

RESEARCH HANDBOOK ON
**Partnerships, LLCs
and Alternative Forms of
Business Organizations**

Edited by

Robert W. Hillman • Mark J. Loewenstein



Research Handbook on Partnerships, LLCs and Alternative Forms of Business Organizations

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RESEARCH HANDBOOKS IN CORPORATE LAW AND GOVERNANCE

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Introduction

This book is devoted to alternative entities—primarily partnerships and limited liability companies. The partnership has been a viable form of association for centuries. The much more recent limited liability company (LLC), which traces its origins to a statute drafted by a group of Wyoming lawyers in 1977, has increasingly become the business organization of choice for new businesses in the United States. Modeled after partnership law, the purpose of the Wyoming statute was to develop a limited liability entity that would qualify for partnership taxation. Prior to the LLC, the entity of choice to achieve those goals was the limited partnership (LP). The LP was less than ideal for these purposes, however, as the general partner retained unlimited liability and the Internal Revenue Service (IRS) could scrutinize the LP's agreements to determine whether the entity had more corporate-like characteristics than partnership-like characteristics. If it did, the IRS took the position that the entity should be taxed like a corporation; if not, the entity would be taxed like a partnership, with pass-through taxation. This IRS practice generated significant transactions costs for LPs, as promoters had to carefully craft their partnership agreements to meet the IRS tests and, to assure limited partners of pass-through taxation, retain a lawyer to render a legal opinion that the entity would be taxed as a partnership.

The Wyoming LLC was successful in achieving its twin goals. It simply provided that no member of the entity would be vicariously liable for the entity's debts or obligations merely by being a member. And as to the tax question, the statute provided certain partnership-like characteristics were "hard wired;" that is, those statutory provisions could not be altered by agreement, thus assuring that the entity would be treated as a partnership for tax purposes. Except for such provisions, the parties were free to craft their relationship as they chose.

The post-1977 preference for the LLC accelerated with a change in the federal income law in 1997, when the IRS abandoned its decades-long practice of scrutinizing whether an alternative entity should be taxed like a corporation and, instead, let alternative entities, regardless of the terms of their governance documents, elect to be taxed as a corporation or partnership. This new regulation is widely known as the "check-the-box" rule. The hard-wired provisions in the Wyoming statute and those that followed its lead were no longer necessary and, rather quickly, statutes were amended to delete such provisions. Somewhat belatedly, the National Conference of Commissioners Uniform State Laws (NCCUSL) proposed a uniform LLC act in 1995 (ULLCA, amended in 1996 to accommodate the check-the-box rules). ULLCA was substantially revised in 2006 (RULLCA). Although these uniform acts have not been widely adopted by the states without substantial amendment, each has influenced the drafters of state LLC laws.

With the development of attractive alternatives to corporations, there has been a growing body of case law and scholarly commentary. A good deal of this litigation and scholarship has focused on the extent to which there might be limits on the contractual freedom afforded to parties under the applicable statute. This volume presents three chapters devoted to the topic. Internal relations, that is, the law and policy as they relate

to the relationship among the parties to a partnership or LLC, as well as the relationship of these actors to outsiders, are considered in six chapters. Tax and accounting issues are represented in two chapters, as are dissolution and fundamental changes.

Alternatives to corporations have been used in many specialized settings and for a variety of purposes, not just as vehicles for commercial enterprises. Four chapters are devoted to this phenomenon. This volume also includes three chapters considering the ways in which the courts and legislatures have responded to the growth of alternative entity law. It concludes with seven chapters offering international perspectives, drawing on the law of the United Kingdom, Japan, China, Russia, India, Taiwan and Brazil.

A summary of the chapters follows.

Chapter 1, by two distinguished jurists from the Delaware judiciary—Leo Strine Jr., the Chief Justice of the Delaware Supreme Court, and J. Travis Laster, the Vice-Chancellor of the Court of Chancery—challenges the conventional wisdom of allowing virtually unlimited contractual freedom in alternative entity agreements. In their experience, arms-length bargaining between sponsors and investors over the terms of the governing instruments of alternative entities does not take place. Moreover, when investors try to evaluate contract terms, the expansive contractual freedom authorized by the alternative entity statutes hampers rather than helps. A lack of standardization prevails in the alternative entity arena, imposing material transaction costs on investors with corresponding effects for the cost of capital borne by sponsors, without generating offsetting benefits. Because contractual drafting is a difficult task, it is also not clear that even alternative entity managers are always well served by situational deviations from predictable defaults. In light of these problems, the authors propose that a sensible set of standard fiduciary defaults might benefit all constituents of alternative entities.

