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Why Corporations?

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Abstract

This Article suggests that reform of the governance of publicly held firms might appropriately include a move from the corporate to the partnership form. The corporate form is susceptible to regulation, rigidly centralized and not readily adaptable to firms' varying circumstances. These features are unsuitable for new economy firms that rely on markets and networks rather than integration. Partnership's greater flexibility and freedom from government interference arguably makes it a better choice than corporation for many publicly held firms. Thus, the persistence of incorporation may owe more to politics and regulation than to efficiency. The rigidity of the corporate form makes it easier to regulate and therefore provides more rent-seeking opportunities for politicians and interest groups than if parties could freely choose their business form. Taxation of corporate distributions reduces owners' incentives to take control of corporate earnings. Also, by protecting managers' power, preserving the corporate form co-opts the interest group that is best able to lobby for change. However, new corporate tax rules, increased federal regulation of corporate governance, and the changing nature of U.S. business may give firms new incentives to use the partnership form. Lawyers may be the agents of change, as they have been in promoting partnership-based business forms for closely held firms.



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WHY CORPORATIONS?

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This Article suggests that reform of the governance of publicly held firms might appropriately include a move from the corporate to the partnership form. The corporate form is susceptible to regulation, rigidly centralized and not readily adaptable to firms' varying circumstances. These features are unsuitable for new economy firms that rely on markets and networks rather than integration. Partnership's greater flexibility and freedom from government interference arguably makes it a better choice than corporation for many publicly held firms. Thus, the persistence of incorporation may owe more to politics and regulation than to efficiency. The rigidity of the corporate form makes it easier to regulate and therefore provides more rent-seeking opportunities for politicians and interest groups than if parties could freely choose their business form. Taxation of corporate distributions reduces owners' incentives to take control of corporate earnings. Also, by protecting managers' power, preserving the corporate form co-opts the interest group that is best able to lobby for change. However, new corporate tax rules, increased federal regulation of corporate governance, and the changing nature of U.S. business may give firms new incentives to use the partnership form. Lawyers may be the agents of change, as they have been in promoting partnership-based business forms for closely held firms.

INTRODUCTION

Calls for reform of the governance of publicly held firms are phrased in terms of *corporate* governance, though the corporate form is just one of several embodied in state statutes. The accepted wisdom is that firms generally divide into closely held and publicly held, with the partnership form being suited to the former and the corporate form to the latter.¹

This Article challenges the assumption that the corporate form is optimal for publicly held firms. In general, the Article views choice of standard form as one of the dimensions in which governance terms are formulated, together with customized contracts, exchange listing agreements, and federal and state law.

1. In this Article, unless otherwise noted, "partnership" refers not only to general partnership, but also to limited partnership, limited liability company, limited liability partnerships and other non-corporate business forms based on partnership.

This Article focuses on what is at stake in standard form contracting.

At first glance, it seems that not much is at stake. Since both partnership and corporate standard forms deal with similar governance problems and since many of those problems are common to all firms, it is not surprising to find many of the same features in both types of standard forms. For example, both provide a mechanism for segregating piles of assets and dedicating them to the firm as distinguished from the firm's owners.² This means that neither the firm's owners, nor their heirs or creditors, can deal with the property as if it were owned individually. In order to avoid a conflict of interests, someone needs to manage these assets separate from the affairs of the individual owners. In other words, *any* firm, whether a corporation or partnership, is to some extent a distinct "entity." Also, standard forms are mostly default rules and in that respect matter only to the extent of the costs of drafting around the rules.

To some extent the differences between the corporate and partnership forms are based on making the forms suitable for the distinct contexts of publicly held firms, in which there is an active market for the firm's shares, and closely held firms, where there is no such market. In the absence of a securities market, exit must be provided by buyout or dissolution rather than trading. Limited liability of corporate shareholders makes an active market feasible, but also involves costs, including the moral hazard of letting people conduct business without full responsibility.

Other differences between these forms are more subtle but still important. In particular, the corporation has always been burdened by the "concession" theory, which originally made it a quasi-public entity. Corporate governance is rigidly centralized and not readily adaptable to firms' varying circumstances.

The greater flexibility and freedom from government interference of partnership-based business forms make these forms better choices than a corporation for many publicly held firms. The persistence of incorporation therefore may be attributable more to politics than to efficiency. The rigidity of the corporate form makes it easier to regulate and therefore provides more rent-seeking opportunities for politicians and interest groups than if the parties to firms could freely choose a legal framework for their business form. An important regulatory aspect is taxation of corporate distributions which reduces owners' incentives to take control of earnings. Also, by protecting managers' power, regulation of the corporate form co-opts the interest group that is best able to lobby for change.

The Article is organized as follows. Part I discusses potential efficiency explanations for the corporate form. Part II discusses some defects in these efficiency explanations. The distinctive aspects of the corporate form,

2. See Henry Hansmann & Reinier Kraakman, *The Essential Role of Organization Law*, 110 YALE L.J. 387 (2000).

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particularly including the corporate type of centralized management, have costs even for publicly held firms, particularly “new economy” firms that are becoming leaner and more market-based.

By contrast, as discussed in Part III, partnership-based forms are fully contractible and not burdened by the legacy of the concession theory. Partnership flexibility also offers firms opportunities to avoid regulation of governance. Part IV considers a political explanation for why, despite partnership’s advantages, publicly held firms continue to adopt the corporate form. Specifically, corporate inflexibility and the concession theory serve both politicians’ interests, by making it easier to regulate business and managers’ interests, by protecting their power. The important question, therefore, is how long these groups can hold off pressures for change. Part V considers other possible explanations for the continued dominance of the corporate form, including network effects. Part VI concludes.

I. AN EFFICIENCY-BASED EXPLANATION FOR CORPORATIONS

This Part discusses a potential efficiency-based explanation for the dominance of the corporate form for publicly held firms. Section A provides a brief introduction to the functions of business forms. Section B discusses the suitability of the corporate form for publicly held firms.

A. *The Role of Standard Forms*

There is an initial question of why it matters whether a firm is a corporation or a partnership. In other words, why are not all of the significant issues concerning the governance of business associations resolved by specific contracts among the participants in the firm or between the participants and the firm itself as a nexus of contracts?³

Statutory standard forms serve at least three general functions.⁴ First, they provide default rules that conserve on contracting costs. These rules obviously are more important as contracting costs increase. Thus, a small and stable group of owners, as in the typical closely held firm, can contract relatively cheaply for most governance rules that bind them. However, it is relatively costly to contract for rules that bind creditors’ claims, such as those that confine creditors’ claims to the assets owned by the debtor firm or to those of the debtor owners.⁵ Moreover, there are distinctions within these broad categories

3. As to the role of the firm as a nexus of contracts, see, e.g., Stephen M. Bainbridge, *The Board of Directors as Nexus of Contracts*, 88 IOWA L. REV. 1 (2002); R.H. Coase, *The Nature of the Firm*, 4 ECONOMICA (N.S.) 386 (1937); G. Mitu Gulati et al., *Connected Contracts*, 47 UCLA L. REV. 887 (2000).

4. See generally, Larry E. Ribstein, *Statutory Forms for Closely Held Firms: Theories and Evidence from LLCs*, 73 WASH. U. L.Q. 369 (1995) (summarizing functions of standard forms).

5. See Hansmann & Kraakman, *supra* note 2 (discussing affirmative and defensive asset

of default rules. Among the owners, it may be costly to foresee the circumstances in which the parties will want to break up the firm, and therefore to provide the terms that govern in these circumstances. With respect to creditors, it is less costly for the firm to contract with a few large individual creditors than with many trade creditors.

Second, business associations provide for distinct *sets* of default terms. This indicates why the law not only provides default rules for business associations, but also groups these terms into separate statutes. Grouping default terms aids planning by combining complementary terms. For example, a term providing for personal liability of owners is efficiently combined with terms providing for direct and equal management rights, per capita profit sharing and dissolution at will. Grouping default terms also aids in interpreting the firm's governance contracts and applying regulation to the firm. The fact that a firm has chosen a particular set of complementary terms better indicates what terms the owners wanted to apply in areas where the standard form and customized contracts are silent than if the parties selected terms from a single menu of default rules. Similarly, using coherent sets of default terms signals to regulators and judges the type of firm that has opted into a particular form. Both of these attributes of coherent sets of terms facilitate the development of interpretive case law associated with distinct business associations rather than simply with individual contract terms. Finally, coherent sets of default terms signal the firm's type to third parties dealing with the firm.

Third, distinct business associations provide for a mix of types of mandatory rules. If there were only a single set of terms, business association terms would be either default or mandatory. Multiple business associations permit associating mandatory rules with particular standard forms, thereby permitting an intermediate form of opting out through form selection.⁶

B. The Suitability of Corporate Features

The corporate form fits publicly held firms particularly well. First, corporations are managed by or under the control of a centralized board of directors. Delegating power to a relatively small group of people enables more efficient decision-making than dispersing power among many owners. Moreover, the corporate form of centralized management involves dividing management between professional full-time executives who manage the firm day-to-day and directors who oversee the board and set policy. The board

partitioning).

6. An example is the limited partnership control rule. See REVISED UNIF. P'SHIP ACT § 303 (1985) [hereinafter RUPA] (amended 2001). The National Conference of Commissioners on Uniform State Laws promulgated a revised version of the limited partnership act in 2001. However, since few states have adopted that revision, this article will rely mainly on RUPA (1985) as a better reflection of current law.

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theoretically permits better monitoring of managers than dispersed shareholders alone can provide.⁷

Second, corporate shareholders are not, like general partners,⁸ personally liable for the firm's debts. Shareholders' limited liability does more than simply transfer risks to creditors—it can create wealth by facilitating freely transferable stock and therefore the development of informationally efficient stock markets.⁹ Commentators have considered limited liability to be an important justification for taxing and regulating corporations.¹⁰

Third, corporate shareholders can freely transfer both their financial and control interests in the firm. By contrast, partnership-type firms by default let members transfer only their economic interests in the firm and not control.¹¹ Free transferability of management rights is important to the development of a market for control, which provides effective monitoring of managers.

Fourth, while each partner has, by default, the power to dissolve a partnership or seek a buyout by the firm,¹² corporations can be dissolved only by action of the board of directors followed by a vote of a majority of the owners. Margaret Blair has argued that this corporate feature is particularly important in order to protect corporate assets from breakup.¹³ She relies on Alfred Chandler's account of the development of modern corporations, specifically on how they were able to create organizations that capitalized on developments in transportation and communication beginning in the mid-19th century.¹⁴ As Oliver Williamson and others¹⁵ have theorized, these firms involved the bringing together of bundles of assets each of which was essential to the others' value—in other words, whose joint value was “asset specific.” Blair views partnership law as unsuited to this bundling because a partnership might be subject to dissolution at the will of any partner, thus giving any

7. See Bainbridge, *supra* note 3, at 28.

8. See UNIF. P'SHIP ACT § 15 (1914) [hereinafter UPA]; RUPA § 306 (1997).

9. See Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89, 96 (1985).

10. See Larry E. Ribstein, *The Deregulation of Limited Liability and the Death of Partnership*, 70 WASH. U. L.Q. 417, 454 (1992); see *infra* text accompanying notes 35-39.

11. See UPA § 27; RUPA § 503; REVISED UNIF. LTD. P'SHIP ACT § 704 [hereinafter RULPA]; UNIF. LTD. LIAB. CO. ACT § 503 (1996) [hereinafter ULLCA].

12. See UPA §§ 29, 31; RUPA § 801.

13. See Margaret M. Blair, *The Neglected Benefits of the Corporate Form: Entity Status and the Separation of Asset Ownership from Control*, in Anna Grandon, ed., *CORPORATE GOVERNANCE AND FIRM ORGANIZATION: MICROFOUNDATIONS AND STRUCTURAL FORMS* 45-66 (Oxford University Press, 2004); Margaret M. Blair, *Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century*, 51 UCLA L. REV. 387 (2003) [hereinafter Blair, *Locking in Capital*]; see also Hansmann & Kraakman, *supra* note 2 (discussing the importance of “liquidation protection”).

14. See ALFRED D. CHANDLER, JR., *THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS* (Belknap Press, 1977).

15. See OLIVER E. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM: FIRMS, MARKETS, RELATIONAL CONTRACTING* (Free Press, 1985); Benjamin Klein et al., *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J.L. & ECON. 297 (1978).

partner potential holdup power,¹⁶ or on a partner's death, subjecting partnerships to the vagaries of succession and inheritance.¹⁷ Blair supports her story by providing accounts of 19th-century firms that sought incorporation in order to lock in firm-specific assets.¹⁸

Fifth, the corporate form protects creditors' ability to rely on corporate assets, which is important in sustaining limited liability. Investors have no right to a dividend, and the firm's assets are committed to its creditors before payout to shareholders.¹⁹

The corporation thus provides a coherent set of terms that enable efficient gap-filling and regulation, consistent with the functions of standard forms discussed in Part I.A. For example, the fiduciary duties of corporate managers can be designed to fit firms in which managers have substantial power, but also are constrained by owners' ability to exit by freely transferring their shares. Moreover, a firm's selection of the corporate form signals that management is separated from ownership, and therefore that the firm may be appropriately subject to regulation that protects investors or employees from powerful managers.

II. THE COSTS OF INCORPORATION

This Part discusses some questions about the explanations for the corporation's widespread use discussed in Part I. As discussed in Part II.A, it is not clear why these features must be provided by incorporation rather than alternative partnership forms. A potential answer is that it is efficient to lock publicly held firms into the specific features that are available in the corporate form, particularly including centralized management. But Parts II.B and II.C show that corporate centralized management is excessively rigid and, indeed, may not be well suited to many modern firms.

A. *The Choice Between Corporation and Partnership*

Although the above story explains why corporate *features* are important for publicly held firms, it does not explain why such firms need to be *corporations* in order to obtain these features. More specifically, the discussion in Part I.B

16. See Blair, *Locking in Capital*, supra note 13, at 409-13. Blair also points out that individual partners might own business assets. See *id.* But questions regarding ownership of assets arise in any firm. Partnership law is distinct in providing presumptions that help determine what belongs to the firm. See UPA § 8; RUPA § 203.

17. See Blair, *Locking in Capital*, supra note 13, at 420-21.

18. See *id.* at 416-22 (discussing Lehigh Coal); *id.* at 442-49 (discussing example of I.M. Singer, showing need to ensure that Singer's messy estate would not break up the Singer business); *id.* at 449 (discussing need for incorporation in companies like Proctor and Gamble, incorporated in the 1880's that relied on branded consumer products and Duke Tobacco).

19. See *id.* at 429-33.

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does not explain why publicly held firms cannot be publicly traded partnerships. Indeed, it is not clear why the corporate form was ever used. Since partnerships antedated corporations,²⁰ they could have been adapted for use by publicly held firms had the corporation never been invented.

1. Chandler and Standard Forms

Chandler's history of the modern firm does not support the need for incorporation. Chandler devotes little attention to the *legal* form of business, focusing instead on institutional innovation. In fact, Chandler notes that increasing use of incorporation in the early 19th century did not itself bring institutional innovation.²¹ Moreover, the modern firm did not "mature," in Chandler's view, until well into the 20th century, long after the major developments in corporate law.²² To the extent that legal form mattered at all in Chandler's story, it was as a response to regulation rather than as a reaction to inherent transaction cost problems. Chandler sees antitrust regulation in the late 19th century as encouraging use of the holding company form pioneered in New Jersey,²³ and notes that in the absence of such legislation cartels might have survived in the U.S. as they did in Europe.²⁴

2. Fundamental Similarities of Corporation and Partnership

The partnership standard form is not as different from the corporate form as Blair and other commentators assume. In both cases, the firm rather than its individual owners owns property. This includes the firm's reputation and goodwill attached to the firm's name.²⁵ The property therefore is not directly reachable by the owners' personal creditors²⁶ or by the owners' heirs.²⁷

Partnership law is admittedly misleading in this respect since it traditionally provides for ownership by the individual owners through something called "tenancy in partnership."²⁸ But this peculiar tenancy systematically negates all

20. Partnership is one of the oldest forms of business association. See ALAN R. BROMBERG & LARRY E. RIBSTEIN, BROMBERG & RIBSTEIN ON PARTNERSHIP, § 1.02 (Aspen Publishers, 2004); See also CHANDLER, *supra* note 14, at 36 (noting that partnership was the standard legal form until well after 1840).

