University of Illinois College of Law
Law and Economics Working Papers

Year 2007 *Paper* 83

The Rise of the Uncorporation

Larry E. Ribstein*

*University of Illinois, ribstein@law.uiuc.edu

The Rise of the Uncorporation

Larry E. Ribstein

Abstract

"Uncorporations" – firms that include key partnership-type features such as distribution and liquidation rights and strong-form manager incentives – are increasingly important beyond their traditional small firm domain. Uncorporations can be used to address agency problems in some types of large firms more cheaply and effectively than is possible with corporate-type monitoring. Large firms are being structured as uncorporations, as with publicly held partnerships, publicly held "private equity" firms and REITs. They are also being wholly or partly governed by separate uncorporations, as with private equity, hedge funds and venture capital firms. These developments and theoretical considerations suggest that the increasing use of uncorporations may be a long-term trend rather than the temporary product of transitory market or regulatory factors. This article discusses differences between corporate and uncorporate modes of governance, describes applications in various contexts, and suggests implications of the analysis for the future of firms and for taxation and regulation of uncorporate forms.

THE RISE OF THE UNCORPORATION

Larry E. Ribstein*

July 29, 2007

Abstract

"Uncorporations" – firms that include key partnership-type features such as distribution and liquidation rights and strong-form manager incentives – are increasingly important beyond their traditional small firm domain. Uncorporations can be used to address agency problems in some types of large firms more cheaply and effectively than is possible with corporate-type monitoring. Large firms are being structured as uncorporations, as with publicly held partnerships, publicly held "private equity" firms and REITs. They are also being wholly or partly governed by separate uncorporations, as with private equity, hedge funds and venture capital firms. These developments and theoretical considerations suggest that the increasing use of uncorporations may be a long-term trend rather than the temporary product of transitory market or regulatory factors. This article discusses differences between corporate and uncorporate modes of governance, describes applications in various contexts, and suggests implications of the analysis for the future of firms and for taxation and regulation of uncorporate forms.

* Mildred van Voorhis Jones Chair, University of Illinois College of Law; Visiting Professor of Law, New York University School of Law (2007-2008). Thanks for comments by Steve Bainbridge, Vic Fleischer, Ron Gilson, Amitai Aviram, Michael Weisbach, and Charles Whitehead.

The modern corporation has had a good run. Throughout the 20th century, the corporation was the legal engine of the industrial revolution. However, for the last twenty years new business forms, which this paper collectively labels "uncorporations," have begun to rise to prominence. These alternative business forms are not merely a fad attributable to favorable tax, regulatory or economic conditions. Rather, they amount to a long-term challenge to the corporation's dominance, including for the large firms that have been considered the corporation's exclusive domain. Building on earlier work discussing problems with the corporate form and comparing corporation and partnership approaches to governance,[1] this paper shows how uncorporations' theoretical advantages are playing out in practice and provides insights on where these developments might be heading.

In general, uncorporate and corporate governance models involve alternative methods of dealing with agency costs that arise from separating managerial power from ownership of the residual claim.[2] Managers have different interests than owners, and may use their power to favor their own interests over those of the investors. For example, because managers invest a substantial portion of their human and financial capital in the firm, they have an incentive to avoid risks that more diversified investors would be willing to take. They also may want to grow the firm and retain earnings to cushion against economic shocks instead of distributing earnings to the shareholders when the firm lacks profitable investment opportunities.

In theory, corporate shareholders guard their investments by voting on directors and corporate transactions. In practice, widely dispersed and uncoordinated shareholders must rely heavily on other agents, including auditors, class action lawyers, judges and independent directors, to keep managers from taking too much for themselves. Investors and policy-makers view the heavy costs of these devices and the residual losses resulting when constraints are imperfect as a reasonable price to pay for the benefits of liquid stock markets and diversified portfolios.

The reasonableness of the tradeoffs inherent in the corporation depends on the availability of other devices for addressing agency costs. An important alternative is to tie managers' economic well-being so closely to that of their firms that monitoring them becomes less necessary. I call this approach "uncorporate" because it foregoes features hard-wired into corporate law in favor of features associated with partnership-based forms such as general and limited partnerships and limited liability companies. Uncorporate mechanisms include significant profit sharing by managers, owners' power to remove capital from the firm, the firm's limited duration, and restrictions on managers' control of the firm's cash. Managers' compensation directly reflects the firm's profits. Given the firm's contractual duties to distribute earnings to the owners and to redeem owners' interests or wind up, the managers must demonstrate that the firm is performing up to market standards in order to retain control over the firm's assets. At the same time, with much of the job of disciplining agency costs done by strong-form incentives, the uncorporate form can deemphasize monitoring. For example, uncorporate firms have flexible control rules and permit contractual modification or even elimination of fiduciary duties.

---

[1] *See* Larry E. Ribstein, *Why Corporations?*, 1 Berk. Bus. L. J. 183 (2004); Larry E. Ribstein, *Accountability and Responsibility in Corporate Governance*, 81 N.D. L. REV. 1431 (2006).

[2] *See* Michael Jensen & William Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Capital Structure*, 3 J. FIN. ECON. 305 (1976).

The separation between corporate-style monitoring and partnership-style incentives is not complete. Corporations also attempt to mitigate agency costs by giving managers incentives to maximize owners' wealth. But corporate managers are more insulated from the market forces that affect owners' wealth than are uncorporate managers. For example, the risk of being deposed by the market for corporate control, while theoretically aligning managers' and owners' interests, operates more loosely and sporadically than the uncorporate incentive-alignment devices discussed in the previous paragraph.

The above distinction between corporations and uncorporations, particularly including corporate managers' relative insulation from market forces, generally tracks the recent emphasis on capital lock-in as the distinguishing feature of the corporate form and modern large-scale business.[3] Corporate managers have the power to decide when to distribute assets to the owners. Conversely, uncorporate governance effectively forces managers to repeatedly return to the capital markets to fund their projects, and thereby to submit to external market scrutiny.

