IMAGINING BUSINESS ASSOCIATIONS WITHOUT AGENCY LAW

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The intractable normative question, “whom should corporate managers serve?” has a legal corollary: for whom are corporate managers agents? The law has always been clear about this: a corporate agent acts on behalf of the corporation as her principal. The legal status of the board of directors is a little trickier: neither each director individually nor the board as a whole is legally an agent of the corporation. Rather, the board has a rather unique position as statutory caretaker. Because it is the supreme spokesperson for the corporation, the board provides the “control” of a principal over the corporate agents. However, it is clear that the board is not the principal, and the corporate agents do not act on the board’s behalf. Although the agency status of corporate officers and other employees is legally clear, the law does not help solve the practical problems that arise when one’s principal is an insensate legal person. If, as most scholars today assert, the corporation is best viewed as a nexus of contracts, then the identification of the principal is even more difficult.

In partnerships and limited liability companies, which I will refer to generally as “entities,” the governing statutes have adopted agency law in its entirety. The statutes state that partners, members, and managers (collectively “managers”) are agents of the entity.¹ Thus, the principal is, as in the case of the corporation, an insensate legal person, but in an entity there is no person or body such as the board of directors with ultimate authority to speak for the principal. This leaves the entity (the principal) in the awkward position of being unable to control or authorize its agents, except through other agents whom it cannot control or authorize. To some degree, the entity statutes solve this problem by specifying a range of actions that all entity managers are authorized to perform on behalf of the (dumb) principal.² The revised Limited Liability Act rejected this approach, however, so it is conceivable that an LLC will have no authorized agents at all.³

¹ See UNIF. P'SHIP ACT § 301, 6(I) U.L.A. 101 (1997); UNIF. LTD. LIAB. CO. ACT § 301, 6B U.L.A. 585 (1996). See also REVISED UNIF. LTD. LIAB. CO. ACT, 6B U.L.A. 469 (2006) (see comment expressly rejecting agency language, although it does not necessarily reject the application of agency law to members or managers of LLCs).

² See UNIF. P'SHIP ACT §301.

These practical and theoretical difficulties suggest that perhaps we need to reevaluate the nature of the relationships involved in business associations of all kinds. Is there another way to think about those relationships that more appropriately reflects the expectations of the parties? In this paper, I propose an “asset-pool” approach to business associations. Agency law concepts are appropriate for natural persons who can manifest consent and exercise control in the ways envisioned by agency law, but these same concepts are ill-suited for entities. Under the alternative asset-pool approach, the asset pool is only the bearer of liabilities; while various natural persons have rights, duties, and obligations with respect to the asset pool and each other. There is no principal-agent relationship among the natural persons or between the natural persons and the asset pool. This approach thus avoids the absurdity of locating rights and powers in fictitious legal persons. The model for this set of relationships is not agency law, but rather ancient forms of business association.

One well-known example of ancient asset-based liability is the Roman family. The family was the basic unit of social intercourse in Rome, and all family property was owned by a single human, the paterfamilias. Everyone and everything belonging to the family, including the wife, sons, daughters, sons’ wives, adopted children, and slaves, was said to be in patria potestas – the power of the father. The offensiveness of this system to modern sensibilities perhaps obscures the fact that this institution was actually a bundle of assets under the control of a single decision-maker. The paterfamilias was liable for everything that was done by those in his power – that is, those who were using the assets in the bundle. But it was the family property, not

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4 Professor Larry Ribstein has persuasively argued that agency law should be delinked from partnership law, and that partnership law should develop its own rules that are appropriate for its nature. Larry E. Ribstein, _Are Partners Agents?_, 3-5 (Ill. Law and Econ. Research Paper Series, Research Paper No. LE08-004, Jan. 18, 2008), available at http://ssrn.com/abstract=1086745. Since partnerships are creatures of contract, the law of the partnership can be, and perhaps ideally would be, determined by the partners themselves. Even so, law must provide default rules and rules governing relations between the partners or the partnership and third parties.

5 This approach bears some similarity to the nexus-of-contracts conception of the corporation. There is an important distinction, however. The nexus-of-contracts approach considers a variety of contracts between many parties interested in the corporation – that is why it is a “nexus”. Here, I am interested in only two contracts: the contract between the contributors and the managers and the contract regulating relations among the contributors themselves. Moreover, these two contracts do not intersect in any meaningful way for my purposes.


