased credit costs in publicly traded firms because, as many writers have pointed out, limited liability facilitates transferability of shares and therefore makes


56. See Ribstein, supra note 18, at 97. There is a logically prior question as to whether vicarious liability of the firm for agent's acts is appropriate. Vicarious liability may be justified (subject largely to considerations of risk sharing and the transaction costs of loss shifting) when the agent's incentives to exercise care are diluted by her potential insolvency and when the principal is in a better position than the third party to monitor, motivate or select agents. See Lewis A. Kornhauser, An Economic Analysis of the Choice Between Enterprise and Personal Liability for Accidents, 70 CAL. L. REV. 1345 (1982); Alan O. Sykes, The Economics of Vicarious Liability, 93 YALE L.J. 1231 (1984).
efficient securities markets possible.\textsuperscript{57}

Because these trading-market advantages are not important in closely held firms, it is tempting to conclude that most such firms would not adopt limited liability if they internalized all costs. This conclusion would be significant in the present context, since the increased availability of limited liability through LLCs is likely to affect mostly closely held firms.\textsuperscript{58} There are, however, several reasons to conclude that limited liability is attractive for closely held firms.

First, even in closely held firms, limited liability may reduce owners' risk-bearing and monitoring costs.\textsuperscript{59} Second, even if the advantages of limited liability in closely held firms are small, its costs to closely held firms in terms of the cost of credit may be even smaller. Creditors' benefits from unlimited liability depend on a comparison of the expected value (V) of debt under each rule. V turns on the creditor's ex ante evaluation of (1) the probability that the firm's wealth will be dissipated or transferred out of reach before collection; (2) the probability that the owners' wealth will be dissipated or transferred out of reach prior to the time of collection; (3) creditor monitoring costs; and (4) collection costs.

To illustrate the comparison, assume Creditor plans to loan fifty dollars to Debtor, and that Debtor can adopt either limited liability (V\textsubscript{L}) or unlimited liability (V\textsubscript{U}). At the time of the loan, Creditor might make different estimates of V\textsubscript{L} and V\textsubscript{U} based on the different collection outcomes that variations in the above factors might produce and on the probability (P) of each outcome. Possible outcomes under limited liability include a twenty percent chance that Debtor will pay the entire debt, a similar possibility that Debtor will pay only sixty percent of the debt, and a twenty percent chance that Debtor will pay the entire debt, but only if Creditor incurs ten dollars in collection and monitoring costs. Under unlimited liability the probabilities may be weighted toward a higher net collection. Creditor's interest charge may reflect, among other things, the difference between V\textsubscript{L} and V\textsubscript{U}.\textsuperscript{60} The expected collection out-


\textsuperscript{58} This follows from the fact that LLCs, to obtain partnership tax treatment and limited liability, will have to adopt partnership-type features of decentralized management, dissolution at will, and restricted transferability that are suited to closely held firms. \textit{See generally} Section IV(B) infra.

\textsuperscript{59} See Ribstein, \textit{supra} note 18, at 101-06.

\textsuperscript{60} It will also reflect the time value of money, inflation and risk (that is, variance of expected values around the mean). The first two factors will not differ according to whether liability is limited. It is not clear that risk, as distinguished from expected value, will differ much. In any event,
comes (C) (net of costs, ignoring interest charges and the time value of money), together with the probabilities (P) for each outcome might look as follows:

<table>
<thead>
<tr>
<th></th>
<th>$V_i$</th>
<th>$V_u$</th>
</tr>
</thead>
<tbody>
<tr>
<td>P</td>
<td>C</td>
<td></td>
</tr>
<tr>
<td>.20</td>
<td>50 = 10</td>
<td>.40 x 50 = 20</td>
</tr>
<tr>
<td>.20</td>
<td>40 = 8</td>
<td>.30 x 40 = 12</td>
</tr>
<tr>
<td>.30</td>
<td>30 = 9</td>
<td>.20 x 30 = 6</td>
</tr>
<tr>
<td>.30</td>
<td>20 = 6</td>
<td>.10 x 20 = 2</td>
</tr>
</tbody>
</table>

It is important to note at the outset that, for small debts, creditors are unlikely to see a significant difference between $V_i$ and $V_u$. First, information about $P$ and $C$ is costly. Thus, lenders of small amounts are likely to conclude that any possible difference between $V_i$ and $V_u$ is insufficient to justify further investigation. A broad market for particular products and services, including analysts and many comparison shoppers, may eliminate the need for investigation by individual consumers. But this sort of market may not exist for smaller firms providing non-standardized services. Second, for small debts the additional collection costs to pursue owners' wealth under individual liability will be large compared to the amount of the debt. This reduces the small creditor's chance of recovering more under unlimited liability than under limited liability. Accordingly, credit charges for small debts probably will not vary significantly in relation to whether the firm has adopted limited liability.

Even for large debts, creditors may conclude that $V_i$ and $V_u$ are not significantly different. The difference turns on such factors as the nature of the firm and its owners, and the firm's ability to offer protection against insolvency risk with and without limited liability. For example, the loan may be made primarily against millions of dollars of "hard" assets, such as raw land or buildings. The creditors may obtain contractual protection against sale or dissipation of these assets. Moreover, these assets can be redeployed following bankruptcy without significant creditors may be able to eliminate any differences in unsystematic (firm-specific) risk by diversifying their loan portfolios, and thus may not reflect these differences in their credit charges.

61. For the seminal work on information costs and the decision to invest in search, see George Stigler, *The Economics of Information*, 69 J. POL. ECON. 213 (1961). The owners can reduce the range and the creditor's investigation costs by signalling or bonding the firm's and owners' wealth.

62. See infra text accompanying note 108.
loss of value. Thus, a limited liability debt of this firm may have a \( V_1 \) that is relatively high in relation to the amount of the debt. At the same time, \( V_u \) may not be much larger because the owners' personal assets are small compared to those of the firm. Indeed, \( V_u \) may even be lower than \( V_1 \) if the increased owner liability risk means that the firm is unable to attract competent owner managers who will maximize the value of the firm’s assets for both owners and creditors.

Conversely, a firm with a relatively low \( V_1 \) may not be able significantly to reduce its cost of credit by offering unlimited liability because its \( V_u \) is not much higher. For example, the firm may be owned by minimally capitalized corporations, by individuals with highly liquid financial assets that are costly to monitor, or by a sole proprietor whose wealth is completely invested in the firm. Moreover, \( V_u \) is significantly affected by collection costs. Contract creditors in many states cannot collect from partners' personal assets without both suing and serving all of the partners individually and exhausting collection efforts against the partnership assets. This may mean delay and costly proceedings in far-flung

---

63. See Oliver E. Williamson, Mergers, Acquisitions and Leveraged Buyouts: An Efficiency Assessment, reprinted in Corporate Law and Economic Analysis 1 (Lucian A. Bebchuk ed., 1990) (suggesting that this sort of firm is appropriate for a leveraged buyout).

64. See Mansour v. Massey, 336 S.E.2d 15 (S.C. 1985); 2 Bromberg & Ribstein, supra note 27, § 5.68.

65. Exhaustion is required if the liability is joint, as it is for the partnership's contract liabilities under the Uniform Partnership Act § 15(b) (1914). See Moseley, Hallgarten, Estabrook & Weeden, Inc. v. Ellis, 849 F.2d 264, 271 (7th Cir. 1988) (applying Illinois law); Commonwealth Capital Inv. Corp. v. McElmurry, 302 N.W.2d 222, 225 (Mich. Ct. App. 1980); Diamond Nat'l Corp. v. Thunderbird Hotel, Inc., 454 P.2d 13 ( Nev. 1969). For joint and several liability, which the Uniform Partnership Act § 15(a) imposes for partners' wrongful acts, the traditional rule is that the liability is individual and may be enforced without exhaustion. See Foster v. Daon Corp., 713 F.2d 149, 151 (5th Cir. 1983) (applying Texas law); Head v. Vulcan Painters, Inc., 541 So. 2d 11 (Ala. 1988); Head v. Henry Tyler Constr. Corp., 539 So. 2d 196, (Ala. 1988); Catalina Mortgage Co. v. Montier, 800 P.2d 574 (Ariz. 1990) (en banc); Phillips v. Cook, 239 Md. 215, 210 A.2d 743 (Md. 1965).

There may be a general move toward an across-the-board exhaustion requirement. See Revised Uniform Partnership Act § 307(c) (Draft August 1991) (adopting exhaustion for all partnership liabilities); UPA Revision Subcommittee of the Committee on Partnerships and Unincorporated Business Organizations, Should the Uniform Partnership Act be Revisited? 43 Bus. Law 121, 143 (1987) (“this result...[is] most consistent with general business expectations today”). Some factors driving the law in this direction include the entity nature of liability under the Uniform Partnership Act, which requires application of partnership property to pay liabilities, and partner contributions to make up any shortfall (see Uniform Partnership Act §§ 40(a), (c), (d) (1914)); the bankruptcy provision that lets the trustee pursue general partners only if partnership assets are insufficient (see 11 U.S.C. § 723 (1988)); and the move in some states toward joint and several liability for all partnership liabilities, which blurs the distinction between the exhaustion and nonexhaustion categories.
jurisdictions. These costs are increased further by the costs and uncertainty of bankruptcy, particularly if the creditor must use a fraudulent conveyance remedy to pursue assets transferred by individual partners. The extra "cushion" afforded by unlimited liability may be a very small net of these collection costs.

Even if $V_u$ exceeds $V_b$, the firm nevertheless may adopt limited liability if it obtains benefits from doing so, such as freely tradeable shares, that outweigh the increased credit costs. Moreover, even parties that prefer personal liability may choose to do so through individual guarantees rather than the form of personal liability that partnership law provides.

---

(see, e.g., GA. CODE ANN. § 14-8-15 (Michie 1989)). For a general discussion of the exhaustion requirement, see 2 BROMBERG & RIBSTEIN, supra note 27, § 5.08(d)-(g).

A move toward an across-the-board exhaustion requirement might itself be explained by considerations similar to those that drive firms toward limited liability: creditors' costs of investigating partner assets make the remedy less of a benefit to creditors than is direct exposure to liability coupled with costly indemnification a cost to partners.

Note that the proposed changes to the Revised Uniform Partnership Act exacerbate a partnership's creditors' problems not only by impeding recovery from individual partners, but also by eliminating the automatic carryover of liabilities from a dissolved firm to a partnership that continues the business. See REV. UNIFORM PARTNERSHIP ACT § 604 and Comment (1991 Draft).

66. This is indicated by a recent bankruptcy settlement of the former law firm of Myerson & Kuhn. The partners contributed in a range only between 50-100% of their assets, giving creditors only 22% of their claims. The settlement protects the partners not only against suits by parties to the proceeding, but also from later suits against them personally. See Legal Beat, WALL ST. J., Oct. 2, 1991, at B5.

67. A recent article casts some doubt on this conclusion by showing that double liability of bank shareholders, which flourished before the Depression but was quickly dismantled afterward, was somewhat successful in effecting substantial collections, minimizing bank failures and creditor losses, and reducing banks' capital requirements. See Jonathan R. Macey & Geoffrey P. Miller, Double Liability of Bank Shareholders: History and Implications, 27 WAKE FOREST L. REV. (forthcoming 1992). Macey & Miller do not show whether the banks' reduction in credit costs offset the significant costs of this system, including litigation and reduced transferability of shares. Moreover, this system was mandated by federal and state statutes, and it is not clear whether there was an effective state competition for bank charters that would have produced a "race to the top" of contract terms. Thus, it is impossible to conclude whether banks would have adopted this system voluntarily.

68. Note that current tax rules may discourage use of guarantees by LLCs and other limited liability firms treated as tax partnerships. In a standard-form partnership, all partners bear the economic risk of loss of partnership debts, and, accordingly, their tax bases for purposes of measuring deductibility of losses include the amount of the debt. See I.R.C. § 752 (1980); Treas. Reg. § 1.752-1T(a) (1991). An LLC's debts normally would be nonrecourse since members are not individually liable. Under rules regarding nonrecourse liabilities, all members take a share of the tax benefit into basis. See Treas. Reg. § 1.752-1T(a)(2) (1991). But if some of the LLC's members guarantee debts, this converts the debts to recourse, and only the guaranteeing members can add the amount of the debt to their basis even if the firm repays the entire debt (and therefore the members actually share the economic burden). Thus, all members have the incentive either to share in the guarantee or to make the debts nonrecourse. See Gazur & Goff, supra note 36, at 466. In light of
Creditors can obtain guarantees from the wealthiest partners, who most likely would be creditors' targets even if all partners were liable. While individual guarantees entail extra contracting costs, these costs may be outweighed by the advantages to the parties of guarantees compared with joint and several liability. For partners, limited liability at the firm level, coupled with individual partner guarantees, avoids exposure to liabilities contracted by co-partners and lingering partnership liability for debts contracted after the partner's withdrawal. Both rules impose significant risk-bearing and monitoring costs on partners. At the same time, creditors holding guarantees may get the benefit of reduced collection costs by avoiding strict partnership-type exhaustion requirements.

Limited liability coupled with guarantees also offers a better opportunity for firms to differentiate among creditors than does unlimited liability coupled with nonrecourse contracts. Jointly and severally liable partners must incur the costs of personal liability to all creditors, including creditors whose debts are too small to incur either the investigation and collection costs that would justify lower credit charges for unlimited liability or the transaction costs of contracting for nonrecourse liability.

the importance of member guarantees in LLCs discussed in the text, this rule operates perversely and therefore may need to be revised.