The potential advantages of uncorporate governance are especially salient and important given concerns about corporate governance in the wake of Enron and other corporate scandals that emerged from the millennial bust. The response to those problems has been extensive new regulation under the Sarbanes-Oxley Act, civil litigation for breach of fiduciary duty and fraud, and criminal liability. These devices have raised significant concerns about excessive costs. But the critics must also confront the question how else to constrain corporate managers given the clear risks of fraud and abuse that triggered Sarbanes-Oxley. Uncorporation incentive and control devices emerge as a possible response to both sets of concerns.

Like the corporate monitoring model, the uncorporate model has potential weaknesses. Uncorporate devices may give managers significant formal discretion to act, but also may circumscribe their effective ability to manage assets in the firm's long-term interests by removing corporate-type insulation from market forces. Also, managers who are subject to stronger incentives to perform are also subject to stronger incentives to cheat or take unwise risks.[4] In some firms the stronger incentives of the uncorporate form may actually increase agency costs in the absence of corporate-type monitoring devices. In other firms strong-form market-based incentive devices may produce lower agency costs than monitoring devices that reduce managers' incentives to cheat but that do not discipline shirking.

It follows that neither the corporate model nor the uncorporate model necessarily produces the best results for all firms. Choice of form for large firms, rather than being a runaway victory for incorporation, comes down to tradeoffs at the margin for each type of firm between high-powered uncorporate-type incentives and market discipline and low-powered corporate-type monitoring. The point of this article is not that there will or should be a general move to the uncorporate form, but rather to highlight the choice of form issue and to argue that the law should not unduly bias the choice.

There already has been a shift toward uncorporations, and specifically the limited

---

[3] *See infra* subpart I.C.

[4] *See* Ronald J. Gilson & David M. Schizer, *Understanding Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock*, 116 HARV. L. REV. 874, 880, n. 24 (2003) (applying this compensation of entrepreneurs in venture capital firms.).

liability company, in smaller firms. The corporate form was once the only reliable way small firms could get limited liability for all of their members. But corporate-type monitoring devices are costly or impracticable for closely held firms. Nevertheless, small firms had to pay both the costs of an unsuitable form as well as the double corporate tax for the "privilege" of limited liability.[5] This has changed over the last twenty years.[6] The 1980s decline in individual tax rates made it especially advantageous to adopt flow-through tax forms in which the firm's profits were taxed directly to the owners. The states, led primarily by lawyers, tinkered with the limited partnership form and ultimately adopted limited liability company (LLC) statutes. Burdened by having to respond to state variations on uncorporations, the IRS finally ruled that closely held uncorporations could elect flow-through tax treatment regardless of their formal characteristics.[7] Tax flexibility spurred the rapid spread of LLCs since the mid-1990s.[8]

Until recently it might have been supposed that uncorporations and corporations would divide neatly between the small, closely-held and large-scale publicly-held domains. Many scholars assume that corporate-type capital lock-in is an essential feature of the modern large-scale business enterprise.[9] However, this paper's emphasis on the distinction between monitoring and strong-form incentives does not divide along publicly-held/closely-held lines. There is no a priori reason to believe that monitoring is a cost-effective way to deal with agency problems in all publicly held firms.

Indeed, uncorporations may be poised to invade the domain of the publicly held firm just as they have closely held firms. Michael Jensen anticipated this development when he wrote 20 years about the "eclipse" of the public corporation.[10] Jensen argued that the substantial free-riding and monitoring costs entailed in corporate-type separation of ownership and control increasingly are not worth bearing. Jensen's prediction proved to be premature, since leveraged buyouts significantly diminished in the 1990s. But so-

---

[5] Small firms long have been able to both have limited liability and avoid the double tax by forming as Subchapter S corporations under Internal Revenue Code (26 U.S.C.) §§1361-63. However, Subchapter S imposes significant constraints, particularly including prohibiting foreign shareholders and more than one class of stock.

[6] This history is traced in Larry E. Ribstein, *The Evolving Partnership*, 26 J. Corp. L. 819 (2001).

[7] *See* Simplification of Entity Classification Rules, 26 C.F.R. pt. 1, 301, 602 (December 10, 1996, effective January 1, 1997).

[8] Data on formations of different types of firms gathered from various sources is presented in L. Ribstein & R. Keatinge, RIBSTEIN & KEATINGE ON LIMITED LIABILITY COMPANIES, §2:1. Tax data show an increase from 221,000 to 1,270,000 LLCs between 1996 and 2004. There are now more LLCs than any other type of unincorporated firm, about half the total. S corporations increased over the same period from 2,290,900 to 3,523,900, while C corporations declined from 2,240,800 to 2,066,806.

[9] *See, e.g.*, Margaret M. Blair, *Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century*, 51 UCLA L. Rev. 387 (2003); Henry Hansmann, Reinier Kraakman & Richard Squire, *Law and the Rise of the Firm*, 119 HARV. L. Rev. 1333 (2006); Naomi R. Lamoreaux & Jean-Laurent Rosenthal, *Corporate Governance and the Plight of Minority Shareholders in the United States Before the Great Depression* (Natl. Bureau of Econ. Research Working Paper No. W10900, Nov. 2004) (available at http://papers.ssrn.com/ sol3/papers.cfm?abstract_id=618582).

[10] Michael C. Jensen, *Eclipse of the Public Corporation*, HARVARD BUSINESS REVIEW (Sept.-Oct. 1989), revised 1997, available at http://ssrn.com/abstract=146149.

called "private equity" firms similar to those Jensen examined have returned to become a powerful force in corporate governance.

This paper's focus on the features of the alternative organization forms provides a perspective from which to view the role of other factors shaping corporate structure, and therefore a basis for predicting whether the rise of the uncorporation is a governance fad or a long-term development. First, there is a question whether restructuring is mainly a function of the cost and availability of debt financing. I argue that debt can be seen as an aspect of the uncorporation – that is, a tax-favored way to provide some of the incentives necessary to address the agency problems of large-scale enterprise.