21. See CHANDLER, *supra* note 14, at 48.

22. *Id.* at 415-83.

23. *Id.* at 318-34.

24. *Id.* at 375.

25. The issue in partnership law is not whether the firm can have a name or whether the name has value, but the extent of that value, particularly in professional firms where the value of the firm's name must be distinguished from that of the partners' individual names. See *In re Brown*, 150 N.E. 581 (N.Y. 1926).

26. The creditors can reach the property by charging order in a partnership, which is comparable to garnishing corporate shares. See UPA § 28; RUPA § 704.

27. See *infra* text accompanying note 50 (discussing rights of heirs on dissolution).

28. See UPA § 25 (describing the features of the tenancy in partnership).

individual rights, including possession, transferability, rights of inheritance, and so forth, so that the partner's individual rights are nominal only.

Since corporations and partnerships own discrete property committed to the firm, it follows that firms' agents manage the firm's property separate from the property of the individual owners. Also, as long as the firm, whether corporation or partnership, is a going concern, the power these agents have over the firm's property includes the power to decide when the property is distributed to the owners, subject to any agreements the owners have made.²⁹ Thus, in the absence of contrary agreement, the owners commit their investments to the firm until it dissolves.

There are four apparently significant differences between the corporate and partnership standard forms.³⁰ First, partners are liable directly or indirectly for the firm's debts while corporate shareholders have limited liability. Second, partnerships by default are managed directly by the partners rather than centralized in executives and directors as in corporations. Third, while corporate shareholders can, by default, freely transfer management rights, new partners by default can be admitted only by unanimous member vote. This reflects the potentially high costs of freely transferring management rights where members have unlimited liability, as well as the smaller benefits of free transferability in closely held partnerships as compared with publicly held corporations. Fourth, and most importantly according to Blair, partnerships by default are dissolved by the will or exit of any member, while the corporate entity survives member dissociation. On dissolution, in the absence of contrary agreement, the partnership's assets are sold and divided among the members or their heirs.

These differences are not, however, as striking as may first appear. To begin with, partnerships always have been able to contract for features that differed from the partnership standard form, including centralized management, free transferability, and continuity.³¹ Accordingly, it is useful to distinguish between features that are contractible at substantial cost, such as limited liability, and those that are contractible at lower cost, such as decentralized

29. Note also that in partnerships, as in corporations, owners have no statutory right to distributions from an ongoing firm. *See, e.g.*, ULPA § 601 (1985).

30. Blair also stresses the "trust fund" theory, or duty to fund the entity for creditors' protection, as an important entity aspect of the corporation. *See* Margaret M. Blair, *Why Markets Chose the Corporate Form: Entity Status and the Separation of Asset Ownership from Control*, Bus., Econ. and Regulatory Policy (Georgetown Univ. Law Ctr., Working Paper No. 429300, 2003). However, shareholders' supposed obligation to provide minimum capitalization survives today only as a marginal factor in veil piercing. *See* Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 CORNELL L. REV. 1036 (1991). Moreover, the "trust fund" theory actually connects corporations and partnerships, since shareholders' financing obligation arguably substitutes for partners' personal liability for the firm's debts.

31. The contractibility of partnership rights, with limited exceptions, is now reflected in uniform laws. *See* ULPA § 103; *see also* ULLCA § 103.

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management, continuity, and free transferability.

Moreover, partnerships long ago could get the benefit of having these defaults plus limited liability by forming subcategories of partnerships, notably including the joint stock company, which provides for centralized management and free transferability,³² and the limited partnership, which provides for centralized management and limited liability of passive investors.³³ Limited liability company statutes now provide for a flexible variant on centralized management.³⁴

Limited liability is the hardest corporate feature to obtain by contract. While firms can make non-recourse contracts with creditors, tort liability is imposed on owners without regard to contract.³⁵ Even non-recourse contracts have been restricted in various ways,³⁶ though explicit contracts are now enforced. Thus, it has been said that “limitation or elimination of liability of the shareholders is not merely the chief single advantage of a business corporation but it is the advantage which in the estimation of legislatures and also in the estimation of the public is of more importance than all the other advantages put together. It is the main thing.”³⁷ Prior to the development of enterprise liability,³⁸ limited liability probably was not an important corporate feature.³⁹ When limited liability did become important, its identification with the corporate form may help explain the move to incorporation.

3. Problems with the Continuity Theory of Incorporation

Blair emphasizes continuity as a central explanation for the use of the corporate form. Indeed, Blair views this greater continuity of the corporate form as “critically important to the creation of complex, productive commercial enterprises.”⁴⁰ However, the continuity inherent in the partnership form has long been recognized.⁴¹ There was traditionally no power to dissolve a

32. See BROMBERG & RIBSTEIN, *supra* note 20, § 1.01(b)(3); Paul G. Mahoney, *Preparing the Corporate Lawyer: Contract or Concession? An Essay on the History of Corporate Law*, 34 GA. L. REV. 873, 885 (2000).

33. See BROMBERG & RIBSTEIN, *supra* note 20, § 1.01(b)(3). For a further discussion of limited partnership rules, see *infra* text accompanying notes 133-136.

34. See *infra* text accompanying note 137.

35. See Ribstein, *supra* note 4.

36. See *id.* at 369-432.

37. EDWARD H. WARREN, CORPORATE ADVANTAGES WITHOUT INCORPORATION, 399 (Baker, Vorhis & Co., 1929).

38. See John Fabian Witt, *Speedy Fred Taylor and the Ironies of Enterprise Liability*, 103 COLUM. L. REV. 1 (2003) (discussing the history of enterprise liability).

39. See Blair, *Locking in Capital*, *supra* note 13, at 419 (noting that many early corporation statutes did not grant limited liability); Mark I. Weinstein, *Share Price Changes and the Arrival of Limited Liability in California*, 32 J. LEGAL STUD. 1 (2003) (noting that California first adopted limited liability in 1931 and showing no share price effect of adoption).

40. See Blair, *supra* note 30, at 27.

41. See, e.g., Arthur J. Jacobson, *The Private Use of Public Authority: Sovereignty and*

partnership prior to an agreed term, at least without just cause.⁴² Moreover, partnerships long have been able to agree to continuation of the business and payoff in cash of deceased partners.⁴³ By adjusting both the amount and terms of payoff, partnerships can achieve significant continuity. Accordingly, it is misleading to focus unduly on partnership default rules in arguing the defects of partnership.⁴⁴ Although Blair cites *Baldwin Locomotive* as a situation where corporate continuity would have been beneficial, the partnership agreement in that case facilitated continuity through slow pay-off of the estate.⁴⁵

To be sure, customized drafting around default rules may require extra expense.⁴⁶ But lawyers have considerable experience with continuation agreements in partnerships. Moreover, early in their history corporations were not used widely enough to give them a clear advantage in predictability.⁴⁷ Thus, it is not surprising that firms at first drafted for corporate features rather than incorporating. Indeed, Blair discusses a prominent example of effective use of continuity provisions in a partnership agreement—Andrew Carnegie’s “iron clad” agreement providing, among other things, for gradual buyout of deceased and retired partners.⁴⁸

Associations in the Common Law, 29 BUFF. L. REV. 599, 648-51 (1980) (discussing various aspects of partnership law’s recognition of the ongoing character of business).

42. See BROMBERG & RIBSTEIN, *supra* note 20, § 7.03(a) n.4; JOSEPH STORY, COMMENTARIES ON THE LAW OF PARTNERSHIP § 273-76, at 410-420 (2d ed. 1846).

43. See BROMBERG & RIBSTEIN, *supra* note 20, § 7.11(e); see also STORY, *supra* note 42, § 199 (discussing clauses for continuation notwithstanding partner death in order to be sure that the business is “steadily carried on”); *id.* § 207 (discussing clause providing for purchase of other partner “at a valuation” if “express stipulation”). The modern exception is the ipso facto provisions of bankruptcy law. See 11 U.S.C. § 365 (2004); see Larry E. Ribstein, *Partner Bankruptcy and the Federalization of Partnership Law*, 33 WAKE FOREST L. REV. 795 (1998).

44. Indeed, even the default rules are changing. In her conference paper, Blair carries the analysis of default rules through to modern partnership and LLC statutes. See Margaret M. Blair, *Corporate Governance Reform Puzzle: What History Can Teach Us*, 1 BERKELEY BUS. L.J. 1, 19-30 (2004). However, she focuses on uniform laws, which misses a significant evolution away from dissolution at will in state limited partnership and LLC statutes. See BROMBERG & RIBSTEIN, *supra* note 20, § 17.02(d)(2) n.19 (listing state limited partnership provisions); LARRY E. RIBSTEIN & ROBERT R. KEATINGE, RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES app. 11-1 (Thomas/West, 2004) (summarizing state limited liability company statutes). Blair also notes that limited liability encourages partner exit from failing firms. See Blair, *supra* (citing Susan Saab Fortney, *High Drama and Hindsight: The LLP Shield, Post-Andersen*, 12 BUS. L. TODAY 46 (Jan.-Feb. 2003)). But this is not a function of the relative continuity of the partnership and corporate form, since one always can sever an agency relationship regardless of form. Rather, it focuses on the traditionally corporate feature of limited liability as an incentive for severing the relationship.

45. See Blair, *Locking in Capital*, *supra* note 13, at 452-54.

46. Thus, Blair cites the Schuylkill charter to the effect that Schuylkill was seeking incorporation because “plain men of business” have difficulty making the right agreements. See Blair, *Locking in Capital*, *supra* note 13, at 420-23. Note that the couple of corporate charters Blair relies on do not necessarily indicate the real reasons for incorporation. The charters were public documents being presented to state legislators, and could be expected to emphasize considerations that would be politically acceptable, as distinguished, for example, from the desire to avoid owner responsibility for corporate debts.

47. In other words, network externalities, which now are said to help entrench the corporate form (see *infra* Part IV.B) might initially have worked against it.

48. See Blair, *Locking in Capital*, *supra* note 13, at 451-52. She notes that the agreement worked

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Blair also suggests that the continuity of the corporation was necessary to protect the going concern from claims of partners' heirs.⁴⁹ But partnership law provides that partners' heirs have no interest in partnership property.⁵⁰ On a partner's death, the firm by default is wound up, which includes paying off the deceased partner's estate.⁵¹ If the partnership agreement provides for continuation, then the firm can be, in effect, wound up by cashing out the estate. The heirs might fight until doomsday about who gets what, but the firm need not be involved in this squabble. Thus, while Blair emphasizes the problems that might have resulted if I.M. Singer got tangled up in Singer's potentially messy estate and even suggests that Singer's success was attributable to resolving these problems by incorporating,⁵² these problems might easily have been avoided by an agreement providing for cashing out the estate on Singer's death.

An additional reason for skepticism about Blair's historical account of incorporation is that many of the firms that turned to the corporate form during the Industrial Revolution were closely held. The distinctive features of the corporate form discussed in Part I would seem to be most useful for publicly held firms. In particular, the continuity of the corporate form is particularly *disadvantageous* for closely held firms since members need an exit route in the absence of a public market for the firm's shares. Moreover, partnership-type buyout rules are least likely to be a problem in publicly held firms with many small shareholders because the firm is unlikely to be forced to liquidate if it has to cash out the shareholders.⁵³ Thus, the Singer scenario may be idiosyncratic or, at most, a problem in a small subset of cases involving a couple of large shareholders.

4. The Unanswered Question: Why Require Incorporation?

Assuming that certain valuable features, including limited liability or, in Blair's theory, continuity, were available only in the corporate form, the important question for present purposes is *why* firms should have had to

so well partners were locked in and caused trouble. This illustrates the trade-off between continuity and the need for exit to avoid lock-in in closely held firms. See *infra* text accompanying note 81.

49. See Blair, *Locking in Capital*, *supra* note 13, at 420-23 (discussing *Schuylkill*); *id.* at 442-49 (discussing *Singer*); *id.* at 452-54 (discussing *Baldwin Locomotive*). As for reliance on charter provisions in explaining incorporation, see *supra* note 46.

50. See UPA § 25(2)(d); RUPA § 501. The only difference is that some states provided that the heirs got legal title if the property was not needed for winding up. See BROMBERG & RIBSTEIN, *supra* note 20, § 3.05(f)(1).

51. See UPA §§ 38, 40; RUPA §§ 801, 807.

52. See Blair, *supra* note 30.

53. To be sure, a buyout right may be a problem if many shareholders seek to leave at the same time, but a mass exodus is arguably a signal that the firm *should* liquidate. In other words, partnership-type buyout, far from being a problem, is arguably an overlooked solution to the accountability problems that have plagued the corporate form. See *infra* Part II.B.2.

incorporate in order to obtain these features. To be sure, the particular device the law used for creating limited liability was to characterize the corporation as a separate legal entity against which creditors' claims could be made.⁵⁴ But the law might from the beginning have recognized that partnership-type firms could be such entities. Perhaps the law should protect creditors from the moral hazard inherent in limited liability by restricting the types of firms that have limited liability and the terms of limited liability contracts or regulating disclosures to creditors. But it is not clear why the law should require formal incorporation to protect creditors.⁵⁵ Limited liability might from the beginning have been offered in partnerships coupled with mandatory constraints such as limits on distributions, as is now the case in limited liability companies and limited partnerships.⁵⁶ These rules forbid distributions by insolvent firms, analogous to the rules that preserve bundles of corporate assets for creditors.⁵⁷

In short, the dominance of the corporate form cannot be explained on the basis that it facilitated the growth of industrial firms. The partnership form always could have been adapted to the needs of these firms. Although adaptation would have involved the development of novel types of agreements, it is unlikely that this would have presented more problems than the evolution of the corporate form from a quasi-public to a private entity. The most that can be said about the importance of the corporate form is that it is arguably better suited than the partnership form to the publicly held firms that eventually emerged from the Industrial Revolution. Yet there is some doubt even about this conclusion, as discussed in the next subpart.

B. The Problems of Corporate-Style Governance

This Section shows that the most distinctive feature of the corporation—centralized management by a board of directors—is, in fact, too rigid to achieve the right balance between discretion and accountability for many firms. Part II.B.1 gives an overview of corporate-type centralized management. Parts II.B.2 and II.B.3 discuss the main corporate governance problems of accountability and inflexibility.

1. Overview of Corporate Governance: “Director Primacy”

Corporate governance is best characterized as based on “director primacy.”⁵⁸ This model features hierarchical decision-making by a small

54. See Mahoney, *supra* note 32.

55. See Ribstein, *supra* note 4.

56. See RULPA §§ 607-608; ULLCA §§ 407-408.

57. See *supra* text accompanying note 20.

58. See STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS ch. 5 (Foundation Press, 2002).

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collective group (the board of directors), which coordinates the nexus of contracts with capital contributors, employees, and others. This approach to decision-making has obvious benefits in light of the decision-making costs involved in reaching consensus among large numbers of people and between groups with disparate interests. The board, in turn, monitors managers and sits atop a broader hierarchy reaching down to semi-autonomous divisions.⁵⁹ This structure provides monitoring to deal with managerial agency costs and allows for specialization at lower levels of the hierarchy to deal with the vast amounts of information that flow through the large publicly held corporation.