Chapter 2, by Professor Mark Loewenstein, explores whether, in fact, the Delaware courts consistently honor the contractual freedom enshrined in the Delaware alternative entity statutes. He finds that a number of Delaware cases can give one pause about the commitment of the Delaware judiciary to freedom of contract, either because the language of the opinion seems less than absolute or the result can be characterized as an implicit rejection of freedom of contract. The latter are relatively rare, he concludes, but extant, while the former are abundant.

In Chapter 3, Professor Benjamin Means considers the wisdom of contractual freedom in family businesses, concluding that a contractarian framework is typically insufficient to support the expectations of family participants. As is true of any closely held business, contracts in family businesses establish relationships rather than the terms of specific, bargained-for exchanges, and the parties cannot be expected to anticipate and adequately address all eventualities that may occur over time. For family businesses, relational aspects are particularly significant: the time horizon stretches across generations, objectives often include more than simple profit maximization, and business dealings involve emotional consequences for the participants that also need to be acknowledged. Instead of adhering to a false assumption that the parties to a business venture are capable of negotiating adequate protections for themselves and likely to do so, Professor Means concludes that contract law should offer a resource—a set of principles that credit the parties' negotiated bargain in full context but that also compensate for what they cannot anticipate or adequately address.

Chapter 4, by Professor Douglas Branson, considers the importance of the implied covenant of good faith and fair dealing in interpreting agreements that govern alternative entities (e.g., operating agreements for LLCs and partnership agreements for LPs). The implied covenant is a part of every contract and, despite statutory freedom of contract provisions in Delaware alternative entity statutes, may serve as a way courts can impose fiduciary duties on those who manage and control alternative entities. His chapter explores the question of how application of the implied covenant results in the application of fiduciary-like concepts, if not fiduciary duties themselves.

In Chapter 5, William Callison examines the case of *Achaian v. Leemon Family LLC*, where the Delaware Court of Chancery held that the terms of an LLC agreement permitted the transfer of voting and other non-economic interests among existing members without member consent. The Court supported its decision with substantial dictum to the effect that the so-called “pick-your-partner” rule of partnership and LLC law provides the same result. His chapter discusses the pick-your-partner concept, criticizes the *Achaian* decision, and considers whether allowing inter-member transfers of both economic rights and managerial and voting power without member consent should be the default rule.

In Chapter 6, Professor Deborah DeMott explores the external aspects of agency law in the context of unincorporated firms, that is, the capacity to bind the firm to the legal consequences of interactions with third parties. She focuses in particular on the impact of acts done by a representative of the firm for which the representative lacked actual authority. She differentiates the terminology and concepts associated with partnership law from the common law of agency, and she argues that basic agency issues in the context of LLCs are muddled, in part due to a historically explicable overhang of partnership concepts and terminology—since obviated by changes in tax law—and that the muddle most significantly affects LLCs organized under the Delaware LLC statute. Her chapter demonstrates that such confusion is not inevitable and that, short of formal changes in statutory text, judicial decisions and an arguable consensus among expert lawyers may mitigate the confusion.

In Chapter 7, Allan G. Donn explores the liability “shield” that owners and affiliates assume will protect them from third-party claims arising out of the property or activities of the entity. Many exceptions have developed, however, to the anticipated liability protection. He categorizes the exceptions into three types: first, explicit exceptions in the entity’s organization statute or judicial interpretations of that statute; second, judicial concepts, such as piercing the corporate veil and successor liability; and third, a statutory override of the entity act’s general liability shield. The chapter demonstrates that erosion of the liability shield continues not only with the application of judicial concepts, such as piercing the veil and successor liability, but by the proliferation of statutes that impose liability directly on owners and affiliates of an entity.

In Chapter 8, Jennifer Ivery-Crickenberger and Professor Michelle Harner consider the law as it relates to the rights of a counter-party to an LLC when that LLC experiences financial distress. They note how the law governing creditors’ rights against LLCs continues to evolve and is often called upon to reconcile federal bankruptcy law, applicable state entity law, any operating agreement governing the LLC, and the parties’ contract. This chapter summarizes certain key issues facing creditors of alternative entities, including: the enforceability of waivers and ipso facto (bankruptcy termination) clauses in prepetition operating and partnership agreements; the impact of the automatic stay and plan

injunction provisions on creditors' rights against the members or partners of a bankrupt entity; and the effect of charging orders in the bankruptcy context.