Second, going private can be seen as a reaction to the relative benefits as well as the costs of being publicly held. While the increasing regulatory and litigation costs of being publicly held, particularly including the effects of the Sarbanes-Oxley Act,[11] have spurred restructuring,[12] exiting the public securities markets is not an essential aspect of the uncorporation phenomenon. Uncorporations can minimize the need for monitoring associated with the separation of ownership and control. For example, equipped with uncorporation incentive and other governance devices, firms can waive fiduciary duties, minimize the control powers allocated to the public owners, or deny the power to trade control rights, thereby nullifying the market for control. Thus, the uncorporation may be able to preserve the diversification and information benefits of public markets while reducing some of the costs of being publicly held.

Third, a focus on organizational forms can help explain why movements out of the corporate form occur at particular times. The benefits of the uncorporate form have been enhanced by innovations in business structure, particularly including Kohlberg, Kravis Roberts' development of the LBO association in the 1980s.[13] Of course tax, regulatory and macroeconomic developments also affect the costs and benefits of particular structures. But understanding the role of structural innovations can help put the role of tax and regulation in perspective. If organizational structure itself provides significant benefits it may be driving tax and regulatory changes as well as the product of these changes.

The uncorporation's rise has important implications not just for the internal structure of business, but for broader social policy. For example, this analysis contributes to the debate on how to tax the earnings of large firms and their managers. There is some concern about potential unfairness and revenue loss from favorable taxation of compensation paid to private equity managers, exemption from the corporate tax of publicly traded partnerships, and the substitution of tax-favored debt for equity.[14] But before legislating changes, it is necessary to consider the effect of these changes on business structure. If increasing tax or regulatory burdens on uncorporations reduces

---

[11] See Public Company Accounting Reform and Investor Protection (Sarbanes-Oxley) Act, Pub. L. No. 107-204 (codified as amended in scattered sections of 15, 18 U.S.C.).

[12] For an analysis of the possible effects of the Act in causing firms to go private, *see* Henry N. Butler & Larry E. Ribstein, THE SARBANES-OXLEY DEBACLE, 53-55 (AEI, 2006).

[13] For an analysis and history of these innovations, see George P. Baker & George David Smith, THE NEW FINANCIAL CAPITALISTS (Cambridge, 1998).

[14] *See infra* subparts II.E and III.D.

business efficiency, this could reduce not only tax revenues but social welfare.

Part I of this paper discusses basic distinctions between the corporation and the uncorporation. Part II discusses specific examples of modern uncorporated firms, including private equity, venture capital firms and hedge funds. It describes the extent to which the uncorporation is moving into the domain once exclusively occupied by the corporate form. Part III discusses the future of the uncorporation, including factors that have encouraged the rise of the uncorporation, as well as the factors that may inhibit or encourage its further growth. Part IV presents concluding remarks.

I. CORPORATE VS. UNCORPORATE GOVERNANCE APPROACHES

This Part discusses the attributes that differentiate the "corporation" from the uncorporation. Both types of business forms include provisions designed to constrain agency problems arising between managers and owners because of the separation of ownership and control. As discussed in the introduction, the corporate strategy emphasizes using agents to monitor managers to address incentive problems, while the uncorporate strategy involves reducing the agency problem by strong-form incentive devices that more closely align managers' and owners' interests. Each subpart contrasts the corporate and uncorporate versions of a specific governance feature. This article focuses on three types of "uncorporate" firms. General partnerships have co-equal owners who by default participate directly in management and control and have personal liability for the firm's debts. Limited partnerships have one or more general partners who have the same rights and powers as in general partnerships, as well as one or more limited partners who have only limited control and management rights and no personal liability for the firm's debts. Limited liability companies (LLCs) generally can elect between the manager-managed form, which is analogous to limited partnerships except with no managerial liability for the firm's debts, and member-managed form, which is like a general partnership only with limited liability.

A. MANAGEMENT

The corporate form separates ownership, control and management functions. The corporation is managed by its officers under the supervision of a board of directors. The shareholders typically do not manage, but instead only approve major transactions and elect the board.[15] Centralizing power in non-owner managers and the board reflects the logistical need to delegate management functions in a publicly held firm with thousands of dispersed owners. It also reduces the risk of opportunistic behavior compared to delegating control to owners with potentially conflicting interests.

In a standard form general partnership the members are also managers and there is no specialization of functions. However, the distinction between corporate and uncorporate management is more subtle for other types of uncorporations. Many limited partnerships and LLCs feature strong managers and owners who are even more passive and disengaged than public corporation shareholders. As detailed in subpart I.C, limited partners and non-managing LLC members may have very little or no voting power.

There are two important distinctions between corporations and these centrally managed uncorporations. First, corporations do not merely *centralize* management, but

---

[15] *See generally*, Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301 (1983) (outlining control, management and ownership functions).

also *specialize* ownership, control and management functions. Corporate managers and directors typically own only a small fraction of the firm's shares. By contrast, in uncorporations there is no complete separation between management and ownership. Managers of general and limited partnerships and LLCs are usually partners or members. Though corporate managers often hold interests in the firm, this is usually in the form of stock options which, in contrast to full equity ownership, give managers a right to share in stock price increases limited downside exposure. Moreover, the incentive effects of stock ownership are muted by insider trading regulation, which impedes managers from cashing in on gains and limiting losses.[16]

Corporate limitations on incentive compensation of managers are inherent in corporate governance. Making corporate managers full-fledged owners would run counter to the corporate approach of placing the risks of the business primarily on the specialized risk-bearers – that is, diversified owners of portfolios of securities. The ownership-specialists would not want to tie up the managers' wealth in the business because this could exacerbate the potential manager-shareholder conflict of interest regarding risk. Instead, the corporate structure emphasizes monitoring to address managers' potential conflicts. Moreover, adjusting managerial compensation to efficiently balance risk-bearing and incentive-alignment requires a decision-maker who is sufficiently informed and motivated to make the right choices. For the reasons discussed immediately below, independent directors may be disinterested but not otherwise suited to the task. Thus, some critics argue that executive compensation is excessive and not well-designed to motivate managers.[17] A possible middle position is that managers' compensation is well-designed given not only the inherent limits on corporate decision-makers but also the significant political and regulatory constraints on corporate governance that practically limit the managers' potential share in corporate profits. Among other things, these constraints reflect the substantial voice of unions and other activist shareholders in corporate governance.

