The “Puts” of the Company’s Contract: Unlocking Unpreventable Problems of Private Ordering in Limited Liability Companies

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“‘Al,” says Bob, “Are you trying to tells us we got screwed by the robots?”’


ABSTRACT

This essay applies principles of process analysis to the study of bottlenecks in the limited liability company, as a result of bargaining failures or problems of private ordering in these companies. This essay focuses on governing the operating agreement or the company’s contract of private limited liability companies (LLCs) to overcome bargaining failures deriving from changes in the ownership structure of these companies after membership interests are sold without the consent of the company’s other members. The main premise on which the governance of the company’s contract relies on boils down to one fundamental assertion. The sale of legal products ought to equal a minimum of supply and demand. In other words, from the normative viewpoint, the coordination of the supply and demand sides of legal provisions ought to be the

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perspective from which legal design both at the legislative and market levels is understood. Thus, managing bargaining problems in the LLC whenever there is an unconsented transfer of membership rights provides the context of this essay. The coordination of supply and demand of legal products provides the perspective. In this light, the main goal of this essay is to provide contractual mechanisms that allow the right legal products and resources to be at the right place at the right time so as to maximize these companies’ profitability and their shareholders’ wealth. The *products* are corporate default rules. Resources include people (members, managers or directors, officers), information, money, or a combination of all these elements.

This essay focuses on the contractual features of the LLC and their members’ freedom of contract. There is a puzzling side to the freedom of contract that the members of these companies enjoy. They are free to set the regulatory framework of the company. However, more often than not, members of these business organizations have not been able to surmount bargaining failures that come as a result of lack of commitment and social expertise on their side, particularly when mutual dependence among members and the managing board is very strong and the level of relational embeddedness is very high.

Between the pervasiveness of the lack of commitment in business organizations where trust seemingly matters, and the stickiness of the relational element, it is difficult to find a tipping point when contractual relations between corporate constituencies are about to collapse. This tipping point can be fairly illustrated with cases where members withdraw or sell their units in the company without the consent of non-transferring members. Whenever the company’s contract maintains restrictions on the transfer of
membership rights, it attempts to create a mechanism of mutual dependence that makes members commit in the long run. Still, this attempt to create a mutual commitment tends to be ineffective even when this commitment was sought when the contractual framework of the business was initially designed.

Thus, from the normative point of view, this essay provides an account of operating agreements of LLCs (the agreements where the members establish the manner in which the business will be operated) that is able to accommodate the introduction of contractual clauses establishing restrictions on transfer of membership rights. I define operating agreements as the \emph{company's contract} or \emph{contracts for the governance opportunity} given by legislatures. Market agents are often given a menu of rules by legislatures that they can use to elaborate their companies’ operating agreements. They can opt out of these rules. But they frequently do not.

At an initial stage of the life of the company, members think of defaults as cost-effective \emph{legal products}. By providing default rules, legislatures give market agents the opportunity to adapt property rights inherent to their membership rights to the nature and purpose of the LLC. This essay looks at operating agreements and restrictions on transfer of membership rights provided therein and explores how the opportunity that members have to govern their operating agreements can be efficiently seized.

Designing mechanisms such as dissolution at will and different types of lock-in clauses, that is, clauses whose purpose is to enforce relational contracts, is meant to foster mutual dependencies in the firm, alliance portfolios and balanced power relationships in
these business organizations. Here, I look at the governance of the company’s contract as a promising tool of members’ onboarding that is focused on the institutional and organizational dimensions of the company as well as on its executive dimension.

KEYWORDS: contract governance, legal engineering, legal products, bottlenecks, members’ onboarding, property rights, restrictions on transfer of membership rights, limited liability companies.

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3 Lock-in clauses can be designed to strengthen property rights of the company’s members and as a consequence lock them in the company and commit to their investment.
I. INTRODUCTION

The modern limited liability company, which is essentially contractual, is an intriguing space for contractual bottlenecks to exist. Contractual bottlenecks are not good or bad. The fact is that they do exist. They assume the form of restrictions on changes to the ownership structure of the company. For example, contractual clauses determining that ownership in the LLC cannot be changed without prior agreement of particular corporate constituencies are contractual bottlenecks. They constrain the private property of the members in the firm and restrain their claims to dispose of that property as they please. Contractual bottlenecks are legitimate and, in most cases, they are legally valid. However, the inefficiencies of the contractual technology used to define their purpose may be fundamentally outdated or inadequate to make such contractual bottlenecks of any use. The effects of contractual bottlenecks are likely to radiate throughout the company and importantly affect the company’s decision-making process by making it less equitable. Thus, bottlenecks, if they are not properly governed from the contractual point of view, are likely to disrupt the operation of the firm.

Given the above, I apply the principles of process analysis and business strategy to the study of contractual bottlenecks in the operation of the firm, specifically when it comes to solving problems related to the change of its ownership structure following an un-consented transfer of membership interests. Then, I focus on contractual mechanisms that members of these companies may want to buy to overcome these constraints. They will want to utilize these mechanisms for their ability to make different expectations of the members clear, to allow the dynamics of these expectations to be tracked over time, and to increase levels of participation in the business organization. These mechanisms are clauses establishing the dissolution of the company at will, whenever a certain type
of bottleneck limits the functioning of the company, and different types of lock-in clauses to control the scarcity of resources legislatures face when providing corporate default rules.

In general, when it comes to legislating new laws or reforming old ones, legislatures focus on the supply side. Legislatures tend to increase the supply of laws because they control the supply mechanisms. What is also fundamentally the case is that resources are scarce. Thus, legislatures try to increase the legislative supply within a context of a scarcity of resources (e.g., people, money, information, or a combination of all of these elements). If one compares law-making to an operating system through the perspective of supply and demand coordination, the next immediate question is how to make sure that the right legal products and resources are at the right place and at the right time so as to allow companies to maximize their profitability and shareholders wealth. The basic formula is this: The sale of legal products equals a minimum of supply and demand.

\[ S = \min \{\text{supply} \& \text{demand}\} \]

The products referred to are corporate default rules. These companies face unpreventable bargaining failures, that is, circumstances conducive to the breach of the company’s contract, and problems of private ordering.⁴ All these unpreventable problems spring out of the microsphere of limited liability companies (LLCs). In the face of these problems, this essay builds on the analytics and decisions involved in creating a productive system of corporate default rules that is likely to minimize these

problems. Productive means *effective* and *efficient*. In other words, the assumption is that legislatures are expected to enact the right law and to enact the law right. This may sound more intuitive to a manager of a plant, a manufacturer or producer of goods, for example, for which the operating system includes a set of processes (physical and managerial) necessary to acquire resources, manufacture the product, and distribute it to the customers. This may also sound intuitive to a service provider for whom the operating system has a similar function. It is a given fact that certain firms grow and prosper while others do not; that there is a myriad of features that distinguish winners from losers in several types of industries; that, generally, successful firms provide goods at a profitable margin. If this holds, legislating (or the act of providing *legal products*) also lends itself to this sort of analysis.

Production means to maximize outputs over inputs, that is, to maximize products over resources. However, this cannot be read independently of the demand side. Let us imagine that firm Blue produces 100 units per hour while firm Orange produces 10 units per hour. At first, one could say that the Blue firm is a winner for it is clearly more productive. Yet, this firm’s picture becomes gloomier if the demand for its products equals 0. By analogy, legislatures ought to observe the market and deliver in accordance with market agents’ expectations. This raises two philosophical and normative questions. One follows the other. What if the question in law, rather than being ‘Can we legislate it?’, is ‘Can we sell it?’ What should be the legislative output? At the end of the day, the market agents’ system is their business. For law to be an output, it has to have the potential to be effectively *sold*. Toward this goal, legislatures must seriously consider demand for laws. Knowing what the demand is involves a law-making
capacity analysis, which implies the following questions: What are the necessary resources? How much resources are needed? Where are they needed?

Moreover, supply should factor in that market agents not only demand certain laws, but also demand encompassing laws that consider productivity goals and the integrative aspect of their business. Market agents construe a business that is likely to encompass different marketing, finance, operations, and accounting-related interests. This is not an easy task for legislatures as the purposes of businesses change rapidly due to global competitive pressures for immediate results that are difficult for law to follow. This has become increasingly the case for LLCs, which also are subject to such competitive pressures, particularly those companies that have hybrid features and additionally combine characteristics of publicly held companies.

On top of this, these business organizations must cope with conflicts that are pervasive in the organization. It might be that the company is not meeting some of its members’ expectations, which leaves to these members one of two options: to withdraw from the company and sell their membership rights or seek stronger relationships with the management. The downside of this second alternative is that in the LLC, managers or directors also are members. So, turning to the top management is not a strategy that will always succeed in surmounting the constraints that haunt the relationships between corporate constituencies.

Thus, this essay considers strategies to design the company’s contract to facilitate onboarding of corporate constituencies to maximize the success of the company.\(^5\) In

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\(^5\) See Daniel M. Cable et al., *Breaking Them in or Eliciting Their Best? Reframing Socialization around Newcomers’ Authentic Self-Expression*, 58 Admin. Sci. Quart. 1 (2013) (discussing the results of several
fact, the reality of the socialization in the company may be very different from the
compny's onboarding strategy. In these circumstances, contract governance becomes
strikingly important, for it tends to align different interests and expectations inside the
organization. Naturally, if managers are incompetent because they cannot perceive
complementarities that members can, there is only so much that contractually designed
onboarding or socialization methods can do. Once members are forced to make an
investment, then they are expected to align their interests with the interests of the
company and other corporate constituencies. They are more likely to stay in the
company, cooperate and optimize the contractual bottlenecks. The point of mechanisms
of contract governance such as dissolution at will and lock-in clauses is to keep them
doing so in the long run.