69. See Uniform Partnership Act § 9(1) (1914) (partnership bound for all debts contracted by partners that are "apparently usual" for business). Note that even restrictions on authority in the agreement or certificate may not be binding. For a discussion of the standards applied concerning whether the third party is bound by statements in the partnership agreement, see I Bromberg & Ribstein, supra note 27, § 4.02(c).

70. See Uniform Partnership Act § 35 (1914) (partner liable for post-dissolution debts to creditors who have not received notice of dissolution). See also Arno Management Corp. v. 115 E. 69th Street Assoc., 569 N.Y.S.2d 656 (App. Div. 1991) (general partner liable for post-withdrawal debts even as to party who knew of withdrawal when the certificate was not amended as required by statute).

71. One commentator suggests that an unlimited liability regime causes firms to substitute partner-level for firm-level debt to help members to control the total amount of debt for which they are responsible. See David W. Leebron, Limited Liability, Tort Victims, and Creditors, 91 Colum. L. Rev. 1565, 1590-95 (1991). Leebron concludes that this is a problem because it would cause creditors of shareholders to duplicate the costs of investigating the value of the firm's assets offered by shareholders as security, as compared with a single investigation for firm-level debt. But duplication of investigation costs is not necessarily a problem, since shareholders could join to borrow on an individual basis but in a single transaction. The real problem is that, even if partners themselves borrow, they are also potentially exposed to personal liability for additional apparently authorized firm-level debt. That is why the partners would prefer a rule barring personal liability for firm-level debts.

72. See Thriftway Lumber Co. v. Tisherman, 672 P.2d 236 (Idaho 1983) (judgment allowed only against partner found to have agreed to pay entire partnership debt).

73. See supra text accompanying note 61.
Conversely, limited liability owners could contract for personal liability only with respect to larger debts that could support customized deals. In short, even if some firms would contract for unlimited liability, limited liability is a superior default rule.

B. Professional Firms

Professional firms are an important category of general partnerships and potentially important users of the LLC form. Because several states' professional corporation acts do not let professionals obtain limited liability for acts of co-professionals, recognition of LLCs for professional firms might eliminate an important barrier to limited liability that does not exist for non-professional firms.

Professional firms' debts to trade creditors seem to adhere to a straightforward application of the above analysis when $V_u$ greatly exceeds $V_i$ because the partners' combined assets ordinarily greatly exceed the firms' marketable assets. In this situation, unlimited liability seemingly would offer a valuable bond that significantly reduces the firms' cost of credit.

The comparison between $V_u$ and $V_i$ is, however, complicated in professional firms because the firms are creditors at the beginning of the rela-


75. The extent to which LLCs will be approved for this purpose is unclear. Many of the statutes are silent on use by professional firms. The Virginia statute precludes use by professionals. See Va. Code Ann. § 13.1-1008 (Michie Supp. 1991). The Colorado statute forbids an LLC from conducting any business that is forbidden to limited partnerships. See Colo. Rev. Stat. § 7-80-103 (Supp. 1990). Moreover, the Colorado statute is inappropriate for professional firms because it mandates centralized management. See id. § 7-80-401. On the other hand, Utah and Kansas explicitly permit use by professionals. See Utah Code Ann. § 48-2b-105(1)(r) (Supp. 1991); Kan. Stat. Ann. § 7-7604(q) (Supp. 1990). Moreover, even if LLCs are approved for professional firms, the courts still may not limit liability for co-partner torts. See infra note 89 and accompanying text.

76. See Eugene F. Fama & Michael C. Jensen, Agency Problems and Residual Claims, 26 J. L. & Econ. 327, 336-37 (1983). Indeed, even partners often offer personal guarantees to creditors. See Sharon Walsh, Landlord Sues Law Firm for $1.2 Million in Rent, WASH. Post, July 5, 1991, at C10 (individual partners of failed law firm being sued for liability on lease they guaranteed; commercial real estate creditor quoted as saying "You cannot get a proposal for a law firm in this town right now without the signatures of the partners—and sometimes their spouses.")
tionship and only become debtors as a result of any subsequent malpractice.77 Accordingly, the client or patient, in fixing the cost of "credit," must assess the probability that any debt will arise. That, in turn, depends on whether the professionals will "chisel" the client or patient by delivering less than the promised degree of service. Even in a limited liability firm, the professional is liable for his or her own negligence. Thus, choosing between limited and unlimited liability in professional firms, in the absence of tax and regulatory constraints, involves a tradeoff between the costs to professionals and benefits to clients of monitoring by co-professionals.

Jack Carr and Frank Mathewson recently have shown how general partnership can be an efficient contract for firms in which monitoring is valuable for clients because holding monitors personally liable makes it costly for professionals to "bribe" them.78 This suggests that even if limited liability is fully available for professional firms, some will remain general partnerships because clients may be willing to pay extra fees in order to ensure effective monitoring.

In an earlier article, Carr and Mathewson had argued that mandatory unlimited liability raises the cost of capital for professional firms generally, and therefore makes them inefficiently small. Capital costs increase because partners must invest resources in monitoring their co-partners' wealth and performance to ensure that they will not chisel clients and then free-ride on the wealthier partners' ability to pay the uninsured portion of malpractice judgments.79

The question the Carr-Mathewson articles pose is whether clients' fees would increase enough to offset these higher capital costs. This calls for an analysis of the expected value to the client of the firm's services under limited and unlimited liability, taking into account the possibility of uncollectible malpractice judgments. There are several reasons clients are unlikely to insist on significant fee discounts for limited liability professional firms.

First, even a limited liability firm has significant assets at stake. These

77. By contrast, non-professional firms' liability to voluntary creditors, with the important exception of product liability claims, usually involves a debt the existence and often amount of which is known at the onset of the relationship.


include the marketable assets of the firm, which is generally vicariously liable for the malpractice of its members,\(^\text{80}\) of the primarily liable member, and of all other members whose negligence contributed to the loss.\(^\text{81}\) Since the members can be expected to have substantial assets, they have incentives to purchase third-party malpractice insurance and to monitor co-partners to minimize their premiums and protect against liability beyond policy limits and within coinsurance and deductibles.

Second, the firm stands to forfeit some of its reputation in the event of member malpractice. Although injured clients cannot recover against goodwill, the firm invests resources in developing its reputation, and this stake gives it an incentive to minimize malpractice.\(^\text{82}\)

Third, even if unlimited liability does increase members’ exposure to malpractice claims, this increased exposure may not provide significant benefits to the client. Although lawyers may have some additional incentive under unlimited liability to monitor co-partners, this increased monitoring may not be particularly useful, indeed may be counterproductive, to the extent that it involves second guessing complex professional decisions. On the other hand, the clients themselves effectively can monitor their own cases through corporate legal departments, general practitioners who review the work of medical specialists, and, in the United Kingdom, by solicitors who employ barristers to try cases.\(^\text{83}\)

The move to limited liability for professional firms over the thirty years since adoption of the first professional corporation act seems to provide an opportunity to test the proposition that most professional firms would prefer unconstrained limited liability. Carr and Mathewson show that law firms have higher average receipts and more income per lawyer in states permitting limited liability.\(^\text{84}\) They attribute the higher income to larger firms’ handling more complex cases that require better, and therefore more highly paid, legal talent. This data seem to support


\(^{81}\) See Kelsey-Seybold Clinic v. Maclay, 466 S.W.2d 716 (Tex. 1971) (triable issue as to whether medical partnership breached duty to use reasonable means to prevent partner from improperly using his position in personal relationship with patient).


\(^{83}\) See Carr & Mathewson, supra note 78, at 322.

\(^{84}\) See Carr & Mathewson, supra note 79, at 780-83.
their thesis that unlimited liability increases larger firms' capital costs, and therefore constrains law-firm size.

Ronald Gilson argues that the move to incorporation for larger firms and wealthier lawyers is actually attributable to the fact that, before 1982, corporations, but not partnerships, could deduct pension payments, a tax break worth more to higher-income lawyers. In other words, firms do not have higher income because they can incorporate, but rather they incorporate because they have higher income. Carr and Mathewson respond that, even if larger firms incorporate for tax reasons, this would not explain why the average size of all firms would be larger in states adopting limited liability, unless the presence of many large law firms in a state was a factor in the move toward limited liability. Gilson notes that a re-examination of Carr and Mathewson's data showed "no significant relationship between extent of liability protection and incorporation." Gilson suggests testing Carr and Mathewson's hypothesis by looking at post-1982 data, or at professional sole-proprietorship corporations, which do not insulate the sole owner from personal liability and therefore must be used only for tax purposes.

Even if Carr and Mathewson correctly conclude that their data show that mandatory unlimited liability artificially restricts law-firm size, their data are still inconsistent with the theory in this Article because they show that many firms choose unlimited liability even when they have a choice. Gilson's response not only refutes Carr and Mathewson, but also casts further doubt on the thesis presented here by contending that there is no correlation between the availability of limited liability and the move to incorporate.

Both conclusions, however, can be reconciled with the death-of-partnership thesis. First, under current law there is no limited liability for professional corporations under many state statutes, and even under statutes that seem to allow limited liability for co-members' acts, the courts may compel unlimited liability by judicial rule.

Second, Carr and Mathewson and Gilson ignore the critical factor that
the partnership form enables a professional firm to avoid double tax on any income it is unable to distribute as deductible salaries.\textsuperscript{90} That is particularly true for large law firms too big to meet the thirty-five-shareholder restriction for Subchapter S Corporations, and whose associates generate significant income for partners.\textsuperscript{91} One piece of evidence supports the importance of this factor: S Corporation filings increased beginning in 1987\textsuperscript{92} when a non-graduated thirty-four percent tax on personal service corporations replaced a graduated tax that had begun at fifteen percent.\textsuperscript{93} Apparently, firms that formerly could distribute all but an amount that would qualify for the lowest tax rate no longer were willing to pay the higher flat tax on the same amount. In other words, at the margin, the double corporate tax is a problem for professional firms. Indeed, the data are, if anything, biased against this result because the S Corporation election forces firms to recognize unrealized gain.

Thus, until the tax distinction based on limited liability is eliminated, it will not be clear whether the many professional firms that remain partnerships do so for tax reasons or because clients are willing to pay enough for unlimited liability to offset its costs to partners.

\textsuperscript{90} See Frank V. Battle, Jr., The Use of Corporations by Persons Who Perform Services to Gain Tax Advantages, 57 TAXES 797, 809 (1979) (questioning whether entire amount of contingent fee could be paid out to lawyers as reasonable compensation); Howard Chapman, The Future of Personal Service Corporations, 24 ARIZ. L. REV. 503, 526 (1982) (noting reasonable compensation problem).

\textsuperscript{91} See Ronald J. Gilson & Robert H. Mnookin, Coming of Age in a Corporate Law Firm: The Economics of Associate Career Patterns, 41 STAN. L. REV. 567 (1989). In this situation, payments to partners may bear little resemblance to wages because they are not directly attributable to partner efforts. (That is not to suggest, however, that the compensation characterization ultimately depends on whether the income is directly attributable to partner efforts.) Professional firms cannot obtain limited liability by organizing as limited partnerships, because the members' participation in control would run afoul of the "control rule." REVISED UNIFORM LTD. PARTNERSHIP ACT § 303 (1985).


\textsuperscript{93} See I.R.C. § 11(b)(2) (1988) (tax applies to "qualified personal service corporation," defined in id. § 448(d)(2) to include law, accounting, and other professional firms).
C. Summary

The foregoing analysis suggests that, were tax and regulatory impediments to limited liability removed, unlimited liability would be valuable only for firms that meet the following combination of criteria:

1. Reduced benefits from limited liability because of such features as decentralized management and restricted transferability;\(^94\)

2. Individual debts large enough to justify lower interest charges for unlimited than for limited liability; and

3. Small-firm capitalization coupled with significant owner wealth or other characteristics justifying a higher interest charge under limited liability.

Some firms, such as professional firms (with respect to non-client creditors), meet all three criteria. However, in a world in which limited liability is not penalized, even these firms probably would prefer limited liability coupled with personal guarantees for some debts to joint and several liability to all creditors. In short, if firms were free to choose organizational form without tax or regulatory constraints, the partnership form (in the sense of a business form whose members are personally liable for the firm's debts) would not survive.

III. Protecting Involuntary Creditors

The analysis in Section II indicates that, while the partnership form would not survive deregulation of limited liability, individual liability may be efficient in some firms for some debts. But some such firms might adopt across-the-board limited liability in order to externalize costs to involuntary, or "tort," creditors.\(^95\) Potential externalities regarding tort creditors might justify regulating or taxing limited liability. Indeed, some commentators question the propriety of permitting unlimited liabil-

\(^94\) See supra text accompanying notes 57-59 (noting increased advantages of limited liability for publicly traded firms that separate ownership and control).

\(^95\) "Tort" refers at least to creditors who do not deal intentionally with the firm before the claim arises. The category arguably also should include some voluntary creditors, such as ordinary consumers, who reasonably cannot be expected to contract to be paid for the extra risks of limited liability.

Saul Levmore suggests that firms may switch "midstream" from partnership to LLC form in order to escape claims to creditors. See Levmore, supra note 17, at 491. However, since partners need creditors' agreement to discharge liabilities (see Uniform Partnership Act § 36 (1914)), it is hard to see what partners can gain from midstream conversion to LLC form. It is even harder to see what partners gain from partnership-LLC conversions over what they already can accomplish by incorporating.
ity in tort cases or suggest abolishing limited liability in some situations.