The second main difference between corporate and uncorporate management is that corporate management is hierarchical and complex while uncorporate management is flat and simple. Corporations provide for boards of directors, which are further divided into committees, are subject to significant requirements regarding independence, and have substantial powers provided for by statute. Many corporate transactions must be approved by the board rather than the executive officers alone. Stephen Bainbridge's "director primacy" theory of corporate governance places the board at the center of the nexus of contracts that comprises the corporation.[18] The board's importance is evident from the attention paid to the process of electing them at an annual meeting, after full disclosure that allows the shareholders to evaluate the directors' stewardship. Partnership and LLC agreements also can have bodies like boards of directors, which may even be called by that name and function like corporate boards. But unlike corporate boards,

---

[16] Indeed, insider trading can provide managerial incentives. *See* Henry G. Manne, INSIDER TRADING AND THE STOCK MARKET (1968).

[17] See Lucian Bebchuk & Jesse Fried, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION (2004). Many other commentators have countered these allegations. *See, e.g.,* Stephen M. Bainbridge, *Executive Compensation: Who Decides?*, 83 TEX. L. REV. 1615 (2005); John E. Core et al., *Is U.S. CEO Compensation Inefficient Pay Without Performance?*, 103 MICH. L. REV. 1142 (2005).

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

uncorporate boards are generally not subject to rigid statutory rules or customs and may be customized to suit particular types of firms.[19]

The corporate board is not simply a group of decision-making individuals, but a group with a particular set of incentives that further distinguishes corporate from partnership management. First, the corporate board is intended as a device for monitoring managers, while a partnership board can be merely advisory. Although a partnership agreement can establish a board with any type of function, powers, procedures and composition, none of these attributes inheres in the nature of a partnership board. Given a corporate board's monitoring function, there is arguably a need to ensure that board members do not have ties to the company or other interests that would cause them to side with the managers they are supposed to be watching. Moreover, the board's job may include challenging managers rather than always endeavoring to be collegial.

Second, a corporate board's function is not necessarily to represent the shareholders' interests exclusively. Rather, there is commentary[20] and some legal authority[21] for the principle that the board should represent all corporate "constituencies." This suggests that directors who are or represent large shareholders may not be the ideal directors from the standpoint of the board's general role and function.[22] Multiple masters can dilute the board's incentive to maximize the interests of shareholders or any other particular group. Indeed, some board members may have an explicit mandate to represent particular non-shareholder constituencies, such as labor.

In short, centralized corporate management is inherently by non-owner agents. Corporations deal with the potential agency costs resulting from this separation in part through the monitoring board. However, these monitors are inherently themselves agents, with their own potential agency costs, and lack strong incentives or even a clear mission to serve shareholders' interests. In order to enhance their ability to deal with conflicts of interest, corporate directors are supposed to be independent. But this independence may not motivate the directors to actively maximize corporate wealth. By contrast, centralized uncorporate management does not inherently entail a separation of ownership and management functions. The alignment of incentives in uncorporations makes it less necessary to include a monitoring body such as a board of directors. Uncorporate directors are typically advisors who are not charged with watching over the managers and so need not be wholly independent. General partners or managing members are free to appoint friends or associates with whom they work well, who may be

---

[19] Some types of uncorporations may be subject to specific statutory requirements, particularly including mutual funds regulated by the Investment Company Act of 1940. *See infra* text accompanying note 146. However, limited partnerships, because of their "unique attributes," are exempt from many (though not all) of the independent director rules in the New York Stock Exchange Listed Company Manual. *Id.* ¶303A.00.

[20] *See, e.g.,* Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999) (arguing for a "mediating hierarch" model of corporate management that serves the corporation's long-term interests by reconciling the objectives of the firm's multiple constituencies).

[21] Unocal Corp. v. Mesa Petroleum Corp., 493 A.2d 946, __ (Del. 1985) (stating that "[w]hen a board addresses a pending takeover bid it has an obligation to determine whether the offer is in the best interests of the *corporation and its shareholders*") (emphasis added).

[22] This may particularly be a problem for hedge funds represented on corporate boards. See subpart II.C., below (discussing the governance function of hedge funds).

franker but less adversarial than corporate directors.

B. CAPITAL LOCK-IN

Hansmann & Kraakman refer to a firm's basic entity characteristic as "affirmative asset partitioning" – that is, separating the firm's from the owners' assets.[23] Hansmann & Kraakman ascribe to corporations the unique entity characteristic of liquidation protection, or insulation of the entity from owners' power to force liquidation.[24] This feature, which has also been referred to as "capital lock-in," has been celebrated as having enabled the modern firm.[25] As discussed above,[26] this feature is central to this article's distinction between uncorporate and corporate firms because it bears on the nature of the incentives of managers of the two types of firms.

Though capital lock-in is often associated with corporations, some form of lock-in is common to both corporations and uncorporations. In particular, liquidation protection is not, and never has been, a unique characteristic of the corporation. Even at the dawn of the modern corporation, in the 19th century, partners clearly could provide for capital lock-in by contract.[27] While these contracts might have been more costly than accepting the standard features of the corporate form, the early corporation was neither well-developed nor widely accepted. Moreover, the liquidation protection form of lock-in is now a standard feature of many LLC and limited partnership statutes, which provide as default rules that individual members cannot unilaterally compel dissolution of the firm or demand cash for their interests upon dissociating from the firm.[28]

The lock-in characteristics of limited partnerships and centrally managed LLCs are not surprising. Lock-in is not uniquely corporate, but rather is an essential aspect of giving significant control powers to managers. If owners could remove their assets at will by unilaterally compelling dissolution of the firm, as they could in traditional general partnerships, this would effectively negate any formal control powers allocated to the managers.

The difference regarding lock-in between partnership and corporate forms lies not in protection from unilateral member liquidation, but rather in other rules relating to

---

[23] *See* Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE L.J. 387 (2000).

[24] *Id.* at __.