In Chapter 9, Professor Franklin A. Gevurtz addresses LLCs set up to protect property personally used by the LLC's owner from seizure by the owner's creditors (asset protection LLCs). He notes that the normal remedy available to creditors of owners of an LLC is a charging order commanding the company to pay to the creditor, instead of the debtor, the debtor's share of any distributions the company makes. This does not work when the LLC is set up to hold assets personally used by a solitary owner rather than to operate a business. The chapter examines the creditor's remedies based upon creative use of charging orders, bankruptcy law, fraudulent transfer statutes, and reverse piercing. It challenges existing scholarship in the area and argues that, properly understood and aggressively applied, these remedies are sufficient to prevent abuse.

In Chapter 10, Professor Bradley T. Borden explores taxation, an important part of any discussion of alternative entities. He provides an overview of U.S. partnership tax (the most complex and perhaps prevalent form of flow-through taxation) and introduces other forms of flow-through taxation. He observes that although alternatives offer tax advantages that explain a large part of their popularity, choosing between corporate and non-corporate entities can be complicated for many businesses, and he explains why some partnerships and LLCs elect to be taxed as corporations. The chapter also identifies some basic cross-border uses of such entities in tax planning.

In Chapter 11, Dean Donald J. Weidner elucidates the significance and use of capital accounts (separate equity accounts) in both partnerships (where they normally are required) and LLCs (where they are not required). He explains why a fundamental understanding of capital accounts analysis is important for understanding accounting practice, potential state default rules, and federal income tax compliance. He also demonstrates how capital accounts analysis is a powerful analytic tool to sharpen the understanding of the economic arrangement of the owners, particularly with respect to how and to what extent they have agreed to share different items of loss.

Chapter 12, by Professor Joan MacLeod Heminway, explores how LLC law deals with fundamental changes, including amendments to LLC organizational documents, organic transactions (merger, conversions, and domestications), and dissolutions. Noting that LLC law originally derived principally from partnership law and emphasized co-equal consent and private ordering among business venturers, she observes that in the courts and in state legislatures corporate law norms have come to play a stronger role in LLC law and emphasis on freedom of contract has intensified. As a result, current LLC law generally does not treat ownership interests in LLCs as property in which members have vested rights that require their individual consent, along with that of all other members, to actions taken by the LLC. Finally, changes to LLC law consistent with these trends have provoked changes to the structure of LLC statutes and entity law statutes more generally. This chapter reviews the current state of fundamental change doctrine in the LLC form in the United States, maps elements of that doctrine to key developments in LLC law, and draws related summary conclusions.

Chapter 13, by Thomas Rutledge, considers fiduciary duties in the context of an event of dissociation or the dissolution of the alternative entity. He notes that both the dissociation of a participant from, and the dissolution of, an unincorporated venture are occasions on which the existing relationship and the resultant fiduciary obligations are

subject to either modification or termination. The existing statutory laws are inconsistent in acknowledging the impact of dissociation and dissolution upon fiduciary obligations and as well in providing guidance thereon, even as the most famous partnership case, *Meinhard v. Salmon*, arose out of allegations that the fiduciary bond between partners continued as to activities post the partnership's purpose. This chapter discusses the manner in which uniform and model unincorporated entity statutes do or do not address the impact of dissociation and dissolution, the confusing case law guidance that has been handed down, the manner in which these disputes should be initially analyzed, and the importance of a priori drafting to address potential problems.

In Chapter 14, Professor Cass Brewer explores the use of LLCs in nonprofit and charitable ventures, including the use of LLCs in hybrid for-profit/nonprofit arrangements. This chapter provides necessary background information on the nonprofit and charitable sector, surveys the relatively common use of LLCs as nonprofit subsidiaries or affiliates, and examines how LLCs are used to facilitate certain charitable or quasi-charitable activities, including program-related investments and social enterprise. He concludes with some very recent, innovative uses of LLCs by donors to charities.

In Chapter 15, Professor Haskell Murray, explores the use of LLCs in the growing field of social enterprises. Social enterprise legal forms first emerged in the United States in 2008 and now a majority of states have passed one or more social enterprise statutes. These social enterprise forms include low-profit limited liability companies ("L3Cs"), benefit corporations, benefit limited liability companies, flexible purpose corporations, social purpose corporations, and public benefit corporations. Social enterprises, also called hybrid firms, have attracted increasing academic attention, but little has been written on if and how states are competing for these entities. This chapter attempts to fill that void, while also providing an overview of the different entity types and highlighting some of the variations within each type.