This Section shows, however, that the potential for externalities may be less than has been supposed. The purpose of this Section is not to make a convincing case against unlimited tort liability; that must await a much longer discussion. Rather, this Section highlights the flaws in the case for unlimited tort liability and suggests caution in mandating unlimited liability. In particular, this Section shows that protecting tort creditors does not justify restricting the development of LLCs.

Subsections A and B discuss both the significant costs of imposing unlimited tort liability on shareholders, which have been well recognized by commentators, and the dubious benefits, which commentators have overstated. Subsection C shows that limited tort liability is well entrenched in the courts, thus casting doubt on the desirability of major changes in the opposite direction. Finally, Subsection D points out that, even if limited tort liability is undesirable, it is inappropriate to protect tort creditors by restricting the availability of the LLC form.

A. Limited Liability and Externalization of Tort Risk

The effect of limited tort liability depends on the availability of insurance. To the extent that the firm can obtain third-party insurance against tort liability, unlimited liability simply forces the personally liable members of the firm to cause the firm to buy such insurance. On the other hand, limited liability lets even fully insurable firms choose not to bear the cost of insurance and thereby transfer tort risks to victims. If assets and insurance are insufficient to cover tort risks, owners may make

96. See Leebron, supra note 71.
98. See FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 47-49 (1991) (noting that limited liability is much less important now than it was when insurance markets were less developed); Reinier H. Kraakman, Corporate Liability Strategies and the Costs of Legal Controls, 93 YALE L.J. 857, 868-76 (1984) (discussing personal liability of managers as a solution to the problem of asset insufficiency, assuming full availability of insurance).
99. See EASTERBROOK & FISCHEL, supra note 98, at 50; STEVEN SHAVELL, ECONOMIC ANALYSIS OF ACCIDENT LAW 175-76 (1987); Hansmann & Kraakman, supra note 97; Christopher D. Stone, The Place of Enterprise Liability in the Control of Corporate Conduct, 90 YALE L.J. 65-76 (1980); Leebron, supra note 71, at 1584-87; Schwartz, supra note 97, at 711-17.
decisions on investments in assets, projects, or precautions that, while privately optimal for the owners, are socially suboptimal. Involuntary creditors, by definition, are not compensated for bearing these increased risks.

The foregoing argument for unlimited liability depends on two critical points discussed in this Section. First, Subsections (1) and (2) question how much difference there really is in owners' incentives to insure and capitalize under limited liability and under unlimited liability. Second, as discussed in Subsection (3), any additional incentive for the firm to insure under unlimited tort liability is inefficient to the extent that tort liability itself is inappropriate—that is, when the firm is in a relatively poor position to insure or protect against the loss.

1. Owners' Incentives to Capitalize and Insure under Limited Liability

The critics of limited tort liability assume that under-insurance and under-capitalization are serious problems. But the factors discussed below indicate that these problems often do not exist, even in many very closely held limited liability firms.

   a. Protecting Owners

Limited liability does not insulate tortfeasors themselves from liability, but merely prevents liability solely by virtue of ownership status. In the most closely held firms, in which under-capitalization is the greatest problem, owners may have sufficiently participated in the tort, either as

100. For various expressions of this general point, see KOSE JOHN & LEMMA W. SENBET, LIMITED LIABILITY, TAX DEDUCTIBILITY OF CORPORATE DEBT, AND PUBLIC POLICY 8-9 (New York University School of Business Working Paper No. 544, 1989) (copy on file with author) (formal model showing that risky investment under limited liability will be higher than what is socially optimal); Kraakman, supra note 98, at 874 n.45 (limited tort liability enables owners to increase the value of their interests under an option pricing model); Leebron, supra note 71, at 1570-74 (private expected value may be higher, and the private risk lower, than the social expected value and risk).

101. It is in this context that the availability of limited liability is expanding through LLCs, and that the dominant role of general partnerships is threatened. At the same time, some commentators have suggested that it is here that limited tort liability is most troublesome in terms of the possibility of externalization. See SHAVELL, supra note 99, at 176; Leebron, supra note 71, at 1626-30.

Professor Hillman argues that I fail to establish that externalization of risk is not a problem for closely held firms. See Robert W. Hillman, Of Arsenic, Old Lace, and Dancing on Coffins: A Comment on the Death of Partnership, 70 WASH. U. L.Q. 470 (1992). That is true. My goal is only to show that externalization is not as serious a problem as has been supposed. Although my theory lacks empirical support, the burden is on those who advocate restricting private ordering to show that there is a problem and that their suggested restrictions are appropriate solutions.
direct actors or as negligent monitors to be held directly liable. The victim may sue the owner-tortfeasor directly, or the liability may circle back from the firm to the owner through indemnification. Because of this risk of personal liability, owners in very closely held firms have a significant incentive to insure against tort liability.

b. Protecting Assets

The owners may have the incentive to insure in order to protect their own investments in the firm’s assets from tort creditors. The owners could, of course, avoid this problem simply by placing ownership of assets in other hands. However, if the firm does not itself own certain assets, it must contract for their use. This may expose the firm to post-contractual opportunism by the asset owners. Leases and other contracts that attempt to avoid this problem are costly to negotiate and draft and in any event leave the firm vulnerable as to rights that have not been reserved to the firm. Moreover, it is harder for the firm to realize economies of managing common assets if the assets are owned separately.

c. Protecting Voluntary Creditors

Just as owners, under limited liability, cannot easily avoid responsibility for torts by minimizing the firm’s assets, so they cannot easily do so by minimizing their own equity investments and capitalizing the firm with borrowed funds. Large creditors are in a position to investigate the firm’s assets and insist on adequate capitalization. Of course, the firm may be able to borrow from voluntary creditors even without collateral or insurance by having the borrowing done against nonfirm assets, as when the owners guarantee the firm’s debts. But some long-term insider creditors (managers and employees) rely on the continued existence of the assets assembled in the firm and therefore would be hurt by a forced liquidation of assets. Owner guarantees will not readily protect these people because insiders seek job protection and not merely repayment of a specific debt. Because these voluntary creditors can adjust their terms to reflect the firm’s exposure to tort risks, the firm has the incentive to insure and capitalize adequately to cover expected tort claims.

102. For the analysis in the professional-firm context, see supra text accompanying note 81.
104. See Hansmann & Kraakman, supra note 97, at 1914.
105. See Easterbrook & Fischel, supra note 98, at 107-08. Protecting assets may be less of an
over, the firm may need to insure as a way of assuring outsider creditors that managers will not attempt ex post to impose risks on creditors by engaging in risky projects or shortsightedly deferring maintenance.\footnote{106}

A firm may need to insure or capitalize even to reassure relatively unsophisticated outside voluntary creditors with smaller claims. While ordinary consumers do not generally investigate sellers' credit or dicker over credit terms, when a firm's ability to stand behind its products or services is an important aspect of the transaction\footnote{107} prices may reflect the firm's financial stability. This is no different from the process by which prices adjust to information about product characteristics and the terms of guarantees if there are enough informed comparison shoppers or analysts in the market.\footnote{108} Also, a sophisticated agent such as a labor union may represent smaller creditors.\footnote{109} And even if credit risks to consumers are not priced in an efficient market, it does not follow that consumers are hurt by under-pricing the risk. Consumers' high information costs relative to the amount of their debt may cause them to seek compensation at a rate that exceeds the true cost of risk at many firms.\footnote{110} This encourages firms to signal or bond their solvency and coverage of tort risks, such as by investing in a brand name the value of which would be reduced if the company could not cover its tort liabilities.\footnote{111}

\begin{footnotes}
\item[106] See David Mayers & Clifford W. Smith, Jr., \textit{On the Corporate Demandfor Insurance}, 55 J. Bus. 281 (1982). Mayers & Smith offer other reasons firms may insure, including assisting larger firms in claims administration. They also assert that closely held firms may have more incentive than public firms to insure to protect owners' nondiversifiable investments. In a more recent article, the authors present data showing that closely held insurance companies are more likely than widely held companies to purchase reinsurance. See David Mayers & Clifford W. Smith, Jr., \textit{On the Corporate Demand for Insurance: Evidence from the Reinsurance Market}, 63 J. Bus. 19 (1990).
\item[107] This would apply, for example, to pest-control services, which enter into long-term service and warranty contracts.
\item[109] See Easterbrook & Fischel, \textit{supra} note 98, at 51.
\item[110] \textit{Id.} at 52; see also text accompanying notes 61-62 \textit{supra} (discussing how firms' cost of borrowing from such creditors may not differ significantly under limited and unlimited liability regimes). Indeed, unlimited liability may be worthless for many small creditors whose collection costs exceed the amount of the debt.
\item[111] It is true that the company may be able to sell the brand name free of liabilities if the company liquidates. See, \textit{e.g.}, Guzman v. MRM/Elgin, 567 N.E.2d 929 (Mass. 1991) (rejecting
\end{footnotes}
In short, under-insurance and under-capitalization are most likely to be problems for certain categories of firms: those that can avoid owning substantial assets, those that do not sell their products in markets in which risks are likely to be efficiently priced, and those with large potential tort liabilities. Many of these firms can be isolated in specific industries, such as hazardous waste, and subjected to industry-specific insurance or minimum-capital requirements. If so, the costs of general restrictions on limited liability, such as restricting the use of LLCs, may outweigh the benefits. That is particularly likely to be the case if, as discussed in the next Subsection, externalization persists even under unlimited liability.

2. Externalization under Unlimited Liability

Compelling unlimited liability may not significantly reduce externalization because, as even some unlimited liability advocates have recognized, shareholders can evade personal liability. First, owners can avoid the effects of liability by hiding assets or shifting them to family members, trusts, pension funds, or the like. Second, firms could disaggregate by transferring assets carrying heavy tort risks to low-asset holders and capitalizing largely through debt financing. Firms actually have pursued these strategies in response to the imposition of statutory unlimited liability for environmental torts.

Unlimited liability, therefore, often simply changes the nature of evasion rather than precluding it. Although there are private contractual and market constraints on evasion of unlimited liability, the constraints resemble those operating under limited liability. Just as limited liability owners need to capitalize and insure the firm to minimize credit costs to voluntary creditors, so unlimited liability owners are under similar

---

112. See Hansmann & Kraakman, supra note 97, at 1909-16. This point is rebutted to some extent by Macey & Miller's discussion of the experience with double liability of bank shareholders. See supra note 67. However, as already noted, Macey & Miller do not establish that the benefits of the system outweighed its significant litigation and other costs.


114. See Hansmann & Kraakman, supra note 97, at 1913-15.


116. See subsection III(A)(1)(c) supra.
constraints to own and retain personal assets on which voluntary creditors may rely. 117 These constraints are admittedly imperfect. As a result, specific regulation may be appropriate to mitigate the most extreme forms of evasion under either regime. 118 But regulation under unlimited liability may need to be more costly and complex than that under limited liability in order effectively to regulate asset transactions of individual shareholders.

It may be harder to evade unlimited than limited liability because high debt or subsidiarization are not complete solutions for personally liable owners. But these greater difficulties also mean that evasion strategies may involve greater secondary costs under unlimited liability than under limited liability. In particular, evasion under unlimited liability means selecting only the poorest owners, or the owners who are otherwise least concerned about liability, rather than the best managers or monitors. It also may mean losing significant benefits of synergy by completely separating potentially complementary lines of business or stages of production rather than by simply reducing economies of scale of management through subsidiarization. These governance effects not only may have generally perverse effects, but also may increase tort injuries by decreasing management efficiency and incentives to take precautions. In short, increasing firms' evasion costs could result in, for instance, a total of one hundred dollars of increased tort exposure for the firms that do not evade, but one hundred twenty-five dollars of increased tort costs for the firms that successfully evade because of the highly risky strategies they employ.

3. Effect of Increased Owner Liability

Even if mandatory unlimited liability did reduce firms' ability to avoid tort liability, this may not help achieve the principal tort objectives of loss prevention and loss distribution.

a. Loss Prevention

Even if personal liability reduces owners' ability to evade tort claims, they can at least partly insure their liability. Accordingly, whether unlimited liability increases loss prevention depends further on whether insurers can monitor and adjust premiums to reflect insureds' standard of

117. Hansmann & Kraakman, supra note 97, at 1913.
118. Id. at 1927-28.
care. Unless premiums are precisely experience rated, a marginal increase in insurance may not make much difference in the level of care owners and their agents exercise.

Moreover, any additional exposure to liability may add little to owners' and agents' extra-legal incentives to act carefully. For example, managers may want to avoid moral responsibility for accidents and to preserve their reputations for running a safe business.\textsuperscript{119} Also, agents, such as drivers, may act carefully to protect themselves from harm.\textsuperscript{120}

Assuming personal liability would increase owner precautions against injuries, this increase may not be efficient from a loss-prevention perspective if the tort system otherwise would force firms to take excessive care. Some tort cases impose liability for essentially unknowable risks, or for injuries that were easily preventable by plaintiffs. Owners may not have been able readily to reduce loss by, for example, choosing less risky projects, hiring more careful agents, observing agents, and controlling agents' behavior by the threat of termination and wage adjustments.\textsuperscript{121} Owners often cannot significantly influence agents' conduct because, among other reasons, agents' loss-creating conduct is not cheaply observable or because they work for a single period. Indeed, unlimited liability may reduce incentives for care by deflecting the loss from agents, who are effectively disciplined by the risk of liability, to remote owners who are not.