[25] *See* Margaret M. Blair, *The Neglected Benefits of the Corporate Form: Entity Status and the Separation of Asset Ownership from Control*, in *Corporate Governance and Firm Organization: Microfoundations and Structural Forms* 45 (Anna Grandori ed., Oxford U. Press 2004); Margaret M. Blair, *Reforming Corporate Governance: What History Can Teach Us*, 1 Berkeley Bus. L.J. 1 (2004); Margaret M. Blair, *Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century*, 51 UCLA L. Rev. 387 (2003).

[26] *See supra* text accompanying note 3.

[27] *See* Larry E. Ribstein, *Should History Lock in Lock-in*, 41 Tulsa Law Review 525 (2006).

[28] *See, e.g.*, Revised Uniform Limited Liability Act, §§404(b), 603; Revised Uniform Limited Liability Company Act, §§603, 701.

managers' control of the firm. First, the corporate form is less hospitable than uncorporate forms to constraints on management's discretion to retain rather than distribute the firm's cash. Corporate statutes explicitly permit corporations to reduce or eliminate basic board functions only in special provisions applying to closely held corporations.[29] It has been argued that provisions compelling distribution of earnings are inconsistent with the corporate norms of retaining earnings under managerial control.[30] Even if the provisions were enforced they would be strictly construed, as courts have a strong tendency to fill gaps in the corporate contract by emphasizing managers' power to retain cash.[31] By contrast, uncorporated firms often include agreements binding managers to make periodic distributions of cash.[32]

To be sure, substantial distributions can be compelled within the corporate form through a capital structure that includes a significant percentage of debt. Given the corporate tax and the firm's ability to deduct interest payments, debt is a tax-preferred mechanism for compelling corporate distributions. Partnerships get a tax break on distributions as compared with corporations because partners pay tax only when the firm earns money and not again when it distributes the earnings. Debt exposes the firm to the risk of potentially high transaction costs of liquidation or reorganization in bankruptcy. This suggests that, tax costs aside, many firms would choose the uncorporate mechanism of compelling distributions. But the tax laws restrict the firms that can make this choice, in particular by barring most publicly traded firms that have operating rather than passive assets.[33]

Second, uncorporations can include provisions compelling termination and distribution of the firm's cash after a set period of time. Indeed, these provisions are consistent with the traditional default rules in limited partnerships requiring inclusion of a term provision,[34] at which time the firm automatically dissolves.[35] While limited

---

[29] *See, e.g.*, Del. G. C.L. §§ 341-356. Although the Delaware statute also expressly provides that its close corporation subchapter does not invalidate provisions authorized under other sections (*see id.* §356), an open-ended interpretation of this provision would seem to conflict with the statute's explicit distinction between closely held and publicly held firms. *See* Ribstein, *supra* note 1 at 197 (discussing limits on restricting board discretion).

[30] *See* Steven A. Bank, *Tax, Corporate Governance, and Norms*, 61 WASH. & LEE L. REV. 1159, 1218–19, 1223–28 (2004).

[31] This is evident in interpretations of dividend provisions in preferred share contracts. For example courts have enforced directors' discretion not to distribute dividends to non-cumulative preferred shareholders, even where this meant that the shareholders would forever lose the right to the cash. *See* Guttman v. Illinois Central Railroad Co., 189 F.2d 927 (2d Cir.), *cert. denie*d, 342 U.S. 867 (1951); Kern v. Chicago & Eastern Illinois Railroad Co., 6 Ill. App. 3d 247, 285 N.E.2d 501 (1972); L.L. Constantin & Co. v. R.P. Holding Corp., 56 N.J. Super. 411, 153 A.2d 378 (1959). This is an attribute of board power rather than of the specific rights of preferred shareholders. Thus, Baron v. Allied Artists Pictures Corp., 337 A.2d 653 (Del. Ch. 1975), *app. dismisse*d, 365 A.2d 136 (Del. 1976) held that preferred shareholders who had taken control of the board under a preferred share agreement that provided for transfer of control when dividends were passed had discretion as to when to resume dividends and thereby relinquish control.

[32] *See infra* subpart III.B.

[33] See IRC §7704, discussed below in subpart II.E.

[34] *See* Uniform Limited Partnership Act §2(1)(a)(V); Revised Uniform Limited Partnership Act

partnership statutes are now generally assumed to be for a perpetual duration,[36] courts enforce contracts for winding up on a particular date or event.[37] By contrast, the corporate norm is perpetual duration. Indeed, courts might view a contractual mandate to wind up as inconsistent with the board's fundamental power to initiate dissolution and other fundamental transactions. Courts at least may be inclined to err on the side of interpreting ambiguous provisions as providing for continuity in the corporate context.

The difference between the corporation and the uncorporation regarding capital lock-in is basic to the distinction between the corporate and uncorporate models. Managerial duties to distribute cash and members' powers to withhold or demand it continually expose managers to the discipline of the capital markets. Managers periodically have to return to the capital markets to raise cash or ask current owners to waive obligations to liquidate or distribute cash. Although the capital markets and the owners might be viewed as monitors, their incentives differ from those of the agent-monitors of the standard corporate form. Rather than making decisions about somebody else's money, capital-providers are looking out for their own wealth in making decisions about when to lend or buy equity. This, in turn, gives managers a strong incentive to maintain the value of the firms they manage.

By contrast, the corporate approach to capital lock-in gives corporate managers significant power to retain earnings, and therefore a kind of piggy-bank they can dip into without being subject to the constraints imposed by external capital markets. Though corporate managers might commit to dividends, thereby approximating uncorporate incentives,[38] managers' incentive to execute these devices depends on how well they are monitored, including by the market for control, an aggressive independent board or activist shareholders. In uncorporations, the incentives provided by the capital markets are built into the firm's structure.

C. OWNER VOTING RIGHTS

The corollary to the strong management powers delegated to corporate managers is that corporations need ways to hold managers accountable to owners. One such mechanism is shareholders' power to elect directors and vote on major corporate transactions. Member voting might seem to be an example of a strong-form incentive device since owners are motivated to exercise their vote so as to maximize the market value of their shares. However, members' participation is more theoretical than real because of the free-rider problem in public corporation governance. The fact that most

---

(1985) (RULPA), §201(4) (requiring partnership certificate to state the latest date on which the partnership is to dissolve); Bromberg & Ribstein on Partnership, §17.02(b).

