FORM AND FUNCTION IN BUSINESS ORGANIZATIONS

By Richard A. Booth

Lawyers and academics who deal with the law of business organizations on a regular basis tend to minimize the differences between partnerships, corporations, and other forms of business organization. It is possible – perhaps even quite easy – to set up a corporation that works like a partnership or a partnership that works like a corporation. Some of us even question whether the law matters in this realm other than in connection with taxes. And soon it may not matter much there. The question that naturally arises is why not get rid of this ever expanding alphabet soup of corporations, partnerships, limited partnerships, LLCs, LLPs, and LLLPs, and replace it with a unified system? In other words, is it not time for entity rationalization?

The standard response is that not every lawyer specializes in the law of business organizations. Indeed, not everyone who sets up a business organization is a lawyer. In other words, there are certain efficiencies inherent in off-the-rack forms of organization. More or less standard form firms reduce transaction costs and therefore make it cheaper and easier to form a business. Simply put, standard form firms mean that it is not be necessary to reinvent the wheel every time one forms a business organization.

This answer – which might well be the first to occur to most lawyers – is strikingly parochial. It more or less assumes that law is for lawyers in that it focuses on the convenience of those who design business organizations. But what about those who work with or within the structure of a corporation or partnership? How are they affected by the difference in structures? More to the point, does it matter to a junior partner or a lower level officer in a corporation that he or she is working in a partnership or corporation? And what about investors, suppliers, and customers? Does it matter to them whether they deal with a corporation or partnership?

It seems clear that there are fundamental differences between forms. Viewed from within, a corporation is a hierarchy with the CEO at the top of the pyramid. It is essentially a vertical form of organization. A partnership, on the other hand, is essentially a horizontal form of organization. Of course, most businesses are somewhat mixed. Division heads within a corporation may have considerable freedom. And a managing partner may have considerable authority. But it seems clear that those within an organization may have a strong preference for one or the other form and that one or the other form may be better for certain lines of business. For example, banks, investment banks, and brokerage firms were once partnerships. Now they are primarily corporations, but many are still essentially partner-owned as a result of massive stock option plans. Law firms are still primarily partnerships (albeit LLPs). Accounting firms have become more like corporations (perhaps as a result of an increasing focus on pre-packaged strategies). And medical practices have become even more like corporations with the advent of HMOs. There are also examples of migration in the other direction. The free-wheeling culture of Enron may have resembled a partnership more than a corporation. Similarly, the heavy use of stock options as compensation in technology firms, together with the relatively small percentage of shares typically offered to the public, is also reminiscent of a partnership. These examples all suggest that choice of form may affect the culture of a firm, and indeed that choosing the wrong form or mixing and matching elements may be harmful.

Why do people choose the business forms that they do? And why do they modify some default rules but not others? Presumably, one would want to know the answer before tinkering too much with existing forms as they have evolved over the years (however many or few). To be sure, I assume here that entity rationalization means simplification to some degree and not just codification. I do not necessarily assume that the goal of entity rationalization is a single form of organization. My point is that even if entity rationalization only involves the designation of certain features of the law or procedures that will be common to all forms of organization, we need to be sure that those features are not linked in some special way to other form-specific features. On the other hand, if entity rationalization means that businesspeople will have more choice (generally a good thing), we need to think about what we should do (if anything) to steer them away from choices that like certain drugs may not interact well with each other.

This article proceeds as follows:

First, I consider the fundamental question of why people form firms. Although a fair amount has been written on this subject, I suggest that the existing theory of the firm literature misses several simple but powerful motivations for firm formation. And the choice of form may depend on the operative motivation.

Second, I consider whether certain types of firms may be more suitable for certain types of businesses. Traditionally, of course, professional firms have been organized as partnerships, whereas firms engaged in team production have been organized as corporations. Is this a matter of historical accident? Or have the rules governing these forms somehow evolved to meet the differing needs of these businesses? I argue that choice of form is often dictated by the reason for firm formation which in turn may depend on the nature of the business to be conducted. In other words, certain forms in fact serve certain businesses better.

Finally, I offer a few observations on why and how these considerations may matter in the context of entity rationalization.

I. WHY DO PEOPLE FORM FIRMS?

Before attempting to answer this question, one must deal with a still more fundamental question. Who cares? Why does it matter? Is it not enough simply to observe that people do forms firms whatever the reason may be? The answer is that if individuals form firms for a variety of reasons, it may be appropriate to have a variety of forms. Moreover, we should not limit our focus to formation. An equally important question is why do people join firms? Some forms of organization may be more attractive to recruits than others.

I have identified at least five general reasons: (1) delegation and specialization, (2) diversification, (3) separation and legitimacy, (4) managing competition, and (5) discipline and incentives. There may be more.