Unlimited liability may, therefore, subvert tort's loss-prevention goal by shifting liability to the least efficient cost-avoiders and producing a higher-than-optimal level of precaution by firms. As a result, firms may wholly avoid certain products, although consumer surplus could have been preserved and accident costs optimized if limited liability had shifted some of the loss-prevention burden to consumers.\textsuperscript{122}

\textsuperscript{119.} Cf. Mark Roe, \textit{Corporate Strategic Reaction to Mass Tort}, 72 VA. L. REV. 1, 23-34 (1986) (managers have reputational incentives not to avoid tort liability by liquidating).

\textsuperscript{120.} See Alan O. Sykes, \textit{The Economics of Vicarious Liability}, 93 YALE L.J. 1231, 1252 (1984).

\textsuperscript{121.} See Shavell, supra note 99, at 170-72; Lewis Kornhauser, \textit{An Economic Analysis of the Choice Between Enterprise and Personal Liability for Accidents}, 70 CAL. L. REV. 1345 (1982); Sykes, supra note 56.

\textsuperscript{122.} For example, it was reported recently that a cord maker turned down a potentially lucrative business in making cords for bungee jumping because of the liability risk. See Pamela Sebastian, \textit{Business Bulletin}, WALL ST. J., Sept. 19, 1991, at A1. Presumably, firms would be even more reluctant to manufacture bungee cords if personal liability increased owners' liability exposure. On the other hand, users presumably are aware that hooking "to elastic cords for the purpose of leaping from precipices into thin air," id., involves some risk, and that any cord's elasticity is finite.
b. Loss Distribution

Assuming plaintiffs and defendants have equal access to insurance, unlimited liability might be justified irrespective of loss-prevention effects if it encourages owners of risk-creating firms and their agents, who are presumably better aware than plaintiffs of the relevant risks, to purchase insurance. But as George Priest explained, the problem with this insurance-based loss-distribution justification for tort liability\textsuperscript{123} is that the resulting shift from first-party insurance, such as accident and worker-compensation policies, to third-party insurance has vastly increased the cost of insurance in relation to the expected loss.

There are several reasons insurance-based liability is inefficient. First, the insurance rationale over-compensates some plaintiffs. When money does not increase the victim’s utility—i.e., when the victim has lost a capacity for enjoying what money will buy—unlimited liability serves only to decrease the injurer’s utility.\textsuperscript{124} Full compensation also involves the moral hazard that victims may not mitigate or economize on claims, problems that are addressed in first-party policies such as health insurance through deductibles and co-insurance.\textsuperscript{125} Second, third-party insurance involves higher collection and administrative costs, since victims can collect only after hiring a lawyer and establishing liability under complex and uncertain tort rules. Third, the shift to third-party liability insurance impedes insurers’ ability to reduce risk by diversification because increases in tort liability are correlated across products and risks.\textsuperscript{126} Fourth, third-party insurance impedes insurers’ ability to separate risks into risk pools because firms must provide insurance for consumers who vary widely in risk and wealth.

Priest shows that this shift to relatively inefficient third-party insurance perversely reduces the total amount of third-party insurance because of adverse selection. Once insurers no longer can offer cost-effective risk diversification and aggregation into risk pools, lower-risk firms will conclude that insurance is overpriced in relation to their ex-
PECTED LOSS AND WILL SELF-INSURE. INSURERS MUST THEN RAISE PREMIUMS AND REDUCE COVERAGE OF THE HIGHER-RISK FIRMS REMAINING IN THE POOL, FURTHER REDUCING THE AMOUNT OF INSURANCE. ALTHOUGH MANDATING PERSONAL LIABILITY WOULD INCREASE ALL FIRMS' INCENTIVES TO INSURE, THE LOW-RISK FIRMS WOULD STILL HAVE RELATIVELY LESS INCENTIVE TO INSURE, AND ADVERSE SELECTION WOULD PERSIST.

THE DISCUSSION SO FAR HAS ASSUMED THAT BOTH OWNERS AND TORT PLAINTIFFS CAN FULLY INSURE. HOWEVER, BECAUSE OF HIGH DEDUCTIBLES AND CO-INSURANCE RESULTING PARTLY FROM THE ADVERSE SELECTION PROBLEM, OWNERS MAY HAVE LESS ACCESS TO LIABILITY INSURANCE THAN PLAINTIFFS. UNLIMITED LIABILITY THEREFORE MAY SHIFT LIABILITY FROM AN INSURABLE PLAINTIFF TO AN UNINSURABLE DEFENDANT, CONTRARY TO LOSS-DISTRIBUTION AIDS. THIS MAY FURTHER EXACERBATE THE EFFECTS OF THE INSURANCE CRISIS BY FORCING FIRMS THAT WOULD OTHERWISE SELF-INSURE TO EXIT MARKETS ALTOGETHER.

THE BASIC LESSON OF THIS SUBSECTION IS THAT, EVEN IF LIMITED LIABILITY LETS FIRMS AVOID TORT LIABILITY, THE END RESULT MAY BE SALUTARY RATHER THAN PERVERSE BECAUSE OTHERWISE TORT REMEDIES WOULD EXCEED APPROPRIATE LOSS PREVENTION AND LOSS DISTRIBUTION. IN OTHER WORDS, ADVOCACY OF UNLIMITED TORT LIABILITY MISTAKENLY ASSUMES THE EFFICIENCY OF THE TORT SYSTEM. WHILE THIS PROBLEM PERHAPS IS BEST ANSWERED BY REFORMING THE TORT SYSTEM, THE ABSENCE OF SUCH REFORM WEAKENS THE ARGUMENT FOR MANDATORY UNLIMITED TORT LIABILITY.

B. THE COSTS OF UNLIMITED LIABILITY

THE COSTS OF UNLIMITED LIABILITY ARISE BECAUSE OWNERS, EVEN IF THEY HAVE THE INCENTIVE TO DO SO UNDER UNLIMITED LIABILITY, CANNOT PURCHASE THIRD-PARTY LIABILITY INSURANCE AGAINST ALL POSSIBLE TORT LOSSES. THIS INABILITY ARISES BECAUSE INSURERS HAVE INCOMPLETE INFORMATION ABOUT TORT RISKS, AND BECAUSE COMPLETE INSURANCE WOULD CREATE ADVERSE SELECTION AND MORAL HAZARD PROBLEMS FOR INSURERS.127

THE OWNERS' INABILITY TO INSURE FULLY MAY RESULT IN POOR LOSS DISTRIBUTION BECAUSE VICTIMS MAY BE MORE FULLY OR CHEAPLY INSURABLE.128 OTHER COSTS HAVE BEEN SURVEYED ELSEWHERE.129 OWNERS WHO ARE JOINTLY AND SEVERALLY LIABLE CANNOT EASILY DIVERSIFY THEIR PORTFOLIOS BECAUSE EACH ADDITIONAL INVESTMENT ACTUALLY INCREASES THE POTENTIAL OF A LOSS THAT COULD

127. See Shavell, supra note 99, at 211-12; Halpern, supra note 55, at 140-42.
129. See Easterbrook & Fischel, supra note 24; Halpern, supra note 55; Leebron, supra note 71; Woodward, supra note 55; Ribstein, supra note 18, at 99-107.
reduce the value of the entire portfolio to zero. The increased risk to owners under unlimited liability also makes it costly for owners to delegate decisionmaking functions to managers without retaining a significant monitoring role.\(^{130}\) And unlimited liability interferes with transferability of shares. Increasing transferees' need for information about the firm and the wealth of the other owners restricts owners' ability to shed their risk by transferring shares, and necessitates share-transfer restrictions to protect non-transferring shareholders.

Limiting shareholders' liability to a percentage reflecting their ownership interests would increase transferability, diversification, and delegation of decisionmaking, but it would also induce wealthy owners to take small equity positions in firms. This would restrict the class from which competent managers and monitors can be drawn. Moreover, pro rata liability involves significant logistical problems in defining and determining each owner's share of liability.\(^{131}\)

These costs of unlimited liability are not imposed on owners who invest after the unlimited liability rule goes into effect. Rather, investors adjust what they will pay to reflect their increased risks under the new system. This increased capital cost may decrease the size and number of firms,\(^{132}\) thereby reducing potential wealth creation by firms.

In general, it is important to keep in mind that the costs of unlimited liability arise solely because of the circumstance of joint investment in an unlimited liability firm. In other words, limited liability eliminates the costs rather than simply transferring them to victims.\(^{133}\)

To summarize: In light of the constraints on evasion under limited liability, the ability to evade liability under unlimited liability, the potential social cost of those evasion tactics, and the dubious benefits of any increased exposure under unlimited liability given defects in the underlying tort system, it is far from clear that unlimited liability reduces tort costs as compared to limited liability. In any event, any such cost reduc-

\(^{130}\) For a discussion of this problem in the context of law firms, see \textit{supra} text accompanying note 79.

\(^{131}\) For example, there is a question whether the pro rata determination should be according to total ownership, or ownership represented by the parties to a particular claim. The problem could be eliminated by forcing plaintiffs to sue all owners, but this solution would raise litigation costs substantially as compared with joint and several liability. \textit{See} Leebron, \textit{supra} note 71, at 1610-12.

\(^{132}\) \textit{See supra} note 84 and accompanying text (discussing data concerning law firm size that supports this assertion).

\(^{133}\) \textit{See} Leebron, \textit{supra} note 71, at 1600.
Deregulation of limited liability is probably less than the potential wealth loss from regulatory compulsion of unlimited liability.

C. Judicial Support for Limited Tort Liability

Limited tort liability is a venerable rule long supported by the courts in cases involving piercing the corporate veil of closely held firms. Significantly, courts have continued to recognize limited liability even as they lower other barriers to liability, particularly the privity limitation on product liability claims. Robert Thompson's recent extensive survey of approximately 1500 veil-piercing cases revealed that courts pierced the veil in a lower percentage of tort cases than contract cases, that courts mentioned undercapitalization in a lower percentage of tort cases (thirteen percent) than of contract cases (nineteen percent), and that courts pierced the veil in only seventy tort cases altogether, of which more than two-thirds involved corporate shareholders. Indeed, Thompson concludes that these figures show that "piercing law is rooted in concerns of inequitable bargains." This respect for the corporate form cannot be attributed to the growth of successor liability, as Thompson argues. Some courts have resisted the "product line" theory, thereby giving companies wide latitude to escape product liability claims by selling off chunks of the firm. Nor can the rarity of piercing be attributed simply to respect for the corporation statutes, since this begs the question of why the courts have declined to extend this essentially common-law theory of liability.

Although the courts' long and deep recognition of limited liability does not in itself establish the normative validity of limited liability, there is arguably a strong relationship between common-law tort rules and eco-

134. See MacPherson v. Buick Motor Co., 111 N.E. 1050 (N.Y. 1916). David Leebron suggests that restricting limited tort liability is consistent with the expansion of strict tort liability. See Leebron, supra note 71, at 1587. In fact, the direction of causation may run the other way: strict liability has expanded because the development of limited liability ameliorated its burdens. Normatively, as discussed in Section III(A)(3) supra, limited liability may even be a necessary antidote to the excesses of strict tort liability.

135. See Robert B. Thompson, Piercing the Corporate Veil: An Empirical Study, 76 CORNELL L. REV. 1036 (1991). It is not clear what kinds of cases were classified as "tort" and "contract." It seems likely that the "tort" classification included at least some cases of voluntary dealing, since the author identified a category of "tort" cases involving misrepresentation.

136. See id. at 1068.

137. Id. at 1072.

138. See supra note 111.
nomic efficiency. 139

D. Involuntary Creditors and Limited Liability Companies

Even if limited tort liability produced a net social loss, it still does not follow that regulation should slow the expansion of limited liability through LLCs. First, any externalities resulting from limited liability are better addressed by industry-specific regulation than by a general restriction on the availability of limited liability that could be readily evaded by the worst offenders. 140

Second, the restrictions on LLCs protect creditors only if these restrictions affect the level of the firms' precautions or their ability to pay claims. But corporate statutes imposing a norm of centralized management do not provide for manager liability to creditors. The only connection between management form and tort liability is that nonowner managers are creditors of the firm and therefore are more likely to run the firm in the creditors' than in the owners' interests. But corporate statutes require only a board of directors and not nonowner managers. In any event, firms readily can avoid these rules by adopting the close corporation form. The difficulties close corporation statutes impose, particularly including filing requirements, may be inconvenient for owners, but do nothing for involuntary creditors who do not see the filings.

The only inhibition on LLCs that might make sense in protecting tort creditors is the tax penalty on limited liability. But as discussed in the next Part, this approach is deeply flawed. 141

IV. Partnership As A Tax Classification

This Article has shown why partnership will not and should not survive as a standard form contract that provides for unlimited liability to creditors. This Section considers whether partnership should survive as a tax classification.

The tax classification system determines whether a business is taxed on a "flow-through" basis, with income taxed directly to the owners and losses deductible against owners' income, 142 or whether income is taxed to the business when earned, with subsequent distributions taxed again at

140. See supra text following note 111.
141. See Section IV (C)(1) infra.
142. Deductibility of losses is subject to limitations, including the rule that losses incurred by
the owner level. A business is considered a partnership under Sub-
chapter K of the Internal Revenue Code if it is not a "corporation," a
term that includes "association." In Morrissey v. Commissioner, the
Court approved a test for determining "association" status based on "re-
semblance" to corporations. The current "resemblance" test set forth
in the Kintner Regulations provides that a business organization is a
corporation and not a partnership if it has at least three of the follow-
ing characteristics: Continuity of life, centralized management, limited
liability, and free transferability of interests.