II. THE BOTTLENECK PROBLEM IN THE LLC

LLCs are inherently contractual business organizations (‘For Shakespeare, it may have
been the play, but for a Delaware limited liability company, the contract’s the thing’).6
This is the legal form of most small and medium-size firms in the United States. One of
the main reasons for their success in most American states since the late 1980s is their
flexibility and ability to attract money from all sorts of investors. Legislatures have
succeeded in providing a legal product mostly constituted by corporate default rules
that consumers of corporate law have consistently chosen to use.

years of research on organizational onboarding—the process by which new employees are introduced to
the culture of a given organization. These authors take a new approach to onboarding that privileges
personal-identity socialization over the traditional approach to organizational onboarding that is based in
the acculturation of the employees. They argue that their new approach is more likely to boost employees’
self-esteem, which allows them to express a positive identity towards the company).

Aug. 19, 2008).
However, this flexibility is also the basis of multiple paradoxes that are inherent to LLCs’ contractual purpose. At the heart of the LLC there is (or at least there should be) a contract, the operating agreement. Operating agreements determine how the company will operate. They control all the rights and obligations of the members; establish the economic interests of the members and the role of managers or directors (top management). According to the Uniform Limited Liability Company Act § 101, ‘An operating agreement means the agreement under § 103 concerning the relations among the members, managers, and limited liability company. The term includes amendments to the agreement.’ In focusing on the paradoxes deriving from the operating agreement, which is the same as the company’s contract, this essay does not draw attention to other charter documents such as the certificate or articles of incorporation, by-laws, certificates of articles of organization or formation. These documents are particularly important at the formation of the company but do not provide the core contractual features of the business.

Operating agreements are contractual tools that are meant to reflect the members’ choices as to the legal framework of their business. They either include corporate default rules provided by statutes or they provide specific rules negotiated by the parties to the company’s contract. This alternative derives from the fact that, in general, statutory default rules can be opted out of by the members if they will. A great number of provisions established in the statutes are off the rack provisions that consumers of corporate law can use to avoid transaction costs or bargaining failures. Statutes such as the Delaware Limited Liability Company Act (hereinafter ‘Delaware Act’) are known for distinctively enhancing the contractual features of the LLC, which determines that

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operating agreements not only be well-drafted, but also very detailed and almost litigation-proof documents.

Unusually, a possible axiom like ‘let us regulate so that we can do better together’ does not always work in a framework that has been contractually designed such as the one of the LLC. Typically, operating agreements provide restrictions on the transfer of membership rights. Lawyers customize these restrictions to the goal of the company. The problem is that members often do not know what the goal of their company is. They, albeit in smaller numbers than in the corporation, show problems of coordination, difficulties in aligning their interests, and ultimately they withdraw from the company by selling their membership rights, totally disregarding the ownership structure and prerogatives that they previously agreed and contracted upon.

Restrictions on the transfer of membership rights are contractual bottlenecks. They limit members’ capacity to bargain. Since they are often unenforceable due to the thickness of the relational element (that is, the close ties, family relationships, or kinship that often bond the members) that permeates the environment in the firm, they weaken members’ property rights in their units, especially if there is not a consensus as to the purpose of determining the ownership structure of the company in one way or the other. These types of contractual bottlenecks constitute in many situations a significant limit to the throughput of the company (provided that the goal of the company is clearly defined). They potentially constrain the company’s growth. Ultimately, they will affect the decision-making process in the company because they determine the capacity of the company to efficiently achieve its goal. The company may have a member that constantly looks for his or her own individual improvement rather than the
improvement of the company as a whole. Such members seek new bargaining opportunities in spite of other members’ lack of capacity to further their own utilities due to their loyalty to kinship or family ties that easily prevent change in a growing company. Consequently, one of the big challenges of these business organizations is to create patterns of *ongoing improvement* in face of corporate resistance that makes the company lag.

The answer ought to reside in the kind of leadership exerted by the top management of LLCs. Nevertheless, an efficient answer to the shortage of throughput of LLCs due to contractual bottlenecks is difficult for the top management to give. Power in these companies is frequently diffused. Managers or directors also are members and this can be an obstacle to creating mechanisms that would improve the bargaining position of weaker members. Given that restrictions on the transfer of membership rights mostly affect these members with weak property rights, the top management should find dynamic ways to make those members more able to excel.

The importance of making these members excel is manifold. The members with what seem to be the weakest bargaining position are the key to controlling the effectiveness of the contractual dispositions laid out in the company’s contract. Put differently, if membership rights of these members are not enforceable, then the company’s contract is only providing *empty property rights*. Governance of the company’s contract should be aimed at creating circumstances or actions that empower these members’ property rights. This is the same story as that one of a group of scouts who keep lagging in their goal to reach the peak of the mountain quickly because the chubbiest member sets the pace of the whole group.
From the policy standpoint, we want to think about lawmaking in terms of capacity. Resources such as money, people, and information cannot be measured in isolation. Considering what happens at the micro-sphere of these companies, the point is to optimize the entire system of corporate default rules. These rules should facilitate a realignment of interests and contractual capacity in the company so that members whose property rights come at the end of the line can potentially come at the beginning, that is, be given the consideration they deserve. Thus, in law it is important to determine which resources are bottlenecks and which ones are not. In asking what the bottleneck is, one should not think of it as an activity, but rather as a resource available to meet the goal provided in the operating agreement of the LLC.

Restrictions on changes to the ownership structure provided by default rules are bottlenecks because, depending on how they are designed and incorporated into the company’s contract, they make some members resemble the chubbiest scout in the group. These members have the least bargaining capacity and the fact that their property rights are weak will determine how the whole company will perform or underperform, especially from a relational point of view. This is not so much the case with the one member who is eager to sell. Contractual bottlenecks determine the effective capacity of the company in overcoming bargaining failures. They determine how swiftly corporate constituencies can overcome bargaining costs implied in changes of ownership. The purpose of having a contractual bottleneck, that is, restrictions on the transfer of membership rights provided by corporate default rules, should be to make the flow of these legal provisions equal market demand.
One point to keep in mind is that contractual bottlenecks are not necessarily good or bad. They exist. They are a reality, in particular in LLCs, which oftentimes are family businesses and want to stay closed to third party interference. Where bottlenecks exist, however, they should be designed to control the flow between a legal provision (a legal product) and the demand of the market for these types of legal provisions. As a consequence, finding the contractual bottleneck in the law and/or in the contractual framework of the company makes a great difference in managing LLCs’ resources.

The governance of the company’s contract is meant to address this issue. Mechanisms of contract governance ought to be designed to manage the legal resources provided to the company by corporate default rules. Therefore, managing this governance opportunity involves adjusting members’ bargaining capacity so that the contractual bottleneck is in the front line of corporate decision-making and all other resources (people, money, and information) have gradual increases in their capacity to make up for the fluctuations, the ups and downs in the decision-making process of the company, deriving from the dependence of their members on each other and, more generally, passed through dependency between corporate constituencies.

Contractual bottlenecks in the LLC provide leeway for conceptualizing facilitative mechanisms of contract governance within the corporate setting. These mechanisms promote exploration and experimentation of contractual formulas and allow members as well as the company’s top management to recombine their interests. Despite their purpose, restrictions on changes in ownership can be functionally designed to facilitate bargaining in LLCs. Ultimately, the goal for the contractual governance of the organization is to create a process of ongoing improvement that makes the company
grow by locking in the investment of its members, on one hand, and unlocking what seemed to be unresolvable problems of private ordering, on the other.

Problems of private ordering can be traced in the LLC in the following way. Restrictions on transfer of membership rights, which mostly limit the transfer of management and also economic rights inherent in the membership, have long been provided by legislatures in the form of default rules. Although they have the opportunity to opt out from these rules, market agents oftentimes roughly transcribe restrictions established by statutory default rules. Typically, if these restrictions are breached, the buyer of the units will not be granted any management rights in the company. However, they can exercise economic rights. The point is that these restrictions fail their purpose, which is to make members hold on to their investment in the company and keep the ownership structure in the company unaltered. Rather than rules of contractual governance, they are designed as prophylactic rules that miss their point. Usually, these restrictions boil down to unanimity requirements or consent of non-transferring members and even directors or managers of the company. Such restrictions keep the company closed to the interference of third parties. They also support the typically concentrated ownership of the LLC with its closed nature and enable the members to insulate themselves from passive investors who might seek control over their investments. Despite the many purposes of restrictions on changes to ownership in LLCs, these business organizations often lack a plan toward a process of ongoing development or regeneration of the contractual setting of the business. Put differently, these restrictions easily become outdated and inefficient as a result of constant changes at the company and firm levels. And this is a distinctive cause of bargaining failures that, in many circumstances, are simply unpreventable.
In addition, these bargaining failures uncover new challenges to understanding the composition and dynamics of property rights held by the members. Un-consented transfers are not invalid, for they allow the buyer to exercise economic rights in the company, unless the operating agreement provides otherwise. Yet, the exercise of mere economic rights rather than management rights can easily work as a revolving door by which the seller unloads its obligations toward the company by entering into a trust agreement with the buyer. The buyer becomes, then, member *de facto*, indirectly exercising management rights that the initial contractual framework of the company was drafted to avoid. This also means that the property rights in the shares of non-transferring members, which are expressed in their right to vote in a new member, are stripped by weakly enforceable contractual clauses.

Unlike the traditional view of property rights, which perceives them as absolute and static, the contractual framework prevalent in these business organizations shows that being a member does not guarantee that their membership rights will not be ripped off by the decision of other members to sell regardless of the existence of a contractual bottleneck. This essay focuses on how lawyers and business strategists can legally engineer and design more holistic solutions that align the dynamics of the property rights that members hold in their units with the goal of contractually governing these business organizations. This essay is about the physics of the company’s contract and how it is possible to *optimize the contractual bottleneck*.

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III – MANAGING THE COMPANY’S CONTRACT WHEN DEMAND FOR CORPORATE DEFAULT RULES IS UNCERTAIN

A. General Considerations about the Design of the Company’s Contract

In this essay, I provide a normative account of operating agreements, which are able to accommodate the introduction of contractual clauses establishing restrictions on changes in ownership of the company through transfer of membership rights. To this end, I try to avoid any sort of contractual determinism while analyzing the micro-structure of the firm.