Director primacy includes the following principal elements. First, directors have broad power both to make all management-type decisions, including the day-to-day operation of the company, managerial compensation, and distributions to shareholders, and to initiate major decisions, including amendment of the charter, or sale, dissolution or merger of the firm.⁶⁰

Second, shareholders lack the power to make management-type decisions or to initiate major decisions. Shareholder power is essentially limited to voting on major decisions and electing and removing directors. Thus, the directors are not really the shareholders' agents in the traditional sense of being under the shareholders' direct supervision and control.

Third, and perhaps most importantly, the balance of power between directors and shareholders described in the preceding two paragraphs is not effectively subject to contrary agreement. A basic principle of corporate law has long been that the firm cannot "sterilize" the board—that is, seriously impair its basic functions.⁶¹ Though corporate statutes provide that management by the board can be qualified to some extent by contrary provisions in the articles of incorporation,⁶² these provisions do not clarify how far such restrictions may go. The existence of some limitation is supported by the fact that corporate statutes explicitly permit reduction or elimination of board functions only in special provisions applying to closely held corporations.⁶³

59. See CHANDLER, *supra* note 14, ch. 13.

60. See, e.g., DEL. CODE ANN. tit. 8, §§ 242 (charter amendment), 251 (merger), 271 (sale of assets), 275 (dissolution) (2004); see also Lawrence A. Hammermesh, *Corporate Democracy and Shareholder-Adopted By-Laws: Taking Back the Street?* 73 TUL. L. REV. 409 (1998) (concluding that shareholders lack power to repeal director-adopted poison pills).

61. See *Clark v. Dodge*, 199 N.E. 641 (1936) (enforcing agreement concerning dividends among other things because the agreement did not unduly restrict director discretion); See also *Galler v. Galler*, 203 N.E.2d 577 (Ill. 1964) (enforcing close corporation agreement including dividend distribution provision where the provision was conditioned on a minimum earned surplus of \$500,000).

62. See, e.g., DEL. CODE ANN. tit. 8, § 141(a) (2004).

63. See *id.* §§ 341-356. To be sure, the Delaware statute also expressly provides that its close corporation subchapter does not invalidate provisions authorized under other sections. See *id.* § 356. This implicitly refers back to the general authorization of contrary charter provisions. But an open-ended interpretation of this provision to permit publicly held firms to significantly dilute board power would be unwarranted as inconsistent with the statute's explicit distinction between closely held and publicly held

Fourth, the board's power is constrained principally by broad fiduciary duties. This enables courts to fill what they perceive as gaps in corporate governance *ex post* at the time of litigation. In other words, courts rather than contracts determine the limits on board power.

2. *Accountability*

The central problem in the director primacy model is finding ways to ensure that the board, having been given exclusive power to manage the firm, exercises this power consistently with the firm's interests rather than in their own interests or in those of the executives who most immediately control the board's selection, tenure, and information. In other words, there is a question whether "board primacy" adequately deals with agency costs. As Stephen Bainbridge has said, "[e]stablishing the proper mix of discretion and accountability . . . emerges as the central corporate governance question."⁶⁴

The important initial question is to whom the directors owe their primary allegiance. The board needs to have some specific set of interests in mind or else it will not easily reach decisions, and its decisions cannot easily be monitored, thereby exacerbating agency costs. In other words, the fact that the directors hold significant power does not necessarily answer the question of to whom the directors are accountable in exercising this power.⁶⁵

Most corporate scholars assume for various reasons that the interests that should matter to directors of most publicly held corporations are those of shareholders.⁶⁶ An alternative view is that directors have responsibilities to multiple constituencies.⁶⁷ In the most fully developed alternative account, Blair and Stout view the board as "mediating hierarchs" who respond to the interests of the various parties to the corporate contract, including creditors, suppliers, and workers.⁶⁸ Blair argues that the corporate separation of ownership and control is designed in order to ensure that neither the shareholders nor any other party to the corporate contract controls the board.⁶⁹

firms and the limitation of contracting flexibility with respect to board powers.

64. See BAINBRIDGE, *supra* note 58, at 207.

65. See Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547 (2003).

66. See, e.g., FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW*, 66-71 (Harvard University Press, 1991); Bainbridge, *supra* note 65; Jonathan R. Macey, *An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties*, 21 STETSON L. REV. 23 (1991); Alan J. Meese, *The Team Production Theory of Corporate Law: A Critical Assessment*, 43 WM. & MARY L. REV. 1629 (2002).

67. For a recent article contrasting the "entity" and "property" theories of board governance, see Leo E. Strine, Jr., *The Social Responsibility of Boards of Directors and Stockholders in Change of Control Transactions: Is There Any "There" There?*, 75 S. CAL. L. REV. 1169 (2002).

68. Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999).

69. See Blair, *supra* note 13, at 46-47.

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These two views of corporate governance mesh to some extent because efficiency demands joint maximization of the interests of all contracting parties and because parties such as workers who associate with a firm primarily as non-shareholders also own shares in the firm.⁷⁰ Markets internalize costs, since a firm cannot ignore the interests of non-shareholders with whom it deals or these parties may take their business elsewhere. Firms accordingly may make promises to non-shareholder constituencies in order to induce reciprocal commitments.

The meshing, however, is not complete. At some point, directors must choose whose interests to serve.⁷¹ Moreover, the law must define managers' duties or they will have no effective duties at all. In other words, the most persuasive argument against the multiple constituencies view is based on agency costs.⁷² The reasons discussed immediately above for making shareholders the residual claimants provide a strong normative argument for making directors responsive primarily to shareholders as a default rule, although firms should be able to contract for an alternative structure.⁷³

The main question regarding corporate governance, then, is whether powerful corporate managers are adequately accountable to shareholders' interests. Theoretically, accountability is provided by, among other things, judicial review under the business judgment rule, shareholder litigation, stock-based compensation, the market for corporate control and activist shareholders.⁷⁴ There are, however, reasons to conclude that the corporate structure outlined above, which gives substantial power to managers and little direct power to shareholders, may not be optimal for many firms because shareholders' powers to approve manager-initiated actions and to remove the directors may not be adequate to police agency costs.⁷⁵

Lack of shareholder power is particularly problematic where managers' interests most directly conflict with those of the shareholders, as in the case of

70. See Eric Talley, *On The Demise of Shareholder Primacy (Or, Murder On The James Trains Express)*, 75 S. CAL. L. REV. 1211, 1213-14 (2002).

71. This point is illustrated by Chancellor Strine's effective "James Trains" takeover defense hypothetical. See Strine, *supra* note 67.

72. See Lynn A. Stout, *Bad and Not-So-Bad Arguments for Shareholder Primacy*, 75 S. CAL. L. REV. 1189, 1202 (2002). Stout says that the answer to this argument is ultimately empirical, based on shareholders' "revealed preferences," and these are embodied in rules such as directors' significant protection from hostile takeovers. But this confuses directors' powers and their duties in exercising these powers. See Bainbridge, *supra* note 65. It is also a somewhat Panglossian view that assumes corporate governance rules are optimal. As discussed below, this may not be the case, at least in part because of the law's bias toward the corporate form.

73. See *infra* text accompanying note 141 (discussing use of the partnership form for this purpose). To the extent that managers' responsibilities to non-shareholder constituencies are legally imposed on firms, the normative argument in the text suggests that these rules may be politically motivated. See *infra* text accompanying note 223.

74. See Bainbridge, *supra* note 58, at 206.

75. See Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 117 HARV. L. REV. (forthcoming Dec. 2004).

managerial compensation.⁷⁶ Shareholders lack any direct control over the design of compensation. Accordingly, shareholders must rely on board supervision of managerial compensation, the managerial labor and control markets, and their power to approve or reject compensation plans that are submitted to them. But as long as managerial compensation generally meets prevailing standards, boards lack incentives to second-guess compensation of powerful executives who are otherwise performing well. Also, again as long as compensation is loosely acceptable,⁷⁷ managerial compensation is unlikely significantly to affect the firm's capital costs or product prices, make the firm a likely takeover target, or diminish an executive's attractiveness to other firms. Shareholders' voting power does them little good because it gives them the poor choice of either denying compensation to well-performing executives or acquiescing in an overly generous pay package.⁷⁸ This leaves shareholders with their usual last resort of judicial supervision. But executive compensation is protected by the business judgment rule,⁷⁹ and even if a court intervenes, derivative procedures are costly.

Bebchuk suggests remedying the above problems by empowering shareholders to change corporate governance arrangements, merge or sell the company, or order distributions.⁸⁰ But this may trigger the high decision-making costs that the hierarchical corporate structure is intended to avoid. These actions involve complex business planning that cannot effectively be done by a large group, particularly given the need for vast amounts of information. Although shareholders can get guidance from experts, they must coordinate around a particular plan, and decide which experts to rely on. It is not clear what shareholders would gain by hiring more experts, who bring their own agency costs.

An alternative way to ensure more accountability to owner interests would be to give owners the power to cash out of the firm. Such a right might be given not only in response to major transactions, as under current law, but at will.

76. See LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION*, (Harvard University Press, 2004); Lucian Arye Bebchuk & Jesse Fried, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation*, 117 HARV. L. REV. (forthcoming Fall 2004); Lucian Arye Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751 (2002).

77. Managers can promote acceptability by "camouflaging" compensation – for example, by using compensation consultants. *See id.*

78. However, there is evidence that shareholders do vote against highly dilutive stock option plans, and that their opposition correlates with lower executive compensation increases in the subsequent year. *See* Kenneth Martin & Randall Thomas, *When is Enough, Enough? Market Reaction to Highly Dilutive Stock Option Plans and the Subsequent Impact on CEO Compensation*, (March 24, 2002) (Law and Econ. Res. Paper No. 02-06, Vanderbilt University), available at http://papers.ssrn.com/paper.taf?abstract_id=321424 (last visited Nov. 14, 2004).

79. *See Brehm v. Eisner*, 746 A.2d 244 (Del. 2000) (en banc) (holding that questionable employment contract nevertheless met loose business judgment standard).

80. *See* Bebchuk, *supra* note 75.

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This would give owners significantly more than they would get from merely being able to sell their interests on the market, since the price would be determined by the value of the underlying assets—that is, without the discount resulting from mismanagement. This is, of course, essentially the right that *partners* have, the rejection of which marks corporate law's significant advance over partnership law according to Blair.⁸¹ That is not to say that partnership-type dissociation rights are better in all, or even many, circumstances than corporate-type lock-in, but only that the appropriate choice between the two approaches involves sensitive tradeoffs and is not obvious.⁸²

3. Inflexibility

Because corporate governance requires balancing the benefits of delegation and hierarchy against the need for accountability, no single solution is likely to work for every firm. Reducing delegation by empowering shareholders may raise decision-making costs for some firms more than it lowers agency costs. The solution lies in enforcing firm-specific governance contracts rather than in the rigid corporate framework. For example, where ownership structure is relatively concentrated in the hands of institutional shareholders, the dangers of meddling by unsophisticated shareholders or of incoherent decision-making might be less than the agency costs of delegating significant power to managers. Also, specific limits on managers' discretion might work better in some firms than a general allocation of governance powers.

The problem of corporate governance lies not in the default allocation of power to strong centralized managers, but in the rigidity of managers' power. As discussed above, corporate law limits the extent to which the firm can qualify the board's power.⁸³ Although the board's power is not plenary, it is subject mainly to court-imposed fiduciary duties rather than firm-specific arrangements. Corporate statutes generally restrict opting out of these fiduciary duties.⁸⁴

Corporate inflexibility is particularly evident in takeover defense cases. These cases involve a sensitive balancing process. On the one hand, enforcing takeover defenses may compromise the viability of the market for corporate control as a constraint on agency costs. On the other hand, there are many

81. The greater accountability of managers in the limited partnership form is illustrated by the fact that it was limited partnerships' move to a corporate-style structure in which assets were locked in that triggered the most extensive federal regulation of partnerships to date. *See infra* text accompanying notes 213-216 (discussing regulation of limited partnership rollups).

82. *See generally* Larry E. Ribstein, *A Statutory Approach to Partner Dissociation*, 65 WASH. U. L.Q. 357 (1987).

83. *See supra* text accompanying note 61.

84. *See* DEL. CODE ANN. tit. 8, § 102(b)(7) (2004) (prohibiting opting out of breach of the duty of loyalty, acts not in good faith or involving intentional misconduct, or transactions from which the director received an "improper personal benefit").

reasons why the parties to a firm might want to give the board ultimate say on takeovers. Shareholders may want to preserve management continuity or to empower managers to bargain for a high price.⁸⁵ They also might be concerned that invalidating takeover defenses would force managers to defend against takeovers by engaging in value-reducing strategies that cannot effectively be regulated.⁸⁶ And giving the shareholders the ultimate say in takeovers might be inconsistent with “team production” and other theories that stress the need to protect non-shareholder interests in order to maximize overall firm value.⁸⁷

Firms may choose to place takeover defenses in the corporate governance documents when they are going public, a time when shareholder choice is not obviously infected by shareholder coordination problems.⁸⁸ Allocating control in the initial charter may not, however, be an effective strategy in all cases because firms’ business and ownership configurations change over time. Thus, corporate statutes must be flexible enough to accommodate adjustments in takeover strategies in going firms.

Despite the need for firm-specific variation and adjustment, the courts have tended to apply fairly rigid rules in takeover cases. In general, they preserve substantial board power to defend against takeovers, coupled with a general fiduciary duty limiting this power that courts apply irrespective of firm-specific background rules.⁸⁹ In other words, the courts and not the parties to the firm have the last word.

This tendency to restrict board power by general rule rather than specific agreement is illustrated by the Delaware supreme court’s decisions in *Liquid Audio*⁹⁰ and *Omnicare*.⁹¹ Prior to these decisions, the Delaware supreme court had relied mainly on its *Unocal* line of cases in which the courts required the board to show that in defending against a takeover they reasonably perceived a threat to the corporation and took action proportional to that threat.⁹² The court imposed more stringent standards on directors in the *Revlon* sale-of-control

85. See Stephen M. Bainbridge, *Precommitment Strategies in Corporate Law: The Case of Dead Hand and No Hand Pills*, 29 J. CORP. L. 1 (2003); Marcel Kahan & Edward B. Rock, *Corporate Constitutionalism: Antitakeover Charter Provisions as Pre-Commitment*, 152 U. PA. L. REV. 473 (2003); Larry E. Ribstein, *Takeover Defenses and the Corporate Contract*, 78 GEO. L.J. 71 (1989).

86. See Jennifer Arlen & Eric L. Talley, *Unregulable Defenses and the Perils of Shareholder Choice*, 152 U. PA. L. REV. 577 (2003). See also Robert B. Thompson & D. Gordon Smith, *Toward a New Theory of the Shareholder Role: “Sacred Space” in Corporate Takeovers*, 80 TEX. L. REV. 261, 326 (2001) (also noting this problem).

87. See Lynn A. Stout, *Do Antitakeover Defenses Decrease Shareholder Wealth? The Ex Post/Ex Ante Valuation Problem*, 55 STAN. L. REV. 845 (2002).

88. See Robert Daines & Michael Klausner, *Do IPO Charters Maximize Firm Value? Antitakeover Protection in IPOs*, 17 J.L. ECON. & ORG. 83 (2001).

89. See Ribstein, *supra* note 85; Kahan & Rock, *supra* note 85 (observing that firms’ arrangements are enforced, but not analyzing the effect of fiduciary duty rules on enforcement).

90. *MM Cos., Inc. v. Liquid Audio, Inc.*, 813 A.2d 1118 (Del. 2003).

91. *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914 (Del. 2003).