Subsection A shows that there is no normative basis for the tax distinc-
tion between "corporations" and "partnerships." Subsection B shows
that the classification is unsuitable as an arbitrary line because it entails
significant costs. Subsection C demonstrates that, even assuming the tax
system does not move to an integrated approach in which all business
entities are treated alike, there are viable alternatives to the partnership-
corporation classification.

A. Absence of Normative Basis for the Classification System

The fundamental flaw of the classification system is that it attempts to
base a mandatory federal classification on an essentially contractual
state-law system. Under state law, the parties can draft freely for "part-
nership" and "corporate" features regardless of which standard form
they select. Accordingly, there is no state-law justification for basing
tax consequences on the parties' choice of label or terms. The question is
whether there is some independent federal tax related basis for attaching
these consequences to particular labels or terms.

investors who are not active in the business (i.e., "passive losses") cannot be deducted against non-
"passive" income. See I.R.C. § 469.

143. See I.R.C. § 7701(a)(3) (definition of "corporation"); I.R.C. § 7701(a)(2) (definition of
"partnership").
144. 296 U.S. 344 (1935).
145. Id. at 357.
146. The name refers to the case that prompted the regulations, United States v. Kintner, 216
F.2d 418 (9th Cir. 1954), in which the I.R.S. unsuccessfully sought to characterize a professional
corporation as a partnership.
147. Other characteristics determine whether the business is neither a corporation nor a
partnership.
148. See Treas. Reg. § 301.7701-2(a) (1991). For leading cases interpreting the Kintner Regula-
tions, see Zuckman v. United States, 524 F.2d 729 (Ct. Cl. 1975); Larson v. Comm'r, 66 T.C. 159
(1976).
149. For a comprehensive analysis of the extent to which corporate law is enabling, see Bernard
Congress never has explained the underlying basis of the tax distinction.\textsuperscript{150} Two rationales for the distinction are prominent in the case law and literature.\textsuperscript{151} The first is that a corporation is regarded as inherently an entity that should be treated separately from the members for tax purposes, while a partnership is inherently an aggregate of the partners so that income associated with the business should be attributed directly to the partners.\textsuperscript{152}

This reasoning is deeply flawed.\textsuperscript{153} Partnerships cannot accurately be described as "aggregates" because they have many "entity"-features. For example, partnerships can hold title\textsuperscript{154} and most ownership rights to property,\textsuperscript{155} and partners can act on behalf of the partnership.\textsuperscript{156} Indeed, the current draft of the \textit{Revised Uniform Partnership Act} attempts to eliminate confusion over this issue by defining a partnership as an "entity."\textsuperscript{157} But even this "clarification" is misleading because, despite it, a partnership has both aggregate and entity features. More generally, whether the business has particular "aggregate" or "entity" features, in-

\begin{itemize}
  \item \textsuperscript{151} Other suggested justifications for the corporate tax are not only weak, but offer no basis for distinguishing between corporations and partnerships:
    \begin{enumerate}
      \item The tax controls corporations' monopoly power and size. See Goode, \textit{supra} note 17, at 38-39. Even if it is sensible to use a tax for this purpose, the form of organization is only a weak proxy for size and monopoly power. See Richard A. Musgrave & Peggy B. Musgrave, \textit{Public Finance in Theory and Practice} 374 (5th ed. 1989).
      \item The tax is justified by corporations' superior ability to pay tax out of the "excess" profits of the corporate form. But firms produce rents regardless of how they are organized. In any event, this basis of the tax has been criticized even as applied to corporations. See Anthony B. Atkinson & Joseph E. Stiglitz, \textit{Lectures on Public Economics} 132 (1987) (tax base includes the cost of capital); Goode, \textit{supra} note 17, at 33-34 (attacking utilitarian assumptions on which the argument is based); Paul Studenski, \textit{Toward a Theory of Business Taxation}, 48 J. Pol. Econ. 621 (1940) (noting the difficulty of structuring an excess profits tax).
      \item The tax compensates for the cost of state regulation and services that benefit business generally. See Goode, \textit{supra} note 17, at 30-32; Studenski, \textit{supra}. But, once again, corporations cannot properly be distinguished from other firms on this ground.
    \end{enumerate}
  \item \textsuperscript{153} For other critiques of the entity-aggregate reasoning see Rudnick, \textit{supra} note 150, at 1049-57; Larry E. Ribstein, \textit{An Applied Theory of Limited Partnership}, 37 \textit{Emory L.J.} 835, 872-73 (1988).
  \item \textsuperscript{154} See \textit{Uniform Partnership Act} §§ 8(3), 10(1) (1914).
  \item \textsuperscript{155} See \textit{Uniform Partnership Act} § 25 (1914).
  \item \textsuperscript{156} See \textit{generally}, 1 Bromberg & Ribstein, \textit{supra} note 27, § 1.03.
  \item \textsuperscript{157} \textit{Rev. Uniform Partnership Act} § 201 (1991 Draft).
\end{itemize}
cluding tax treatment, should be based on the inherent desirability of these features rather than on whether the firm "is" an "entity" or an "aggregate."

The second rationale for the tax distinction is that the corporate tax is essentially an excise tax on benefits the state confers on corporations by according them the special privileges of doing business in the corporate form.\(^\text{158}\) Upholding a 1909 corporate tax as not violating the then-existing constitutional prohibition of an individual income tax, the Supreme Court stated:

[T]he tax is laid upon the privileges which exist in conducting business with the advantages which inhere in the corporate capacity of those taxed, and which are not enjoyed by private firms or individuals. . . . The continuity of the business, without interruption by death or dissolution, the transfer of property interests by the disposition of shares of stock, the advantages of business controlled and managed by corporate directors, the general absence of individual liability, these and other things inhere in the advantages of business thus conducted, which do not exist when the same business is conducted by private individuals or partnerships.\(^\text{159}\)

The "special-privileges" rationale is no more sensible than the entity-aggregate distinction. In the first place, there is no reason to believe that the corporate tax properly measures the value of any benefit from corporate features.\(^\text{160}\) Firms adopt either corporate or partnership features after weighing their costs and benefits in light of the nature of the firm's business.\(^\text{161}\) Corporate features, therefore, are no more inherently "benefits" for a corporation than are partnership features for a partnership.

158. For commentary advocating a "benefits" theory of the corporate tax, see Goode, supra note 17, at 27-29; Studenski, supra note 151.


160. See Goode, supra note 17, at 28. There are other problems with the "benefit" theory. It is not clear how supposed state-conferred benefits, including limited liability, can justify the federal corporate tax. Also, even assuming the "benefits" of corporate features could be measured, it is not clear why they should carry a price tag, unless it is costly for society to produce them. See Musgrave & Musgrave, supra note 151, at 373-74 (criticizing "benefits" theory in part on this ground). For a critical evaluation of the argument that the corporate tax justifiably compensates for the social cost of limited liability, see infra Section IV (C)(1).

More importantly, the "benefit" theory is unsound because the tax is not actually based on any "special privilege" of incorporation. All but one of the supposed "privileges" of incorporation the Supreme Court listed are clearly available by contract to partnerships, and all can be negated by corporations.

Limited liability is the one corporate "privilege" that could be considered a "special privilege" of incorporation. As this Article has shown, limited liability is an attractive feature for most firms. Moreover, limited liability is not clearly available to noncorporations by contract. Perhaps for this reason, limited liability is the feature that best identifies "corporateness" and has been singled out by some commentators as the most important corporate tax characteristic. But limited liability, rather than determining corporate tax treatment, is merely listed to-

162. See Alvin L. Warren, Jr., The Corporate Interest Deduction: A Policy Evaluation, 83 YALE L.J. 1585, 1600 n.72 (1974) (questioning "benefits" argument in part on the ground that the supposed benefits are available to all).

163. See supra text accompanying note 159.

164. See Ribstein, supra note 18, at 89-91.

165. Corporate shareholders can guarantee the firm's debts and enter into agreements among themselves restricting transferability of shares and providing for dissolution at will and decentralized management. See infra text accompanying note 172.

166. See supra Section II.

167. Even this is questionable. For a discussion of the parties' ability to obtain limited liability by contract without incorporation, see Ribstein, supra note 18, at 112-27.

168. See supra note 5 and accompanying text. Note, however, that limited liability was not part of the corporate form in its early states. See Phillip I. Blumberg, Limited Liability and Corporate Groups, 11 J. CORP. L. 573 (1986); Oscar Handlin & Mary Flug Handlin, Origins of the American Business Corporation, 5 J. Econ. Hist. 1 (1945).

For a contrary view on the importance of limited liability to the classification system, see AMERICAN LAW INST., FEDERAL INCOME TAX PROJECT—SUBCHAPTER K: PROPOSALS ON THE TAXATION OF PARTNERS 386 (1984) (asserting that limited liability alone should not be regarded as a sufficient reason for imposing corporate tax treatment). This view is not necessarily inconsistent with the point in the text, which simply is that limited liability should be regarded as important if the system is based on some conceptual difference between "partnership" and "corporation."

Limited liability arguably is also a distinctively "entity" feature that is closely associated with the entity basis for tax classification. However, even partnership-type unlimited liability has the entity feature that creditors in many states must first exhaust partnership assets before proceeding against the partners' individual assets. See supra note 65.

The arbitrariness of the corporate-partnership classification is demonstrated by the I.R.S.'s unwillingness to allow the same factors that make a "partnership" a tax "corporation" to work in reverse to make a close "corporation" a "partnership." Close corporations offer limited liability together with "partnership" features such as restricted transferability and decentralized management. The federal classification system seems to compel treating a close "corporation" that adopts these features as a tax "partnership." Yet this would be inconsistent with the state law on which the federal system supposedly is based, which treats a "corporation" as any firm organized under the state's corporation statute.

A General Counsel Memorandum initially declined to apply either the four-factor test or the state's label, and instead derived the relevant corporate features from Justice Marshall's ancient opinion in Dartmouth College v. Woodward. The Memorandum states:

If an organization is to qualify as a corporation in this context, we believe that it: (1) must be a legal entity; (2) must derive its existence from a charter granted by a sovereign; and (3) must be able to maintain its existence and identity throughout a continually occurring succession of persons that have interests in it.

Perhaps realizing the pitfalls of establishing a second tax definition of

---

170. Limited partnerships were characterized initially as associations, based on the limited partners' limited liability, in a 1916 regulation that was reversed in 1918 and replaced by a multi-factor resemblance test. See John J. Sexton & Donald F. Osteen, Classification as a Partnership or an Association Taxable as a Corporation, in 24 Tulane Tax Inst. 95, 106-07 (1975). The final break from limited liability came when the Service withdrew its earlier proposal classifying LLCs as corporations solely on the basis of limited liability of all members. See supra note 51.

Note, however, that limited liability is a significant tax classification factor because firms that adopt limited liability must "pay" for it by adopting features that probably are net tax detriments. See infra Section IV (B)(1). For a discussion concluding that limited liability should not determine tax classification see infra Section IV(C)(1).

171. A similar question of whether labels or characteristics control is raised by the new Texas "registered limited liability partnership," which offers limited liability through the general partnership form. See infra note 205 and accompanying text.

172. See, e.g., Model Business Corporation Act § 7.32 (1985) (permitting agreements providing for all of these features).


174. It would also be inconsistent with Subchapter S of the Internal Revenue Code, which is intended as the only way a "corporation" can obtain flow-through tax treatment.


"corporation" for close corporations, the General Counsel later declined to apply either the four-factors test or standards derived from *Dartmouth College* as "a separate set of tests." 178

In short, the I.R.S. could neither apply its existing rule to close corporations nor provide a coherent alternative rule. This sort of dilemma flows naturally from the lack of a clear normative basis for the current classification rules.

**B. Cost of the Tax Classification System**

This Section shows that the partnership-corporation classification system not only lacks any discernable tax-related justification, but also is costly. The costs of the partnership-corporation classification system arise out of the parties' incentives in the face of the tax consequences of choice of form. Under the partnership-corporation classification system, parties to firms can choose to either (1) avoid the excess ("T") of two-tier over one-tier taxation by forming a Subchapter S Corporation, adopting two of the "partnership" features—unlimited liability, restrictions on transferability, dissolution at will and decentralized management—or by forming a taxable corporation but shifting to tax-deductible labor or capital inputs; 179 (2) bear the two-tier tax with reduced profits; or (3) shift the tax through higher consumer prices or lower supplier costs. 180 This

---

178. Gen. Couns. Mem. 37,953 (May 14, 1979). Note that these Memoranda in effect leaned in favor of state labels over uniformity in a context in which the labels resulted in two-tier taxation but in which incorporation might have facilitated some tax deductions, as for pension payments. LLCs present the converse situation: the state's "noncorporate" label supports single-tier taxation.

179. As to these substitution effects of the corporate tax, see Atkinson & Stiglitz, *supra* note 151, at 173-87 (discussing incidence of corporate tax in connection with general discussion of tax incidence); Joseph A. Pechman, *Federal Tax Policy* 153 (5th ed. 1987) (effect of corporate tax depends on the "degree to which the noncorporate form of doing business can be substituted for the corporate form and production can be transferred from capital-intensive to labor-intensive industries"); Posner, *supra* note 139, at 459 (corporate tax gives firms the incentive to employ deductible debt or labor or to switch to noncorporate forms of business organization); Arnold C. Harberger, *The Incidence of the Corporation Income Tax*, 70 J. Pol. Econ. 215-40 (1962) (a leading article discussing the effects of corporate tax in shifting capital to noncorporate sector). If the forms of financing or organization are not perfectly equivalent for a given type of production, this may cause capital to flow to different forms of production that offer better risk-adjusted returns.