Delegation and Specialization

People often retain agents because they do not have the time or expertise to do their own business. In other words, it may be cheaper to hire someone to do some tasks than it is to do them yourself whether in terms of out of pocket expenses or in terms of opportunity costs. And if you need someone to perform a particular task repeatedly, it may be cheaper still to hire one or more employees.

But why would an employee take a job in such a pyramid scheme in which the employer keeps the profits? In theory, the employee could sell his or her services to the firm or its customers and keep the profit. One answer is that a firm may be able to generate more business opportunities than could a self-employed individual. The firm may have some employees who spend their time primarily generating business opportunities – such as a sales staff or rainmaker – while others do the actual work. Moreover, the firm may have other resources or tools that the employee needs in order to do the work that the employee could not afford to acquire individually. Thus, another reason for forming a firm is to facilitate specialization or delegation to achieve economies of scale.

This is a fairly simple reason for firms, but there is no doubt some truth in it. Indeed, it is more or less the model that comes to mind when one talks about agency costs.

On the other hand, individuals could in theory rent all of these resources to each other. For example, one person might set up shop as a business-getter and then sell business opportunities to those who specialize in performance. Of course, some customers might object to being sold a product or service by one person only to have some other person provide it. Still, some industries are so organized at least roughly speaking. Indeed, that is the essential idea behind franchising.

The classic response to the question of why people form firms is that markets do not work very well for some (or many) transactions. As Ronald Coase pointed out long ago, this is particularly true when it is difficult to determine the value of a particular input up front or to determine its contribution to return after the fact.[1]

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[1] Ronald H. Coase, *The Nature of the Firm,* 4 Economica 386 (1937). Arguably, that problem has become acute in recent years as difficult-to-value ideas in the form of intellectual property have become one of the primary inputs of business. Thus, technology firms may be fundamentally different from traditional manufacturing firms, and the controversy surrounding their heavy use of stock options may be an expression of this deeper difference. One senses that the use of stock options in such firms is not just about saving cash for the firm, but that employees are also more reluctant to give up ownership to investors. (Indeed, many law firms that took on such clients in the late 1990s insisted on part payment of their fees in equity. Clearly, there is some demand-side explanation for the use of stock as currency.) In any event, this trend may be thought of as the emergence of a new form of organization that might be thought of as a publicly traded partnership (not that there have not been such animals in the past). If so, it would suggest that some of the pressure being brought to bear on such firms to conform to notions of the corporate norm

The classical theory of the firm explanation seems to miss some rather obvious reasons for firm formation. For one, some tasks simply cannot be performed by a single individual acting alone. A Broadway play is a good example. Of course, it may be possible for one of the actors to hire the rest of the cast. But someone still needs to direct the show. Thus, one function of the firm may be to establish lines of authority in the context of an undertaking in which it is important to choose a course of action from among multiple acceptable alternatives. For another, some inputs may not be available for rent. For example, an entrepreneur who needs more capital may not be able to borrow all that he needs. Thus, he may have no choice but to form a corporation and sell shares if he is unwilling to take on a partner.

Moreover, and more important, the classical explanation seems to suggest that forming a firm should be more the exception than the rule. That is, it suggests that one would form a firm and submit to it only if necessary. But the opposite seems to be closer to the truth. People seem more inclined to do business in groups than to strike out on their own. Indeed, going into business solo is typically seen as a relatively high risk strategy. In any event, there would seem to be far more firms in the world than one would expect if forming a firm is in fact a last resort.

Diversification

Although delegation and specialization may be sufficient reason for forming a firm, participants in a firm may also benefit from diversification in a variety of ways. A firm may be able generate a more regular stream of business opportunities than could an individual. Or the firm may be able to smooth out the income stream for individuals. For example, a lawyer may join a law firm in order to be assured of a steady income irrespective of whether his or her individual practice is busy or slow during any particular period. Similarly, by joining a firm, one may be able to call on others to fill in if one is too busy or even simply to manage one's schedule and get in a game of golf. A firm may also provide a form of insurance by absorbing the costs of accidents through vicarious liability.[2] These benefits may exist quite independently from economies of scale. For example, a lawyer may bill $500,000 per year on the average by billing $1,000,000 every other year or $2,000,000 every fourth year. If the lawyer joins together with a large enough group of other lawyers with similar billing patterns, everyone in the firm can be paid regularly on the basis of the average. No one in the firm makes any more money (on the average) than he would as a solo practitioner. In other words, there are no economies

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(such as treating the grant of stock options as an expense) may be fundamentally misguided. In other words, it may have the effect of retarding or even stunting the evolution of this new form of organization. In a sense, then, the tribulations of technology are an illustration of one of the subtle dangers of rationalization, namely, forcing all firms into a standard mold.