92. See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).

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setting,⁹³ and in the *Blasius* setting, where the board took action that interfered with the shareholders' voting power.⁹⁴ But these tests were rarely applied to invalidate a takeover defense.⁹⁵

The Delaware supreme court signaled a shift in *Quickturn Design Systems, Inc. v. Shapiro*⁹⁶ when it invalidated a "delayed redemption provision" because it interfered with a subsequent board's authority to redeem a pill, thereby unduly restricting the board's power to manage under DGCL Section 141(a).⁹⁷ Since this case supported the board's power, it comported with the broad interpretation of that power in previous takeover defense cases. However, it indicated that the board's power might be limited other than by a *Unocal*-type fiduciary duty analysis.

Liquid Audio and *Omnicare* clarified this limit on board power by finding an area of inviolate shareholder control. Both cases invalidated board-approved takeover defenses on the ground that they usurped a basic shareholder function of voting on major corporate decisions. *Liquid Audio* overturned the directors' expansion of the board from five to seven members in the face of a hostile bid. The bidder had two nominees for the board, who were elected, as well as a proposal to amend the bylaws to expand the board by four members, which would have given it control irrespective of the incumbent's expansion move (i.e., six of either nine or eleven members). Since the corporation had a staggered board bylaw provision, the bidder needed to amend the bylaws to take immediate control whether or not the incumbents expanded the board. Institutional Shareholder Services had recommended voting for the bidder's two nominees, but against giving the bidder immediate control by approving its expansion proposal. The chancery court refused to invalidate the takeover defense under the *Blasius* and *Unocal* standards because it did not materially affect the shareholders' choices. The supreme court reversed, emphasizing evidence that the incumbents' board expansion was done for the express purpose of preventing a change of control that might occur if the board split were closer and one or two incumbents resigned. The supreme court reasoned that the board's action violated a basic tenet of corporate governance:

Maintaining a proper balance in the allocation of power between the stockholders' right to elect directors and the board of directors' right to manage the corporation is dependent upon the stockholders' unimpeded right to vote effectively in an election of directors. This Court has repeatedly stated that, if the stockholders are not satisfied with the management or actions of their elected representatives on the board of directors, the power of corporate democracy is available to the

93. See *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

94. See *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651 (Del. Ch. 1988).

95. See *Thompson & Smith*, *supra* note 86, at 286-94 (discussing the "death of *Unocal*").

96. 721 A.2d 1281 (Del. 1998).

97. For further discussion of the case, see *infra* text accompanying notes 250-54.

stockholders to replace the incumbent directors when they stand for re-election.⁹⁸

Although *Liquid Audio*'s structural analysis was novel, both the chancery and supreme courts relied on the general standards governing takeover defenses under *Blasius* and *Unocal*. Neither court was moved by the fact that the bylaws let the incumbents expand the board and could be amended by the shareholders to permit the bidder to take immediate control despite the board expansion. The supreme court quoted the venerable *Schnell* principle that "inequitable action does not become permissible simply because it is legally possible."⁹⁹ That principle may be appropriate in a case like *Schnell*, which involved clear manipulation of the annual meeting date to entrench incumbents without apparent corporate purpose. But it does not necessarily justify ignoring the shareholders' freely made governance choices.

Kahan and Rock argue in favor of the *Liquid Audio* result as "understood in the context of the governance structure adopted by the firm" because, although the firm had wanted minimal entrenchment, the board attempted "to confer greater entrenchment than provided for in the firm's governance structure."¹⁰⁰ But the case illustrates the risks of second-guessing the parties' agreement. Unlike in *Schnell*, the board's move made it only a little more difficult for the incumbents to take control—that is, in the specific case where incumbent directors leave or switch sides. The bylaws arguably contemplated this kind of marginal edge by letting the board add directors.

The judicial tendency to ignore the background contract was even more pronounced in *Omnicare*. The court refused to enforce a deal protection provision in the NCS-Genesis merger agreement requiring submission of the transaction to the shareholders over a higher Omnicare bid because directors holding two thirds of the stock had agreed to vote as shareholders for the merger. Applying *Unocal*, the majority reasoned that the deal protection provisions "were designed to . . . preclude the consideration of any superior transaction" and "completely prevented the board from discharging its fiduciary responsibilities to the minority stockholders when Omnicare presented its superior transaction."¹⁰¹

The court so held although the Delaware statute explicitly authorized this deal-protection provision. The legislature amended the statute in 1998 to clarify that the board could require a shareholder vote whether or not the directors continued to favor the transaction. This was after *Van Gorkom* held that a shareholder vote would not validate the transaction if the board withdrew its

98. *Liquid Audio*, 813 A.2d 1118, 1127.

99. *Schnell v. Chris-Craft Indus., Inc.*, 285 A.2d 437, 439 (Del. 1971), *quoted in* *Liquid Audio*, 813 A.2d 1118, 1132.

100. Kahan & Rock, *supra* note 85, at 515.

101. *Omnicare*, 818 A. 2d 914, 936.

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recommendation.¹⁰² Thus, the statute permitted clarification of the corporate intent in this situation, and the corporation had provided this clarification. The chancery court observed that “it is simply nonsensical to say that a board of directors abdicates its duties to manage the ‘business and affairs’ of a corporation under section 141(a) of the DGCL by agreeing to the inclusion in a merger agreement of a term authorized by § 251(c) of the same statute.”¹⁰³ But the supreme court stated the apparently absolute rule that “[t]he directors of a Delaware corporation have a continuing obligation to discharge their fiduciary responsibilities, as future circumstances develop, after a merger agreement is announced” and the board therefore was “*required* to contract for an effective fiduciary out clause to exercise its continuing fiduciary responsibilities to the minority stockholders.”¹⁰⁴ This fiduciary out, in the court’s view, was necessarily better than letting the shareholders decide where the shareholders were also the directors.

The court’s disregard of the corporate governance structure cannot be defended as effectuating the shareholders’ intent. The board had effectively preserved shareholder value by making a deal with the only promising bidder at the time, Genesis, which had demanded the deal-protection provision. Although Omnicare eventually topped the locked-up Genesis bid, it is unrealistic to ignore the shareholders’ benefit from enforcing deal-protection devices.¹⁰⁵ As dissenting Justice Steele observed: “We should not encourage proscriptive rules that invalidate or render unenforceable precommitment strategies negotiated between two parties to a contract who will presumably, in the absence of conflicted interest, bargain intensely over every meaningful provision of a contract after a careful cost benefit analysis.”¹⁰⁶

The courts, therefore, engage in a rigid structural analysis that applies equally to all corporations. They have been said to be creating a “sacred space” in which shareholders exercise inviolate rights to vote and sell.¹⁰⁷ The term aptly conveys the courts’ disregard of mundane day-to-day realities and specific governance terms. Moreover, firms may not find relief from these rules through explicit waiver. Since the *Unocal* rule addresses managers’ self-interest in defending against takeovers, it is subject to the self-dealing exception to opting out of fiduciary duties.¹⁰⁸ The problems of the takeover cases, moreover, are inherent in the corporate form. If the board has inviolate power to run the

102. See *Smith v. Van Gorkom*, 488 A.2d 858, 887-88 (1985).

103. See *Omnicare*, 818 A.2d 914, 937 (quoting the chancery court).

104. *Id.* at 939 (emphasis added).

105. See Kahan & Rock, *supra* note 85. For an extensive analysis of *Omnicare*, criticizing the court’s refusal to enforce the pre-commitment device, see Sean Griffith, *The Costs and Benefits of Precommitment: An Appraisal of Omnicare v. NCS Healthcare*, 29 J. CORP. L. 569 (2004).

106. *Omnicare*, 818 A.2d 914, 948.

107. See Thompson & Smith, *supra* note 86.

108. See *supra* note 84 and accompanying text.

company, accountability demands that there must be some equally inviolate way to preserve monitoring by the shareholders.

Thus, the corporate structure is problematic not simply because it tends to facilitate managerial rent-seeking, but also because it is excessively rigid. Firms need to be able to customize shareholders' and directors' powers to deal with firm-specific features such as ownership concentration or the nature of the firm's business. This might include not only variations on management forms, but also on the extent to which assets are locked-in under central management control or subject to partner-like cash-out.¹⁰⁹ As discussed below in Part III, this flexibility is a main advantage of the contract-based partnership form.

C. The Changing Nature of the Firm

Part II.B accepts the need for strong centralized management in publicly held firms but questions the efficiency of the inflexible corporate version of centralized management. This Part shows that there is a more basic question concerning the need for the corporate-type hierarchy in modern firms.

Blair theorizes that the corporate form was used in the late 19th century so that firms could lock assets together in a tightly coordinated firm under strong central management.¹¹⁰ Blair builds on Chandler's history in which firms capitalized on developments, such as the railroad, that had vastly reduced transportation and communication costs and made large centralized organizations feasible. Firms solved the throughput problem—that is, employing modern industrial processes to ensure that everything got to the right place at the right time, including parts into automobiles and orders from Sears' warehouses to mail order customers.¹¹¹ Blair notes that the need for tight coordination could enable owners of critical assets to “hold up” the firm. In order to avoid this problem, firms had to own warehouses, parts suppliers and other assets that were critical to producing the firms' extraordinary returns.¹¹²

As several recent writers have discussed, however, the Chandlerian firm is being superseded by new technologies and market mechanisms that reduce firms' needs for centralized coordination and to own fixed assets.¹¹³ This is

109. As to the potential advantage of cash-out over lock-in, *see supra* text accompanying note 82.

110. *See* Blair, *supra* note 13.

111. *See generally*, CHANDLER, *supra* note 14.

112. *See supra* text accompanying notes 13-15.

113. *See* Naomi R. Lamoreaux et al., *Beyond Markets and Hierarchies: Toward a New Synthesis of American Business History*, 108 AM. HIST. 404 (2003); Richard N. Langlois, *Chandler in a Larger Frame: Markets, Transaction Costs, and Organizational Form in History*, BUSINESS AND ECONOMIC HISTORY ONLINE, <http://www.h-net.org/~business/bhcweb/publications/BEHonline/2003/Langlois.pdf> (2003) [hereinafter Langlois, *Larger Frame*]; Richard N. Langlois, *The Vanishing Hand: The Changing Dynamics of Industrial Capitalism*, 12 IND. CORP. CHANGE 351 (Apr. 2003); William Savitt, *A New New Look at Corporate Opportunities* (Sept. 2003) (Columbia Law and Econ. Working Paper No. 235), available at http://papers.ssrn.com/paper.taf?abstract_id=446960 (last visited Nov. 14, 2004). For a popular account, *see* JOHN MICKLETHWAIT & ADRIAN WOOLDRIDGE, *THE COMPANY: A SHORT*

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basically consistent with Chandler's story because, while Chandler sometimes seemed to suggest in his 1977 book that he was presenting a complete picture of industrial development, his theory is clearly contingent on prevailing technologies and other economic conditions.¹¹⁴ While centrally managed firms are useful in providing a "buffer" that solves the asset specificity problem where markets have not yet developed institutions that can accomplish this task, they become less necessary after the market matures.¹¹⁵ Dell, for instance, can assemble computers just in time from parts provided by its network of independent suppliers rather than by Dell-owned factories,¹¹⁶ airlines can lease their planes rather than owning them, and Manpower, Inc. can supply temporary workers rather than firms having to permanently hire workers in order to handle peak loads.¹¹⁷ Suppliers, in turn, are protected from market uncertainty and holdup by their ability to deal with many customers. All of this is consistent with Coase's original insight that the existence of firms depends on the transaction costs of using markets.¹¹⁸

In general, while the transaction cost balance favored strong centrally managed firms during the Industrial Revolution, it favors looser market-based organizations today.¹¹⁹ There is therefore a wide spectrum of firm types ranging from traditional hierarchical firms to firms that rely on spot markets or loose networks of contracts. This means that even the most traditional Chandlerian firms need flexibility to change with the times, and that there are many non-Chandlerian firms for which new approaches to governance may be appropriate. New-economy firms may own minimal hard assets, relying instead on contracts with suppliers such as Infosys (programming) and Flextronics (manufacturing electronics devices). If these firms have lower costs, they will tend to out-compete more traditional firms.

Another important development is firms' greater reliance on skilled workers than on hard assets. Power therefore devolves to the workforce rather than concentrating in middle managers. This produces organizational structures

HISTORY OF A REVOLUTIONARY IDEA 131 (Modern Library, 2003) (noting that "[t]he story of the company in the last quarter of the twentieth century is of a structure being unbundled"). *See also id.* at 142-46, 183-84 (discussing the rise of the "virtual" company and networks); William A. Klein & G. Mitu Gulati, *A Case Study of Collaborative Production Under High Uncertainty: Economic Organization in the Construction Industry*, 1 BERKELEY BUS. L.J. 137 (2004) (describing roles of firms, markets, and contracts in the construction industry).

114. *See* CHANDLER, *supra* note 14, at 376 (noting that the modern business enterprise was an "organizational response to fundamental changes in processes of production and distribution made possible by new sources of energy and by the increasing application of scientific knowledge to industrial technology"). *See also* Langlois, *Larger Frame*, *supra* note 113.

115. *See* Langlois, *supra* note 113.

116. *See* Lamoreaux et al., *supra* note 113.

117. *See* Langlois, *supra* note 113, at 372.

118. *See* Coase, *supra* note 3.

119. *See* MICKLETHWAIT & WOOLDRIDGE, *supra* note 113, at 182 (discussing the balance between transaction and hierarchy costs).

that are “flatter” than the vertical hierarchies of the Chandlerian firm, involve greater reliance on incentive compensation throughout the organization, and make less distinction between owners and managers.¹²⁰

The evolution of the firm has important implications for governance. The Chandlerian firm brought significant assets together under central management whose job was to engage in planning that would mitigate market uncertainties. Managers accordingly had to have broad powers to decide what to do with the assets and when and whether to sell them or distribute them to the shareholders. Thus, Chandler sees as a critical event James Duke’s refusal to distribute dividends despite the insistence of the large shareholders sitting on his board.¹²¹ But in more developed markets, firms’ value no longer necessarily depends on strict enforcement of director primacy. Instead, the development of market-based buffering mechanisms means that efficient governance choices can be expected to vary more from firm to firm.

Despite these fundamental changes in firms’ structure, there has been little apparent move from the corporate form. Part IV considers an explanation for this persistence of incorporation—that the law locks publicly held firms into the corporate form in order to further rent-seeking by politicians and corporate managers.

D. The Concession Theory and Regulation

Corporations originated as state-created monopolies that business people purchased from lawmakers, endowed with particular powers.¹²² Thus, Chief Justice Marshall in *Dartmouth College* characterized a corporation as “an artificial being, invisible, intangible, and existing only in contemplation of law. Being the *mere creature of law*, it possesses only those properties which the charter of its creation confers upon it, either expressly, or as incidental to its very existence.”¹²³ This state-creation characterization effectively sets a presumption in favor of regulating corporations that does not apply to other business associations or contracts.¹²⁴

The idea of the corporation as a legal creation lends itself not only to regulation, but also to reduced constitutional constraints on regulation. As

120. See Raghuram G. Rajan & Julie A. Wulf, *The Flattening Firm: Evidence from Panel Data on the Changing Nature of Corporate Hierarchies*, at http://papers.ssrn.com/paper.taf?abstract_id=393684 (last visited Nov. 14, 2004).

121. See CHANDLER, *supra* note 14, at 387. Similarly, Henry Ford’s retention of earnings gave rise to the famous case of *Dodge v. Ford Motor Co.*, 170 N.W. 668 (Mich. 1919).

122. See generally Henry N. Butler, *Nineteenth-Century Jurisdictional Competition in the Granting of Corporate Privileges*, 14 J. LEGAL STUD. 129 (1985).

123. *Trs. of Dartmouth Coll. v. Woodward*, 17 U.S. 518, 636 (1819).

124. See Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 WASH. L. REV. 1, 8-10, 64 (1990) (discussing the concession theory and presumption in favor of regulation).