Note that the two-tier tax influences many other financial decisions, depending on current tax rules and rates, including acquisitions or the form in which earnings are returned to shareholders (e.g., by dividends or share repurchase). These effects are ignored here because they are not particularly relevant to classification of business enterprises.

Section discusses the costs associated with the first type of strategy that result from the corporate-partnership distinction.

It is important to keep in mind that an extra firm-level tax, irrespective of the basis of the classification, necessarily affects the allocation of resources by increasing firms’ capital costs or consumers’ product costs as compared with the costs in the absence of the tax. For example, if the tax is shifted to consumers, this may, among other effects, reduce consumer demand for the corporation’s product, and therefore the corporation’s demand for inputs. Indeed, any tax, however structured, can lead to some distortion. Accordingly, it is important to show, as this Article does in Section IV(C), how an alternative classification system may lead to less costly distortion.

1. Perverse Choice of Governance Rules

Substituting “partnership” for “corporate” features may cause a firm to incur extra agency or other governance costs (“G”) that it would not incur without the tax classification. A firm will incur these costs if \( G < T \) (the extra amount of any two-tier tax), as when the firm only must make some minor governance adjustment to receive one-tier tax treatment. The firm effectively receives a tax subsidy for incurring extra governance costs. Because these costs neither transfer nor produce resources, they are a deadweight cost of the tax-classification system.

a. Limited Liability

Because limited liability may be beneficial for many firms even after considering higher credit costs, it is often costly for a firm to give up limited liability for tax benefits. As a result, many firms will adopt limited liability now that they can do so and still receive partnership tax treatment. However, despite the increased availability of single-tier taxation for limited-liability firms, the two-tier tax continues to penalize limited liability. Because limited liability single-tier firms must negate at least two of the other three “corporate” characteristics, limited liability increases the importance of these other factors. At the same time, as discussed in this Subsection, the other classification features often are net detriments for firms that adopt limited liability.

181. See generally supra Section II.
b. Continuity of Life

The Kintner Regulations provide that the organization lacks the corporate characteristic of continuity of life if the death, insanity, bankruptcy, retirement, resignation, or expulsion of a member causes dissolution, even if the members can agree to continue the business after a member's dissociation.\footnote{182} Thus, the regulations seem to emphasize the partners' power to cause at least a technical dissolution.\footnote{183} But the regulations also provide that there is no continuity if the firm continues only upon unanimous agreement.\footnote{184} Thus, it is not clear whether a firm must have a unanimity provision to lack continuity of life.\footnote{185}

The continuity-of-life factor has been applied to LLCs.\footnote{186} Indeed, the I.R.S. has answered the unanimity question in the LLC context by ruling that a Florida LLC had continuity of life when the members could continue the business by only a majority, rather than a unanimous, vote.\footnote{187} Accordingly, LLC members have a tax incentive to provide by agreement, or to form under a statute that provides (1) for dissolution on dissociation of a member; and (2) that the business can be continued after dissociation only by unanimous vote of the remaining members.

These tax incentives to provide for discontinuity are inconsistent with the inefficiency of such rules in many LLCs. It is undoubtedly important for some closely held firms to provide for liquidity by letting owners cash out of the firm at will and to resolve potential problems of valuation and continuing liability problems by giving the dissociating partner the power to compel sale of assets and payment of liabilities.\footnote{188} But these rights can be costly because they facilitate opportunistic conduct by dissociating partners.\footnote{189} Requiring unanimity for continuation is particularly costly

\footnote{182. Treas. Reg. § 301.7701-2(b)(2) (1991).}
\footnote{183. For recognition that the power to dissolve prevents continuity of life despite an agreement to continue, see Zuckman v. United States, 524 F.2d 729 (Cl. Ct. 1975) (no continuity despite contract not to dissolve entered into with creditor); Foster v. Comm'r, 80 T.C. 34 (1983); Larson v. Comm'r, 66 T.C. 159, 173-74 (1976).}
\footnote{184. Treas. Reg. § 301.7701-2(b)(2) (1991).}
\footnote{185. For a ruling that a royalty trust lacked continuity although only a majority vote of members (together with a unanimous vote of the managers) was enough to continue the business following dissolution, see Rev. Rul. 88-79, 1988-2 C.B. 361, 1988-38 I.R.B. 17.}
\footnote{186. See Rev. Rul. 88-76, 1988-2 C.B. 361; Gazur & Goff, supra note 36, at 447-50.}
\footnote{187. See Priv. Ltr. Rul. 90-10-027 (Dec. 7, 1989).}
\footnote{188. See Larry E. Ribstein, A Statutory Approach to Partner Dissociation, 65 WASH. U. L.Q. 357 (1987).}
\footnote{189. Id. at 384-89, 393-95. Moreover, even if the benefits of the cash-out right outweigh the costs, the parties may want to avoid the potentially costly discontinuity associated with a technical
because of the negotiation costs involved in continuing the business.\textsuperscript{190}

These costs of discontinuity, however, probably are not worth the benefits in a limited liability firm. Continuation of the firm after partner disassociation is significantly less costly in limited liability than in unlimited liability firms because the departing member or estate need not be concerned with whether the firm pays continuing liabilities, and continuing members need not worry about increased exposure to liability resulting from the departure of a member.

c. Free Transferability

The Kintner Regulations provide that a firm does not have the corporate characteristic of free transferability if a member cannot assign management rights (as distinguished from a right merely to participate in profits) without the consent of the other general partners.\textsuperscript{191} This rule has been applied to LLCs.\textsuperscript{192} Moreover, even if a firm has no other corporate characteristics, it is usually treated as a corporation if it has interests that are traded or are "readily tradable."\textsuperscript{193} Thus, a firm with truly liquid interests generally cannot be taxed as a partnership, and a limited liability firm with relatively illiquid but legally transferable interests cannot be taxed as a partnership unless it lacks both centralized management and continuity of life.

Transfer restrictions may be appropriate in a closely held firm because members are concerned with who their associates are, with how control is allocated, and with conflicts of interest that new members may introduce.\textsuperscript{194} General partners also may be concerned about admitting new

\textsuperscript{190} For a discussion of the escalation in decisionmaking costs associated with requiring a high percentage vote for approval, see James Buchanan & Gordon Tullock, \textit{The Calculus of Consent} 105-09 (1962).


\textsuperscript{194} On the latter point, see William J. Carney, \textit{The Theory of the Firm: Investor Coordination Costs, Control Premiums and Capital Structure}, 65 WASH. U. L.Q. 1 (1987) (investors may have different preferences concerning financial policies such as the timing of distributions). For a discus-
members who can recklessly incur new liabilities for which the members are personally responsible.

This emphasis on illiquidity, however, has significant governance costs since it is expensive to secure unanimous agreement to transfers and to give members hold-up powers they can use opportunistically. As with continuity of life, these costs are unlikely to outweigh the benefits for limited liability firms because limited liability members have significantly less reason than individually liable owners to care who their co-members are. Nevertheless, as discussed below, a liquidity test for flow-through treatment focusing on marketability rather than consent restrictions does have some merit.

d. Centralized Management

The Kintner Regulations provide that a firm has the corporate characteristic of centralized management if any person or subgroup of members has exclusive management authority. This factor does not appear to involve a significant problem for LLCs, given the other factors discussed above. An LLC that adopts limited liability must lack either continuity of life or free transferability, and thus almost necessarily will be closely held. Owners of a closely held firm ordinarily prefer to participate directly in management because they cannot easily protect themselves from mismanagement by selling their shares in an efficient market.

Decentralized management may, however, involve significant governance costs even in a closely held firm. First, members of such a firm may wish to be passive, consistent with a strategy of holding a diversified portfolio of investments. Indeed, one of the most important advantages of

195. In Frandsen v. Jensen-Sundquist Agency, Inc., 801 F.2d 941 (7th Cir. 1986), Judge Posner reasoned that the rule against restricting transfer in close corporations was based on the higher costs of securing agreements to transfer. He expressed these costs mathematically in terms of an n-member set as n(n-1)/2. For the similar problem in connection with continuation agreements, see supra text accompanying note 190.

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

197. However, as discussed in the next subsection, decentralized management may give even limited liability members an incentive to screen co-members.

198. See infra Section IV(C)(3).

limited liability is that it facilitates separation of management and risk bearing.\(^{200}\)

Second, centralized management meshes well with dissolution at will, which many closely held firms are likely to adopt, particularly in light of the tax-classification factors. Members' ability to dissolve the firm at will gives them an effective veto power that decreases the benefit of having a direct say in the firm's decisions.

Third, even if members might want some role in management, they may have an even greater desire that their co-members be passive. The partnership model of decentralized management generally means that each owner is, in effect, an agent of the firm who can bind the firm to contracts and torts.\(^{201}\) Giving members the power to bind the firm may necessitate costly monitoring, bonding, and screening of members.

Because of these costs of decentralized management, members of limited liability firms may prefer to adopt centralized management. Not surprisingly, therefore, LLC statutes at least permit LLCs to be managed by elected managers.\(^{202}\) One LLC statute even mandates centralized management.\(^{203}\) But an LLC that adopts centralized management must accept either corporate tax treatment or stringent, and possibly costly, constraints on both transferability and continuity of life.

2. Risk and Uncertainty

In addition to encouraging perverse governance choices, the attempt to identify "partnership" or "corporation" features results in costly uncertainty because tax rules cannot categorize the nearly infinite number of possible agreements into which the parties can enter under state law. This problem results from trying to fit a scheme of federal uniformity into one of state contractual variation. The more the uncertainty about classification, the greater the volatility of after-tax cash flows of firms seeking "partnership" classification. It is costly for risk-averse investors

\(^{200}\) See Ribstein, *supra* note 18, at 105 (discussing this as an advantage of limited liability even in closely held firms).

\(^{201}\) See UNIFORM PARTNERSHIP ACT §§ 9-14 (1914). This is a feature of many LLC statutes. See infra note 202. Indeed, giving all members the power to bind may be necessary to avoid the "corporate" feature of centralized management. See infra text following note 215.


\(^{203}\) See COLO. REV. STAT. § 7-80-401 (Supp. 1990).
to assume this risk or to attempt to reduce it by diversification. The uncertainty also affects lawyers, who are exposed to potential malpractice liability as a result of frustrated client expectations concerning tax classification. Following are some examples of the uncertainty inherent in each classification factor.

a. Limited Liability

Although this characteristic seems to be clear, it is not. It is uncertain whether it is present for owners who adopt a limited liability standard form but give personal guarantees. Conversely, it is unclear whether a "partnership" lacks limited liability if it wholly or partially opts out of unlimited liability. Even if creditors enter into nonrecourse contracts with all voluntary creditors, they would still be exposed to tort liability. More recently, Texas has made it possible for partners partially to limit their personal liability for co-partners' torts by forming a "registered limited liability partnership." It is not clear whether a nominal partnership that only partially limits liability has "corporate-type" "limited liability."

b. Continuity of Life

It is uncertain whether a firm has continuity if the parties can continue the business by less than a unanimous vote after member dissociation.

---

204. As discussed supra at notes 68-72, many closely held firms might prefer this form of limited liability.

205. See Tex. Rev. Civ. Stat. Ann. art. 6132b §§ 2, 15, 45-A to 45-C (West Supp. 1992). Section 15(1) provides that partners are jointly and severally liable for partnership debts and obligations, except as provided by § 15(2). Id. §§ 15(2) and (3) provide:

(2) A partner in a registered limited liability partnership is not individually liable for debts and obligations of the partnership arising from errors, omissions, negligence, incompetence, or malfeasance committed in the course of the partnership business by another partner or a representative of the partnership not working under the supervision or direction of the first partner at the time the errors, omissions, negligence, incompetence, or malfeasance occurred, unless the first partner:

(a) was directly involved in the specific activity in which the errors, omissions, negligence, incompetence, or malfeasance were committed by the other partner or representative; or

(b) had notice or knowledge of the errors, omissions, negligence, incompetence, or malfeasance by the other partner or representative at the time of occurrence.

(3) Paragraph (2) does not affect the joint and several liability of a partner for debts and obligations of the partnership arising from any cause other than those specified in paragraph (2).

206. See supra text accompanying notes 183-85.
Even if this question were settled in favor of continuity of life, it still would not be clear what would happen if the parties agreed that the firm could be continued following member withdrawal only by unanimous vote, if the agreement also prohibited dissociation, backed up by specific enforcement or heavy liquidated damages.\textsuperscript{207} Indeed, the \textit{Uniform Partnership Act} itself penalizes partner dissociation prior to expiration of an agreed term or completion of an agreed undertaking.\textsuperscript{208} The courts have held that there is no continuity of life as long as there is a power to dissolve, even if there is no right to do so.\textsuperscript{209} But the firm nevertheless might have continuity of life if the penalties made the “power” illusory. Similarly, the firm may or may not have continuity of life if the members can withdraw at will but have pre-agreed to vote for continuation of the firm after withdrawal, subject to enforcement by injunction or severe penalties, or if the members have given a binding power of attorney to the co-members to vote for continuation.

c. \textit{Free Transferability}

Questions similar to those just discussed concern the tax effect of provisions in the parties’ operating agreement that bind the partners, subject to significant penalties or specific performance, to vote for transfers. There is also a question whether an interest has been fully transferred if it has been assigned and the assignee has significant management-type rights to information and to compel dissolution.

d. \textit{Centralized Management}

This “corporate” feature raises particularly troublesome questions.