[35] *See* RULPA §801(1); Tsakos Shipping & Trading, S.A. v. Juniper Garden Town Homes, Ltd., 12 Cal. App. 4th 74, 92, 15 Cal. Rptr. 2d 585, 595 (1993); Levine v Levine, 648 So. 2d 1228, 20 Fla. L. Weekly D201 (Fla. App. 1995).

[36] *See* U.L.P.A. (2001) §104(c).

[37] *See, e.g.,* Anthony v. Padmar, Inc., 307 S.C. 503, 415 S.E.2d 828 (1992), on other grounds *aff'd in part, rev'd in part*, 320 S.C. 436, 465 S.E.2d 745 (1996) (dissolution on sale of all or substantially oall of the assets).

[38] *See* Frank H. Easterbrook, *Two Agency-Cost Explanations of Dividends*, 74 Am. Econ. Rev. 650 (1984).

owners of large firms typically own only a small portion of the stock discourages them from acting, knowing that others will share the fruits of their labors.

Some shareholders who own only small stakes in their firms may actively participate in governance despite the free-rider problem. But these activist shareholders often have self-interested reasons for acting that are inconsistent with the interests of other corporate owners.[39] For example, labor pension funds may be seeking leverage in labor negotiations by embarrassing the portfolio firm's managers. Indeed, when a shareholder with a small percentage holding spends significant resources on governance, it is often reasonable to assume that the holder is pursuing a private financial or political interest rather than seeking to confer a financial benefit on free-riding shareholders.

Shareholders can buy a large enough stake to mitigate the free rider problem. However, as Mark Roe has discussed,[40] regulatory and tax rules impede large shareholdings by institutions. Moreover, large shareholders must forego the risk-reduction benefits of portfolio diversification. This may introduce a conflict of interest between shareholders with diversified portfolios and those who are undiversified and therefore exposed to firm-specific risks. Large shareholders may want the firm to engage in costly risk-reduction, such as by diversifying, that would be wasteful for diversified shareholders. The question, then, is whether the monitoring benefits of large shareholders outweigh the costs associated with governance by non-diversified owners.

Shareholders also may use coordinating devices to mitigate the free rider problem while still owning a diversified portfolio. For example, institutional shareholders may engage the services a proxy consulting firm such as Glass, Lewis or Institutional Shareholder Services[41] which earn fees analyzing firms and recommending voting strategies. These firms may reduce the free rider problem to the extent that there are economies of scale in governance research and voting. However, these economies exist only for standardized research and recommendations rather than active firm-specific management. Moreover, the fee structure of the proxy consulting industry is based on the sale of advice and not on increasing the firm's value from using the advice. This industry is really another level of agents in the corporation's monitoring structure.

Apart from the free rider problem inherent in share voting, it is important to keep in mind that institutional shareholders are themselves firms, and therefore face their own agency problems. Whether these firms seek to maximize the value of the other firms they hold in their portfolios depends in part on their managers' incentives. As discussed below in Part III, a key aspect of the rise of uncorporated firms involves the use of uncorporate structures to mitigate agency problems in investment management firms and motivate

---

[39] *See* Stephen M. Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L. REV. 601, 634 n.88 (2006) (noting that "the most activist institutions—union and state and local employee pension funds—may have interests that diverge substantially from those of other investors"). For discussions of the incentives of activist shareholders *see* Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445, 479–81 (1991); Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795, 801–19 (1993); Stewart J. Schwab & Randall S. Thomas, *Realigning Corporate Governance: Shareholder Activism by Labor Unions*, 96 MICH. L. REV. 1018, 1033–34 (1998).

[40] *See* Mark J. Roe, STRONG MANAGERS, WEAK OWNERS (1996).

[41] *See* Paul Rose, *The Corporate Governance Industry*, 32 J. CORP. L. __ (2006) (analyzing the proxy consulting industry).

them to intervene effectively in the governance of their portfolio firms.

The many problems with share voting seem to support Berle & Means' conclusion that shareholders can hardly be considered owners.[42] Seventy-five years after Berle & Means, Lucian Bebchuk still sees the shareholder franchise as a "myth," as indicated by the sparse record of activist shareholder successes.[43] Berle & Means' proposed solution of increasing disclosure obviously did not address the free rider problem that inhibits shareholders from effectively using the disclosures the law made available. By the same token, merely increasing these shareholders' power to challenge managers as Bebchuk and others propose[44] cannot solve the problem, which lies not in the shareholders' power, but in their incentives in exercising the franchise. Indeed, to the extent that pension funds and other institutional shareholders have interests separate from those of their co-shareholders, increasing shareholder power might decrease the welfare of shareholders as a whole.[45]

In contrast to the crucial role of owner voting in the corporation, uncorporate business forms provide for significant variation and flexibility in voting rights. General partnership statutes, which are primarily designed for very closely held firms, provide by default for member voting on all decisions, with important matters decided by unanimous decision.[46] At the other end of the scale, limited partnership statutes provide for no or very limited voting rights.[47] As discussed below, limited partners' contractual rights may be even less than their statutory rights.[48] LLC statutes may give members of manager-managed LLCs somewhat greater voting rights than limited partners have,[49] but these

---

[42] *See generally* ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

[43] See Lucian Bebchuk, *The Myth of the Shareholder Franchise*, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=952078.

[44] *See, e.g.*, Lucian Bebchuk, *Letting Shareholders Set the Rules*, 119 HARV. L. REV. 1784 (2006).

[45] To be sure, empowering pension funds and other large shareholders might have the effect of enabling non-shareholder corporate constituencies to get more corporate resources, and this theoretically could improve general social welfare. For a skeptical analysis of this proposition, *see* Ribstein, *supra* note 1. Conversely, as discussed below in subpart III.D, uncorporate approaches to governance might increase the share allocated to equity holders. For present purposes it is enough to note that shareholder voting is not necessarily the most effective way to protect shareholders' interests.

[46] See UPA §18(e), (h); RUPA §401(f), (j).