These restrictions enable corporate constituencies, in particular members of the company, to maintain the closed nature of their business and to ensure that changes in the company’s ownership structure are approached from an entitlements perspective. At the same time, these restrictions influence market agents’ behavior as to the way they perceive their investment in the company, and the relationships of power between members and directors of the company. All in all, these restrictions, besides being contractual bottlenecks, are expected to be mechanisms of governance utilized to face the uncertainty deriving from the incompleteness of the company’s contract.

Considering the type of contractual relationships in these business organizations, the thickness of the relationships (or strong relational links) between members and other constituencies, and the pervasiveness of the conflicts that often undermine the implementation of onboarding strategies and alignment of contrasting interests, it is legitimate to ask policy-wise how much resources are needed and when (i.e., the optimal
updating frequency) in order to meet the market agents’ demand for an efficient menu of corporate default rules. The uncertainty of demand determines that legislatures might find it optimal to fix one of these variables (how much and when) and follow market signals to decide upon the other. From the policy point of view, in order to answer the riddle that is the other variable, legislatures ought to ask another set of questions. What represents the relevant cycle during which a new menu of defaults should be provided or reviewed? What represents the period of risk of a shortage of efficient corporate default rules deriving from the uncertainty of the contractual relations among market agents? What represents the total amount of menus used as protection during the period of risk?

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SS = X - \mu_r
\]

\[
FR = 1 - \frac{E[SH_c]}{\mu_c}
\]

In these two relations, SS represents a hedge or buffer against the risk of uncertainty (deriving from outdated legal products); X represents the menus of corporate default rules available during a period of risk or uncertainty; \(\mu_r\) is the expected demand for a period of risk; FR is the performance measure or indication of how well the risk or uncertainty is managed. This measurement is based on a representative period of time (a cycle); \(E[SH_c]\) represents the expected shortages of efficient legal products per cycle (which depends on the period of risk); and \(\mu_c\) represents the expected demand per cycle. The connection between these two relations is that \(E[SH_c]\) depends on X, that is, the corporate default rules available during a period of risk or uncertainty.
The context in which corporate default rules are designed is pervaded by risk or uncertainty.\(^9\) The lawmaker does not know what is the demand or the expectations of the market agents that account for a shortage of efficient corporate default rules. Market frictions such as asymmetries of information, negative externalities, restrictions on competition, collective action problems that cause institutional apathy and opportunistic behavior in general, have traditionally been linked to a need for more regulation. It is even said that these problems justify the restricting of members’ freedom to contract and design the company’s operating agreement, both at the moment of its foundation and beyond.\(^10\)

However, this view of the company, considering only its contractual features, must be tempered with the right approach to property rights. This includes their governance by contract. Against this backdrop, the shaping of fundamental legal institutions executed by lawyers is of undeniable importance.\(^11\) Lawyers, acting as gatekeepers, can engineer the company’s contract through well-crafted and clever solutions based on Pareto efficiency. Still, default rules informing the contractual choices taken by market agents and their lawyers are designed by legislatures. Frequently, these rules have displayed weak enforceability. They also fail to create incentives for market agents to change, particularly when the legal framework no longer fulfills their interests. In addition to

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\(^10\) See Stefan Grundmann, *European Company Law: Organization, Finance and Capital Markets*, 51 (2nd ed. 2012) (stating that considerations in respect to collective action problems that lead to ‘shareholders’ apathy’ ‘… are important for restricting the freedom to design the company’s statutes at the moment of its foundation, but they are certainly no less important for restricting the freedom to change the statutes later’).

managing with an outdated legal framework, market agents may also be ill-advised by their lawyers.

The potentially pervasive effects of outdated default rules and the inefficient role played by ill-prepared lawyers in customizing contractual relationships justifies thinking seriously and systematically about a model policy that could create a hedge or buffer to manage the uncertainty or risk that comes with market frictions. In reality, it is difficult for the lawmaker to account for a cost from the shortage of legal products such as default rules. Thus, I think of lawmaking in terms of management of the uncertainty or risk of providing market agents with outdated rules that do not meet the expectations on the demand side.12

In this context, and from a technical or mechanical standpoint, this essay additionally explores the alternatives available to lawyers and business strategists to readjust the relationships between corporate constituencies in LLCs whenever there is a change in ownership that is not accommodated by the hedge given by the default rules adopted to regulate the operating agreement. The readjustment of relationships in the company is undertaken through the design of contract clauses that facilitate the flow between legal provisions and market demand. Put differently, the bottom line of this readjustment is to transform contractual bottlenecks into non-bottlenecks. This creative endeavor can be compared to the drafting work of an engineer. The lawyer, like the engineer, understands the importance of relevant information being effectively communicated (in

12 There are, however, several reasons legislatures and regulators (politicians) will not always enact or reform law pursuant to the interests of the market. Market can be defined in economic terms as a transaction by which there is interplay between supply and demand. Markets have different structures and some of them have very complex structures. There is this view that markets are legally construed and can exist only in the framework set by law and government. This is the case of financial markets. See Katharina Pistor, A Legal Theory of Finance, 41 J. Compar. Econ. 315 (2013).
the case of the lawyer, upon the incorporation of the company and the drafting of its constitutional documents).

This section is about drafting the contract of the LLC. First, it considers the approaches taken in the literature to corporate law and the corporate contract. Second, it treats some of the views that try to explain why firms are thought to be more beneficial than markets. This section is also an attempt to create a scheme of governance of the company’s contract by which the use of legal products such as corporate default rules is likely to contribute to the throughput of the company and members’ onboarding. The robustness of this scheme will be tested elsewhere against the analysis of the internal fluctuation of property rights in different circumstances and contractual settings.

Here, lawyers are described as reflexive intermediaries who assess current realities and harness them to create the best possible solutions in the interest of their clients, whether they are the members who favor a change of ownership, those who do not, the management body, or any third parties. A scheme of governance of the company’s contract calls for mechanisms that strengthen property rights through contract. Thus, this section additionally focuses on the definition of property rights ex-ante. It proposes two solutions to strengthen property rights at this stage: the dissolution of the company at will and the inclusion of lock-in clauses in the company’s contract. This normative construction of the interplay among property rights, transaction costs, and economic and political concerns owes a large debt to Ronald Coase, in particular his works *The Nature of the Firm*\(^\text{13}\) and *The Problem of Social Cost*.\(^\text{14}\)


B. The company’s contract: Why do members use it?

Why do members need to draft a contract when they incorporate the LLC? The answer to this economic question is two-pronged: it relates both to one's approach to corporate law and to the corporate contract, which has much to do with the structure of the firm and the definition of legal entity, and to the proposed view of interactions among individuals, which tries to explain the benefits of the firm in comparison to those of the market.15

The so-called nexus of contracts theory stands out in any discussion regarding the corporate contract.16 This theory submits that the firm is a nexus of contractual arrangements. In other words, the firm is what holds together a bundle of contracts such as employment contracts, supply contracts, lease contracts, and so on.17 Pursuant to this theory, corporate law is composed of a number of standard terms available to parties to use as they please.18 The nexus of contracts theory has been challenged by an increasingly strong property rights approach that maintains that some features of the company cannot be subjected to freedom of contract. Cases in point are limited liability,

15 See Ronald H. Coase, The Nature of the Firm, 4 Economica 391 (1937) (arguing that whether a multiparty activity will be organized within a firm or through market transactions is dependent upon the respective transaction costs).


18 See Frank H. Easterbrook & Daniel R. Fischel, The Corporate Contract, 89 Colum. L. Rev. 1445 (1989). It is important to note that default law is not an inherent consequence of nexus of contracts, although Easterbrook and Fischel have strongly argued in favor of default rules. There also are mandatory rules in many fields of contract law. Besides, the traditional view of fiduciary duties is that they are mandatory, and that one cannot, in principle, opt out of if one is a fiduciary. This view has been eroded somehow regarding the LLC.
capital lock-in, and even fiduciary duties, when creditors and possibly members’ rights are at stake.\textsuperscript{19}

The contractual nature of the firm has long been recognized. For example, it has been framed within the conceptual lines of long-term contracts. It also has been defined as an alternative to the coordination offered by the market through the pricing system, and which is based upon a contract that sets the limits within which the entrepreneur directs the factors of production.\textsuperscript{20} However, I propose an explanation for the efficiency of some contractual solutions over others. This entails having an eye on the residual rights of control that come along with the ownership of property rights in the firm.\textsuperscript{21}

With respect to the interactions among individuals that have fostered most of the theories of the firm, three lines of thought are worth mentioning. One is followed by the

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  \item \textsuperscript{19} Excluding limited liability and capital lock-in from contractual freedom serve a purpose of stability of the company and protection of third parties in dealings with the company or its members. The argument of subtracting fiduciary duties from freedom of contract is not so straightforward. Some authors find it puzzling. They argue that if ex ante one has the right to sign or not under specified conditions, one has the freedom ex ante to be restricted or not from performing certain behaviors via contract. See Henry N. Butler & Larry E. Ribstein, \textit{Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians}, 65 Wash. L. Rev. 1 (1990). For an anti-contractarian position, see Sandra K. Miller, \textit{Fiduciary Duties in the LLC: Mandatory Core Duties to Protect the Interests of Others beyond the Contracting Parties}, 46 Am. Bus. L.J. 243 (2009).
  
  \item \textsuperscript{20} See Ronald H. Coase, \textit{The Nature of the Firm}, supra note 15 at 391-392.
  