[2] *See* Alan O. Sykes, *The Boundaries of Vicarious Liability: An Economic Analysis of the Scope of Employment Rule and Related Legal Doctrines*, 101 Harv. L. Rev. 563 (1988).

of scale. Nevertheless, the lawyers in the firm are distinctly better off because they have a regular income. Risk is reduced even though return remains the same.[3]

Separation and Legitimacy

In some cases, people form a firm simply to separate businesses from self. (Martha Stewart may be the exception that proves the rule.) Of course, one of the primary motivations here is limited liability and the insulation of certain assets from unrelated liabilities. But limited liability aside, forming a corporation (for example) may give the business more legitimacy than doing business under one's own name as a sole proprietor. It suggests to the world that the business is something more than (and different from) the individual who owns it. Of course, technically, that is true with a corporation. And indeed this separation of business from participants is what allows a corporation to raise equity capital from outsider investors.

But separation may also be achieved simply by filing an assumed name certificate and calling oneself a company. Thus, to some extent the separation rationale is circular. Forming a company generates legitimacy only because the world associates the word with legitimacy.[4]

A related but somewhat more substantial reason for forming a firm is that when two or more people have joined together to conduct a business, it suggests that the business may be better thought out and therefore more trustworthy than a business that has been started by a single individual who may have idiosyncratic ideas. Similarly, it may be easier to attract others to join a firm than it is to retain the services of an independent contractor or free-lance agent to provide some needed input. Or association with a firm may add value to an agent's contribution. For example, I joined a law faculty in part because it gave my work a legitimacy that would have been difficult to achieve on my own. My basic point here is that there is a tendency to view firms primarily in terms of internal control structure. But external appearance may also matter. To sum up, people sometimes form firms simply to gain status for the enterprise or to define status to the world.

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[3] That is also the fundamental explanation for why people buy insurance and annuities. *See* Richard A. Booth, *Making Economic Sense of Unisex Life Insurance (Or the Difference Between Cost and Value and Why It Matters to Real People)*, Social Science Research Network, 7 Law & Economics Abstracts, Working Paper Series, No.7, Feb. 18, 2002 (http://papers.ssrn.com/paper.taf?abstract_id=296782). There are, however, limits to the value of diversification. Investors dislike conglomerate firms. *See* Richard A. Booth, *Stockholders, Stakeholders, and Bagholders (Or How Investor Diversification Affects Fiduciary Duty)*, 53 Bus. Law. 429 (1998). And notwithstanding the growing taste for stock options, it appears that Employees dislike being paid in options that are not closely tied to performance of the division or unit for which they work.

[4] Indeed, it was probably once the case that the public placed more trust in sole proprietorships than they did even in partnerships or later corporations. There may also have been a higher level of trust associated with family companies using names such as "Alex. Brown & Sons" or "Hills Brothers." (I have also noticed recent variations such as "Sisters," "& Daughters" and "& Kids." Indeed, one wonders whether the use of such names may not have led to peculiar legal results once upon a time, suggesting that it connoted a somewhat distinct form of organization. Today, the construction seems to be more quaint than substantive.

Managing Competition

In some cases people form firms to reduce competition. In other words, two or more competitors might form a partnership in order to split the available profits while saving the costs of competing (such as advertising). Of course, by eliminating competition a firm may also be able to raise prices or restrict output. Although this may be illegal under the antitrust laws for very large businesses, it is fairly clear that it is an important reason for some smaller businesses. Indeed, it has become quite common even for relatively mundane businesses to seek or demand non-competition agreements even from low level employees. (For example, Hank Hill might be asked to agree not to go to work for another propane company in Texas.) Whatever one might think of such tactics, and whether or not such agreements are ultimately enforceable, it is quite clear that non-competition is a motive. Moreover, although one could attempt to negotiate a series of contracts with one's competitors, such tactics would likely be illegal even on the smallest scale. In any event, it is far easier to achieve the same result by forming a firm or by requiring employees to sign a noncompete agreement.[5]

Although it is clear that businesspeople might form a firm to reduce competition, it is also possible that forming a firm may increase competition. In some cases, consumers are more likely to seek out a department store or supermarket than a boutique or specialty shop. Of course, the opposite is true as well. I would never think of going to my car dealer rather than Jiffy Lube for an oil change. The point is that a firm with a wider array of products and services may sometimes be more attractive to consumers.[6] Or the firm may serve to concentrate talent in such a way that it produces a better product. For example, a law firm or a law faculty for that matter may produce better services or written product because the various members are able to have their work reviewed or checked or commented on by others. Again, the outside world may be more inclined to view a group as more legitimate than an individual, but to some extent it may be because the product of the group is superior.

Mixed motives are also possible. For example, a group medical practice may seek out a new partner in order to offer a new area of care or expanded hours. But the group may also worry that the new recruit may use the group as an entree to the community and then split off to form a new competing practice taking business along.[7]

Discipline and Incentives

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[5] Interestingly, in the landmark case *Meinhard v. Salmon,* 249 N.Y. 458 (1928), Judge Cardozo repeatedly refers to the various parties as being "in treaty" with each other, rather suggesting a business deal may have some of the elements of a truce.