[47] Neither the original Uniform Limited Partnership Act (1916), nor the 1985 Revised Uniform Limited Partnership Act on which most current state statutes are based, provided for limited partner voting rights. The most recent version of the Uniform Limited Partnership Act gives limited partners only a right to vote on fundamental transactions, and no default right to periodically elect the firm's managers. *See* ULPA (2001) §406. Note, however, that partnerships are subject to many of the governance rules in the New York Stock Exchange Listed Company Manual. The main exception is the rules for owner approval of securities issuances (¶312.03).

[48] *See infra* subpart II.E.

[49] *See* Revised Uniform Limited Liability Company Act (2006), §407(c)(4) (providing that

rights are highly variable among the states and are often modified in the operating agreement.

Instead of strong member voting rights, uncorporate firms provide for alternative incentive-based constraints on management, including profit-based compensation, liquidation rights and cash distributions, as discussed in more detail in Part III. These provisions make it less necessary to scrutinize how managers are running the firm and what they are doing with the firm's cash, either through board monitoring or fiduciary duties.

D. FIDUCIARY DUTIES

Corporate managers' fiduciary duties further supplement shareholders' monitoring power. Fiduciary duties must carry a lot of the weight in constraining agency costs in corporations given strong manager power, shareholders' limited liquidation right, the free-rider problem inherent in shareholder voting, and the agency problems with other forms of monitoring. Indeed, firms lack explicit power in corporate statutes to wholly waive these duties. Statutes like Delaware's permit waiver of the duty of care, but not the duty of loyalty.[50] Even the due care waiver is subject to a good faith qualifier that the Delaware courts are still defining. For example, in *Stone v. Ritter*[51] the Delaware Supreme Court opined that the board's conscious failure to adopt a compliance program in the face of a known duty to act may violate good faith, and therefore may constitute a non-waivable breach of duty that survives a fiduciary duty waiver in the charter. So the courts have carved out a space for judicial supervision that resists any attempt at contractual avoidance.

The problem with corporate fiduciary duties is that, like other forms of monitoring, they rely on enforcement by agents, including lawyers and, of course, courts. Judges' incentives are complex. They have personal interests in power, prestige and leisure.[52] Judges may be somewhat motivated to serve the state's interest because state legislators and officials control judges' jurisdiction and pay. But even if judges are subject to political discipline, the nature of this discipline depends on which interest groups are dominant. If lawyers dominate, state judges and legislators may have incentives to promote more litigation than shareholders would prefer. Indeed, there are indications that Delaware law has been very responsive to lawyers' interests.[53] To be sure, lawyers' clout is tempered at least in Delaware by the state's incentive to maximize franchise fees, and therefore incorporations.[54] But Delaware clearly has a competitive

---

unanimous member consent is required for certain important acts and for a majority member vote to elect a manager.

[50] *See* Del. Gen. Corp. L. §102(b)(7).

[51] 911 A.2d 362, 365 (Del. 2006).

[52] *See* Richard A. Posner, *What Do Judges Maximize? (The Same Thing Everybody Else Does)*, 3 Supreme Court Economic Review 1 (1995).

[53] *See* Jonathan R. Macey & Geoffrey Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469 (1987).

[54] *See* Roberta Romano, *Law as Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225 (1985). For an analysis showing evidence of a general state competition to provide corporate

edge over other states that its lawyers can exploit.

Even the best motivated judges lack the necessary information to second-guess business decisions. Judges need to understand not only the particular transaction under review, but also the general context within which corporate managers operate. Excessive liability can deter managers and directors from making the sort of risky decisions that diversified shareholders would want them to make. Thus, the business judgment rule spreads its capacious protection over all but the most egregious or conflicted managerial decisions. This was evident from the decision in the *Disney* case, where the Supreme Court finally sent the plaintiff home empty handed despite clear evidence that the corporation had spent $140 million to hire and fire an evidently incompetent president.[55]

Enforcing fiduciary duties involves an additional set of agents – that is, the derivative plaintiff and his lawyer who volunteer to represent the corporation. Because lawyers only get a portion of the recovery and nothing if they lose, they have a significant incentive to shirk by settling cases for less than their expected value. On the other hand, because the lawyers do not bear all of the corporation's litigation costs, including the indirect costs in executive time and disruption, and because corporate managers may have an incentive to pay corporate assets to settle even frivolous suits, lawyers have an incentive to bring cases that have a negative net present value to the firm. [56]

Firms theoretically could contract to waive or modify fiduciary duties and remedies. However, despite the problems just discussed, fiduciary duties may be worth their costs if managers' incentives are not aligned with those of members and monitoring works imperfectly. Firms therefore need to balance the costs and benefits of fiduciary duties. Obviously managers cannot be trusted to unilaterally decide the extent of their own discipline. At the same time, the problems inherent in shareholder voting raise questions about entrusting this decision to a shareholder vote in a publicly held firm. Firms might minimize this problem by committing to a particular fiduciary duty term when they go public. But firms could face the shareholder voting problem if they later want to adjust the term to reflect the firm's changing needs or environment.

Though state law recognizes the difficulty inherent in judicial second-guessing of managerial decisions by applying the business judgment rule, stringent and mandatory federal duties have been imposed in the wake of Enron in the guise of disclosure obligations – most importantly, the duty to disclose internal controls deficiencies under Section 404 of the Sarbanes-Oxley Act.[57] Delaware courts apparently have taken the cue and revived a state law version of this duty known as the "Caremark" rule.[58] Whether or not these duties are cost-justified, the important point for present purposes is that

---

law, *see* Roberta Romano, *Is Regulatory Competition a Problem or Irrelevant for Corporate Governance?* 21 OXFORD REVIEW OF ECONOMIC POLICY 212 (2005).

[55] Brehm v. Eisner, 2006 WL 1562466 (Del. June 8, 2006).

[56] *See generally,* John C. Coffee, Jr., *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 Colum. L. Rev. 669 (1986).

[57] 15 U.S.C.A. § 7242.

[58] Caremark International Inc. Derivative Litigation, 698 A.2d 959 (Del. Ch. 1996). *See* Stone v. Ritter, 911 A.2d 362, 365 (Del. 2006) (stating that "we hold that *Caremark* articulates the necessary conditions for assessing director oversight liability").

fiduciary duties are an inherent aspect of controlling the high potential agency costs of delegating significant power to managers with only weak accountability to owners.