  \item \textsuperscript{21} See Ronald H. Coase, \textit{The Institutional Structure of Production}, 82 Amer. Econ. Rev. 713 (1992), which basically consists of his Nobel Lecture (saying that because in the world of positive transaction costs it is extremely costly and unprofitable for individuals to negotiate, even when a great deal of contracting is allowed by the law (e.g., defaults), the rights individuals possess are to a great extent determined by the law. In his words ‘It is obviously desirable that these rights are assigned to those who can use them most productively and with incentives that lead them to do so and that, to discover (and maintain) such a distribution of rights, the costs of their transfers should be low, through clarity in the law and by making the legal requirements for such transfers less onerous. Since this can come about only if there is an appropriate system of property rights (and they are enforced), it is easy to understand why so many academic lawyers (at least in the United States) have found so attractive the task of uncovering the character of such a property rights system, and why the subject of “law and economics” has flourished in American law schools’).
\end{itemize}
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proponents of transaction costs economics (TCE), another emerges from property rights literature, and the third is supported by the literature on incentives theory. The basic question is: Why do companies exist? In other words, why is it that individuals often prefer to organize their activities into a firm rather than transacting on an individual basis in the market? What drives integration? Classically, TCE sees the firm as an alternative method of coordination to the pricing mechanism. The firm appears out of an attempt to avoid transaction costs of carrying out all transactions through the market (e.g., costs of drawing a contract, costs regarding inspections, or policy costs of the contract, arrangements to settle disputes, etc.). Also, the allocation of resources is undertaken through administrative decisions of a board, which has drawn the attention of Coase, and later Jensen and Meckling, to agency relationships (e.g., master and servant, employer and employee). These considerations have been developed in modern writings, in particular in the field of new institutional economics (NIE).

The approaches taken by TCE and the property-rights literature can be distinguished from one another by two elements: transaction costs and the incompleteness of

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26 See Michael C. Jensen & William H. Meckling, supra note 16.

contracts. TCE takes the transaction as a *basic unit of study*.\(^{28}\) Private ordering (or private governance) is, therefore, the distinctive aspect of the formulation drawn by this literature. Driven by the measure of efficiency, private ordering, in the form of the most diversified contractual arrangements, is considered to be in itself self-sufficient in terms of incentives to overcome contractual inefficiencies ex-post. Since there are transaction costs and, consequently, contracts are naturally incomplete, parties will manage to find the best solutions to overcome inefficiencies ex-post.\(^{29}\)

Taking a different tack, the property rights literature centers on contractual inefficiencies ex-ante. It tries to create incentives such as *residual rights of control* by which bargaining inefficiencies are overcome ex-ante. It is interesting to note that TCE does not disregard the importance of ownership arrangements. Nevertheless, it rejects the construction of a scheme of property rights based exclusively on a centralized legal system that defines a priori the *dos* and *don’ts* of the allocation of ownership. TCE bases the construction of a system of property rights on private ordering. For the advocates of TCE, property rights matter because the owner wields decision-making power in those areas in which the contract is incomplete.

I do not perceive these views in an either/or context; we can combine the two.\(^{30}\) In terms of policy, I ask how much resources are needed and when, so that market agents’ expectations toward the provision of an efficient menu of corporate default rules are

\(^{28}\) See Oliver E. Williamson, *supra* note 22.

\(^{29}\) It may be too late to solve contractual inefficiencies ex-post. The point of incomplete contract theory is that incompleteness leaves space for ex-post opportunism for which the parties need to find a solution ex-ante. See Eric Maskin & Jean Tirole, *Unforeseen Contingencies and Incomplete Contracts*, 66 Rev. Econ. Stud. 83 (1999).

\(^{30}\) The incentives theory mentioned above in the text is basically a variety of the property rights theory of the firm. Therefore, we do not explore it.
met. Considering the level of uncertainty legislatures face, I also ask whether lawyers and business strategists can optimize contractual bottlenecks and how. This involves considerations of legal policy that set the tone on mechanisms of contractual efficiency ex-ante, such as the terms by which ownership and control are allocated in the company. It implies thinking about property rights differently, in a context wherein the lines dividing ownership and control are often blurred. It requires an understanding of who has the residual decision-making power and how that affects institutional design. It implies considering those situations in which control in the company may be acquired through a change in ownership (for example, by an un-consented transfer of membership rights, which allows a third party to interfere with the business of the company even if the so-called owners have not given their consent to it). Ultimately, it is all about understanding and making use of the dynamics of control.

LLC members use an operating agreement because they need to follow a standardized procedure that is implied in the creation of this business organization. They are thus advised by their lawyers who draft the agreement for them. But even if, in reality, members often ignore the agreement they themselves made sure was drafted, either because of close ties among them or because they want to keep a certain status quo, the fact is that by using the company’s contract, they allocate a priori the resources available for the operation of the firm and execution of the legal entity. It gives them the psychological wherewithal to move on with their business.

However, the company’s contract cannot keep up with the company's business. Except for the alteration of the members of the company, the directors, the share capital, or the registered office, as well as other relatively easy alterations to make, business practices
are likely to become rooted into a status quo that shields corporate constituencies. Governance of the contract can help break this status quo and induce the renegotiation of the contract ex-post.\textsuperscript{31} This is the other reason that members use the contract. It allows them to use governance mechanisms that will generate renegotiation at a future point in time.\textsuperscript{32} One way to conceptualize this governance opportunity is to think of governance of property rights by contract. Property rights of members, for example, should be strong enough to make other corporate constituencies such as managers feel that it is in their self-interest to behave in a manner that will put them in an advantageous bargaining position in the future regarding the members that have stronger property rights. This is true particularly if future transactions are planned.

Let us imagine a situation in which managers or directors are appointed by one of the members. If a merger is planned by which the member that appointed managers in the company will obtain a greater stake in the new undertaking, managers or directors are naturally committed in aligning their interests with the interests of the member that appointed them. On the member’s side, it is useful to have allies in a company that now merges two different corporate policies, in particular regarding the distribution of dividends and retained earnings of the company. It may be that the only way to have safeguards against opportunism is by using opportunism itself. The question is: How

\textsuperscript{31} See Florian Möslein & Karl Riesenhuber, \textit{Contract Governance – A Draft Research Agenda}, 5 ERCL 248 (2009) (distinguishing four topics of contract governance – governance of contract law, governance of contracts, governance by means of contract law, and governance through contract. In theory, the lines demarcating these forms of contract governance are more or less clear. In practice, the dividing lines are not so evident).

\textsuperscript{32} It is true that the theory of incomplete contracts treats the phase of renegotiation as one way in which parties can behave opportunistically ex-post. See, for example, Ilya Segal, \textit{Complexity and Renegotiation: A Foundation for Incomplete Contracts}, 66 Rev. Econ. Stud. 57, 58 (1999) (stating that ‘Each inefficient future trade is a potential hold-up opportunity: each party may claim that it is efficient trade, in the hope of extracting a greater share of \textit{ex post} surplus’). However, this should not prevent the parties from being provided with tools that enable them to surpass high transaction costs involved in the revision or redraft of a contract or serve the company and the interests of its members by breaking a dominant status quo that is not beneficial.
can property rights be strengthened to surmount the opportunistic behavior of corporate constituencies as a result of an engrained status quo in the company?33

C. Giving strength and substance to property rights through contract:

How to manage the governance opportunity

The idea of governance of contractual relations goes back to Coase’s groundbreaking work on the nature of the firm. The understanding that market agents can choose between the market and the firm for the organization of factors of production is in itself a governance choice.34 The problem with the word governance, however, is that it is often ill-defined in respect to its foundations, object, and purpose or functionality.35 The word governance is used by the layman in several ways to mean control, power, management, administration, the exercise of authority, or the act of governing. When it comes to the corporation, we try to attribute a more normative substance to the word governance by framing it within a perspective that takes the relationships between members, managers, and third parties (possibly creditors) into account. This is in line with a holistic understanding that in law, just as in an operating system or a plant,

33 See Oliver E. Williamson, The Economics of Governance, 95 Amer. Econ. Rev. 1, 14 (2005) (stating that ‘property and contractual hazards invite the use of private ordering to infuse order, thereby to mitigate conflict and realize mutual gains from trade’).

34 See Oliver E. Williamson, Id at 2 (claiming that ‘As against simple market exchange, governance is predominantly concerned with ongoing contractual relations for which continuity of the relationship is a source of value’).

35 See Henry E. Smith, Exclusion versus Governance: Two Strategies for Delineating Property Rights, 31 J. Legal Stud. 453, 455 (2002) (referring to ‘governance’ to mean the ‘…high degree of delineation of rights to resources in terms of use…’). He clarifies that ‘…governance can be supplied by norms, regulation, or contract. This dovetails with prior usage, because we often use the term “governance” to refer to the norms of use in common-pool regimes, to the exercise of power of the state, and to organization of economic activity through contractual restrictions’. Later, in his paper at 470 he says that ‘Governance … consists of a set of norms picking out important uses of the asset. In between are proxies that target sets of uses of varying sizes. Along this spectrum are various hybrid rules, which deny access to attributes on the basis of features or activities of the potential entrant; for example, commoners may have a rule that limits the number or type of animal an appropriator can bring onto the commons’).
everything is connected. This also is true of corporate constituencies. It is in this setting that I advance a scheme to govern the company’s contract and the relationships between corporate constituencies.

(i) Governance as reflection of reality and lawyers as *reflective intermediaries*

The foundations of contract governance rest on the uncertainty of company contractual incompleteness. The incompleteness of contracts may be associated with the extent to which members can exercise residual rights of control, and managers can exercise their discretion and business judgment.36 In the context of this uncertainty that is part and parcel of the impossibility of foreseeing all possible future events that may cause losses of efficiency, the governance structure of a company by contract should be a reflection of reality. In this context, lawyers work as *reflective intermediaries*. They look at the market and market agents’ demands and try to make the business function by adopting a 360º degree perspective. Yet, market agents can shape the market for the benefit of a particular agent or group of agents. If this happens, what are the guarantees that lawyers will provide the best solutions? Law can still be perceived and used as a commodity, as is explained below.

(ii) A multi-stakeholder perspective of the company and a chicken and egg question: what comes first: the market or the law?