\textsuperscript{207} There is some question whether an agreement to continue in a partnership is specifically enforceable. \textit{See Infusaid Corp. v. Intermedics Infusaid, Inc.}, 739 F.2d 661 (1st Cir. 1984) (refusing to allow withdrawal from joint venture); \textit{Robert W. Hillman, Indissoluble Partnerships}, 37 U. FLA. L. REV. 691 (1985). Even if such an agreement is not specifically enforceable, perhaps an agreement not to withdraw from an LLC or other limited liability firm should be, as long as this does not require judicial supervision of an agreement to perform personal services. The reason for the distinction is that in an LLC, unlike a partnership, mandating continuation does not force the member to continue being personally liable for the firm’s debts, which might entail an indefinite investment of human capital in monitoring. \textit{See Ribstein, supra} note 188, at 378-79 (discussing this basis of the dissolution-at-will rule). Specifically enforcing continuation of an LLC is, in effect, no different from prohibiting the members from cashing out—a right they would not have in a standard-form corporation.

\textsuperscript{208} \textit{See UNIFORM PARTNERSHIP ACT § 38(2) (1914) (prematurely dissolving partner subject to damages and not entitled to share of firm’s goodwill).}

\textsuperscript{209} \textit{See supra} note 183.
There is centralized management in a limited partnership "if substantially all the interests in the partnership are owned by the limited partners." The I.R.S. will rule that a limited partnership has centralized management if the limited partners' interests exceed eighty percent of the total partnership interests. But the I.R.S. ruled that a twenty-five-member LLC managed by three of its members had centralized management without specifying what percentage interest the managers owned. Thus, the limited partnership eighty-percent rule may not apply to LLCs.

The limited partnership rule arguably should not be applied to an LLC with designated managers, since LLC members, unlike limited partners, generally can participate in day-to-day control even if some power is delegated to member-managers. If the rule is not applied in this situation, the LLC has centralized management if the LLC statute or operating agreement explicitly places all management power in the managers. But the result is unclear if there are managers whose power is restricted, or if managers have plenary power but any member can bind the firm, or if there are no designated managers but only a few of the members have the right or power to bind the firm.

Similar questions arise even if the limited partnership eighty-percent-

213. See REVISED UNIFORM LTD. PARTNERSHIP ACT § 303 (1985) (limited partner may be liable for participating in control). The rule is based on the personal liability of the general partners. For criticism of the rule, see Joseph J. Basile, Jr., Limited Liability for Limited Partners: An Argument for the Abolition of the Control Rule, 38 VAND. L. REV. 1199 (1985); Ribstein, supra note 34, at 48-52. One state has abolished the "control rule." See GA. CODE ANN. § 14-9-303 (Michie 1988).
214. The Colorado statute requires the LLC to be managed by managers, but does not prohibit the firm from making some or all of its members managers. See COLO. REV. STAT. § 7-80-401 (Supp. 1990). The Texas statute provides for management by members unless the LLC's regulations provide otherwise. See TEX. REV. CIV. STAT. ANN. art. 61326 § 2.12 (West Supp. 1992). The other LLC statutes provide for management by members unless the members agree otherwise. See FLA. STAT. § 608.422 (Supp. 1989); KAN. STAT. ANN. § 17-7612 (Supp. 1990); NEV. REV. STAT. ANN. § 86.291 (1991); UTAH CODE ANN. § 48-2b-125(2) (Supp. 1991); VA. CODE ANN. § 13.1-1024 (Michie Supp. 1991); Wyo. STAT. § 17-15-116 (1977).
215. Under some statutes, members automatically have the power to bind the firm. See FLA. STAT. § 608.424(2) (Supp. 1989); TEX. CIV. STAT. ANN. art. 6132b § 2.10(2) (West Supp. 1992); UTAH CODE ANN. § 48-2b-125(1) (Supp. 1991); Wyo. STAT. § 17-15-117 (1977). Under other statutes the members have only the power to bind provided for in the articles of organization or operating agreement. See KAN. STAT. ANN. § 17-7613 (Supp. 1990); NEV. REV. STAT. ANN. § 86.301 (1991).
rule is generally applied to LLCs because the rule would not apply to LLCs in which there is no delegation to managers.\textsuperscript{216} Thus, it would have to be determined when the LLC's management passed the threshold for centralization—for example, when the members have merely delegated some ministerial power to managers.

3. \textit{Loss of Drafting Flexibility}

Firms cannot easily reduce the uncertainty discussed in Subsection 2. Until the I.R.S. rules generally on an issue, the firms must obtain "private letter" rulings.\textsuperscript{217} But these rulings are expensive, result in significant delay,\textsuperscript{218} and lack precedential value.\textsuperscript{219}

Alternatively, state legislatures can reduce uncertainty by enacting mandatory provisions designed to ensure that all firms formed under the statute receive partnership tax classification without risk of error, or by conforming their statutes to uniform laws that have received a partnership-classification ruling. These responses to the tax-classification system reduce firms' ability to adapt terms to specific circumstances and reduce innovation by firms and state legislatures.\textsuperscript{220}

Indeed, this has been the dominant legislative strategy concerning LLCs. Unlike limited partnerships, whose tax classification is relatively settled by a long history of public and private rulings, LLCs have only a relatively limited tax history as tax "partnerships."\textsuperscript{221} Thus, there is more uncertainty in LLCs than in limited partnerships concerning such

\textsuperscript{216} See Priv. Ltr. Rul. 90-10-027 (December 7, 1989) (no centralized management in LLC that did not provide for a manager).

\textsuperscript{217} The Service may issue a general ruling on, for example, a particular LLC statute, but this ruling may not be very useful if the statute permits variations and the Service has not ruled on the effect of adopting these variations.

\textsuperscript{218} Based on anecdotal information and an informal study of private letter rulings, the time from request to issuance is around six months.


\textsuperscript{220} For example, firms formed pursuant to the \textit{Revised Uniform Limited Partnership Act} are tax partnerships. But there is a question whether a state statute that is slightly different will receive this classification. For a 1989 listing of such statutes deemed to conform with \textit{REVISED UNIFORM LTD. PARTNERSHIP ACT}, see Rev. Rul. 89-123, 1989-2 C.B. 261. The Georgia version, which became effective in April 1988, remained for three years in a sort of tax limbo awaiting a ruling that it was similar to the \textit{REVISED UNIFORM LTD. PARTNERSHIP ACT} despite its rejection of the "control rule." The ruling finally came in September 1991. \textit{See Rev. Rul. 91-51, 1991-38 I.R.B. 4}. Indeed, this uncertainty about the tax status of the control rule may have been at least partly responsible for the development of LLCs, which are very similar to limited partnerships without a control rule.

\textsuperscript{221} See supra note 170.
matters as centralized management and limited liability. To compensate for the limited tax guidance, the LLC statutes are more rigid concerning some corporate characteristics than limited partnership statutes.

The two most important examples of LLC rigidity concern transferability and continuity. Under most of the LLC statutes enacted to date, a transferee of an interest does not obtain full management rights, as distinguished from merely financial rights, unless the non-transferring partners consent to the transfer. Although the Revised Uniform Limited Partnership Act also conditions transfer of management rights on unanimous agreement by the non-transferring partners, that Act, unlike the LLC statutes, lets the partners "pre-agree" to transfer in the partnership agreement. Accordingly, most LLC statutes help ensure that firms organized under the statute will lack the "corporate" tax feature of free transferability of interests. Similarly, while most LLC statutes provide that the firm continues following dissociation of a member only if the remaining members unanimously consent to continuation, the

---

222. See, e.g., Rev. Proc. 89-12, 1989-1 C.B. at 798-801. See supra text accompanying note 211 (providing guidance as to the circumstances in which I.R.S. will rule in favor of partnership tax classification of limited partnership).


224. See Revised Uniform Ltd. Partnership Act § 401 (1985) (admission of general partner); id. § 704 (right of assignee of limited partnership interest to become limited partner).

225. This is true of all but the Texas statute cited supra note 223.

226. See Revised Uniform Ltd. Partnership Act § 401 (1985) (additional general partners may be admitted "as provided in writing in the partnership agreement"); id. § 704 (assignor may give assignee of limited partnership interest the right to become a limited partner "in accordance with authority described in the partnership agreement"). Although § 401 only refers to "additional" general partners, any question that the same rule applies to a transfer of interests is eliminated by § 18 of the Uniform Partnership Act, which provides: "subject to any agreement between [the partners] ... (g) No person can become a member of a partnership without the consent of all the partners." Uniform Partnership Act § 18 (1914). "Agreement" in the lead-in to the section obviously is not limited to the contemporaneous "consent" provided for in subsection (g). The Uniform Partnership Act applies to limited partnerships to the extent that there is no inconsistent limited partnership act provision. See id. § 6(2); Revised Uniform Ltd. Partnership Act § 1104 (1985). For an argument that a contemporaneous consent requirement existed under the prior version of the Uniform Limited Partnership Act, see Joseph J. Basile, Jr., Admission of Additional and Substitute General Partners to a Limited Partnership: A Proposal for Freedom of Contract, 1984 Ariz. St. L.J. 235. For another discussion comparing LLCs and limited partnerships in this respect, see Gazur & Goff, supra note 26, at 414-15.

Uniform Limited Partnership Act provides that the business of a limited partnership may be continued pursuant to a written partnership agreement even without the partners' contemporaneous consent, as long as there is at least one remaining general partner. 228

C. Alternative Classification Systems

The absence of a normative basis for the partnership-corporation classification, coupled with a showing that the classification imposes significant costs, presents a powerful case against this system. But any attempt to identify firms that should be taxed on a two-tier basis is, perhaps, subject to the same criticisms. If so, the argument reduces to one over whether corporate and individual taxes should be integrated and the double tax eliminated. 229 In other words, as long as it is accepted that some firms will be taxed on a two-tier basis, the case against the current classification system is incomplete without a showing that there is some better method of distinguishing among firms. This Subsection examines three alternative classification methods suggested by modern arguments for the two-tier tax. 230

I. Limited Liability

Although limited liability is not now the determinative factor in distinguishing one- and two-tier firms, it is worth exploring whether it should be. First, a limited-liability-based test would at least reduce the costs discussed in Subsection B. Limited liability is the "corporate" feature that most clearly distinguishes between "corporations" and "partnerships." Because firms easily can contract for the other "corporate" terms, regardless of the standard form they adopt, the rules for determin-

For LLC statutes that permit the members to provide for continuation in their agreement, see FLA. STAT. § 608.441 (Supp. 1989); KAN. STAT. ANN. § 17-7622(3) (Supp. 1990); TEX. REV. CIV. STAT. ANN. art. 6132b § 6.01 (West Supp. 1992).

228. See Revised Uniform Ltd. Partnership Act § 801(4) (1985). For another discussion comparing limited partnerships and LLCs in this respect, see Gazur & Goff, supra note 36, at 420-24.


Saul Levmore suggests that single-tier taxation is not necessarily ideal. See Levmore, supra note 17, at 493-94. I agree. I only question whether the classification system should be based on the distinction between "partnerships" and "corporations" given that some firms are taxed on a two-tier basis.

230. For a critical discussion of some traditional reasons given for the two-tier tax, see supra note 151.
ing when these terms are "corporate" necessarily are complex, unpredictable, and costly to follow.

Second, it is important to evaluate the limited liability characteristic for a complete critique of the current system. A firm that adopts limited liability must be careful to reject two of the remaining three "corporate" characteristics if it wants partnership tax treatment. Because of the poor fit between limited liability and the partnership features,231 as well as the costs of unpredictability and uncertainty,232 the current system in effect induces firms either to adopt partnership-type unlimited liability or to adopt limited liability and forego the single-tier tax. Accordingly, the corporate tax can be considered the price of limited liability even under the current system, in which limited liability is not determinative.

Kose John, Lemma Senbet, and Anant Sundaram argue that a separate entity-level tax appropriately offsets the potential for over-investment in risky projects that results from limited liability.233 They point out that limited liability arose prior to corporate taxation to facilitate investment in risky projects. The development of capital markets provided an alternative risk-sharing mechanism such that incentives to take risk became excessive under limited liability and had to be counterbalanced by corporate taxation. The authors show how to design a tax system in which, even with a single set of tax rates, different technologies can be taxed differently through devices such as tax credits and deductions.234 They also show that the tax system actually displays some of these features.

There are several problems with this argument. First, it is unclear whether any externality results under unlimited liability, given the parties' incentives to insure and take care under limited liability, the potential problems with extended liability of shareholders, and the parties' ability to evade exposure under an unlimited liability regime.235 Second, reputational and other constraints on excessive risk taking probably will cause any externalities to differ even among businesses in the same activ-

231. See supra Section IV(B)(1)(b)-(d).
232. See supra Section IV(B)(2).
235. See supra Section III.
ity. As a result, the tax would have to be designed on a firm-by-firm basis. It is highly unlikely that merely human lawmakers could implement such a plan.

Third, even if a corporate tax could be designed to measure firms' excessive risk taking under limited liability, the measurement would be based on historical data concerning firms' risk-creating behavior. After paying the tax "price" of entering risky limited liability activities, firms would be as free to impose uncompensated risks as they are without the tax. The tax would be an effective constraint only if the government functioned as an insurer and engaged in monitoring, experience rating, and premium re-evaluation. There are significant problems in motivating government agents to perform these tasks adequately. Moreover, the results under federal deposit insurance should give some pause as to the desirability of using the corporate tax as an extensive federal insurance system covering creditors of all limited liability firms.

In short, the only normative reason for basing the two-tiered tax on limited liability is that a single-factor classification would reduce some of the perverse governance and unpredictability costs that exist under the present multi-factor system. As discussed below, there is a stronger case for making liquidity the single factor.