[6] *See generally* Randall S. Thomas, et al., *Megafirms*, 80 N.C.L. Rev. 115 (2001).

[7] *See, e.g.,* Gelder Medical Group v. Webber, 41 N.Y. 680 (1977).

One final motivation for forming a firm (or joining one) is that association with a group may generate additional motivation perhaps particularly for people who are not self-starters. In other words, it may be that people form or join firms to force themselves to work harder to impose discipline that may be difficult to self impose. For example, securities firms have traditionally been fairly serious about policing themselves (recent events notwithstanding), although one could argue that they do so mostly to avoid the consequences of external punishment by the SEC or private litigation. Another related reason for forming or joining a firm is to gain the benefits of institutional memory.

To sum up, there are several distinct reasons why people form firms. Curiously, most of those reasons seem to turn more on the relationship of active participants to each other or on the relationship of the firm to various third parties (including creditors), than on the relationship between participants and investors as is the classical approach. Of course, investors are interested in how well managers work with each other. But not too interested. A diversified investor cares little about the fortunes of individual companies. It may therefore be that we lawyers, judges, and academics have given short shrift to how well the rules work for those who toil day to day in the trenches of partnerships and corporations. Moreover, the recent spate of corporate scandals strongly suggests we should focus more on internal controls than we have in the past, particularly in connection with firms that do not have a large involved shareholder. External monitors may not be nearly as important as we have made them out to be.

II. DOES FORM FOLLOW FUNCTION?

The fact that there seem to be several discrete reasons for forming firms suggests the possibility that there may be a need for several discrete firm forms or – assuming complete freedom of contract – that several distinct forms are likely to evolve. Thus, it is useful to summarize how various existing forms differ from each other and how well they may fit with the needs of business.

In a partnership, partners are presumptively equals with respect to control and financial participation. The partners own the firm and keep the profits in equal per capita shares. Each partner has one vote (or a veto as to some decisions). Each partner can bind the others in the ordinary course of business. There is no need in a partnership for any formal grant of authority to the partners. And each partner is personally liable for the excess debts of the firm. Accordingly, each partner owes a fiduciary duty to the partnership and each other partner. Partnership interests cannot be transferred at least insofar as they carry control rights. Finally, and perhaps most important, it is easy to get out of a partnership through dissolution or now disassociation.

In a corporation, ownership interests are represented by shares which may be owned by active participants or passive investors in any proportion, but usually in proportion to financial contribution (though this may be changing with the increasing use of stock options). Thus, the firm is owned by the shareholders, and each shareholder is entitled to a prorata share of the financial returns. Shareholders have no management authority. Rather, they are entitled to vote on a limited number of issues. Only the board of directors acting as a group has inherent authority to manage the corporation. Technically, at least, the officers of the corporation from the CEO on down have only such authority to bind the firm as the board confers. Shareholders have no personal liability for corporate obligations beyond the amount they agree to invest. Although limited liability does not technically extend to management as management, it does so in practice. The directors (and presumably the officers) owe a fiduciary duty to the corporation and presumably the shareholders. And they may be liable to the corporation for a breach of duty, but they are not ordinarily liable to creditors. Shareholders owe no duties to each other except that a controlling shareholder may be accountable as if a director if the shareholder uses the power to control to the detriment and exclusion of the remaining shareholders.[8] Finally, shares of a corporation are freely transferable both as to financial rights and control rights, but it is very difficult to get out of a corporation other than by selling one's shares.

Comparing the array of reasons for firm formation to these two polar possibilities, it seems fairly evident that the corporation is better for certain kinds of undertakings and the partnership is better for others.

If purely horizontal diversification is important, the partnership is probably best. Thus, it is not surprising that law firms tend to be partnerships. Under the partnership form, each lawyer is largely free to practice as if independent. A law partner may generally bind the firm with his signature and is under a duty while associated with the firm to work solely for the firm and to contribute billings to the firm (or at least to account for them). A law partner is also generally free to leave the firm with his business if the partnership turns out to be disadvantageous.[9]

If the goal of the firm is to assemble a variety of different inputs (which may be difficult to value up front) with a view to producing a product that is not primarily the work of a particular individual (as in a manufacturing operation), then the corporate form may be more appropriate. The corporate form generally lends itself to such ventures that are based on team production because it is likely in such ventures that differences of opinion will arise among participants as to how best to run the business. Under the corporate form, the board of directors has the ultimate power to resolve such disputes or to delegate the authority to do so. If it is crucial that someone make a decision – if failure to decide is the danger – then the corporation is probably best.