7 J. Inst. 2.9.1-2; Stephenson, _supra_ note 6, at 340-41.

8 See J. Inst. 2.9.1-2, 4.7.6-8; Stephenson, _supra_ note 6, at 340-41.
the *paterfamilias*, that bore the liability for the actions of the sons and slaves.\footnote{See J. Inst. 2.9.1-2, 4.7.6-8; STEPHENSON, supra note 6, at 340-41. Note, however, that because the family property was owned by the *paterfamilias*, this distinction would have no practical effect.} The asset-pool theory explains the peculiar doctrine of noxal liability, which seems aberrant to modern eyes. Noxal liability permitted a *paterfamilias* to turn over a wrongdoing slave to the victim rather than paying for the injury.\footnote{See J. Inst. 4.8.} Thus, noxal liability permitted the *paterfamilias* to remove the offending asset from the pool.

In addition, asset segregation was available in the Roman family:\footnote{If the liability arose in a business activity, the liability might be limited in some circumstances to the assets related to the business. See generally David Johnston, *Limiting Liability: Roman Law and the Civil Law Tradition*, 70 Chi.-Kent L. Rev. 1515, 1519-22 (1995) (discussing how a creditor who brought an *actio de peculio* against a *paterfamilias* based on an obligation made by the actions of a son or a slave could only recover up to the amount in the *peculium*, regardless of whether this value was the full extent of the debtor’s obligation).} The *paterfamilias* was permitted to set aside a pool of assets (the *peculium*) to be used by his sons or slaves in a separate enterprise.\footnote{In addition, a son’s military earnings, and later his earnings from a profession, were held in a separate *peculium*. See STEPHENSON, supra note 6, at 396-97.} Liabilities arising from that enterprise were limited to the assets in the *peculium*.\footnote{See Johnston, supra note 11, at 1516, 1521-22.} The *peculium* itself, however, was owned by the *paterfamilias*.\footnote{Id.} As noted, the actions of all those in *patria potestas* bound the *paterfamilias*, so that sons and slaves functioned somewhat like agents, but the liability of the *paterfamilias* arose from the ownership of the relevant property.\footnote{Id. at 1526-27 (discussing liability based on the *peculium*). Johnston argues that the general liability of the *paterfamilias* with respect to the family assets in general is based on consent because the *paterfamilias* put the son or slave in charge of the business. See id. at 1520-21. See also MAX WEBER, THE HISTORY OF COMMERCIAL PARTNERSHIPS IN THE MIDDLE AGES 85-91 (Lutz Kaelber trans. 2003) (discussing the family as holder of common property generally).} The family was not the only bundle of assets recognized in Roman law, however. The state, the emperor, and the church held property in their own names and were subject to rights and obligations with respect to that property.\footnote{This was permitted by Constantine’s Edict of Milan in 313. See CHARLES NORRIS COCHRANE, CHRISTIANITY AND CLASSICAL CULTURE 197 (Oxford Univ. Press 1944) (1940). See The Internet Medieval Source Book, Medieval Sourcebook: Galerius and Constantine: Edicts of Toleration 311, 313, available at http://www.fordham.edu/halsall/source/edict-milan.html, for an English translation of the Edict.} The estate of a deceased
person was held as a universitas iuris,\textsuperscript{18} which contained all the assets of the decedent and which would usually pass in its entirety to its new owner.\textsuperscript{19}

The best, although less well-known, model for the asset-pool theory of business associations is the medieval commenda.\textsuperscript{20} To create a commenda, an investor transferred custody of specific property, such as goods or cash, to a trader, who took the property abroad to engage in business.\textsuperscript{21} The trader had complete discretion\textsuperscript{22} with respect to the commenda (the assets), based on the original agreement. In the commenda, only the trading assets were put at risk.\textsuperscript{23} The asset pool could include a share in another pool of goods or in a ship, or could be created by the trader from the combined goods of several investors.\textsuperscript{24} The original agreement provided for a division of profits between the investor and the trader; this was usually 75-percent to the contributor and 25-percent to the trader, but it could vary.\textsuperscript{25}

How would an asset-pool theory of business associations work today? The first requirement for this approach is an identifiable pool of assets to serve as the focus of business conduct.\textsuperscript{26} Every form of business association other than a sole proprietorship has such a pool.\textsuperscript{27} It is the creation of the pool – by the contribution of property to the entity or the subscription for shares – that creates the association

\textsuperscript{18}This is sometimes said to be a precursor to the modern corporation.


\textsuperscript{21}See id. at 10.

\textsuperscript{22}This arrangement was a practical one at a time when communications were difficult and slow. It would also be practical today, where most businesses require expertise beyond that of ordinary investors.

\textsuperscript{23}See Harris, supra note 20, at 11.

\textsuperscript{24}See id. at 13.

\textsuperscript{25}See id. at 10.

\textsuperscript{26}I use the terms “business” and “enterprise” to mean purposive human endeavor, not necessarily profit-making activities.