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“mere” creatures of law, corporations need not be given the same constitutional rights accorded individuals. Thus, while Justice Marshall in *Dartmouth College* applied the Contracts Clause of the Constitution to corporations, this application was soon qualified by the states’ ability to reserve the power to amend statutes retroactively.¹²⁵ This effectively lets states transfer wealth from politically weak shareholders to politically strong managers. For example, state anti-takeover statutes resulted from direct lobbying of corporate managers, and reduced the value of corporate shares by limiting shareholders’ key right to transfer control in hostile takeovers.¹²⁶

The entity theory of the corporation also provides a basis for constraining corporate political activity. Individuals’ political speech, including speech in the form of political campaign contributions, receives high-level First Amendment protection.¹²⁷ But when this political activity is characterized as that of the corporate “entity,” it loses this strong protection unless the corporation is in a narrow category of firms that are deemed to express shareholders’ views.¹²⁸ Moreover, constitutional protection of corporate speech may be further reduced to the extent that courts characterize the speech of corporate entities as commercial, and therefore entitled only to a lower level of protection.¹²⁹

To be sure, the state-creation theory has had payoffs for corporations. Most notably, it smoothes the way toward the internal affairs rule in choice of law, which ensures that a corporation’s internal governance is controlled by the incorporating, or creating, state regardless of where the corporation does business.¹³⁰ The internal affairs rule, in turn, has enabled jurisdictional competition, a powerful force in adapting corporate law to the needs of publicly held firms. Thus, the concession theory of the corporation might be viewed as a tradeoff for corporate advantages. But this begs the question of whether there was ever any normative justification for encumbering corporate advantages

125. See Henry N. Butler & Larry E. Ribstein, *The Contract Clause and the Corporation*, 55 BROOK. L. REV. 767 (1989). The restrictive application of the Contract Clause in corporate cases contrasts with its relative vitality outside of corporate governance. For example, the clause has been applied to invalidate retroactive franchise regulation. See, e.g., *Equipment Mfrs. Inst. v. Janklow*, 136 F. Supp. 2d 991 (D.S.D. 2001); *Rolec, Inc. v. Finlay Hydrascreen USA, Inc.*, 917 F. Supp. 67 (D. Me. 1996); *Holiday Inns Franchising, Inc. v. Branstad*, 29 F.3d 383 (8th Cir. 1994).

126. See Henry N. Butler, *Corporation-Specific Anti-Takeover Statutes and the Market for Corporate Charters*, 1988 WIS. L. REV. 365 (1988).

127. See *First Nat’l Bank of Boston v. Bellotti*, 435 U.S. 765 (1978).

128. See generally Larry E. Ribstein, *Corporate Political Speech*, 49 WASH. & LEE L. REV. 109 (1992).

129. See generally Henry N. Butler & Larry E. Ribstein, *Corporate Governance Speech and the First Amendment*, 43 U. KAN. L. REV. 163 (1994). This is the issue the Supreme Court recently avoided addressing in the *Nike* case. See *Nike, Inc. v. Kasky*, 539 U.S. 654 (2003) (dismissing writ of certiorari as improvidently granted).

130. See Larry E. Ribstein, *The Constitutional Conception of the Corporation*, 4 SUP. CT. ECON. REV. 95, 99 (1995).

with increased regulatory burden. Part IV provides a political explanation of the regulatory burden on corporate features.

III. THE PARTNERSHIP ALTERNATIVE

As discussed above, the corporate form has both costs and benefits for publicly held firms. Accordingly, it is not obvious whether such firms would be better off organizing as partnerships than as corporations. In order to address this question, Part III.A discusses some advantages of a default partnership structure for publicly held firms, while Parts III.B and III.C discuss benefits attributable to the flexibility of the partnership form.

A. Partnership Structure

As discussed above,¹³¹ the corporate form is suited to publicly held firms in providing for limited liability, free transferability, continuity, and centralized management. In some respects, however, the structure of partnership-type business forms is actually better adapted to modern firms than the rigid corporate structure. Most importantly, partnership-type firms offer an agreement-centered approach to centralized management that provides flexibility and adaptability. These features suit the trend toward markets, flatter hierarchies and networks of contracts and away from the strong central management of the integrated Chandlerian firm.¹³²

Partnership-type statutes provide for two alternative default approaches to centralized management. Firms that want clear separation of ownership and control can choose the limited partnership in which all management power is allocated to general partners, while limited partners are basically glorified creditors with only such voting rights as are provided in the limited partnership agreement.¹³³ The limited partnership form until recently had terms that inhibited its use by many firms, particularly including the personal liability of the general partners and of any limited partners who participated in control.¹³⁴ Limited partnerships long have been able to minimize the effect of this rule by having corporate general partners. Limited partnership statutes also mitigate control liability with myriad safe harbors and by precluding liability unless limited partners represent themselves as general partners.¹³⁵ This flexibility has been clarified recently by permitting limited partnerships to organize as limited liability limited partnerships (LLLPs) with full limited liability, and by statutes

131. *See supra* Part I.B.

132. *See supra* Part II.C.

133. *See* RULPA § 302.

134. *See id.* § 303.

135. *Id.*

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that eliminate limited partners' liability for participating in control.¹³⁶

Firms that want a more flexible form of centralized management than limited partnership offers can organize as limited liability companies and choose to be managed by managers. Under this structure, firms can concentrate the power to bind in a few individuals designated as managers while adopting any internal structure it prefers. Alternatively, firms can be member-managed but place internal management power in some members—perhaps even calling these members “managers.”¹³⁷

These partnership structures provide important alternatives to the rigid, corporate-type centralized management structure. In particular, partnership-type statutes neither require nor even provide for an all-powerful and independent monitoring board, although partnerships can contract for such a mechanism. Managers of partnership-type firms accordingly derive their power from the specific agreement rather than from the fundamental architecture of the firm, as in the corporate context. In interpreting the extent of the managers' power, courts therefore have to refer to this agreement.

Moreover, partnerships are conducive to owner control of distributions. These provisions have been influenced by partnership taxation, which is imposed on partners based on earnings at the partnership level irrespective of whether these earnings are distributed. Compelling distribution of earnings effectively constrains agency costs while reflecting the reduced need for centralized control over corporate assets discussed above.¹³⁸

Partnership structure is particularly well-adapted to modern firms that rely more on skilled human capital than on fixed assets.¹³⁹ In order to retain their key workers, such firms may have to give them more than the limited participation in profits that is involved in typical corporate stock options. Firms may have to promise workers real participation in management, analogous to the promotion to partner in law firms after workers have served an apprenticeship in which they have proved their loyalty and worth.¹⁴⁰ Rather than relying on self-interested Blair-Stout-type “mediating hierarchs” to choose to take the interests of multiple constituencies into account,¹⁴¹ partnership-type firms give workers real control by making them partners or managing members.

Firms with passive owners who contribute only capital and not services

136. All of these changes are embodied in the 2001 revision of the Uniform Limited Partnership Act. *See generally*, ALAN R. BROMBERG & LARRY E. RIBSTEIN, BROMBERG AND RIBSTEIN ON LLPS, RUPA AND ULPA (2003 ed.), ch. 9 (discussing this revision).

137. *See generally* RIBSTEIN & KEATINGE, *supra* note 44, ch. 8.

138. *See supra* Part II.C.

139. *See* Rajan & Wulf, *supra* note 120, at 33-35 (noting evidence of the relationship between flatter management hierarchies and declining value of fixed assets per employee).

140. *Id.* at 33.

141. *See supra* text accompanying note 68.

would want to empower managers to make significant decisions, such as the sale of the company. But even these firms would not necessarily want to adopt the corporate model in which some veto power is necessarily reserved to owners. Rather, such firms might want to choose the limited partnership form and rely on specific contractual controls on managerial discretion, such as those included in the *Gotham* agreement discussed below.¹⁴² In this setting, the key partnership attribute is not necessarily a superior default structure, but greater flexibility to take account of firm-specific needs in governance arrangements.

B. The Contractibility of Partnership

In contrast to corporations, which historically have been treated as creatures of law and therefore have been particularly vulnerable to regulation,¹⁴³ partnerships do not bear the legacy of the concession theory. Indeed, partnerships historically were viewed as “aggregates” of the partners rather than as legal entities, and this theory survived to some extent in the Uniform Partnership Act (UPA).¹⁴⁴ For example, partnership property was formally characterized as belonging to the partners individually, though the partners as a group held all the important rights in the property.¹⁴⁵ To be sure, partnerships, like other legal business forms, have what Hansmann and Kraakman have termed the “essential” entity feature of partitioning the business and its assets from partners’ personal affairs and creditors.¹⁴⁶ Indeed, partnership statutes now clearly characterize partnerships and partnership-type firms as legal entities.¹⁴⁷ However, except to the extent that the continuity of the firm’s operations requires entity treatment, the fundamental legal rights connected with partnerships are viewed as residing in the individual members.

The contractual nature of the partnership is clearly evident in partnership governance. Partners’ rights and duties among themselves are explicitly subject to contrary consent or agreement in the 1914 Act,¹⁴⁸ and at least presumptively so in the 1997 Act, which provides that the agreement controls except as to specific categories of provisions.¹⁴⁹ The partnership agreement can allocate

142. See *infra* text accompanying notes 159-68.

143. See *supra* Part II.D.

144. See generally BROMBERG & RIBSTEIN, *supra* note 20, at § 1.03(b).

145. See *supra* text accompanying note 28.

146. See Hansmann & Kraakman, *supra* note 2, at 390.

147. See RUPA § 201; ULLCA § 201. There is, however, some residual confusion on this score. See BROMBERG & RIBSTEIN, *supra* note 20, § 1.03. This is reflected in the Supreme Court’s holding that a limited partnership is a citizen of all states where members reside for purposes of diversity jurisdiction, in contrast to corporate citizenship in a single state irrespective of where shareholders reside. See *Carden v. Arkoma Assocs.*, 494 U.S. 185 (1990); RIBSTEIN & KEATINGE, *supra* note 44, at § 10.06 (discussing application of *Carden* to LLCs).

148. See UPA §§ 18, 21.

149. See RUPA § 103.

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power between managers and owners¹⁵⁰ by providing, among other things, for procedures for conflicting interest and other transactions,¹⁵¹ management and governance arrangements,¹⁵² and variations in transferability of shares.¹⁵³ Accordingly, partnerships permit nuanced and firm-specific variations in governance rather than the general structural rules and ex post judicial pronouncements that characterize corporate law.

Most importantly, there is substantial authority enforcing contractual limits on fiduciary duties in partnerships and limited liability companies.¹⁵⁴ In general, fiduciary duties potentially permit open-ended ex post judicial manipulation of agreements, often to fit a particular pre-conceived notion of how the firm is governed. But flexibility has become especially important as corporate-style mandatory fiduciary duties no longer suit modern business structures.¹⁵⁵ For example, the corporate opportunities doctrine assumes that firms are collections of hard assets with rigid boundaries, so that opportunities readily can be assigned to particular firms, and that opportunities are best exploited by firms rather than their employees. But these assumptions do not hold for flexible, market-based firms that rely more on human capital than on hard assets.¹⁵⁶ This puts a premium on firms' ability to allocate business opportunities by contract rather than being locked into mandatory fiduciary duties.

Delaware is even more explicit than the general law in enforcing partnership agreements. Its non-corporate business association statutes provide that "[i]t is the policy of this chapter to give maximum effect to the principle of freedom of contract and to the enforceability of . . . agreements."¹⁵⁷ Consistent with this provision, Vice Chancellor Strine has opined that Delaware courts "will not be tempted by the piteous pleas of limited partners who are seeking to escape the consequences of their own decisions to become investors in a partnership whose general partner has clearly exempted itself from traditional fiduciary duties. The [Act] puts investors on notice that fiduciary duties may be altered by partnership agreements, and therefore that investors should be

150. See *supra* Part II.B.

151. See *infra* text accompanying notes 159-166; RUPA § 103(b)(3) (providing for certain types of agreements restricting the duty of loyalty).

152. See BROMBERG & RIBSTEIN, *supra* note 20, at § 6.03.

153. See *id.* § 3.05(c); *In re Asian Yard Partners*, No. 95-333-PJW, 1995 WL 1781675 (Bankr. D. Del. Sept. 1995) (interpreting complex provisions on assignment of limited partnership interests).

154. See generally BROMBERG & RIBSTEIN, *supra* note 20, at §§ 6.07(h), 16.07(h); RIBSTEIN & KEATINGE, *supra* note 44, at § 9.04; Larry E. Ribstein, *Fiduciary Duties and Limited Partnership Agreements*, 37 SUFFOLK U. L. REV. 927 (2004); Larry E. Ribstein, *Fiduciary Duty Contracts In Unincorporated Firms*, 54 WASH. & LEE L. REV. 537 (1997).

155. See *supra* Part II.C.

156. See Savitt, *supra* note 113.

157. See DEL. CODE ANN. tit. 6, §§ 1413 (Workers Cooperative Act), 15-103 (General Partnership Act), 17-1101 (Limited Partnership Act), 18-1101 (LLC Act); DEL. CODE ANN. tit. 12, § 3823 (statutory trusts).

careful to read partnership agreements before buying units. In large measure, the [act] reflects the doctrine of *caveat emptor*¹⁵⁸

The Delaware approach to partnerships is evident in the Delaware supreme court's *Gotham* limited partnership case.¹⁵⁹ The general partner's parent corporation had acquired limited partnership units in an odd lot tender offer. The transaction effectively entrenched the general partner because it increased the parent's stake to almost the one third vote needed to remove the general partner. The agreement authorized the general partner to *issue* new partnership units at a price set by a formula in the provision (the five-day market average). Directors unaffiliated with the general partner approved the odd lot offer at a price determined by the formula. The agreement provided for *non-issuance* transactions (including resales) with the general partner or its affiliate on terms substantially equivalent to those obtainable from an unaffiliated third party upon approval by an independent audit committee. The court held that the transaction was a resale subject to this fairness standard because the parties had treated it as such, and that it did not comply with the agreement's provisions applying to such a transaction because it was not approved by an audit committee or purchased on terms obtainable from an independent third party.

Thus, relying on the freedom-of-contract provision in the limited partnership statute, the court worked through the standard in the agreement applicable to the transaction at issue. The agreement in effect traded off governance procedures and judicial review. An issuance of new securities involved valuation problems, but these were dealt with by applying a formula. Despite the pricing provision, there was a potential concern with voting dilution that was dealt with by a limited partner vote.¹⁶⁰ Resale of existing market-traded interests presented less of a pricing issue except to the extent the transaction was with insiders. The agreement addressed the conflicting interest problem directly through independent review under an arms' length standard. In short, the duties of the general partner's affiliate were not determined according to some mandatory aspect of partnership structure, but rather by the contractual provisions applicable to the specific transaction at issue (i.e., the resale).

The *Gotham* court opined in dictum that the freedom-of-contract provision did not let the parties *eliminate* fiduciary duties, as the chancery court had suggested. This indicates that there may be a case in which the court deems that

158. Miller v. Am. Real Estate Partners, No. Civ.A. 16788, 2001 WL 1045643 (Del. Ch. Sept. 6, 2001).

159. Gotham Partners, L.P. v. Hallwood Realty Partners, L.P., 817 A.2d 160 (Del. 2002).

160. This vote was provided for by a stock exchange rule applied to the partnership through its listing agreement. See American Stock Exchange Guide (CCH) ¶ 10,198B, Sec. 713, May 8, 2002, available at <http://wallstreet.cch.com/AmericanStockExchangeAMEX/AmexCompanyGuide/PART7/SHAREHOLDERSAPPROVALSS710-713/1626000388.asp> (last visited Nov. 14, 2004).