This may explain why the most common exception to the business judgment rule seems to arise in failure to manage cases. In other words, the courts seem to find failure to manage to be perhaps the one situation in which a board may be held to have violated the duty of care.[10]

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[8] *Compare* Ringling Bros. -- Barnum & Bailey Combined Shows, Inc. v. Ringling, 53 A.2d 441 (Del. 1947) *with* Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983).

[9] *See, e.g.*, Meehan v. Shaughnessy, 404 Mass. 419 (1989).

[10] *See, e.g.*, Francis v. United Jersey Bank, 87 N.J. 15 (1981); Smith v. Atlantic Properties, Inc., 384 Mass. 817 (1981). *See also* Smith v. VanGorkom, 488 A.2d 858 (1985).

Although failure to manage is usually characterized as a breach of fiduciary duty, it is not clear that it is a fiduciary duty that would or should apply with equal force in the context of a partnership. Obviously, a partnership has no board. But more to the point, it is not usually important that a partnership act with a single mind. Thus, the failure to manage exception to the business judgment rule (and indeed the business judgment rule itself) may be subtly related to the reason why businesspeople choose the corporate form and not necessarily inherent in fiduciary duty itself.

In short, it is not utterly clear that fiduciary duty means the same thing in partnership law as it does in corporation law, and to assume that it does (to have a single section applicable to all forms) may lead to unintended consequences.[11]

Moreover, in a corporation it may be vital that inputs not be easily withdrawable. Accordingly, the courts are reluctant to grant dissolution. In a partnership, on the other hand, withdrawal is easy even if motivated by nothing more than a partner's belief that he would be better offer elsewhere.

It bears noting that the latest revision of the Uniform Limited Partnership Act (ReRULPA) explicitly recognizes the connection between form and function. As the prefatory note to the 2001 Act states:

> The new Act has been drafted for a world in which limited liability partnerships and limited liability companies can meet many of the needs formerly met by limited partnerships. This Act therefore targets two types of enterprises that seem largely beyond the scope of LLPs and LLCs: (i) sophisticated, manager-entrenched commercial deals whose participants commit for the long term, and (ii) estate planning arrangements (family limited partnerships). This Act accordingly assumes that, more often than not, people utilizing it will want: strong centralized management, strongly entrenched, and passive investors with little control over or right to exit the entity. The Act's rules, and particularly its default rules, have been designed to reflect these assumptions.

Indeed, the prefatory note reads like a brief for the argument that different firms have different functions and that different functions may necessitate very different collections of statutory provisions or the interpretation thereof.[12]

And what of the LLC? Curiously, the LLC appears to be the form that allows for maximum rental of inputs. It can be a partnership without partners or a corporation without shareholders. It is the form that finally frees an entrepreneur to form a business separate from himself and yet to maintain total control over it.

In summary, as I have suggested before, and as several of the papers at this conference now suggest, if one were to eliminate the arguably artificial incentives of limited liability

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[11] It may be that idea of fiduciary duty should be limited to the duty of loyalty as the Delaware courts have sometimes suggested. *See* Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983).

[12] For example, the prefatory note cites disparate outcomes on the question whether a limited partner may remain an investor in the firm under UPA Section 42, an ambiguity that arose because ULPA and RULPA both incorporated the UPA by reference for matters not covered by the limited partnership statute.

and differing tax treatment from the mix of reasons for choosing a particular form, there would still be good reasons for choosing one form over another.

Up to now, I have focused primarily on the interests of managers and investors. It almost goes without saying that managers and investors may have a distinct preference for one form over another. Indeed, most people would likely say that organization law is primarily about the relationship between investors and managers. But suppliers and customers may also care about organizational form. In other words, it also seems quite possible that third parties may have a preference for dealing with a particular kind of firm.

It is difficult to believe that an entrepreneur does not think about how choice of entity will help the business succeed. Indeed, many say that venture capital firms prefer to deal with corporations. Although there are several technical reasons offered for this preference (such as worries about unrelated business income for nonprofit investors), most have been debunked. In the end, however, it may be that investors are simply worried that there may be too many surprises lurking in the customized structure of alternative forms such as LLCs. Thus, it may be that one function of the corporate form is to provide a more or less standardized package of rights (or at least parameters) that can be more easily and reliably understood by potential investors and other third parties.[13] As it turns out, this is nothing new. The stock exchanges have always imposed listing standards presumably for similar reasons. And recent events notwithstanding, one of the essential functions of GAAP is to foster comparability across companies. Although one might question the need for standardization, it seems clear that in a world of innumerable investment opportunities, a firm can compete better for capital if it is more easily understood by potential investors. In other words, it costs less for investors to invest in a familiar form of organization. That is not to say that a new control feature of some sort might not be attractive and indeed afford the firm an edge from time to time. But that does mean that it makes sense to reinvent the wheel with every deal. Boiler plate has its value.