2. Private Ordering: The Corporate Tax and Agency Cost

Hideki Kanda and Saul Levmore argue that a two-tiered tax system reduces agency costs. They maintain that imposing a separate entity-level tax eliminates perverse incentives high-bracket owner managers might have under a single owner-level tax system to time asset dispositions to minimize their own tax liabilities. While the two-tier system

236. For a model of taxes on limited liability as an insurance system, see Anindya Banerjee & Timothy Besley, Moral Hazard, Limited Liability and Taxation: A Principal-Agent Model, 42 OXFORD ECON. PAPERS 46 (1990). The authors argue that taxes on limited liability should be distributed to creditors who could pass the subsidy back to managers in the form of a lower interest rate. The authors at first assert that the lower interest rate not only offsets the moral hazard effect of the taxes, but also further increases the managers' effort, leading to a reduced interest rate compared to limited liability without the tax. Id. at 54. But it is unclear how the subsidy to creditors can make the managers better off than they would be without any tax. Indeed, the authors later say that their argument "should not be taken as a vindication of the view that taxes should be higher in the presence of limited liability. We prefer to regard it as saying that a non-zero transfer to creditors is optimal." Id. at 57.

237. See infra Section IV(C)(3).

may give managers a tax incentive to delay distributions, the authors argue that asset-disposition decisions are more important than distribution decisions because the shareholders can create "homemade dividends" by selling and realizing capital gains, and because disposition decisions have a greater effect on real resource allocation than distribution decisions.\footnote{Kanda & Levmore, supra note 238, at 236-37.} Kanda and Levmore argue that parties will choose two-tier taxation when the agency costs of one-tier taxation, including the costs of contracts and other incentive devices designed to minimize these costs, exceed the extra tax and other costs of the corporate form.\footnote{Id. at 238-40.}

Although Kanda and Levmore purport to justify the current system, they fail to do so. The current system is based on a mandatory tax definition of the classification categories. In other words, firms can choose their tax status only by choosing the appropriate governance terms. Thus, owners who adopt particular governance terms may be forced to accept two-tier taxation whether they want it or not. Even if these terms relate to agency-cost protection, there is no reason not to let investors make the tradeoffs themselves. For example, partnerships with freely traded or tradable shares generally cannot elect to be taxed on a single-tier basis.\footnote{See infra note 246 and accompanying text.} While Kanda and Levmore argue that free transferability reduces agency costs connected with the firm's distribution policy, they concede that investors themselves could decide on one- or two-tier taxation after they have selected free transferability, rather than being forced by the tax system into a particular choice.\footnote{See Kanda & Levmore, supra note 238, at 252 n.90. In the same note, Kanda and Levmore argue that free transferability might relate to owners' control over distributions in the sense of enabling them to create "homemade dividends." However, the "control" explanation for two-tier taxation is incomplete. See id. Finally, Saul Levmore argues in his comment on my Article that tax rules must constrain firms from seeking "windfalls" through midstream changes. See Levmore, supra note 17, at 494. Even if this is a significant problem, Levmore nowhere shows how the partnership-corporation classification rules contribute to its solution.}

More importantly for present purposes, the Kanda-Levmore argument of giving distributees the power to control the timing of distributions, and therefore to delay the triggering of the second tax. See id. at 213-26. However, as they note, this explains only that owners should have to pay for controlling the timing of distributions, and not why they should have such control, or why owners who select corporate features such as limited liability and free transferability for reasons other than to control timing nevertheless must accept the second-level tax. Id. at 226. The latter point is particularly significant for present purposes since, under the current rate structure, incorporation is never a tax advantage even with the ability to control timing. See supra note 51.
does not support an alternative system in which the parties can choose tax classification, just as they choose other elements of their contract, by electing the corporate or partnership form and then freely contracting within that form. The problem is that there is no reason why parties to firms ever would want to pay the government for this agency-cost protection. In the first place, perverse asset deployment can occur only when (1) managers are in a relatively higher tax bracket than most owners; (2) it is in the managers' interests either to retain the asset (to avoid recognition of gain) or to sell (to recognize a loss that managers can deduct against their other income); (3) it is in the other owners' interests to substitute a lower-cost asset or to retain the one it has; and (4) there is no readily available alternative (such as leasing the existing or substitute asset) that would yield a favorable tax result for the manager while not penalizing the other owners. This combination of circumstances is sufficiently unlikely that firms rarely would choose to meet it with two-tier taxation.

Moreover, Kanda and Levmore do not make a persuasive case that the two-tier tax is a better way than private contracting to deal with this sort of agency cost. They paint a dismal picture of the ability of shareholders to deal with these problems through derivative suits and direct constraints on management. Yet, as they note, firms can deal with these problems through such devices as supermajority voting and incentive compensation. Moreover, Kanda and Levmore show how regulators and taxing authorities have been able to design rules for such single-tier forms as mutual funds that minimize the asset-disposition problem even when owners lack significant controls. It is not clear why private parties could not develop such forms.

3. Liquidity

The classification system appears to be moving toward a liquidity-based distinction that may be preferable to the current corporation-partnership distinction. As a result of the 1988 rule subjecting "publicly traded partnerships" to corporate tax treatment, most publicly held

243. See Kanda and Levmore, supra note 238, at 231-32.
244. Id. at 240.
245. Id. at 245-50.
246. See I.R.C. § 7704 (1988). For a discussion and criticism of this provision, see Ribstein, supra note 34, at 874-77. "Publicly traded partnership" means a partnership whose interests are traded in an established securities market or are "readily tradable" on a market. I.R.C. § 7704(b).
firms now cannot obtain single-tier treatment. Conversely, in light of the I.R.S.’s recognition of LLCs, virtually any closely held firm can obtain partnership tax classification by fine-tuning its governance structure to conform to the classification rules. In other words, for most closely held firms, governance costs of adopting flow-through tax are now less than the avoided tax. As a result of these changes, a switch to a system squarely based on the liquidity factor probably would have only minor revenue implications. At the same time, such a single-factor test would be superior to the current system by saving the extra governance costs and unpredictability inherent in applying the four-factor test.

The appropriate liquidity test is clear, predictable, and does not so completely shackle the holders as to cause high opportunism or decision costs. One possibility would be a rule like that for publicly traded partnerships based on trading or tradability of the stock rather than the “free transferability” characteristic under the four-factor test. Professional firms, or firms with relatively few owners or decentralized management, or with any sort of a restriction on transferability, clearly would not have liquid shares under this test. Another alternative simply would be to have an upper limit on the number of shareholders without directly restricting transferability.

It is important not to push the liquidity argument too far. Rebecca Rudnick has attempted to make a normative argument for a liquidity-based approach. Rudnick’s argument is based largely on the assumptions that a liquidity test would appropriately impose a tax on pure profit and that firms’ demand for liquidity is inelastic such that the tax would not cause firms to shift to other organizational forms to avoid it. The “pure profit” assumption ignores entrepreneurs’ adapting organizational

247. The exception is firms having gross income consisting 90% or more of “qualifying” (i.e., “passive”) income. See I.R.C. § 7704(c)-(d).
248. See supra note 51, and accompanying text.
249. That is particularly true in light of the fact that liberal rules regarding internal governance commonly are available only to firms that have restricted liquidity. See MODEL BUSINESS CORP. ACT, § 7.32(d) (1985) (close corporation provisions available only if firm not listed on national securities exchange or regularly traded by securities dealers); DEL. CODE ANN. tit. 8, § 342 (a) (1991) (special close corporation provisions available only if corporation's stock is subject to restrictions on transfer, is held by 30 or fewer persons, and corporation has not made a public offering of its securities).
250. See supra Section IV (B).
251. See supra notes 195-96.
252. See Rudnick, supra note 150.
forms to suit different types of businesses. Accordingly, tax considerations aside, freely transferable shares are no more inherently a benefit for a firm that adopts this feature than are non-transferable shares for a closely held firm.

Rudnick's "inelasticity" assumption ignores the fact that a liquidity tax will cause capital to shift to forms of production for which illiquid shares are efficient.\(^{253}\) Indeed, Rudnick herself defends the liquidity test partly on the basis that it funnels capital to start-up firms.\(^{254}\) The most that can be said for the "inelasticity" argument is that firms are less likely to give up liquidity than other features solely for tax reasons (that is, the usual case for liquidity is \(G > T\)).\(^{255}\)

In short, a liquidity-based test may not be the best available means of distinguishing one- and two-tier firms. But for present purposes it is enough to conclude that such a test would be superior to the four-factor partnership-corporation distinction now being employed.

V. CONCLUSION: THE FUTURE OF BUSINESS FORMS

This Article has argued that the partnership form has been preserved by legal rules that make limited liability costly, including the tax distinction between partnership and corporation. These rules are normatively unjustified. Moreover, their demise is signalled by the proliferation of LLC statutes and new tax rules that are more favorable to limited liability. This Conclusion briefly discusses the legal regime that can be expected to emerge from these developments.

First, many more states almost certainly will adopt LLC statutes. The two forces driving this development are tax rules and the state competition for business formation. Tax regulation probably will continue to favor LLCs since there does not appear to be any powerful interest group injured by this regulation.\(^{256}\) As long as tax rules permit the attractive

\[^{253}\) For a leading discussion of the business factors relevant to the choice between "open" (publicly traded) and closely held organizational forms, see Fama & Jensen, supra note 76.

\[^{254}\) See Rudnick, supra note 150, at 1190, 1216-18.

\[^{255}\) As discussed supra note 238, Kanda and Levmore argue that a transferability test is consistent with their control theory of the two-tier tax. However, as already discussed, this theory is suspect. See supra note 238.

\[^{256}\) See Roe, Political Elements, supra note 3, at 1498 (arguing for a "survival" theory under which tax rules emerge from the bureaucracy without interest group pressure and survive if not opposed by powerful interest groups or other political forces). By comparison, the emergence of publicly traded limited partnership was halted by legislation, see supra text accompanying note 245, when the revenue implications of the "disincorporation" boom became apparent.
combination of limited liability and partnership taxation while penalizing incorporation, the pressure for state legislation permitting or facilitating these firms can be expected to continue. The significant financial benefits of LLCs make them attractive to business people and, therefore, generate fees for lawyers during a general recession for legal business. Bar groups are a potentially potent interest group in pressing for LLC legislation. State legislators comfortably can respond to this pressure on the ground that otherwise business may leave the state and form in a neighboring LLC state. In any event, state legislators have no personal interest in resisting LLC statutes, since they would not be giving up an opportunity to earn rents as was the case in the move away from special chartering of corporations.

The move toward LLCs will come at the expense of other, more costly, limited liability business forms for closely held firms, including limited partnerships, statutory close corporations, and Subchapter S Corporations. Moreover, as this Article has shown, many fewer firms will adopt unlimited liability through the general partnership form than was formerly the case. This development may be hastened by the project currently underway to revise the Uniform Partnership Act, which so far has introduced costly unpredictability without resolving many of the important problems inhibiting modern use of this ancient form.

257. Lawyers might say that LLCs generate something for law professors to write about.

258. Note that the state competition for LLCs may not work the same way that state competition for corporate charters worked to pressure corporate law toward freedom of contract. Once it was recognized that, under comity principles, foreign corporations must be recognized outside their states of organization, firms could form in foreign states and return to their home states to transact business. As a result, the states had to compete for chartering business. For a discussion of the role of state competition for chartering business in the development of modern corporate statutes, see Henry N. Butler, Nineteenth Century Jurisdictional Competition in the Granting of Corporate Privileges, 14 J. LEGAL STUD. 129 (1985). But comity principles are not clearly recognized for LLCs. Thus, a state that does not provide by statute for foreign LLCs may be able to avoid recognizing the limited liability of a foreign-state LLC that has at least minimum contacts with the forum state. See supra note 45. Moreover, most LLCs are closely held, so that it is costly relative to the size of the firm to pay taxes and fees in more than one state. See Ayres, supra note 18, at 374-75 (making similar argument about close corporation rules). The state competition concerning LLCs is, therefore, more for capital itself than for chartering business.

259. See Butler, supra note 259.

260. See supra Section I. There is some possibility, however, that limited partnerships could experience a resurgence in light of the recent tax ruling (that, in effect, sanctions abolition of the "control rule." See supra note 220. And incorporation could remain important if there is a return to pre-1986 tax rates that favored incorporation for firms that retain earnings.

261. See supra Section II.

262. For a critique of an early draft of the Revised Uniform Partnership Act see Larry E. Rib-
The partnership form is, however, likely to survive in at least two situations. First, there undoubtedly will be many existing firms for which the move to a new organizational form will involve significant transition costs. These could be either tax costs (particularly the recognition of gain on appreciated assets) or the costs of negotiating new agreements among partners or with creditors. Second, many smaller firms that have no agreement will continue to be characterized as general partnerships.

In any event, partnership law is likely to survive insofar as partnership statutory provisions are adopted in LLC statutes. Alternatively, some states may follow Texas' lead and adopt limited liability within the context of general partnership statutes.

Perhaps in the long run limited liability might come to be regarded as the residual business form, with individual liability reserved for firms that make special filings. This could result not only from the wider acceptance of limited liability, but also from the reduced attractiveness to creditors of individual liability because of procedural barriers and exhaustion requirements that focus liability on the firm rather than on the individual partners.

Whatever happens, the development and tax recognition of LLCs promises to change the law of business associations radically and to provide more evidence of how government regulation has shaped the firm.

---


263. See *supra* note 205 and accompanying text.

264. See *supra* text accompanying note 65.