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the agreement provides inadequate protection and mandatory fiduciary duties come into play.¹⁶¹ But the important point for present purposes is that the court's analysis started with the agreement, and the narrow qualifying dictum suggests that the analysis will end there, too, in all but the exceptional case in which the parties seek to eliminate fiduciary duties. Thus, for example, the opinion suggests that, under the circumstances of the case, the general partner could have entrenched itself had it followed the procedures for a non-issuance transaction and obtained audit committee approval of an arms' length third-party price, even without a limited partner vote.

Similarly, in *Marriott Hotel Properties II Ltd. Partnership*,¹⁶² the Delaware chancery court held that a general partner had no affirmative *Unocal* duty to protect the limited partners in connection with a tender offer by the general partner's parent in light of the partnership's specific structure and purpose as simply a Marriott hotel financing arm. The court observed that "the limited partners neither expected nor had any right to expect, that the General Partner or its directors would seek to act independently of [the parent corporation] Host in relation to the Offer."¹⁶³

Also, in *In re Nantucket Island Associates Ltd. Partnership Unitholders Litigation*,¹⁶⁴ Vice Chancellor Strine held, again after a careful review of interrelated provisions in the partnership agreement, that a general partner breached a limited partnership agreement by amending the agreement to allow it to issue new senior partnership units without the limited partners' consent. The court noted that, although the agreement could have authorized this sort of "blank check" issuance, it did not do so:

This case therefore stands as yet another example of how important it is to draft limited partnership agreements carefully. Although our law permits a limited partnership agreement to invest far-ranging authority in a general partner, it also requires a clear and unambiguous articulation of that authority so that investors are given fair warning of the deal they are making by buying units. When a general partner drafts an agreement that is susceptible to more than one reasonable interpretation, the one most favorable to the public investors will be given effect.¹⁶⁵

The agreement let the general partner sell additional units without limited partner consent "on such terms and conditions, and additional Limited Partners shall have such rights and obligations, as the Managing General Partner shall determine."¹⁶⁶ The agreement provided for amendment with limited partner

161. See Ribstein, *supra* note 154. The Delaware legislature responded to *Gotham* by clarifying that the agreement can provide for elimination of fiduciary duties and liabilities, other than "the implied contractual covenant of good faith and fair dealing." RULPA – General Amendments, ch. 265, § 15, tit. 6, § 17-1101, Del. Laws 265 (effective August 1, 2004).

162. No. Civ.A. 14961, 2000 WL 128875 (Del. Ch. Jan. 24, 2000).

163. *Id.* at 17, n.69.

164. 810 A.2d 351 (Del. Ch. 2002).

165. *Id.* at 361.

166. *Id.* at 361-62 (quoting Section 4.3 of the agreement).

consent in certain situations, including when the amendment adversely affects limited partner rights *other than* as permitted by the foregoing provision. The court held that this exception did not permit unilateral amendment with sufficient clarity to meet the interpretation standard quoted above, particularly in light of commercial practice requiring blank check authority to be made explicit.¹⁶⁷

Compare these cases with the corporate cases discussed above.¹⁶⁸ Managers' power to run partnerships is determined solely by "reasonable interpretation" of the agreement rather than by a general principle that the board should have extensive power to run the firm. If the agreement does empower the managers, this power is not subject to the "sacred space" of owner exit and voice rights.¹⁶⁹ At least in the leading state of Delaware, the agreement may modify both loyalty and care duties, not merely the duty of care as in Delaware corporate law.¹⁷⁰ Delaware's prohibition on eliminating fiduciary duties only preserves only a small space for judicial power when the court determines that the agreement has failed to serve the parties' objectives.

C. Flexibility and Regulation

The flexibility of the partnership form discussed above in this Part not only affects internal governance arrangements, but also might make it harder for government to regulate partnerships. In other words, partnership forms facilitate regulatory "arbitrage," thereby reducing government's ability to exercise monopoly power over these features. Indeed, the limited partnership was born in arbitrage, as a way to avoid usury laws.¹⁷¹ Moreover, even apart from arbitrage opportunities created by multiple forms, government cannot easily regulate partnership governance when important issues such as the existence of a separate board of directors, limited partner voting rights, and transferability of management rights are inherently subject to firm-specific agreements.¹⁷²

Regulation of governance across different business forms presents at least two problems for regulators. First, such regulation is more difficult to draft, as

167. This contrasts with the Delaware Supreme Court's landmark holding on poison pills, which upheld the then-novel issuance of flip-over poison pill rights. *Moran v. Household Int'l, Inc.*, 500 A.2d 1346 (Del. 1985). The court settled the board power issue quickly through an extremely broad reading of the board's power to issue rights and preferred stock in connection with those rights under 8 Del. Code title 8, sections 157 and 151(g), respectively. Consistent with the general approach in corporate cases, the court focused on the general allocation of power between directors and shareholders in responding to takeovers.

168. See *supra* Part II.B.3.

169. See Thompson & Smith, *supra* note 86.

170. See *supra* note 84 and accompanying text.

171. See BROMBERG & RIBSTEIN, *supra* note 20, at § 1.02(a).

172. See *supra* Part III.B.

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legislators and regulators must find a way to apply the regulation to many different governance devices. An example of the difficulty of adapting regulation designed for corporations to flexible partnership structures is a case involving the application of the derivative suit device to a hedge fund organized as a limited partnership in which partners incurred injuries directly through their capital accounts.¹⁷³ Chancellor Chandler observed:

[W]hereas corporations are largely creatures of statute with some limited contractual flexibility, limited partnerships offer greater contractual flexibility with only a few statutory constraints. Consequently, the structure and function of a limited partnership is sometimes analogous to the corporate model with the limited partners having similar rights and responsibilities as corporate shareholders and the general partner acting in much the same capacity as a corporate board of directors—but not necessarily so. Application of corporate law rules to disputes related to a limited partnership necessitates a bit of flexibility. This is true because the facts unique to a limited partnership dispute include the contents of the limited partnership agreement—how it specifies or modifies the entity’s function and structure and the rights and responsibilities of the general and limited partners [I]n some instances, the relationships among the parties and the function and structure of the partnership itself may diverge from the corporate model so dramatically that some claims, which in a corporate context might be classified as derivative, *must* be brought as direct claims in order to enable the injured parties to recover while preventing a windfall to individuals or entities whose interests were not injured.

Second, having to shape the regulation to cover additional business forms gives interest groups an opportunity to lobby for different rules in the partnership context than those that apply to corporations. Drafting glitches or political compromises, in turn, can enable firms to exploit differences in treatment in their drafting and planning.¹⁷⁴ The other pressures toward partnership discussed above in this Part suggest that choice of form is increasingly on the margin, and therefore even a small increase in federal regulation may be enough to push some firms toward a potential partnership escape hatch.

The malleable nature of partnerships already has undercut the extension of the corporate tax to partnership-type firms. Congress and the IRS attempted through the tax classification rules to identify features that would subject firms to the corporate tax.¹⁷⁵ But state variations on the partnership form, particularly LLCs, made it too hard to maintain a coherent distinction between the two

173. See *Anglo Am. Sec. Fund, L.P. v. S.R. Global Int’l Fund, L.P.*, 829 A.2d 143 (Del. Ch. 2003).

174. This was evident in early corporate history, as antitrust laws first caused firms to avoid cartels in favor of New Jersey holding companies, and then to avoid holding companies in favor of unitary operating companies. See CHANDLER, *supra* note 14, at 333-34.

175. These rules at first were slanted against a firm’s being a partnership because partnership-type firms were trying to reduce their taxes by taking advantage of tax breaks that were intended for corporations. The case that prompted the initial classification rules was *United States v. Kintner*, where the I.R.S. unsuccessfully sought to characterize a professional corporation as a partnership. 216 F.2d 418 (9th Cir. 1954).

types of entities. This effectively forced the IRS to adopt the “check the box” rule, thereby permitting partnerships to decide for themselves how they want to be taxed.¹⁷⁶

Something similar could happen with regard to federal securities regulation. The federal securities laws do not explicitly apply to particular business forms. Instead, they regulate all firms whose interests fit within the broad definition of a “security.”¹⁷⁷ This limits firms’ ability to avoid federal regulation of corporate governance simply by choosing their standard form or state of incorporation. Thus, the federal securities laws clearly apply to at least some partnerships and limited liability companies, particularly if they have centralized management and are publicly traded.¹⁷⁸ Nevertheless, partnership forms have given at least closely-held member-managed firms a limited opportunity to opt out of the securities laws altogether by choosing governance rules that do not fit the definition of a “security.”¹⁷⁹

Avoidance could increase as federal securities regulation expands beyond its traditional disclosure roots and regulates substantive corporate governance, which was previously the province of state law.¹⁸⁰ Such substantive regulation includes regulation of takeovers through the Williams Act,¹⁸¹ bookkeeping through the Foreign Corrupt Practices Act,¹⁸² insider trading and other insider misconduct through Section 10(b) and Rule 10b-5,¹⁸³ and the omnibus regulation in Sarbanes-Oxley.¹⁸⁴ This body of federal law is making state law and state jurisdictional competition increasingly irrelevant.¹⁸⁵

Regulation of corporate governance also may expand in effect through

176. See Simplification of Entity Classification Rules, 26 C.F.R. pt. 1, 301, 602 (Dec. 10, 1996, effective Jan. 1, 1997). There was also a possible public choice explanation: the IRS arguably reduced the pressure for integration by providing an escape hatch through partnership. See Jennifer Arlen & Deborah M. Weiss, *A Political Theory of Corporate Taxation*, 105 YALE L.J. 325, 367-68 (1995).

177. See, e.g., SEC v. W.J. Howey Co., 328 U.S. 293 (1946) (holding that sale of portions of an orange grove was covered by securities laws).

178. See BROMBERG & RIBSTEIN, *supra* note 20, §§ 2.13(e), 12.14 (discussing application of securities laws to partnerships); RIBSTEIN & KEATINGE, *supra* note 44, § 14.02 (discussing application of federal securities laws to LLCs).

179. See Larry E. Ribstein, *Form and Substance in the Definition of a “Security”: The Case of Limited Liability Companies*, 51 WASH. & LEE L. REV. 807 (1994); Larry E. Ribstein, *Private Ordering and the Securities Laws: The Case of General Partnerships*, 42 CASE W. RES. L. REV. 1 (1992).

180. For discussions of this expansion, see William B. Chandler, III & Leo E. Strine, Jr., *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents Of One Small State*, 152 U. PA. L. REV. 953 (2003); Larry E. Ribstein, *International Implications of Sarbanes-Oxley: Raising the Rent on U.S. Law*, 3 J. CORP. L. STUD. 299 (2003); Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections Upon Federalism*, 56 VAND. L. REV. 859 (2003).

181. See Securities Exchange Act of 1934 §§ 13(d), 14(d)-(e), 15 U.S.C. §§ 78m(d), 78n(d)-(e).

182. See *id.* § 13(b)(2), 15 U.S.C. § 78m(b)(2).

183. See Larry E. Ribstein, *Federalism and Insider Trading*, 6 SUP. CT. ECON. REV. 123 (1998).

184. See Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.A.) [hereinafter Sarbanes-Oxley Act].

185. Mark J. Roe, *Delaware’s Competition*, 117 HARV. L. REV. 588 (2003).

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stock exchange rules. The stock exchanges long have regulated the governance of listed firms, beginning even before enactment of the federal securities laws.¹⁸⁶ This regulation extends to listed non-corporate firms.¹⁸⁷ This regulation might technically be viewed as quasi-contractual in the sense that firms are free to choose where to list. Thus, firms that oppose control of governance need not take the drastic step of changing their form—they can, at least theoretically, choose to list on a less restrictive exchange. Accordingly, given the threat of loss of listings, exchanges might be expected to refrain from broad cross-form regulation. Firms' ability to avoid exchange regulation of governance by delisting seemingly was brought home when, in response to a more liberal NASDAQ rule, the New York Stock Exchange was forced to drop its prohibition on dual-class stock. When the SEC moved to prohibit such competition by adopting Rule 19c-4,¹⁸⁸ it was shot down for exceeding its authority under the securities laws.¹⁸⁹ Yet the SEC seemingly ultimately had its way when it persuaded the exchanges to agree to prohibit dual-class stock.¹⁹⁰

Since the Rule 19c-4 flap, the SEC has sought to use its power over the exchanges as a lever to persuade the exchanges to act together to adopt other regulation of substantive corporate governance.¹⁹¹ The SEC recently approved NYSE and NASDAQ rules regarding shareholder voting on compensation plans,¹⁹² noting that the rules would provide “clear and uniform standards for shareholder approval of equity compensation plans.”¹⁹³ Also, following prodding by then-SEC chair Harvey Pitt in February, 2002,¹⁹⁴ the NYSE and NASDAQ adopted governance rules that would, among other things, require boards to have a majority of independent directors and would define independence.¹⁹⁵

The expansion of federal regulation directly and through exchanges may give firms an additional impetus to avoid the federal securities laws by choice

186. See Robert B. Thompson, *Collaborative Corporate Governance: Listing Standards, State Law and Federal Regulation*, 38 WAKE FOREST L. REV. 961 (2003).

187. An example is the American Stock Exchange voting rule applied in *Gotham*. See *supra* note 161 and accompanying text.

188. 17 C.F.R. § 240.19c-4 (2004).

189. *Bus. Roundtable v. SEC*, 905 F.2d 406 (D.C. Cir. 1990).

190. See Rules Regarding Shareholder Voting Rights, Exchange Act Release No. 34-35121, 59 Fed. Reg. 66,570 (Dec. 19, 1994).

191. See Thompson, *supra* note 186, at 977-78 (characterizing the interaction between the SEC and the exchanges as a “forum approach”).

192. Equity Compensation Plan Approval Order, Exchange Act Release No. 34-48108, 2003 SEC LEXIS 1540 (June 30, 2003).

193. *Id.* at *88.

194. Press Release, Securities and Exchange Commission, Pitt Seeks Review of Corporate Governance, Conduct Codes (Feb. 13, 2002), at <http://www.sec.gov/news/press/2002-23.txt> (last visited Nov. 14, 2004).

195. See NYSE Final Corporate Governance Rules, at <http://www.nyse.com/pdfs/finalcorpgovrules.pdf> (last visited Nov. 14, 2004).

of form. Foreign firms have already indicated decreased willingness to cross-list in the U.S. in the wake of Sarbanes-Oxley.¹⁹⁶ The SEC may have avoided even more extensive defections by deciding not to extend the full force of the Sarbanes-Oxley audit committee rules to foreign firms.¹⁹⁷ Also, some U.S. public firms are taking advantage of the ability to avoid federal regulation by falling below the securities' laws minimum size or "float" for mandatory registration.¹⁹⁸

Will increased federal regulation lead to a move away from incorporation? As federal law reaches beyond disclosure into the details of governance, it becomes increasingly sensitive to variations among forms in governance rules. This may not be a problem for regulating *corporate* governance because the inflexibility and standardization of the corporate form lets regulators reach most firms simply by identifying the formal device being regulated, such as the board of directors. However, as discussed above,¹⁹⁹ regulating across business forms presents special problems.

There are recent examples indicating these problems of expanding federal securities regulation into control of internal governance. First, what if a firm does not have a board of directors? The SEC ultimately exempted such firms from the audit committee requirement if their activities are "limited to passively owning or holding (as well as administering and distributing amounts in respect of) securities, rights, collateral or other assets on behalf of or for the benefit of the holders of the listed securities."²⁰⁰

Second, how do strict rules regarding director independence apply to partnerships where the relevant board is that of the corporate general partner or manager that is a closely held corporation? In this situation the directors are inherently not independent of the shareholders who control the corporate partner and appoint its directors. The SEC ultimately recognized this when it dropped the rule that a director would be an "affiliated person" if it is the "designee" of an affiliate.²⁰¹

Third, the New York Stock Exchange has gone further in acknowledging the problem of regulating non-corporate entities in amending its proposed corporate governance rule to provide that "[d]ue to their unique attributes"

196. See Craig Karmin, *Foreign Firms Lose the Urge To Sell Stock in U.S. Market*, WALL ST. J., July 24, 2003, at C1; See also Ribstein, *supra* note 180 (discussing foreign firms' reduced incentive to cross-list in the U.S.). But see Michael A. Perino, *American Corporate Reform Abroad: Sarbanes-Oxley and the Foreign Private Investor*, 4 EUR. BUS. ORG. L. REV. 213 (2003) (arguing that Sarbanes-Oxley is unlikely to significantly deter cross-listing).