In Chapter 16, Professor Peter B. Oh challenges the common view that the business trust is an obscure and unimportant form of business association and argues the importance of the business trust today. He traces the development of business trusts over the past two centuries as the form has evolved from a creature of common law into modern statutory and contractarian forms. Not surprisingly, Delaware again takes the lead by allowing statutory business trusts with unquestioned limited liability (for beneficiaries and trustees) and by embracing a *laissez faire* approach allowing contractual flexibility. The chapter discusses contemporary uses of business trusts in such diverse settings as holding real estate, asset securitization, risk management, and pooled asset management (most notably, pension plans). Although the chapter suggests business trusts should be used to an even greater extent than they are today, it recognizes that to unlock the true potential of this alternative, more empirical and other information on the use of business trusts is required.

In Chapter 17, Allison Martin Rhodes and Robyn Axberg discuss why law firms are distinct from typical business entities and how the notion of the law partnership has evolved and will continue to evolve to serve the profession. The chapter explores the unique regulatory, cultural, and historical forces affecting law firms, which drive entity selection, governing agreements, and management. Partnership law is the beginning of the story, but ethics rules that govern lawyer conduct and order relationships among lawyers and with clients play a pervasive role. State regulation of the law firm and the high stakes

of personal and professional liability also drive the business model. The chapter evaluates how law firms struggle to select structures that both ensure compliance with the ethics rules and promote stability and flexibility in firm management.

In Chapter 18, Robert Keatinge explores the phenomena of harmonization, rationalization, and uniformity in business entity legislation. The number of business entities from which an entrepreneur may choose has increased dramatically in the past 40 years. This change has been reflected in modification of the traditional forms of business organization (such as partnerships, corporations, and LPs), the introduction of variants on the traditional forms (such as the LLP and limited liability limited partnership) and the introduction of entirely new forms (the best example of which is the LLC). Each form may be considered as a collection of “characteristics.” The proliferation and changes in the forms of business organization have resulted in a corresponding change and increase in the characteristics of the forms and fostered a desire to bring some order and consistency to the statutes under which the organizations exist. This desire has been reflected in three statutory movements: harmonization (the attempt to eliminate unintentional distinctions among the characteristics), rationalization (a desire to eliminate intentional distinctions among the forms seeking to select the “best” characteristics from among the traditional and new forms and impose that characteristic on all forms), and pursuit of uniformity (the movement to conform the statutes of the various jurisdictions governing a particular form to each other). This chapter compares and contrasts these three movements, providing insights into how the law might efficiently evolve.

In Chapter 19, Professor Nadelle Grossman focuses on uniformity as a goal in alternative entity law, analyzing the debate between supporters of uniformity, including NCCUSL, who argue that uniformity among state LLC acts generates administrative and cost savings, and its critics, who argue that uniformity undermines state experimentation to achieve more efficient LLC laws. She argues in the chapter that these debates about uniformity are misguided. She demonstrates, through a qualitative study of the LLC acts of the first seven adopters of RULLCA, that states diverge frequently, often extensively, from RULLCA. Relying on her interviews of practitioners on the committees that ushered through these new LLC acts, she concluded that uniformity was not a primary goal sought by most of these LLC act committees. She argues that a framework of casual convergence, rather than uniformity, better captures the posture of LLC law. By reformulating LLC law as casually convergent, she suggests that commentators and policy makers can turn their debate to the advantages and disadvantages of such loose convergence, and whether it achieves the right balance between uniformity and state experimentation.

Chapter 20, by Professor Mohsen Manesh, explores the use of dictum by Delaware courts to shape the law of alternative entities. He notes that the liberal use of dictum by the Delaware courts to address matters unnecessary to the resolution of the disputes with which they are presented is a celebrated facet of the state’s rich corporate law tradition. Indeed, academics, practitioners, and jurists alike have praised the judicial practice as a distinctive and invaluable feature of Delaware corporate law—a vital reason for the state’s success in attracting corporate charters. Less noticed, however, is dictum’s role in Delaware’s burgeoning unincorporated alternative entity jurisprudence. As this chapter shows, when one probes Delaware’s LP and LLC decisions, one sees the same judicial hallmarks of dictum familiar to the state’s corporate law precedents. This use of dictum, in both the corporate and alternative entity contexts, in turn represents only one facet of

a larger legal system that has evolved in Delaware to empower the state bench to act as the chief regulator of all Delaware businesses.