The company must be viewed not only from the perspective of members’ investment, but also from a perspective that considers the creation of economic value. This demands an all-inclusive view of the company in which all corporate constituencies are regarded as potential contributors to the creation of such economic value. When these circumstances obtain, law can be seen as a commodity. Putting it differently, law can be used as an instrument that is legislatively processed and put to the use of shaping the market when it faces evolutionary limitations.

One might ask whether the duty to restore optimality of contractual relations rests upon the law or upon the market. It is notoriously difficult to answer this question. In fact, it can be perceived as a chicken or egg question, what comes first: the law or the market? Answering this question correctly matters, for a theory of contractual bottlenecks depends upon the relation that equals the sale or provision of legal products (corporate default rules) to a minimum of supply and demand for these rules. I maintain that law follows the markets in most situations, and in most cases, law comes afterwards.37 In fact, the LLC in the United States as well as its correspondent in the United Kingdom, for instance, were first created by market agents with the support of lawyers and notaries, without the existence of a legal framework for these companies. Thus, we

37 See Mark Freeman et al., Shareholder Democracies?: Corporate Governance in Britain and Ireland before 1850 (2011) (analyzing the practice of governance in joint-stock companies in Britain between the Bubble Act of 1720 and the Companies Act of 1844. According to the authors, this was a period during which the legal status of the joint-stock company in England was most uncertain, and in Scotland and Ireland was still not entirely resolved. They explain that the reason for the choice of this period is that it was one in which corporate governance structures, whether in corporations or in unincorporated companies, were largely formed without state intervention. They refer to it as the ‘key era of experimentation in British corporate governance history’). This is a good illustration of how law sets its foundations from below.
submit that law has the potential to restore optimality through a process based upon observation and experimentation. In this framework, experimentation trenches the traditional delineation of property rights to find cues for using property rights to alleviate inefficiencies informed by bargaining failures. Experimentation can be undertaken through contract governance, the object of which is the respective contract (management of contractual relations).

Companies’ operating agreements are an example of how legal engineering and experimentation can be undertaken under the aegis of default rules. There are multiple ways to engineer the contract of the company. It can be done by including clauses regulating the voting and structure of the general meeting, the voting and structure of the management board, or the inclusion of one particular member in the management board. This member frequently is the majority shareholder or an activist shareholder. It can be a member who possesses expertise, knowledge, and sophistication in financial and business matters, and in types of transactions in which the company proposes to engage. This member is expected to be capable of evaluating the merits and economic risks of acquiring or holding the units.

Other mechanisms to engineer the company’s contract can be, for example, to provide additional warrants and representation clauses, pre-contractual agreements (e.g., promissory share sale and purchase agreements, escrow agreements, certificates, instruments, and other documents foreseen in those agreements), transfer restrictions,

38 For example, LLC agreements may require that each member represents and warrants to the company and to each other member that (a) the member is acquiring membership interests in the company for the member’s own account and investment; (b) the member acknowledges that the interests have not been registered under the Securities Act of 1933 or any state securities laws, and may not be resold or transferred by the Member without appropriate registration or the availability of an exemption from such requirements; and (c) the member agrees to the terms of the Agreement and to perform the member’s obligations thereunder.
the determination of situations in which only the company can take action, the regulation of ownership interests, capital contributions, the distribution and allocation of capital, tax allocations, limitation of fiduciary duties of directors to the company, any member, and to other directors, and limitation of corporate opportunities for directors, the regulation of deadlocks, accounting reports, tax matters, indemnification and compensation of members, employees, and agents. All these are mechanisms of managing or directing the contractual venture.

However, giving strength and substance to property rights through contract, a work that lawyers and business strategists can do at the level of the market and legislatures can do at the level of legal policy, requires an accurate understanding of the mechanisms that can be used for that purpose. It is not just a matter of doctrinal knowledge or political convenience. It should be a matter of adequate reasoning and market sensitivity to the situations that can cause negative externalities and inefficiencies ex-post.\textsuperscript{39} The first question to ask is: Are stronger property rights more likely to encourage the application of the right resources at the right time for the sake of the company’s development and its members’ investment in it?

From a functional standpoint, the company’s contract can be drafted to meet this purpose. It can also be drafted to enable the periodic readjustment of property rights in order to internalize harmful externalities.\textsuperscript{40} It is likely that well-defined and strong property rights, which can be achieved through specific clauses regulating voting rights,

\textsuperscript{39} See Bruce H. Kobayashi & Larry E. Ribstein, \textit{Law as a ByProduct: Theories of Private Law Production}, Illinois Program in Law, Behavior and Social Science Paper No. LBSS11-27 (2011) Available at SSRN: http://ssrn.com/abstract=1884985 (referring to the weakness or even lack of property rights in law held by private lawmakers, which prevents them from engaging in innovation).

\textsuperscript{40} See Harold Demsetz, \textit{supra} note 23 (stressing that property rights work as mechanisms of internalizing externalities. In his words, property rights permit that the cost of externalities is brought to bear on the decisions of all interacting persons).
the composition of the management board, capital contributions, fringe benefits, loans that must be granted by members to the company, or the procedure for the transfer of property rights in shares, will unleash behavior that may be socially beneficial.

On one hand, bargaining failures may be reduced by the clarity and enforceability of the applicable rules. On the other hand, there can be a psychological effect that induces members, managers, and employees of the company to align their interests with the interests of those who hold stronger property rights, in order to benefit from the control the latter exert in the company. However, there are no guarantees that they will be rewarded by those holding stronger property rights. Part of the work of legal engineering has to do with choosing governance mechanisms with the potential to enable such effects. This task is greatly facilitated by the menu of default rules provided by legislatures. However, it must be preceded by an effort to define property rights that each corporate constituency holds in the company.

D. Mechanisms to define property rights as a management strategy of the governance opportunity

As put by Alchian and Demsetz, ‘The strength with which rights are owned can be defined by the extent to which an owner’s decision about how a resource will be used actually determines the use.’ According to Alchian and Demsetz, the management board, capital contributions, fringe benefits, loans that must be granted to the company, or the procedure for the transfer of property rights in shares, will unleash behavior that may be socially beneficial.

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As put by Alchian and Demsetz, ‘The strength with which rights are owned can be defined by the extent to which an owner’s decision about how a resource will be used actually determines the use.’ Accordingly, the way the scope of property rights in shares is designed is likely to have an influence on the exercise of these rights. It also is likely to affect the management of the company. Hence, delimiting a workable and efficient system of property rights is vital, especially if experiments are to be made at

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the market and legal policy levels to test the best way to adopt the best rules or to adjust existing ones. Delimiting here means specifying rights, duties, privileges, and powers that are certain in their content and enforceable. It means adding value to the rights of members so that they will want to hold on to their shares unless a buyer is willing to pay the right price for them. This is an alternative to renegotiation, which is undertaken through unspecified arrangements that encourage renegotiation ex-post to reach optimal results. Delimiting property rights ex-ante is equally important for a market to develop.

There are two types of contractual strategies that can be drawn to strengthen property rights: the dissolution at will of the company (or its threat) and the inclusion of lock-in clauses in the company’s contract. From the standpoint of the evolution of the firm, it is important to find mechanisms that enable market agents to choose the best rules to regulate their contractual relationships (and readjust them when needed) as well as the way in which the ownership structure of their company changes. It is equally important to create mechanisms that nudge legislatures to draft the best legislation (or provide the most efficient legal products). Consequently, in thinking about these two types of mechanisms, the question is: Will their adoption help optimize bottlenecks, that is, contractual commitments or safeguards?

(i) Dissolution at will as a remedy for un-consented changes of ownership

Frequently, courts are overwhelmed with cases of deadlock, dissension between members, or equivalent situations of bilateral monopolies where shareholders switching costs in LLCs were prohibitively high. Judicial dissolution has been treated in the literature and in jurisprudence as a mechanism to overcome these situations and respond
to unexpected changes in the relationship of the parties. An interesting case worth pointing out is Kirksey v. Grohmann, which was appealed to the South Dakota Supreme Court.

Kirksey v. Grohmann deals with a feud between four sisters who inherited from their mother equal ownership interests in family land. They decided to incorporate an LLC to which they transferred their property interests in exchange for equal shares in the LLC’s share capital (25% each). They decided to create the LLC to avoid paying estate taxes, to keep the land in the family in light of the fact that it had been there for over one-hundred years, and to make sure that the sisters and not their spouses would retain ownership interests in the real property. Following early valuations of the land and to obtain the benefit of those valuations, some family members were required to live there, and the land was used for agricultural purposes. The eldest sister had lived there as a hired hand before their mother’s death. Additionally, two other sisters, together with the eldest, owned livestock on the land. So that agricultural activities could continue, the sisters decided that the LLC would enter into a lease agreement by which the land would be leased to three of them. However, soon after the LLC was created, the relationship between its members begun to deteriorate. One of the members complained that the others ‘failed or refused to share information’ to which she believed that she was entitled as a tenant to the lease. Moreover, the complaining member claimed that two other members subleased part of the land without notice to the LLC as required by the operating agreement. The eldest sister and one of the members the complaints were made against responded by saying that the necessary information was always given. Moreover, she argued that all members had received notice of the

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42 See Larry E. Ribstein, *Close Corporation Remedies and the Evolution of the Closely Held Firm*, 33 W. New Eng. L. Rev. 531 (2011) (defending that judicial dissolution is a contractual mechanism for responding to unforeseeable changes in which owners cannot cheaply exit via sale of their shares).