197. See Ribstein, *supra* note 180 (discussing and analyzing the SEC rules).

198. See Peter A. McKay, *Though Stock Is Publicly Held, Firms Adopt Private Mentality*, WALL ST. J., July 28, 2003, at C1.

199. See *supra* text accompanying note 175.

200. SEC General Rules and Regulations, 17 C.F.R. § 240.10A-3(c)(7)(i)-(ii) (2004).

201. See *id.* § 240.10A-3(b)(1)(iv)(E)(1).

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limited partnerships need not comply with rules requiring listed companies to have a majority of independent directors and certain committees to have entirely independent directors.²⁰² The Exchange observed that “partnerships are managed by a general partner rather than by a board of directors,” and therefore that only the *corporate* general partner can be subject to these standards.²⁰³

Extending regulation into corporate governance faces another test with the SEC’s proposed rule to require firms to implement direct nomination of directors by shareholders.²⁰⁴ The rule is explicitly subject to applicable state law not prohibiting such direct nomination.²⁰⁵ This would present complications for corporations in determining the precise state law that would satisfy the condition. More importantly for present purposes, it is not clear how the rule would be applied to publicly held partnerships.

To be sure, courts and regulators may resist evasion of federal regulation through publicly traded partnerships.²⁰⁶ Thus, when manager entrenchment topped the regulatory agenda, the SEC and ultimately the exchanges refused to permit firms to entrench managers by moving to the non-standard governance form of dual-class stock.²⁰⁷ Analogously, the Supreme Court recently crafted a rule that attempts to apply the employment discrimination laws irrespective of the form of the firm.²⁰⁸ These moves suggest that, when the regulatory stakes are high enough, regulators will try to foreclose arbitrage moves.

There are, however, inherent limits on the extent to which the governance of firms can be regulated where business forms eliminate convenient regulatory handles. Management and control can be allocated in nearly infinite ways, as illustrated by the broad range of business forms that states have developed. Firms might have several management layers, as with the corporate general partner control of limited partnerships. Firms such as limited partnerships could have a “board of directors” with merely advisory power while another body (or bodies) within the firm holds shares of real power. For example, in *Simpson v. Ernst & Young*,²⁰⁹ the firm claimed that plaintiff was a partner and therefore not subject to the employment discrimination laws. This determination turned in part on the plaintiff’s control. Plaintiff could vote for members of an “Advisory Council,” but the court held that the real power was in the “Management

202. See Governance Rules, *supra* note 195, at 1.

203. New York Stock Exchange, NYSE’s Corporate Governance Rule Proposals, ¶22 n.9, at www.nyse.com/pdfs/amend1-04-09-03.pdf.

204. Security Holder Director Nominations, 68 Fed. Reg. 60784 (proposed Oct. 23, 2003).

205. *Id.* at 60787-88.

206. See Saul Levmore, *Uncorporations and the Delaware Strategy*, 2005 U. ILL. L. REV. (forthcoming Feb. 2005) (predicting that “[f]ederal law will grow to regulate partnerships and other forms”).

207. See 17 C.F.R. § 240, *supra* note 188.

208. See *Clackamas Gastroenterology Assocs. v. Wells*, 538 U.S. 440 (2003).

209. 850 F. Supp. 648 (S.D. Ohio 1994).

Committee,” whose members were selected by the Chairman, who in turn was selected by the Management Committee.

Moreover, the problems of determining voting rights, or even who can be considered an “owner,” are potentially more complicated than what the SEC and the exchanges faced regarding dual-class voting. For example, whose voting rights should be regulated in a firm that has general partners, a limited partner and holders of fractions of a limited partnership interest? Courts, legislators and regulators could define the kinds of transactions or entities regulated by structure rather than name. But it will be difficult for them to avoid drawing lines that invite regulatory arbitrage. Thus, although the Court’s employment discrimination test focuses on control, choice of form may prove to be relevant to the level of control, as well as to other features cited in the test the Court applied, including “[w]hether the parties intended that the individual be an employee, as expressed in written agreements or contracts.”²¹⁰ Courts may develop rules of thumb differentiating among business forms, and Congress may have to clarify the law.

Finally, some indication of how Congress will have to approach regulating partnerships can be inferred from the most comprehensive federal regulation of partnerships so far, the Limited Partnership Rollup Reform Act of 1993²¹¹ and the SEC’s rollup disclosure rules in Regulation S-K.²¹² The Act and rules are intended to address the specific problem of limited partnership rollups which, after Congress’ decision to tax publicly traded limited partnerships as corporations,²¹³ turned into financial disasters because investors bought the interests based on tax benefits and distributions that did not materialize.²¹⁴ The rollups promised the liquidity of a public market for interests in the firm in exchange for heavily discounted prices, large fees, and removing the investors’ right to cash out of the firm. Although the statute regulates both disclosure and the terms of the transactions, including fees and dissenters’ rights,²¹⁵ it reaches only a narrowly defined set of transactions. Most importantly, the rule applies only to “finite-life” entities—i.e., those that have a policy of distributing rather

210. See *Clackamas*, 538 U.S. at 450.

211. 15 U.S.C. §§ 78n, 78o-3, 78f (2004) (providing for disclosure in connection with rollups, regulation of fairness opinions and compensation of brokers, restrictions on changes in the financial or governance structure of the firm, and requiring exchanges to condition listing on providing for dissenters’ rights).

212. See Regulation S-K, 17 C.F.R. §§ 229.900-229.915 (2004).

213. See I.R.C. § 7704 (2004).

214. For an analysis of the problems and ensuing regulation, see John Geschke, Note, *Regulating Rollups: General Partners’ Fiduciary Obligations in Light of the Limited Partnership Rollup Reform Act of 1993*, 47 STAN. L. REV. 85 (1994).

215. See Limited Partnership Rollup Reform Act of 1993, 15 U.S.C. §§ 78o-3, 78f. The law accomplished the latter regulation by requiring exchanges to condition listing of rollup securities on the existence of these rights.

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than reinvesting assets.²¹⁶ As the SEC said in proposing its initial rollup rule, “the definition of roll-up transaction has been more precisely tailored to target those transactions that raise the concerns addressed by the rules.”²¹⁷ Thus, the most comprehensive federal regulation of partnership governance was carefully designed to apply only to a limited category of vehicles involving a precisely delineated problem.

IV. A POLITICAL THEORY OF THE CORPORATE FORM

This Article so far indicates that publicly held firms could get appropriate default rules with less regulatory burden and more flexibility if they selected partnership standard forms such as limited partnership or centrally managed limited liability companies. Yet while this has been the case for some time,²¹⁸ there is no discernable move to partnership by mainstream publicly held firms outside of specific industries such as real estate. If incorporation is inefficient for many firms, why does it continue to dominate? This Part discusses a rent-seeking explanation for the corporation. Publicly held firms select the corporate form not entirely because of its inherent advantages, but rather at least in part because they are channeled into it by regulation and tax laws. The corporate form assists government regulation of firms because, as discussed above,²¹⁹ the corporation always has been considered a creature of state law and because its inflexibility makes it easier for regulators to craft restrictions.

Part IV.A discusses how this regulation serves politicians’ and managers’ interests. Part IV.B discusses how the corporate form has been protected by direct regulation. Part IV.C discusses the roles of tax considerations in explaining the persistence of incorporation.

A. *The Relevant Interest Groups*

This Section discusses the incentives of the main political actors in preserving regulation of corporate features. Politicians seek not only to assist interest groups that favor regulation, but also to preserve their own power to transfer rents. Corporate managers and shareholders might be expected to resist profit-reducing regulation. But regulation of the corporate form serves the best organized group—corporate managers—by helping them to a bigger slice of

216. See 15 U.S.C. § 78n(h)(5)(A) (2004) (excluding from regulation, *inter alia*, “a transaction that involves only a limited partnership or partnerships having an operating policy or practice of retaining cash available for distribution and reinvesting proceeds from the sale, financing, or refinancing of assets in accordance with such criteria as the Commission determines appropriate”); 17 C.F.R. § 229.901(b)(2)(i) (2004) (defining “finite-life” entity).

217. See Roll-up Transactions, 50 S.E.C. Docket 14, 1991 WL 529543 at *4 (Oct. 30, 1991).

218. See Larry E. Ribstein, *Unlimited Contracting in the Delaware Limited Partnership and its Implications for Corporate Law*, 16 J. CORP. L. 299 (1991).

219. See *supra* Part II.D.

the smaller, regulated, pie.

Politicians could gain directly from controlling corporate governance. First, state legislators could earn political favors by making or blocking changes in general incorporation statutes just as they did by selling special charters. This is particularly true for changes that affect existing contracts, and thus do not give affected parties an opportunity to mitigate wealth transfers.²²⁰ A prominent example is the anti-takeover statutes of the late 1980's.²²¹ Another is the Bubble Act, which was favored by, among others, the South Sea Company's backers who were concerned about competition for capital by the non-chartered joint stock, or "bubble," companies that imitated the South Sea Company's financial structure.²²²

Second, regulation of corporate governance helps prevent publicly held firms from becoming a powerful rival to government, and therefore lawmakers. For example, some states have enacted statutes permitting or requiring directors to take account of non-shareholder constituencies in corporate control transactions.²²³ Also, federal law, particularly the shareholder proposal rule,²²⁴ encourages non-shareholder constituencies to participate directly in corporate governance. Firms are induced to regulate themselves, or at least not lobby actively against business regulation, thereby lowering the lobbying costs of advocates of regulation.²²⁵

Third, regulation of business forms inhibits the regulatory arbitrage opportunities discussed above.²²⁶ The freer firms are to choose among alternative business forms, the harder it is to regulate the governance of firms.

The main group that could be expected to oppose increased regulation of firms' governance is managers. Corporate managers have common objectives regarding corporate governance and can coordinate through organizations such as the Business Roundtable. They also have a strong incentive to oppose fetters on the business that would reduce profit-making opportunities and, indirectly, managers' share of corporate wealth.

220. See Butler & Ribstein, *supra* note 125.

221. See Butler, *supra* note 126.

222. See Henry N. Butler, *General Incorporation in Nineteenth Century England: Interaction of Common Law and Legislative Processes*, 6 INT'L. REV. L. & ECON. 169, 172-73 (1986) (arguing that the key group was Parliament, which was concerned about the value of its chartering business); RON HARRIS, *INDUSTRIALIZING ENGLISH LAW: ENTREPRENEURSHIP AND BUSINESS ORGANIZATION, 1720-1844*, at 64-79 (Cambridge University Press, 2000) (stating that the key proponent of the Act was the South Sea Company itself, particularly regarding the exemption for subscriptions of the South Sea Company).

223. See, e.g., 805 ILL. COMP. STAT. ANN. 5/8-85 (West 2004); IND. CODE ANN. § 23-1-35-1(d) (West 2004); MO. ANN. STAT. § 351.347 (West 2004); N.Y. BUS. CORP. LAW § 717(b) (McKinney 2004); OHIO REV. CODE ANN. § 1701.59(e) (West 2004).

224. See 17 C.F.R. § 240-14(a)-8 (2004).

225. Corporate lobbying is also influenced by direct regulation of corporate campaign contributions and corporate speech. See *supra* text accompanying note 128-31.

226. See *supra* Part III.C.

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Managers' incentive to oppose regulation of corporate governance is, however, tempered by the regulation's effect on increasing managers' power within firms, and therefore their share of corporate wealth. For example, non-shareholder-constituency statutes and other corporate social responsibility rules arguably dilute managers' duties²²⁷ and state anti-takeover legislation helps entrench managers. More generally, managers could be expected to favor the dominant governance model, which gives directors the primary role in governance, abetted by broad judicial interpretation of the board's powers under statutes and governance documents, and constrained only by vague fiduciary duties.²²⁸ Thus, managers could stand to lose more than they would gain from deregulating corporate governance. Even if this were not the case, managers are risk averse because they cannot easily buffer or diversify investments in human capital, and therefore would probably prefer the status quo to a new equilibrium that would threaten their tenure or returns to their human capital.²²⁹

Lawyers may, however, be the agents of change. Lawyers not only will write new agreements, but also have incentives to refine business association statutes to accommodate publicly held partnership-type firms and special purpose entities, just as they have developed and promoted these statutes for closely held firms.²³⁰ Lawyers lack managers' stake in, and therefore incentive to maintain, the corporate status quo. Indeed, lawyers stand to increase their business by advising on changes in the law.²³¹

B. Direct Regulation of Corporate Features

Firms that preferred to adopt non-corporate business forms historically have been constrained by rules that limit the use of corporate features by non-corporate firms. Thus, the English Bubble Act of 1720 outlawed "all . . . publick undertakings . . . presuming to act as a corporate body . . . raising . . . transferable stock . . . transferring . . . shares in such stock . . . without legal authority, . . . and all acting . . . under any charter . . . for raising a capital stock . . . not intended . . . by such charter . . . and all acting . . . under any obsolete charter . . . for ever be deemed to be illegal and void"²³² Similar rules survive in state corporation statutes that effectively bar incorporation by estoppel, imposing personal liability on those who

227. See *supra* text accompanying note 72.

228. See *supra* Part II.B.3.

229. See John C. Coates, IV, *Private vs. Political Choice Of Securities Regulation: A Political Cost/Benefit Analysis*, 41 VA. J. INT'L L. 531 (2001).

230. For a discussion of lawyers' role in lawmaking, see Larry E. Ribstein, *Lawyers as Lawmakers: A Theory of Lawyer Licensing*, 69 MO. L. REV. 299 (2004).

231. However, other considerations suggest that lawyers may resist change. See *infra* Part V.

232. 6 Geo. 1, ch. 18 (1720) (Eng.).

presume to act as a corporation without incorporating.²³³ But this does not prevent parties from contracting for corporate features in partnership or other types of firms.

The main problem with trying to get corporate features without incorporating is not that firms have been expressly prohibited from doing so, but the risk that courts may not enforce novel contracts without statutory authorization. Courts and legislators historically have been hostile to non-corporate limited liability. Although it was permitted in limited partnerships, the parties to these firms had to accept the significant limitations of general partner liability and the limited partner control rule.²³⁴ Thus, although limited liability is now widely available in partnership-type firms, the historical constraints on the spread of limited liability may help explain why non-corporate limited liability forms have not been developed or widely used for publicly held firms. Parties who attempt to create new forms of limited liability risk judicial non-enforcement of the liability shield.²³⁵

Even if a state recognizes a novel form of limited liability, another state might not enforce the shield. Although the internal affairs rule enforcing formation-state law generally applies to established business associations, in other contexts interstate enforcement would be subject to the general rules on contractual choice of law. Applying those rules, a court might not enforce contractual choice of a state limited liability rule, particularly if no party resides in the forum state and limited liability in novel contexts is considered contrary to local public policy.²³⁶

C. The Corporate Tax

The double tax on earnings at the corporate level and then again on dividends may partially explain the persistence of incorporation. The entity-level tax on firms can be viewed as an end in itself, with incorporation as the means. An entity-level tax arguably is politically attractive because it removes the tax one step from voters, who see it as a tax on “corporations” rather than, more realistically, on them. But while this would explain a single-level tax at the corporate level, it does not necessarily explain a second-level tax on dividends at the shareholder level.²³⁷

233. See, e.g., MODEL BUS. CORP. ACT § 2.04.

234. See *supra* text accompanying note 134; Larry E. Ribstein, *An Applied Theory of Limited Partnership*, 37 EMORY L. J. 835 (1988).