There is probably less bureaucracy in a partnership and more choice of who will handle your business. Indeed, it is clear in a partnership that each partner has the authority to bind the firm. With a corporation, on the other hand, there is an ultimate authority and it is fairly clear that all of the assets of the business are pledged in connection with each transaction undertaken.

As I have also argued elsewhere, the ultimate rationale for limited liability is that it facilitates bargaining with creditors. In the absence of limited liability, entrepreneurs would be presumed to risk all of their wealth in connection with each and every venture. With limited liability, an entrepreneur must agree to assume any risk beyond her investment in the venture. In other words, creditors are forced to negotiate for additional security.

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[13] *See* Larry E. Ribstein & Bruce H. Kobayashi, *Choice of Form and Network Externalities,* 43 Wm. & Mary L. Rev. 79 (2001).

III. IMPLICATIONS FOR ENTITY RATIONALIZATION

The fact that form follows function and that certain features of organization law tend to be found together living in symbiosis suggests that firm form matters. But the fact that discrete forms exist and persist does not necessarily imply that we should maintain rigid or even prototypical firm forms. And it certainly does not imply that we should return to the days of mandatory rules and the traditional corporate norm. After all, business people and business lawyers might easily negotiate their way to the proper combinations even in the absence of a statute. Perhaps it would be more efficient for the law to provide a menu of provisions from which the parties may choose, though it is unclear that such a creature would be a statute or law in any traditional sense.

On the other hand, if organization law is essentially contractual, then why do we need it at all? Although it may be somewhat extreme to suggest the repeal of organization law altogether, it is not self-evident that we should bother to rationalize it. It is not clear that these contracts are any more important than other contracts. For example, franchising is an important form of business organization, but there is no general franchise law designed to relieve the parties of the need to specify the terms. For some reason, the law leaves franchising almost entirely to negotiation, albeit a rather one-sided negotiation.[14] Then again there are many forms of contractual arrangements that are the subject of fairly elaborate efforts to set down some standard terms, for example, the Uniform Commercial Code and the Restatement of Agency. It bears noting that neither of these emanated in the first instance from a governmental authority. Both were the work of the American Law Institute, the UCC a joint effort with NCCUSL. Similarly, most jurisdictions have standard forms for very common contracts, such as retaining a real estate broker or conveying residential real estate. So it may be that rationalization will come not from above but from convention. Or it may be that the first authoritative source of law tends to remain authoritative.[15] Why does the law come from so many different sources and take so many different forms? What belongs in a statute and what should be left to contract? Organization law itself comes from multiple sources: state law, federal law, the ABA, NCCUSL, the ALI, and indeed the various stock exchanges, and maybe even the FASB. Undoubtedly, we should think hard about why a particular rule comes from a particular authority before we undertake to rationalize the system.

[14] To be sure, there are scattered statutes designed to address identified problems of franchising, for example, automobile dealer's day in court laws. Corporation law was once so too. So it may be that someday franchising will evolve into a more standardized state. Or it may be that because of the one-sidedness of the typical franchise arrangement, there will be no perceived need for further standardization. At first blush, one sidedness may seem like a good reason for the law to step in and dictate fairer terms. On the other hand, if the more important function of a statute is to catalyze or even substitute for negotiation, there may be little real need for statutes in the area of franchising.

[15] With markets, it appears that the first place where liquidity arises tends to be the place where it remains and where traders will return first. In other words, it is very difficult to start a second market in any given commodity. It may be the same with law, and some such effect may explain the persistent power of Delaware in corporate law.

The ultimate question, however, is why do we have organization law at all? The easy answer is that it is cheap and convenient. But that is not a good enough answer. If it were, then no one would object to the notion that it is essentially a contract that may be varied at will.[16] There are at least two ways in which organization law differs from a simple standard form contract. There may be more.

First, organization law provides a set of default rules for individuals who fail to plan. This may be a good enough reason to worry about getting it right. Indeed, the common law of partnerships and later corporations, from which modern statutory law evolved, was (by definition) all about controversies, that is, sorting out the rights of various business constituencies. Statutes arose slowly and section by section as various common controversies were settled by legislative fiat.[17] It is important to remember also that failure to plan may be intentional. Businesspeople often fail to plan because they sense that they are unlikely to reach an agreement with each other or because it is just too expensive to specify each detail. Thus, choosing a form is about choosing the preferred set of default rules. In addition, organization law may also be about reserving power to change these complex contracts without renegotiation among parties, whether by changing the law or effectively agreeing to have the courts supply the missing terms through such vague concepts as fiduciary duty. The courts have traditionally been very reluctant to reform contracts except in the context of mutual mistake and even then it is more likely that the contract will be voided.[18] To be sure, contract law generally implies a duty of good faith. RUPA now explicitly incorporates a duty of good faith among partners. And corporation case law has recognized a duty of good faith. But the duty of good faith has seldom made a difference even though it has repeatedly been cited by bondholders.[19]

Second, organization law provides a catalyst of sorts that makes it easier to reach an agreement in a complex multilateral setting. There are at the very least three parties to most businesses: participants, investors, and third parties, including creditors as well as suppliers and customers. And both participants and investors may often be divided into subgroups. All of these groups must negotiate somehow over both control and financial return. Needless to say, such a negotiation can be exceedingly complex and like a game

[16] This is not to say that convenience is not a distinct benefit. Of course, it is entirely possible that those who object to the freewheeling contractual model of organization law are simply wrong.