\textsuperscript{27}The fact that sole proprietors, unlike all other business forms, do not segregate assets, has led to some difficulty in the conversion of sole proprietorships to LLCs. Many state statutes provide for transfer by operation of law of the assets and liabilities of an existing entity to an LLC, but lack such a provision for sole proprietorships. Courts have read into the statutes a comparable provision for sole proprietorships. See, e.g., C & J Builders & Remodelers, LLC v. Geisenheimer, 733 A.2d 193 (Conn. 1999) (solving the most immediate problem of transferring business assets and liabilities to the LLC, but raising a new problem – identifying the assets to be transferred).
in the first place, and so it is appropriate to view the asset pool as the core of the relationships involved. In addition, someone must be empowered to take care of the assets in the pool. In a corporation, statutes provide that the board of directors manages the assets that make up the corporation. In other entities, the persons who contribute assets to the pool designate someone at that time to make decisions affecting the assets. If they fail to designate someone, the governing statutes provide a default custodian. So far, this is consistent with current law. Under the asset-pool approach, however, the designated managers would not be considered agents of anyone. Rather, they would be empowered, by contract or statute, to act with respect to the pool of assets. They can bind it in contract or tort, transfer it, and otherwise deal with it as if they were its owners. They can also confer similar powers on others. The assets are available to satisfy liabilities arising from the acts of the managers with respect to the assets. Profits from the assets are added to the pool, unless the contributors have otherwise agreed. The theoretical owners of the assets are the investors, not the corporation or entity.

The asset-pool approach explains the phenomenon of corporate officers and directors owing fiduciary duties to shareholders who are not their principals. The duty of the manager to the contributors is “fiduciary” in a sense, because a person holding another’s property for the other’s benefit is generally, unless otherwise agreed, a fiduciary. But the nature of those duties is determined with reference to that particular relationship, not by agency law. Because they are custodians of the fund, managers would be held to the duty of loyalty applicable to holders of

28 Cf. WEBER, supra note 15, at 75 (discussing examples of the partnership as “simply a fund”); and WEBER, supra note 15, at 68 (quoting a Genoan charter of 1165 in which the parties agree that the managing partner “is obligated to carry this whole partnership to Bugia, to put it to work . . .”).

29 This approach probably closely resembles the actual expectations of many parties in closely-held corporations.

30 Managers in this scheme are obviously analogous to trustees, but to apply trust law to business organizations would be, once again, to subject relationships to legal rules designed for a different set of circumstances. Investors have always been free to create a trust if they chose to do so; however, few have done so, which suggests that trust law does not provide a desirable set of rules for business associations. Another analogy is a bailment, where the bailor has agreed not to seek a return of the bailed property until some specified event, such as dissolution.

31 Cf. WEBER, supra note 15, at 70 (describing the societas maris).

32 To avoid many practical problems, the legal owner of the assets would continue to be the entity.


34 See Malone v. Brincat, 722 A.2d 5, 9 (Del. 1998) (“An underlying premise for the imposition of fiduciary duties is a separation of legal control from beneficial ownership”).
constructive trusts when they are dealing with the assets in the fund. In the absence of agreement, the managers would have no power or authority with respect to the ownership of the assets in the fund or the relations among the owners inter se. Thus, if the managers act so as to affect the ultimate ownership of the assets or alter the governance structure, those actions would be officious and therefore invalid, if not tortious, as an interference with another’s property or contract right, unless the contributors have expressly or impliedly consented to the managers’ participation in those decisions. In practice, this would mean that such actions by the managers would be very closely scrutinized. Similarly, the selection of new or continuing managers by the contributors would be strongly protected from interference. The managers themselves should have little role in the process by which successor managers are chosen, such as the election of directors, other than providing information and agreeing to the terms of their own service.

With respect to the managers’ powers, these too should be determined by reference to the contributor-custodian relationship. The contributors have agreed to risk these assets in the hands of the managers, with the expectation that the managers will engage in a more or less specified business. The assets were not put at risk with respect to other businesses – that is, activities that do not involve the assets in the pool or that involve the assets in a venture outside the scope of the contribution. There will, of course, be difficult determinations about the precise delineation of the scope of the contribution, even if the parties have entered into an express agreement about it, but the determination of that scope should be by reference to the intent of the parties at the original creation of the venture. The reasonable expectations of third parties dealing with managers should also be protected, because those expectations were, or should have been, part of the risk the contributors accepted when they created the venture. Thus, rules such as those

35 Decisions about how to use the property would be largely at the discretion of the managers, because this was presumably the intent of the parties in placing the assets in the custody of the manager. This would maintain the current distinction applied in business associations between the duty of care and the duty of loyalty.

36 Decisions affecting ownership would include issuing shares (i.e., dilution), entering into mergers or de-facto mergers, interfering with (or preferentially enabling) the sale of shares by a single shareholder, or expelling a partner or member. Decisions affecting relations among the owners would include changes to bylaws or operating agreements and actions affecting voting rights or policies. Thus, under the asset-pool approach, the distinction between management and governance described in Blaisius Indus., Inc. v. Atlas Corp. would have to be maintained. See 564 A.2d 651, 660 (Del. Ch. 1988) (distinguishing matter that “does not involve the exercise of the corporation’s power over its property, or with respect to its rights or obligations” from matter that “involves allocation, between shareholders as a class and the board, of effective power with respect to governance of the corporation.”) (emphasis in original).