235. One way around this is statutory recognition of limited liability apart from established business forms. See Larry E. Ribstein, *Limited Liability Unlimited*, 24 DEL. J. CORP. L. 407 (1999). This is related to the network effects discussed *infra* Part IV.D.

236. See generally Larry E. Ribstein, *From Efficiency to Politics in Contractual Choice of Law*, 37 GA. L. REV. 363 (2003) (discussing rules on enforcement of contractual choice of law).

237. See Arlen & Weiss, *supra* note 176, at 332-33.

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Alternatively, the entity theory of the corporation can be seen as providing a theoretical basis for the double tax.²³⁸ But neither the entity theory nor the corporate form is essential to maintaining the double tax. State competition to develop partnership standard forms ultimately broke down the clear boundaries between corporations and partnerships.²³⁹ Closely held firms generally now can elect whether to be taxed as partnerships or corporations,²⁴⁰ while publicly held firms are now taxed as corporations regardless of form.²⁴¹

A better political explanation of the double-level tax on corporate earnings and on distributions to shareholders is that it encourages retention of earnings in the firm and therefore assists managers' control of those earnings.²⁴² In other words, the corporate tax helps bolster the distinctively corporate approach to governance of strong central managers and non-interference by owners.²⁴³ Specifically, by imposing a tax cost on distributions, the corporate tax reduces the benefits of giving owners control over distributions. Conversely, if dividends were tax free, as they are in partnerships, owners would have more incentive to contract to compel distributions, including through standard forms that emphasize owner control rather than director primacy.²⁴⁴

Without a tax on dividends, firms would have more incentive to find contractual mechanisms to compel distributions.²⁴⁵ Firms once did this through

238. See Marjorie E. Kornhauser, *Corporate Regulation and the Origins of the Corporate Income Tax*, 66 IND. L.J. 53 (1990). But see Steven A. Bank, *Entity Theory as Myth in the Origins of the Corporate Income Tax*, 43 WM. & MARY L. REV. 447 (2001) (arguing against this basis of the corporate tax).

239. Larry E. Ribstein, *The Evolving Partnership*, 26 J. CORP. L. 819, 829-30 (2001). Note that government may have loosened tax classification rules in order to reduce the political pressure for integration. See 26 C.F.R. pt. 1, 301, *supra* note 176. This suggests that there is a tension between regulation and competition: broad regulation invites political opposition, while narrow regulation invites competition and arbitrage.

240. See *supra* note 176 and accompanying text.

241. See I.R.C. § 7704.

242. See Arlen & Weiss, *supra* note 176. But see Reuven S. Avi-Yonah, *Corporations, Society and the State: A Defense of the Corporate Tax* (Mar. 2004), (Public Law Research Paper No. 40, University of Michigan), available at http://papers.ssrn.com/paper.taf?abstract_id=516202 (last visited Nov. 14, 2004) (explaining corporate tax as a constraint on managerial power).

243. Although managers support retaining earnings, retention arguably runs counter to politicians' interests in bolstering corporations' economic power, and therefore their ability to compete with government. But this effect is mitigated by the constraints on corporations' ability to convert their money into political power. See *supra* text accompanying note 129.

244. It has been argued that two-level corporate taxation reduces agency costs by reducing conflicts between managers and shareholders as to asset dispositions by the firm. See Hideki Kanda & Saul Levmore, *Taxes, Agency Costs, and the Price of Incorporation*, 77 VA. L. REV. 211 (1991). However, even if this is true, it is not clear why firms need this sort of mandatory tax rule to minimize agency costs when contractual approaches are available. See Ribstein, *supra* note 10, at 469-71.

245. To be sure, eliminating the dividend tax might simply reduce firms' reliance on debt without increasing distributions, thereby reducing overall constraints on agency costs. See Dino Falaschetti & Michael J. Orlando, *Cutting the Dividends Tax . . . and Corporate Governance Too?* (November 16, 2003), available at http://papers.ssrn.com/paper.taf?abstract_id=471021 (last visited Nov. 14, 2004). That is particularly likely to be true if firms are limited to the corporate structure, which impedes contracting for distributions. For the reasons discussed below in this Part, the partnership form would then become especially important in providing contractual alternatives to debt as a constraint on agency

leveraged buyouts, which effectively committed managers to distributing cash flow by converting stock into debt.²⁴⁶ But a lower tax on dividends increases their attractiveness compared to debt, other things being equal.²⁴⁷ Corporate managers might commit to a policy of increased dividends.²⁴⁸ But the threat of hostile takeovers that might once have enforced such a policy has now been diminished, and the business judgment rule virtually eliminates any fiduciary duty to make distributions in publicly held firms, at least without aggravating circumstances.

Perhaps the most effective way for corporate managers to commit to distributions is through a charter provision compelling distributions under certain circumstances. The enforceability in the corporate context of such a restriction on broad managerial discretion, however, is subject to doubt.²⁴⁹ By analogy, *Quickturn* invalidated a delayed redemption provision in a poison pill that bound a new board because the provision “restricts the board’s power in an area of fundamental importance to the shareholders—negotiating a possible sale of the corporation.”²⁵⁰ The court did indicate that a limitation on the board’s power might be included in the charter under Section 141(a).²⁵¹ However, it is not clear how far such a restriction could go. As discussed above, the courts have proscribed board “sterilization.”²⁵² Accordingly, a broad charter restriction on a board’s general power to decide how much earnings to retain might be unenforceable. This doubt is reinforced by *Omnicare*, which refused to enforce a deal-protection provision that was explicitly authorized by the Delaware statute.²⁵³

Partnership provides an important alternative to incorporation for firms that want to force managers to distribute earnings. Provisions concerning distributions are routine in partnerships.²⁵⁴ This is not surprising, since partners taxed on partnership-level earnings are exposed to a high risk of squeeze-out where earnings are not distributed.²⁵⁵ Thus, for example, the partnership agreement may compel distributions of cash receipts subject to a reserve

costs.

246. See Michael Jensen, *Agency Costs of Free Cash Flow, Corporate Finance and Takeovers*, 76 AM. ECON. REV. Papers & Proceedings 323 (May 1986).

247. Debt, however, retains the advantage of deductibility at the corporate level. The implications of this point are explored *infra* text accompanying note 259.

248. See Frank Easterbrook, *Two Agency-Cost Explanations of Dividends*, 74 AM. ECON. REV. 650 (1984).

249. See *supra* text accompanying notes 61-63.

250. *Quickturn Design Sys., Inc. v. Shapiro*, 721 A.2d 1281, 1291-92 (Del. 1998).

251. *Id.* at 1291.

252. See *supra* text accompanying note 61.

253. See *supra* text accompanying note 105.

254. Indeed, this was an aspect of defining partnerships for purposes of rollup regulation. See *supra* text accompanying note 215.

255. For a case involving general partner fiduciary duties in this squeeze-out scenario, see *Labovitz v. Dolan*, 545 N.E.2d 304 (Ill. App. Ct. 1989).

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provision.²⁵⁶

Recent tax changes may decrease the attractiveness of incorporation. The Jobs and Growth Tax Relief Reconciliation Act of 2003 reduces the tax on most dividends to 15%, and 5% for low-income taxpayers.²⁵⁷ On the one hand, this increases the attractiveness of incorporation for shareholders by reducing the double-tax penalty. On the other hand, it reduces incorporation's attractiveness for managers by increasing the pressure on managers to distribute earnings. After-tax benefits of distributions are now more likely to exceed the benefits of retaining earnings, other things remaining equal.²⁵⁸ Indeed, many firms have increased their dividends in the wake of the new tax rates.²⁵⁹ The increasing attention to distributions may encourage some firms to make initial public offerings in partnership, rather than corporate form, or at least with charter provisions that commit to distributions. More importantly, the increased recognition of the advantages of corporate distributions may provide an atmosphere conducive to more radical changes in the law.

The reduced tax on dividends may be seen partly as an effort to head off political pressure to move toward integration, or a single investor-level tax.²⁶⁰ It also reduces managers' incentives to use debt, which is fully taxable at the shareholder level. Debt, in turn, may further reduce managers' control over cash flow.²⁶¹ In effect, high debt can be seen as a kind of "home-made" integration, since it produces something like the tax effect of a single level tax at the claimant level. By contrast, low taxation of dividends produces something like a single-level tax at the corporate level. This preserves the political advantage of keeping the tax one step removed from individual taxpayers.²⁶² Accordingly, the dividend proposal may be a way of saving both the corporate form and the corporate-level tax, at least in the short run. Nevertheless, this Section shows that such tax changes may contribute to the demise of the corporation in the long run.

256. *Henkels & McCoy, Inc. v. Adochio*, 138 F.3d 491 (3d Cir. 1997) (applying such a reserve provision to protect creditors from excessive partner distributions). Although the case suggests caution in drafting distribution provisions in light of the creditors' rights provisions of limited partnership and similar statutes, it does not suggest a problem in restricting the general partner's discretion regarding distributions.

257. Pub. L. No. 108-27, § 301, 117 Stat. 752, 758 (2003).

258. This is analogous to the effect of the Tax Reform Act of 1986, which, among other things, caused top corporate tax rates to exceed top individual rates and eliminated the lower tax on capital gains, thereby making incorporation disadvantageous enough for some firms that they had an incentive to push the envelope on tax classification.

259. See Peter A. McKay & Bob Davis, *Dividend Tax Cut Pleases Companies More than Investors*, WALL ST. J., Aug. 5, 2003, at C1 (noting that share prices of dividend-increasing companies have risen less than the market, but that this may reflect the fact that recent significant market gains have been in non-dividend-paying technology stocks and other non-dividend-paying sectors).

260. See *supra* note 176.

261. See *supra* text accompanying note 246.

262. See *supra* text accompanying note 237.

V. NON-POLITICAL EXPLANATIONS FOR CORPORATE DOMINANCE

In addition to the political considerations discussed in Part IV, there are other impediments to ending the dominance of the corporate form. One is “network” effects. Publicly held corporations have generated significant case law, commentary, and forms that aid interpretation and application and thereby reduce transaction costs as compared with other default rules that are not as widely used and therefore have not generated such devices. The cases concerning non-corporate business forms mainly relate to closely held firms. Thus, for example, while incentive compensation could be designed in partnerships to mimic the effects of corporate stock options, risk-averse executives might shun this alternative because of its novelty and uncertainty about tax and other effects.²⁶³ Investors also may distrust new forms until they can be confident that governance and fiduciary duty rules in these forms will protect them. Just as network effects may explain the continued dominance of Delaware corporation law,²⁶⁴ they also may explain the survival and rigidity of the corporate form.²⁶⁵

The move to publicly held partnerships therefore presents a kind of chicken-egg problem. Like starting a new telephone network or computer operating system, the new system may not take hold until the network is established, which cannot happen until the system is accepted. To be sure, the network barrier is permeable. For example, the limited liability company became widely used despite the existence of the limited liability partnership, which was comparable in every way except that it allowed firms to access partnership interpretive materials.²⁶⁶ The corporation itself arguably faced a network barrier in its early history.²⁶⁷

To the extent that network effects constrain a beneficial move to partnership-type publicly held firms, these effects may interrelate with the tax and regulatory constraints discussed above in this Part. As discussed above, courts may be unwilling to enforce limited liability contracts or novel business forms created in other states.²⁶⁸ This increases the risks associated with these novel forms and, accordingly, the benefits of the network of interpretive cases.

It is important to emphasize that interpretive networks are not always

263. See Joseph Bankman, *The Structure of Silicon Valley Start-Ups*, 41 UCLA L. REV. 1737 (1994) (explaining the use of Subchapter C corporations despite tax disadvantages of this form).

264. See, e.g., Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757 (1995).

265. This survival and rigidity also may be an artifact of federal regulation of corporations. See Roe, *supra* note 185. If so, erosion of federal regulation by the availability of alternative partnership forms discussed in Part III.C. may have the side effect of increasing jurisdictional competition.

266. See Bruce H. Kobayashi & Larry E. Ribstein, *Choice of Form and Network Externalities*, 43 WM. & MARY L. REV. 79 (2001).

267. See *supra* note 47.

268. See *supra* text accompanying notes 238-239.

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beneficial. As this Article has shown, the corporate form may be more costly than the partnership form for many firms, particularly if courts apply the existing body of inflexible corporate cases to partnerships. This suggests that the benefits of a new set of rules for publicly held partnerships may exceed the learning and other costs such new rules entail.

There may be other reasons for continued dominance of the corporate form that relate neither to its efficiency nor to politics. For example, the switch into partnership depends both on suitable partnership forms being developed and firms getting adequate legal advice about the availability of these alternatives. Lawyers may have reputational incentives to participate in making “wholesale” changes.²⁶⁹ However, in order to make these changes on the retail level of individual clients, lawyers have to be willing to learn about the new forms and advise on their use. They may be concerned that their investments in the new learning will not pay off in higher fees or that the increased risk of malpractice in giving such advice exceeds any additional fees.

VI. CONCLUSIONS AND IMPLICATIONS

This Article should be viewed mainly as raising the question posed in its title rather than providing definitive answers. In other words, the Article shows that it is not clear why the corporate form so long has been so synonymous with big business in the United States that the choice of form issue rarely arises in the context of the publicly held firm. Although the corporate structure is well adapted to publicly held firms, the corporate form began to be used before the era of the publicly traded firm. In any case, whatever the corporation’s advantages, it also has defects that make it unclear why the corporation ever should have dominated to the exclusion of partnership-based forms. In particular, the corporate form is characterized by an inflexible governance structure and increased susceptibility to government regulation.

Recent developments are making the corporate form even less attractive and therefore are deepening the puzzle posed by the continuing dominance of the corporate form. Business increasingly is moving away from the model of the large, integrated firm with strong central management and toward markets and networks. Reduction of the second-level tax on dividends decreases the benefits and increases the cost of strong managerial control over retained earnings. And expanding federal regulation of substantive corporate governance increases the benefits of avoiding such regulation through arbitrage of business forms. Conversely, the partnership form offers modern firms the flexible alternative to incorporation they need. The partnership form not only provides flexibility, but ensures greater independence than corporate law from

269. *See supra* text accompanying note 230.

the constraining effects of government regulation. In short, solving the problems of corporate governance arguably seems to include making *corporate* governance irrelevant.

It is not clear, however, how or whether such a shift will come about. The very fact that partnership offers an escape from regulation also gives regulators an incentive to resist change in the status quo. They may directly regulate alternatives to incorporation, or less directly preserve double corporate taxation which provides an incentive to maintain managers' hold on distributions. Even without direct regulation, firms' concern about enforcement of alternatives to incorporation combines with network effects to inhibit the development of alternative business forms. Managers are unlikely to lead any moves to change the law because of their benefits under the existing corporate structure.

On the other hand, whatever regulators do, changing characteristics of firms may increase the costs of corporate inflexibility so that developing and adopting new business forms becomes worthwhile. Moreover, lawyers have some incentive to promote the wholesale legal changes that are necessary to smooth the way toward publicly traded partnerships, even if many lawyers may be reluctant to retool for the partnership era. Thus, political resistance to change ultimately may determine only when, rather than if, the curtain drops on the corporation.

Finally, this Article suggests that the institutions that matter to business development may include selection of the appropriate business form. It follows that it is important to understand the precise functions of choice of business form. These functions include the applicable default rules, including the choice between corporate-type lock-in and partnership-type distribution of assets. But as discussed in this Article, the overriding importance of the partnership form may be in its contractibility and relative immunity from government interference.²⁷⁰

270. This has potential implications for emerging economies. For a review of some other institutional considerations that matter in this context, see Bernard Black et al., *Russian Privatization and Corporate Governance: What Went Wrong?*, 52 STAN. L. REV. 1731 (2000).