43 Kirksey v Grohmann, Kirksey, 2008 SD 76, 754 N.W. 2d 825.
sublease as they were all aware of the sublease arrangement when the sublease payments were initially equally distributed. The complaining party ended up selling her interest in the livestock. At that point, she was no longer a tenant. Nevertheless, this did not end the acrimonious relationship between the members of the LLC. Two members who were not tenants to the lease (including the earlier complaining member and one other sister) hired a real estate agent to value the land. The price, which was estimated at several million dollars, caused those two members to seek the termination of the lease agreement, the dissolution of the LLC, and the partition of the land. These members filed a motion to terminate the lease agreement at the general meeting of the company. The two other members opposed the motion. Given that the company’s contract required resolutions be decided by majority vote, the motion failed due to the deadlock. In the face of the deadlock, the member who moved the action and the one who seconded it filed a petition with the circuit court of South Dakota requesting that the court dissolve the LLC because ‘its economic purpose was unreasonably frustrated and it was not reasonably practicable to carry on the company’s business in conformity with the articles of organization and the operating agreement.’ They added that ‘the strained relationship between the sisters made it impossible for any major decision-making’ to occur and that the two opposing members had ‘a personal financial interest in continuing the lease agreement and preventing dissolution of the LLC’ to the detriment of the plaintiffs. The circuit court denied the plaintiffs’ petition. They appealed to the Supreme Court of South Dakota, invoking the error of the lower court in granting summary judgment against judicial dissolution of the LLC. The Supreme Court reversed the summary judgment granted in favor of the defendants and remanded the case for

44 This is an example of opportunism fueling a situation of deadlock. They were trying to dissolve the LLC that was set up exactly to prevent a split-up of the land.
entry of an order of judicial dissolution and winding up pursuant to S.D. Codified Laws § 47-34A-806. The Supreme Court provided that

The sisters created their company with the understanding that they would have relatively equal say in its overall management and operation. Although each sister has an equal vote, there no longer exists equality in the decision making. [G and R] have all the power with no reason to change the terms of a lease extremely favorable to them. Leaving two sisters, half the owners, with all the power in the operation of the company cannot be a reasonable and practicable operation of a business. Moreover, their deadlock certainly impedes the continued function of the business in conformity with its operating agreement. No procedure exists in the company’s documentation to break a tie vote and protect the company in the event of changed condition. As long as the company remains in control of, and favorable only to, half its members, it cannot be said to be reasonably practicable for it to continue in accord with its operating agreement.

The court goes on saying that in this case

… we have two members of an LLC that hold all the power, with the other two having no power to influence the company’s direction. We recognize that forced dissolution is a drastic remedy and may produce financial repercussions for the sisters, but how can one reasonably conclude that the economic purpose of this company is not reasonably frustrated? The members cannot communicate regarding the LLC except through legal counsel. *The company remains static, serving the interests ... of only half its owners.* They neither trust nor cooperate with each other. The sisters formed their company contemplating equal ownership and management, yet only an impenetrable deadlock prevails. [Emphasis added]
One might ask why dissolution is needed for this problem. Could not this situation of self-dealing be resolved under the duty of loyalty? If fiduciary duties do not provide a solution, dissolution would still be an alternative. Next, one might wonder about less severe solutions for the problem, such as changes in the governance agreement. The rub lies in the idea that even though rights were foreseen statutorily, the reality was not reflective of the agreement into which the members had entered. Furthermore, this is a case that mirrors how the relationships of power in small companies are likely to freeze the business purpose for which they were created. The firmly established status quo that subverted the purpose of the ownership interests led the court to dissolve the LLC.

It is interesting that in this case the court opted to take the drastic measure of dissolution instead of reasoning about other remedies like, for example, breach of fiduciary duties, breach of contract, or the controlling shareholders’ opportunism. In this essay, we recognize that restrictions on transfer of membership rights fail as governance mechanisms of the LLC, which, given its nature and purpose, frequently begs for a contractual structure that limits the openness of the market for its shares. The failure rests in the fact that members end up selling their units in breach of the requirement of consent stipulated in the company’s contract. In the United States, if the transfer is not

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45 See Robert B. Thompson, Corporate Dissolution and Shareholders’ Reasonable Expectations, 66 Wash U. L. Q. 193 (1988) (stating that ‘The legislation and judicial decisions expanding dissolution rights and providing alternative remedies reflect this reality more accurately than the traditional statutory and fiduciary norms, which overlooked the intimacy of the participants’ relationship, the illiquidity of their investment, and the inability of participants in such enterprises to plan adequately for disharmony’). Courts have been keen to reiterate the principle stated by the US Supreme Court that ‘where a dispute arises from obligations that are expressly addressed by contract, that dispute will be treated as a breach of contract claim’. Moreover, any fiduciary claims arising out of the same facts that underlie the contract obligations would be foreclosed as superfluous’. On this, see Fisk Ventures v. Segal, 2008 Del. Ch. 158 (May 7, 2008); Vila v Bwwebties LLC, -- A3d --, 2010 Del. ch. Lexis 202 (Rel. ch. Oct. 1, 2010 citing Nemec, 991 A.2d at 1129 (citing Blue Chip Capital Fund, 906 A.2d 827, 833 (Del. Ch. 2006); Gale v. Bershad, 1998 Del. Ch. LEXIS 37, 1998 WL 118022, at *5 (Del. Ch. March 3, 1998).

46 This is, in fact, stressed by Meghan Gruebner, Delaware’s Answer to Management Deadlock in the Limited Liability Company: Judicial Dissolution, 32 J. Corp. L. 641, 656 (2007) (arguing that ‘A buy-sell agreement is probably the best solution for management deadlocks, because it allows the communication
consented, the transferor can still transfer the economic rights. In Europe there are countries where such a transfer may be considered by courts as entirely unenforceable. The problem is that often these measures are not sufficient to prevent the indirect influence of a third party in the company, which subverts the purpose for which the LLC was created. One could think that the fact that operating agreements offer exit mechanisms such as rights of appraisal would be enough to prevent bargaining failures and situations of bilateral monopoly. Nevertheless, when exit mechanisms are consecrated in the company’s contract, they may be outdated because they were agreed upon at a time when the contractual expectations of the parties were different.

Given these circumstances, the question is whether it is normatively acceptable to push the remedy of judicial dissolution beyond fault of controlling shareholders, as in Kirksey v. Grohmann. In other words, can dissolution be used in broader terms for protection of the interests of corporate constituencies?47 It is difficult to say conclusively, because dissolution is a drastic measure. However, in the United States, LLCs like partnerships are often at will; any member can send the company into dissolution. A court may order dissolution for some important reasons such as the frustration of the economic purpose of the company. Furthermore, we refer to dissolution because constituencies hold common interests in the company and, therefore, a possible scenario of dissolution has the potential to (re)adjust the interests of shareholders, managers, employees, and even creditors.48 This is so because, if the

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47 See Mark Freeman et al., supra note 37 (referring to special rights of dissolution in conjunction with the clause of limited liability).

48 In the context of the problems raised by dissolution, see Jianpei Li & Elmar Wolfstetter, Partnership Dissolution, Complementarity and Investment Incentives, CESifo Working Papers, No. 1325 (2004)
company ends, any economic rents they expect to draw from the LLC will most likely be destroyed and managers and employees will lose their jobs if the company is dissolved.

According to the Delaware LLC Act, an LLC is dissolved and its affairs shall be wound up upon, among other causes, the happening of events specified in an LLC agreement. The Delaware LLC Act focuses strongly on the agreement. Courts are not very likely to overrule a governance agreement for which the parties explicitly bargained. This stands in contrast with older case law on close corporations. Additionally, case law on fiduciary duties emphasizes the priority of contracts. The Delaware LLC Act also foresees judicial dissolution. Courts may order dissolution for some relevant reasons such as when it is not reasonably practicable to carry on the business in conformity with an LLC agreement. As to the reasonably practicable standard for judicial dissolution, and for the most part similarly to the case Kirksey v. Grohmann above, courts have ordered dissolution of an LLC where there is a deadlock. However, it is not infrequent (analyzing the relationship between investment and the dissolution decision. The dissolution rule to which they refer is typically a buy-sell provision, which they propose be combined with a right to veto the proposed dissolution. Otherwise, dissolution will always entail an efficiency loss).

49 See § 18-801 (dissolution). This is a default rule, which means that members have considerable leeway to dispose otherwise.


51 See Fisk Ventures, LLC v. Segal 2008 Del. Ch. LEXIS 84.

52 See 6 Del. C. §§ 18-802 (judicial dissolution). Some court decisions stress that in cases in which the standard for judicial dissolution is met, the ultimate determination of whether dissolution should be ordered is committed to the relevant court's equitable discretion. See, for example, Haley v Talcott, 864 A.2d at 93.


In this judgment of the Court of Appeals of New York, it is stated that 'Any corporation may arrive at a condition where dissolution is the right and necessary course'. This is true not only of the corporation, but also the LLC.
that operating agreements include a waiver clause by which members agree that the initiation of a dissolution action will cause irreparable damage and they therefore agree to waive their rights to seek dissolution or the appointment of a liquidator.

The LLC is often described as a hybrid entity (at times, referred to in jurisprudence as an alternative entity) that combines characteristics of corporations, limited partnerships, and general partnerships. Partnerships are at will, and LLCs frequently are as well. Perhaps the reason why LLCs are at will is that the United States LLC laws are based on partnership law (the statutes are very similar). This is different in Europe, where private limited liability companies are small versions of the corporation.54

It has not always been like this in the United States, especially before the first LLC state statute had been implemented (which happened in Wyoming in 1977). Previously, when the Treasury Regulation §§ 301 – 7701-2 defining business association was still in force,55 Larry Ribstein, the recognized expert in the field, claimed that given the high costs related to the illiquidity of partnership interests, a partner’s power to dissociate from the firm at will was desirable. Nevertheless, he called attention to ex ante

54 This is apparent if one reads the Bill Jacket of the NY LLC Law, where reportedly Chapter 34 of the Consolidated Laws Limited Liability Company Law was enacted at the same time that partnership and business corporation laws were amended. It was possible to learn through a letter of John B. Daily, Senator for the 61st District, dated as of 13 July 1991, addressed to Ms. Elizabeth D. Moore, the Counsel to the Governor, that the Bill of the LLC for the State of New York would not only allow the formation of LLCs under New York law, but also the recognition of general partnerships that provided professional services as registered limited liability partnerships (RLLLPs) under state law, and the recognition of limited liability status of general partnerships that provided professional services that had registered as limited liability partnerships (LLPs) in other states. It is understandable that the joint treatment of LLCs and RLLPs, especially for tax purposes, determines similar legal solutions for different types of business organizations to be adopted.