37 Even if it were possible to draft an agreement defining the scope of the business in sufficient detail to answer all disagreements, such an agreement would have very high transactional costs.
governing apparent authority and estoppel would continue in practical effect, although removed from their agency law packaging.

How would the law be different if it were based on the asset-pool approach? The business judgment rule would continue to apply, because the shareholders, as contributors, assigned management power to the board when they created the asset pool. But the board, in dealing with the asset pool, would be restricted by the original contract. In consequence, the law would include some notion similar to the old *ultra vires* doctrine, and persons forming new pools of assets would be encouraged to make clear their understanding of the limits of the venture. Where the manager is an equity participant in the venture, as in the *commenda*, the members would not have the power to remove him or her without cause. In other cases, where the manager’s participation in the investment is not an essential part of the manager-investor relationship, the members would be free to remove the managers at will. With respect to corporations, the law should facilitate the removal of directors by shareholders, unless the directors were expected to participate as directors in the profit of the venture. This is not ordinarily true in corporations today; however, the change in law might precipitate a change in that custom.

The asset-pool approach would provide a solution to the problems addressed in at least four of the papers that are part of this Roundtable. Professor Heminway explores a manager’s duty to disclose personal information to shareholders. Under agency law, it is hard to justify many of the existing mandatory disclosure obligations because managers do not owe duties to the shareholders. If the shareholders are viewed as contributors to an asset pool and the managers are viewed as their chosen custodians, the obligation of the managers to disclose material information is obvious – it would be a term, express or default, of the contributor-custodian agreement. Professor Simmons notes the under-theorized and undervalued role of in-house counsel in corporate governance. That state of affairs reflects the awkward position of in-house lawyers, whose client does not exist and therefore

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38 Courts are already required to distinguish these two situations. *See* Merola v. Exergen Corp., 668 N.E.2d 351, 354 (Mass. 1996) (explaining the difference between employee-stockholders, who are not entitled to enhanced protection as minority shareholders, and minority shareholders, who are so entitled).


40 The disclosure requirements of the Federal securities laws fill a gap in state corporate law, which requires that managers provide information to shareholders only in limited situations. *See generally* Malone v. Brincat, 722 A.2d 5, 10-11 (Del. 1998) (explaining the disclosure requirements within Delaware General Corporation Law).

cannot act as the client in the lawyer-client relationship. Instead, in-house counsel must interact with natural persons who are not their clients and whose interests diverge from, and perhaps conflict with, the interests of the lawyer’s nominal client. If the law abandons its illogical vision of the entity as the principal, we can re-conceive the position of in-house counsel, whose job would be acting for the benefit of the owners of the asset pool, and whose client would be the shareholders.  

The asset-pool approach would be most useful in dealing with corporate governance issues that are intractable under current law. Professors Fairfax and Bruner explore the uncertainties about, and problems of, the shareholders’ power to alter the governance mechanisms of the corporation. The specific issues they address are instances of a broader problem that Professor Bruner describes as the law’s ambivalence toward shareholder governance. That problem results from and reflects the imposition of agency law on the corporation, where the principal does not actually exist and the true parties in interest – the shareholders – have no legal status at all. Under an asset-pool approach, where the board is the custodian of assets pursuant to a contractual delegation by the shareholders, the shareholders, and only the shareholders, would control governance decisions. The practical difficulties of coordinating shareholder action, including the rational apathy problem, would be addressed by placing a contractual or legal obligation on the managers to facilitate shareholder action, but the managers would have no other role in governance.

The law of business associations would look very different if it jettisoned agency law and adopted a new set of doctrines based on the conception of the business association as an asset pool. Such a change in law would impose high costs on existing businesses. It is possible, therefore, that agency law is actually the best legal regime despite the fact that it is a poor fit for many business associations.

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42 As in the case of shareholder control of governance, the managers would have the contractual or legal obligation to represent the shareholders’ interests with counsel when it is impractical for the shareholders to do so directly.


44 See Bruner, supra note 43, at n.44 and accompanying text.

45 This is also true regarding fundamental changes to the asset pool, such as mergers and similar transactions.


47 Under this approach, as under current law, dissenting shareholders must be protected if the terms of the original contract are to be changed without their consent. The important point here is that, unlike current law, the board of directors would not be part of that process. One appropriate protection might be expanded appraisal and buyout rights.
Consideration of the alternative, however, may help illuminate the benefits, as well as the problems, of the regime at hand.