[17] *See, e.g.,* Stokes v. Continental Trust Co., 186 N.Y. 285 (1906) (construing common law of preemptive rights).

[18] *But cf.* Bethlehem Steel Co. v. Turner Construction Co., 2 N.Y.2d 456 (1957) (upholding contract with price to be determined by seller based on industry rates). Bank lending at the variable prime rate is also a familiar example.

[19] It is not entirely clear what *good faith* means as distinct from refraining from a breach of fiduciary duty. But it seems unlikely that it could mean that in that even a simple contract or debt obligation implies a duty of good faith but clearly does not entail a fiduciary duty. One possibility is that it entails a duty not to interfere with performance or to attempt performance. *See* Wood v. Lucy, Lady Duff-Gordon, 222 N.Y. 643 (1918). *But see* Bartle v. Home Owners Cooperative, Inc., 309 N.Y. 103 (1955).

of rock-scissors-paper may not – indeed probably will not – have a single stable solution. In the absence of well crafted default rules, it might often be impossible to reach an agreement at all. In other words, prepackaged firms may be designed to solve complex bargaining problems involving multiple constituencies.

As I noted earlier, the best explanation for limited liability is that facilitates bargaining between investors and creditors. Others have argued recently that partnership law may perform a similar function by setting default rules where the most deals are likely to end up anyway. For example, it has been argued that the default rule that partners are entitled to equal financial return may have evolved because those who are willing to agree to such a deal are more likely in the end to make deals and form firms (and ultimately succeed in making money). Thus, those who agree to equal shares will prosper and those who insist on a greater share or are willing to accept a lesser share will evolve away. It has also been argued that partnerships are much more popular in the UK because they are somewhat more difficult to dissolve.

Although the foregoing arguments suggest that organization law matters, they do not really speak to the question of whether it is important to rationalize or unify the extant system. The jury is still out on this question. Clearly rationalization would have some benefits, but it would also have some costs.

Perhaps the most obvious benefit is statutory simplification. But it is far from clear that this can be achieved. Witness the proposed Texas Business Organizations Code. In any event, it has proved to be a monumental effort.

A more concrete benefit may come from the identification and elimination of conflicting statutory provisions. For example, corporation law specifies the consequences of defective incorporation – joint and several liability for knowing participants. But presumably a non-corporation is also a partnership by default – the consequences of which are very different. In many situations, it is not at all clear which of these two provisions should apply. Presumably, a unified statute would eliminate such problems.[20]

A subtler benefit arises from the fact that the law may sometimes confuse organizational rules with rules designed to regulate certain businesses that gravitate to a given form. For example, personal liability for partners may be more a function of attitudes toward professional malpractice than of partnership law.[21] Clearly, such concerns weighed heavily in the evolution of the LLP. Similarly, limited liability for shareholders may be more a function of team production than of corporation law. Entity rationalization may help clarify these rules. For example, withdrawing such crutches as the prohibition on practicing law in the corporate form, will force regulators to say what they mean.

[20] For further discussion of these issues, see the articles by William Clark and Robert Keatinge in this symposium.

[21] For further discussion of these issues, see the article by Thomas Rutledge in this symposium.

On the other hand, some issues that appear to be matters of professional ethics or otherwise outside the realm of organization law may in fact properly be part of organization law. For example, the enforceability of non competition agreements has been viewed as a matter of professional rules in some cases, simple contract in other cases, and fiduciary duty in still other cases. If in fact controlling competition is a proper reason for forming a firm, it may be that non competition agreements should be viewed as part of organization law. Clearly, corporation law views competition as within its purview.[22] But partnership law is essentially silent on the subject.[23]

This raises the more general question of what should be included in organization law and what should not. For example, some states have recently added provisions relating to divisive reorganizations. Perhaps we should also consider statutory provisions relating to poison pills, or tracking stock, or the terms of compensatory stock options. Such additions to statutory law are clearly not necessary. These devices have arisen without benefit of legislative clergy. Still, most states have fairly elaborate provisions outlining the most common terms of preferred stock even though with a few exceptions these provisions must be reiterated with specificity in the articles of incorporation in order to be enforceable. Is it really necessary that they be in the statute? Indeed, the rights of various ownership units in partnerships are often far more complex than the preferred stock. Yet partnership law is almost totally silent about the ways in which financial rights may be varied.