55 This refers to regulations 26 C.F.R. §§ 301.7701-1 to 301.7701-3, also known as ‘check-the-box regulations’ which allowed members of LLCs to elect to have the business treated as a corporation given that LLCs were ‘disregarded’ as separate taxable entities, and were treated as sole proprietorships for tax purposes.
uncertainty and the costs that non-dissociating partners would have to bear. For example, the abusive exercise of dissolution at will by a partner ‘may cause all of the non-dissociating partners to give up partnership assets without adequate compensation or to lose the benefit of firm specific human capital.’\textsuperscript{56} Thus, he fashioned a cost–benefit approach to partner dissociation.\textsuperscript{57} One interesting idea is the fact that dissolution at will can not only be used by partners when they were not able to predict \textit{ex ante} potential causes of dissociation, but also it can be used when there is no uncertainty in the face of the contractual obligations assumed by the parties. In these circumstances, dissolution can be used as a ‘threat of dissociation to force renegotiation of the bargain.’\textsuperscript{58} Another possibility is to utilize dissolution at will in order to induce a particular investor to invest more. This investor, who can be a ‘vital resource contributor,’ will have considerable incentive to renegotiate the company’s contract if faced with the threat of dissociation by other members. If other members dissociate, the investor will lose the investment made to that point. Another argument put forward by Ribstein in favor of dissolution at will is that it is a cost-efficient contractual device that avoids higher costs of dissociation and prevents the withdrawal of firm-specific investments in human capital, for instance.\textsuperscript{59} Nevertheless, he points out that his conclusions do not necessarily apply to corporations (closely and publicly held alike). No reference is made to the LLC because it would not be created until a few years after. Still, dissolution at


\textsuperscript{57} See Larry E. Ribstein, \textit{supra}

\textsuperscript{58} See Larry E. Ribstein, \textit{supra} at 390.

\textsuperscript{59} See Larry E. Ribstein, \textit{supra} at 391 (arguing that ‘A related point favoring dissociation at will is the availability of cost-efficient contractual devices to protect against costly dissociation. If the statute provides for dissociation at will, the partnership can discourage dissociation and protect against withdrawal of human capital and other resources by developing firm-specific capital the partners would lose by leaving, by limiting the compensation to be paid to the dissociating partner, by providing for payment of liquidated damages, or by limiting post-dissociation competition’).
will is an alternative that is plainly foreseen for partnerships, but which also is worth exploring in respect to the LLC. This was, in fact, done by the court in Fisk Ventures, LLC v. Segal, where the court applied by analogy the statute for limited partnerships.

Additionally, courts can generally order corporate dissolution or other relief when cases of deadlocked members or managers, or manager misconduct make judicial dissolution warranted. The dissolution order may be issued based upon equitable considerations. This means that dissolution may be a sound alternative and, therefore, can be granted despite an LLC agreement containing an exit mechanism (e.g., a put right) because, for example, it would ‘not be equitable to force [the petitioning member] to use the exit mechanism where the member would remain liable on personal guaranty of entity’s mortgage after exit,’ or it would not be fair to force a buy-out at all if, according to the operating agreement, the petitioner is given an option to leave and, depending on the

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60 I am grateful to Larry Ribstein for having discussed this idea with me while I was a Visiting Scholar at the University of Illinois College of Law back in 2011. See § 18-801 (b) of the Delaware LLC Act where it is foreseen that ‘Unless otherwise provided in a limited liability company agreement, the death, retirement, resignation, expulsion, bankruptcy or dissolution of any member or the occurrence of any other event that terminates the continued membership of any member shall not cause the limited liability company to be dissolved or its affairs to be wound up, and upon the occurrence of any such event, the limited liability company shall be continued without dissolution’.


62 See Vila v. Bvwebties, LLC, -- A.3d --, 2010 Del. Ch. Lexis 202 (Rel. ch. Oct. 1, 2010); Phillips v. Hove – A.3 d --, 2011 Del. ch. Lexis 137; Achaian, Inc. v. Leemon Family LLC, 25 A.3d 800 (Del. ch. 2011) (this case poses the following question: May one member of a Delaware limited liability company assign its entire membership interest, including voting rights, to another existing member, notwithstanding the fact that the limited liability company agreement assigns the affirmative consent of all of the members upon the admission of a new member, or, must the existing member assignee be readmitted with respect to each additional interest it acquires after its initial admission as a member?); and Fisk Ventures, LLC v Segal, --A3d --, 2009 Del. ch. Lexis 7 (Del. ch. Jan 13, 2009) aff’d 984 A.2d 124 (Del 2009). In this last case the court famously stated that ‘if that deadlock cannot be remedied through a legal mechanism set forth within the four corners of the operating agreement, dissolution becomes the only remedy available as a matter of law. The Court is in no position to redraft the LLC Agreement for these sophisticated and well-represented parties’.

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circumstances, it decides not to do so. This is a business decision of the petitioner that does not necessarily imply a circumvention of the agreement.

As ‘creatures of contract, designed to afford the maximum amount of freedom of contract, private ordering and flexibility to the parties involved,’ LLCs’ legal framework, especially the one provided by the Delaware LLC Act, is meant to be flexible. It allows the parties to structure their company as they deem appropriate. The wide scope of freedom of contract, private ordering, and, consequently, flexibility enables members to draw property rights in their units by experimenting with new solutions. Additionally, they can align their interests in ways that can seem unusual in the eyes of an outsider, but which make perfect sense considering the context of the company. The LLC is a good example of how contract law can create a laboratory—an analytical legal matrix—that sets the grounds for new conceptualizations of property rights and their delineation. It also sets the grounds for mechanisms to (re)arrange the members’ and managers’ governance relationship. The alternative of dissolving a company should be understood in light of the ample scope of freedom of contract and the enforceability of the company’s contract that statutory default rules provide. By reading dissolution (including dissolution at will) in light of the principle of freedom of contract, the validity of contractual clauses that use it to avoid acute bargaining failures

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65 See Larry E. Ribstein, supra note 56 at 364 (enhancing the relative flexibility of closely-held firms by saying that ‘Despite variation among firms, the relatively closely-held firm is a suitable model for designing statutory dissociation provisions because economies of scale of transaction costs make large firms more likely than smaller ones to enter into customized agreements’).
in the company is maintained. That does not jeopardize courts’ competence to order judicial dissolution.

The imposition of restrictions on transfer of shares is likely to create deadlocks and hold-ups and, consequently, prevent the company from operating or furthering its business object or goal (for example, the decision-making process of the company would be seriously affected if resolutions at the general meeting are subject to impasse). If this happens, it may not be reasonably practicable for the company to carry on its business. A clause allowing dissolution at will, by which a company may be dissolved at the will of one of its members, is understandable because it is unlikely to result in a destruction of going concern value. It would be interesting to evaluate the costs and benefits resulting from the choice that parties are given by law to contract around such provision instead of drafting for it. This implies rethinking the principle of maintaining the substance of the company that is provided by American law in light of mechanisms of governance such as safeguards and commitments that point in the direction of an optimal level of contractual bottlenecks.

This does not eliminate questions related to minority or majority members’ oppression. Nevertheless, if bargaining for maintaining the ownership of the company is optimal, those who most value the company and their investment in it will take that threat of dissolution seriously.

Hence, dissolution costs may work as a red light that pops on if members and managers threaten to jeopardize the enabling environment created by the defaults they chose when they entered into the company’s contract. Dissolution costs comprise those incurred
from accountancy and legal advice (which include services regarding personal liability, restructuring, liquidation and insolvency, and taxation). These are costs that the parties to the company’s contract may not be ready to bear. Furthermore, the parties to the company’s contract, as well as managers and the employees of the company, may have sunk investments on human and physical capital they are not willing to lose with the premature dissolution of the business.66

(ii) Lock-in clauses

Lock-in, in this context, means investment commitment.67 A lock-in contractual clause is engineered to reflect the needs of the company and its shareholders in the long run. For that reason, lawyers while drafting the company’s contract will pay attention to the contractual technology they are using.68 Lock-in techniques are used intentionally to bond market agents to a commitment they made when they assumed contractual obligations. The stickiness of the relational element in LLCs leads to a stable equilibrium that is difficult to upset. Putting it differently, when the relational element prevails, different contractual practices are hardly developed in the LLC in the long run, for there is a stable equilibrium from which market agents appear not to deviate (even when deviating from it would seem to be beneficial). However, members and managers

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66 See Timothy Guinnane & Susana Martinez Rodriguez, For Every Law, a Loophole: Flexibility in the Menu of the Spanish Business Forms, Department of Economics Yale University, Economics Department Working Paper No. 103, Economic Growth Center Discussion Paper No. 1012 (2012) (referring to one of their findings which was that Spanish firms they included in their sample and belonging to the ‘chemicals and pharma’ sector seemed to be more worried about untimely dissolution than other firms such as those in the ‘food and drink’ sector because the former type of firms ‘…had more sunk investments in intellectual property and firm-specific human and physical capital…’).


of these companies often engage in opportunist behavior. Thus, within the logic of
transaction costs economics, the purpose of lock-in clauses is to enable institutional
change and contractual innovation and simultaneously avoid opportunistic or
treacherous behavior. I explore lock-in clauses based upon a system of periodic or
continuous revision of the existing menu of corporate default rules, but there are other
alternatives for designing these clauses. It will all depend on the imagination,
knowledge, intuition, and expertise of the lawyer.

For example, drafting a clause providing a mechanism equivalent to a put-option or a
‘right to sell’ as an insurance or guarantee of minority shareholders’ investment and of
shareholders’ investment in general may be an alternative to dissolving the company
and, at the same time, overcome bargaining failures if they exist. The exclusion of the
seller of units from the company when this sale is un-consented could be drafted as
another type of lock-in clause. The question that arises is: Which member is excluded,
the seller or the buyer? The answer is intimately connected with the system of transfer
of property rights in a particular jurisdiction.