In Chapter 21, Professor Elspeth Berry evaluates the three types of partnership which the UK offers as alternatives to a company as a business vehicle. These are the general partnership, the LP and the limited liability partnership (LLP). She observes that of the three, the general partnership, enshrined in statute in the 19th century, offers the most flexibility, informality, and privacy. It is governed by one short piece of legislation, much of which is subject to contrary agreement. The LP, which was established shortly afterwards, is a variation on the general partnership and offers limited liability to some of the partners in return for registration and the non-engagement of those partners in management. In contrast, the more recent LLP is actually a body corporate and offers features of both partnership and company law, including limited liability for all its members in return for registration and disclosure of its accounts. The author notes that the LLP legislation has yet to be fully tested by the courts, so that considerable areas of uncertainty remain, particularly as to whether members can also be employees, and their mutual duties and their enforcement. She also comments that it suffers from the modern disease of excessive legislative governance with over 30 enactments to date.

In Chapter 22, Professor Zenichi Shishido examines choice of legal form by closely held business organizations in Japan, with a primary focus on the Stock Company and LLC forms. These two forms provide firms with varying degrees of contractual freedom, particularly relating to order-made membership rights, exit options, and fiduciary duties. But demand for contractual freedom varies depending on the needs of a given firm. By analyzing the incentive structures of family firms, partnership-type firms, and venture capital-backed firms, the chapter elucidates the advantages and disadvantages of the Stock Company and LLC forms for firms with different appetites for contractual freedom. It discusses implications for the legislative policy surrounding choice of legal form, and it offers a proposed solution allowing firms to choose complementary “sets” of fiduciary duties and exit options depending on the dynamics of the bargaining situation they face.

Chapter 23, by Professor Nicholas Calcina Howson, provides a broad introduction to the partnership form of business organization in the People’s Republic of China (PRC). It considers historical antecedents of the law-based partnership form in China’s imperial, Republican, and Communist post-1949 but pre-reform periods; critical aspects of the PRC’s current partnership law and applied partnership norms (including those designed for foreign-invested but China-domiciled partnership vehicles); and the ways in which China’s judicial institutions presently engage with both formal partnership establishments and other law-based and non-law-based alternative enterprise forms in contemporary China (including holdovers from an entirely different ideological and political economic context). Of particular note is the chapter’s discussion of the judiciary’s aggressive efforts to apply statutory or apparently equitable partnership law principles *ex post* with respect to capital aggregating arrangements that are not *ex ante* registered as formal partnerships under PRC law or subject to explicit partnership agreements, and indeed arrangements that are registered or self-declared as something else entirely.

In Chapter 24, Professor Vladimir Orlov explores the legal forms of business activity in Russia that are distinct from capital-oriented corporations because of the personal participation of owners. These forms include partnerships, cooperatives, and limited liability companies. He discusses the recently updated business law in the context of a legal culture

that traditionally is highly prescriptive in nature. He concludes that in contrast with large companies, smaller enterprises based on owners' personal participation need simple and flexible rules. They are not well served by inflexible legislative solutions and a business law that is becoming ever more prescriptive in nature.

Chapter 25, by Professor Afra Afsharipour, evaluates India's 2008 legislative adoption of the Limited Liability Partnership Act. The chapter discusses how the legislation, which was a long time coming, was prompted by the pleas of entrepreneurs and professionals for a more flexible associational form offering limited liability and reduced regulatory compliance costs when compared with the existing company option. But despite the initial fanfare, the new LLP option has fallen short of its potential. Professor Afsharipour discusses the reasons for the lukewarm reception, including regulatory uncertainties concerning the use of the LLP form by law firms and continuing obstacles to foreign direct investment in LLPs. She concludes that the LLP experience demonstrates that the success of future legislative reforms will key on comprehensive reform of the legislative process and a more complete buy-in from powerful constituencies.

In Chapter 26, Professor Andrew Jen-Guang Lin discusses the fundamentals of partnership law in Taiwan as well as existing options of Silent Partnerships under the Civil Code and Unlimited Companies with Limited Liability Shareholders set forth in the Company Act. He notes that the special needs of venture capital, accounting, and law firms have prompted efforts, supported by the government, to introduce yet another form of business association, the LP, to Taiwan. Although the Proposed Limited Partnership Act has not been enacted into law, its favorable prospects prompt him to offer a detailed analysis of how the new LP will differ from existing associational forms.

In Chapter 27, Professor André Antunes Soares de Camargo presents a broad view of the Brazilian alternatives to the corporate form of organization, starting with the main characteristics of doing business in Brazil, then analyzing the most important contractual forms that an investor may take into account as a first move into the Brazilian market. The chapter discusses the main business association forms under Brazilian laws and considers investor options in establishing a different and separate legal entity, which leads to different rules (rights and obligations) and possible reduction of autonomy but synergy gains as well. The chapter also evaluates the main changes that two Bills of law currently under discussion by the Brazilian Congress will possibly cause to this subject matter.

PART 1

CONTRACTUAL FREEDOM