One of the distinct risks of entity rationalization – at least if it assumes a menu approach that permits relatively free mixing and matching of terms – is that businesspeople will overplan and choose terms that do not work well together. The default rules for a particular organization may be internally coordinated in ways that are difficult to sort out. Mixing and matching rules from different organizations may be dangerous. The challenge is to determine which elements are safely modified and which are not.[24] Too much freedom of contract or making it too easy to mix and match terms may also confuse the courts about which rules go together. Both phenomena are arguably illustrated by the Massachusetts experience.

In *Donahue v. Rodd Electrotype Co.,*[25] the court ruled that in a closely held corporation shareholders owe each other duties that are a similar to those that partners owe each other

[22] *See, e.g.,* ALI, Principles of Corporate Governance § 5.06.

[23] That does not, however, seem to stop the courts from periodically asserting in the context of cases involving closely held corporations that shareholders are akin to partners and therefore owe each other enhanced duties. Moreover, conflict rules may vary depending on locale. For example, it may be more condoned for a lawyer in a small town to represent clients with conflicts simply because there are fewer lawyers to go around. Or it may be that such rules are more strictly enforced in more urban areas as a way of spreading the wealth and (in effect) controlling competition.

[24] In other words, statutory law is rather like computer software. One is never sure what one can safely modify or delete.

[25] Donahue v. Rodd Electrotype Co., 367 Mass. 578 (1975).

because they are effectively locked in by the lack of a liquid market through which they might be able to exit (cash out). The result was that a minority shareholder was able to force the corporation to repurchase her shares because the majority shareholder had sold a block of his own shares back to the corporation. Although this rule seems sensible enough given the facts of the case, it quickly led to a series of unintended consequences. In a sense, it gave the minority shareholder exit rights similar to those in a partnership without considering the concomitant right to force dissolution of the firm. The unintended consequences were quick to follow. In *Wilkes v. Springside Nursing Home,*[26] the plaintiff minority shareholder argued in effect that he could not be fired from his positions as director, officer, and salaried employee, a position that is clearly consistent with the status of partner. In *Smith v. Atlantic Properties,*[27] the four shareholders retained veto power over fundamental business decisions and fell into deadlock (and tax troubles) as a result of their inability to choose between dividends and reinvestment. In *Merola v. Exergen Corporation,*[28] the plaintiff claimed that he had become a partner as a result of buying stock and hence could not be fired. And the question remains open whether the shareholder to shareholder duties created in *Donahue* mean that a minority shareholder can sue directly (rather than derivatively) when a controlling shareholder uses his or her power to the disadvantage of the minority. In short, Massachusetts bought into a multistep rejiggering of its corporation law prompted at least in part by shareholder opportunism in the wake of new found rights. And majority shareholders found that they did not have the power (or wealth) they may have thought they had.

On the other hand, Delaware and Maryland have more or less resisted the temptation to develop a special body of case law for close corporations.[29] Indeed, it is well settled in Delaware that shareholders have no duty to each other.[30] But it is also well settled that a controlling shareholder may not use that control to exact a benefit to the detriment and exclusion of the remaining shareholders.[31] In any event, Delaware and Maryland have seen relatively little close corporation litigation. Moreover, it may well be that failure to appreciate the subtle interconnections between default rules may explain why the close corporation election has proved to be unpopular.[32]

CONCLUSION

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[26] Wilkes v. Springside Nursing Home, Inc., 370 Mass. 842 (1976).

[27] Smith v. Atlantic Properties, Inc., 384 Mass. 817 (1981).

[28] *Merola v. Exergen Corporation,* 423 Mass. 461 (1996).

[29] *See* Nixon v. Blackwell, 626 A.2d 1366 (1993); Toner v. Baltimore Envelope Co., 304 Md. 256 (1985).

[30] *See* Ringling Bros. -- Barnum & Bailey Combined Shows, Inc. v. Ringling, 53 A.2d 441 (Del. 1947).

[31] *See* Sinclair Oil Corp. v. Levien, 332 A.2d 139; (Del. 1975).

[32] Thus, the MBCA has more or less abandoned the idea of a formal election and opted instead for a provision that enables (authorizes) closely held corporations to conduct business under a shareholder agreement. MBCA § 7.32.

Business organization law matters. The fact that one can bargain around the law does not mean that most people do so. Indeed, it may be that the law is vital to getting any negotiation going. Bargaining happens in the shadow of the law. Thus, there is every reason to try to get the default rules right and to take great care in making sure that the rules are right in relation to each other. To the extent that entity rationalization eliminates unintentional conflicts between forms, it is a good thing. But simplification for its own sake is risky business.