(iii) Lock-in clauses: A continuous review system of corporate default rules

The idea of creating a continuous review system by which clauses are constantly revised
is in line with the construction of an environment that encourages longstanding
investment by market agents, and dissuades them from behaving opportunistically.
Lock-in clauses make members, managers, and employees of the company put their
money where their mouth is. Unlike the dissolution clause, these clauses pay due
respect to the principle of substance of the company. The regular update of clauses, and
particularly the clause that regulates changes in ownership, is meant to help overcome inconsistencies and ambiguities in the interpretation of the company’s contract. It also is supposed to trigger disclosure of information that is likely to be omitted or kept secret since there are no mandatory requirements of disclosure for these companies as there are in respect to public companies, especially if listed in stock markets.69

Roberta Romano stresses that the standard pattern of financial regulation is the provision of legislation in a crisis atmosphere under conditions of great uncertainty followed by status quo stickiness, for the legislator somehow waits until it gets a consensus about what has happened so that a tailored solution can be designed. In order to face this problem, Romano proposes that Congress and regulators include, as a matter of course in financial legislation and regulation adopted in the midst or aftermath of a financial crisis, procedural mechanisms that require automatic subsequent review and reconsideration of those decisions along with regulatory waiver powers that would create flexibility in implementation and promote experimentation.70 She is dealing with financial regulation and suggesting solutions to be implemented mostly by legislatures. Her understanding echoes the idea that, in the face of substantial uncertainty followed by status quo stickiness, it is crucial that legislatures and regulators are in a good position to facilitate a change of paradigm. Lock-in clauses, however, should be contextualized within the market operative system. They should be understood at the level of contracting because LLCs are contractual in their nature and purpose.

69 Drafting or redrafting a contract normally requires the reviewing of the former contractual framework and the collection of new information from the parties so that the revised contractual setting matches their expectations.

70 See Roberta Romano, Regulating in the Dark, in Regulatory Breakdown: The Crisis of Confidence in US Regulation, 86-117 (Cary Goglianese ed. 2012). However, the idea of ‘sunset legislation’ is not new.
We present the continuous review system in a scenario where the market’s demand for corporate default rules within a certain cycle is uncertain and not constant. In this scenario, legislatures face the risk of providing outdated rules. The mechanics of managing the menus of corporate default rules (X) is the following. Demands for default rules occur, thereby depleting the existing menus of corporate default rules (the key aspect in this scenario is that demand is not constant, it is uncertain and conditional upon the market dynamics); once the menu of corporate default rules becomes outdated, the expectation is that the legislative process be set in motion to provide up-to-date, revised legal products that appeal to the demand side; eventually, legal revision occurs and new and up-to-date menus are established, until there are new demands for revised default rules. The process repeats.

This process, which we name *continuous review*, is one by which legislatures constantly monitor the level of corporate default rules menus, waiting for them to become outdated (*review point*), at which time, new statutory rules are enacted. The specificity of this process of continuous review lies in the need for legislatures to systematically keep track of the menus of corporate default rules. The only way to meet this goal is by understanding the level at which these menus ought to be managed and constantly updating data. This is when answers to the questions asked above should be provided.

What represents the relevant cycle during which a new menu of defaults should be provided or reviewed? What represents the period of risk of a *shortage* of efficient corporate default rules deriving from the uncertainty of the contractual relations among market agents? What represents the total amount of menus used as protection during the period of risk?
If all variables in this process are fixed, the variation is in the cycle, that is, the time that it takes to arrive to the next review point. Thus, in this scenario, the cycle is the average time between review points ($\mu_c$). The period of risk is, in reality, a lead time ($L$). It is the time legislatures have to implement a decision and during which there must be an understanding of what the average demand for new defaults is ($\mu_r$). Additionally, protection against provision of outdated legal products ($X$) is the same as the review point. Put differently, the expected shortage of legal products per cycle ($E[SH_c]$) depends upon the review point, that is, the next point when the law will be reviewed.

In sum, the managing policy of corporate default rules within a continuous review process is the following. How much law and when it is needed (i.e. optimal updating frequency) depends on determining the review point. If, by observation, the menu of corporate default rules reaches the review point, this menu must be reviewed. Determining the review point can be an onerous endeavor since demand is unknown. In these circumstances, every possibility of demand has a probability of demand. Consequently, the review point is equivalent to the hedge or buffer ($SS$), the operation of which requires continuous market observation.

(iv) Lock-in clauses: A periodic review system of corporate default rules
— A fixed time problem

This scenario is similar to the previous one, except that demands for legal products now occur at constant intervals of time. The mechanics are similar. There will be demands for default rules that deplete the existing menus of corporate default rules; once the menus of corporate default rules become outdated, legislatures proceed when it is time
to review, that is, they adjust the existing menu of corporate default rules to new demands; when review occurs, new and up-to-date menus are established until there are new demands for revised default rules. The process repeats.

I call this hypothetical *periodic review* because legislatures are only expected to monitor the menus of corporate default rules at certain times rather than constantly. The time intervals between review points are fixed (every T period). The same questions as before should be posed. What represents the relevant cycle during which a new menu of defaults should be provided or reviewed? What represents the period of risk of a shortage of efficient corporate default rules deriving from the uncertainty of the contractual relations among market agents? What represents the total amount of menus used as protection during the period of risk?

The length of the cycle will be the average time between orders (T). From the policy perspective, what is required is to learn the average demand of corporate default rules during T (u_c). The period of risk will be the interval during which it has to be investigated what is the average demand of corporate default rules during L and T (µ_r). The protection during the period of risk will be equivalent to q and I where q denotes the amount of corporate default rules demanded or which are called for review and I denotes the amount of existing menus of corporate default rules at the review point. Here, E[SHc] will depend on q and I.

The problem with a periodic system of review of corporate default rules is that market life cycles are becoming increasingly shorter. Markets’ dynamics, which involve all sorts of competitive phenomena, ranging from mergers and acquisitions, new business
strategies that often lead to product cannibalization, and mainstream technology, put a
great amount of pressure on the physics of legal policy and corporate decision-making.
Again, the response depends on market observation, for the market defines demand.

(v) Lock-in clauses: Implications of continuous and periodic review systems for the
governance of the company’s contract

The implementation of any of the processes of review at the policy level will have
implications at the market level, especially if it responds to the demands of the market
by efficiently determining the review point. However, processes of review that respond
efficiently to the demand side are not a guarantee that systematic review of contractual
clauses, in particular those regarding ownership, will come to pass. Systematic review
can be provided for and reflected into the company’s contract because there may be new
legal products that market agents will want to abide by. Still, so can restrictions on
changes of ownership be included into the company’s contract. Thus, neither of the
systems of review constitutes proxy of contractual compliance. They do not replace the
members’ freedom of contract and, for this reason, do not guarantee that members will
abide by the default rules included in the company’s contract that they accepted.

There must be incentives for market agents to align their demands with legislative
reviewing cycles. The problems do not differ very much from those that make contracts
incomplete—uncertainty, high transaction costs, and weak property rights that do not
provide their holders a strong bargaining position. The possibility for any member to
trigger a reviewing process in the company after there exists a reviewing point at the
legislature’s level is paradoxically dependent on the supply side. That is, it is dependent
upon whether legislatures are successful in observing the market and determining the review point.

Then, it will also depend on determining the exact contractual bottleneck. It may be that restrictions on changes of ownership are functional rather than dysfunctional in certain companies. It is difficult to say which contractual strategy will work best, for this depends on the circumstances of the business. Still, clauses regulating ownership as well as other clauses of the company’s contract, such as those regulating governance, must be attuned to the reality of changing circumstances in business. This may be achieved through experimentation at the level of contracting, which is likely to determine that the environment in the company will also change. Lock-in clauses serve this purpose. The special aspect of these clauses is the fact that, if well drafted, they are liable to make market agents commit to their investment.

IV. CONCLUSION

This essay proposes a scheme for the governance of the company’s contract. It is a mechanical scheme that approaches the legislative process as an operations system and the company’s contract as the legal context for a process of ongoing improvement in the company. In doing so, an eclectic language is used that makes reference to concepts of law, engineering, organizational economics, business operations, and strategy.

Default rules, which members normally include in the company’s contract, give members a governance opportunity. Members have the option to adopt these rules, or contract around them and choose other contractual solutions. One possible way to
manage this governance opportunity is to adopt mechanisms that allow members to manage their property rights through contract. I point out two alternative strategies—dissolution at will and lock-in clauses.

In respect to the dissolution of the company at will, I make a connection with partnership law. This makes sense especially for LLCs, which are in substance partnerships. There are obligations that are so basic that, if broken, the company can arguably be dissolved. However, the principles of partnership law can be very specific. If dissolution at will is foreseen in the company’s contract, members are empowered in their ownership rights. The threat of dissolution at will is likely to encourage members and managers to align their interests by nudging them to act non-opportunistically. Furthermore, the mechanism of dissolution may work as an investment incentive since it gives members and potential investors the idea that it is possible to leave the business, if particular circumstances arise. This is a mechanism that can be used not only by the seller of the units to pressure other members to provide their respective consent, but also by any other non-transferring member. The latter can threaten to dissolve the company in the case of an un-consented change in the ownership structure of the company.

Lock-in clauses appear here as mechanisms that are supposed to reflect the needs of the company and its members, and are able to lock-in investment. They are embedded in two different systems of review, a continuous review system or a periodic review system of corporate default rules. These systems are fundamentally analytical, for they are based on market observation. In these circumstances lawyers act as reflective intermediaries whose task is to overcome the paradox inherent to the freedom of contract of market agents and efficiently craft the company’s contract to govern the
property rights of members and (re)arrange the relationship between corporate constituencies whenever it is needed.