In uncorporations, the above costs of fiduciary and other duties may not be worth bearing because, given managers' strong incentives and owners' liquidation and distribution rights, there is less of an agency problem to police. In other words, the parties to an uncorporation have devices by which they can constrain managers to act in their interests without as much need for costly judicial supervision. Thus, the costs of judicial interference with management discretion are likely to outweigh the benefits in this context. Rather than imposing judicial standards on management behavior, the courts can simply interpret the constraints and incentives the parties have contracted for.

There is substantial authority supporting enforcement of fiduciary duty contracts in uncorporations.[59] In the leading state of Delaware, in contrast to the corporate limitations on contracting,[60] LLC and limited partnership statutes permit complete waiver of fiduciary duties.[61] The Delaware courts have applied the statutory waiver provisions by holding that fiduciary duties apply only in the gaps left by the contract, interpreted in light of the general contractual principle of good faith.[62] Good faith in this context is simply a rule of flexible interpretation[63] rather than an aspect of the duty of loyalty as it is in the corporate context.[64] The Chief Justice of the Delaware Supreme Court has written that "courts should look to the parties' agreement and apply a contractual analysis rather than analogizing to traditional notions of corporate governance."[65]

An important example of the application of these principles is the Delaware Supreme Court's opinion in *Gotham Partners, L.P. v. Hallwood Realty Partners, L.P.*[66] *Gotham* involved a publicly held hedge fund organized as a limited partnership. The firm made a public offer of so-called "odd lot" units that significantly increased the ownership percentage of the general partner's parent. This transaction involved a managerial conflict of interest that would have triggered a mandatory fiduciary duty of loyalty in the corporate setting. The partnership agreement required that the terms of self-dealing

---

[59] *See* Larry E. Ribstein, *Fiduciary Duty Contracts In Unincorporated Firms*, 54 Washington & Lee Law Review 537 (1997).

[60] *See supra* text accompanying note 50.

[61] *See* Del. Code, tit. 6, §§17-1101, 18-1101. At least 13 other state LLC state statutes provide for waiver of fiduciary duties without specific restrictions. *See* Ribstein & Keatinge, *supra* note 8, Ch. 9, app. 1.

[62] *See* Larry E. Ribstein, *Fiduciary Duties and Limited Partnership Agreements*, 37 Suffolk U. L. Rev. 927 (2004).

[63] *See id.*

[64] *See supra* text accompanying note 51.

[65] Myron T. Steele, *Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies*, 32 Del. J. C. L. 1, 1 (2007).

[66] 817 A. 2d 160 (Del. 2002).

transactions must be "substantially equivalent to terms obtainable by the Partnership from a comparable unaffiliated third party," and for audit committee review. However, the agreement provided for such duties only as to resale of units and not for issuance. The court characterized the transaction as a resale and therefore applied the contractual standard, which the court held defendant had breached by failing to comply with the contract's procedural safeguards. Notably, the court's reasoning made clear that this self-dealing standard would not have applied had the transaction been an issuance rather than a resale. The court also expressed "concern and caution relating to . . .dubious dictum" in the trial court's opinion suggesting that a limited partnership agreement may eliminate fiduciary duties, noting that the statute did not so provide.[67] The Delaware legislature swiftly reacted to the court's "caution" by amending the statute to permit elimination of fiduciary duties in limited partnership and LLC agreements.[68]

The difference between uncorporations and corporations regarding fiduciary duties also may bear on the remedy. Since uncorporations substitute liquidation and other mechanisms for fiduciary duties, remedies in these entities need to focus on the contract's specific protective devices rather than on the firm's power to enforce the managers' fiduciary duties. Thus, in *Anglo American Security Fund, L.P. v. S.R. Global International Fund, L.P.*[69] the court held that a suit by limited partners in a hedge fund for diminution of value by acts of the general partner could be brought directly by the partners rather than derivatively on behalf of the firm. The court emphasized that any diminution of value affected current rather than later partners, so that paying damages to the fund would be a windfall to the later partners and fail to redress the injured.[70] Though this problem generally affects corporate derivative suits, courts permit these suits in recognition of the difficulty of apportioning injury among the shifting group of shareholders, and in order to deter wrongful behavior. However, this cumbersome remedy may be inappropriate in the uncorporation, which substitutes specific contractual rights for a general managerial fiduciary duty to the entity. Thus, the *Anglo American* court noted that "the limited partners have absolutely no control over the governance and management of the Fund," but instead are protected only by the managers' disclosure duty and by their ability to withdraw from the fund.[71]

E. TRANSFERABLE SHARES AND TAKEOVERS

Corporate shareholders have a default right to freely transfer both management and economic rights. Indeed, the courts have limited even contractual restrictions on

---

[67] *Id.* at 167-68.

[68] Del. Code, tit. 6, §§17-1101, 18-1101 [cite to amending statute].

[69] 829 A. 2d 143 (Del. Ch. 2003).

[70] The court also noted that the Fund "operates more like a bank" because the partners have individual accounts and the fund has no going concern value. However, since the partners' accounts depended on the overall value of the Fund, it is not clear how these facts distinguish the Fund from a corporation. As discussed in the Text, the important distinguishing feature is the specific nature of the defendants' duty rather than the nature of the Fund's assets.

[71] 829 A. 2d at __.

alienating corporate stock.[72] Transferable shares are particularly important in publicly held firms because they enable owners to overcome the free rider problem by transferring to owners who can aggregate the shares into control blocks. Henry Manne explained how the market for control could make share voting an effective governance tool, thereby answering Berle & Means' critique of corporate governance.[73]

Uncorporation managers are generally insulated from the market for control. While corporate shareholders can freely transfer both economic and control rights, uncorporation owners can freely transfer only economic rights.[74] This prevents outsiders from using the securities markets to aggregate control rights. The bar on transferring control rights originated in general partnerships, where members need to accommodate liquidity with the ability to screen who will exercise partners' significant management rights. Restricted transferability carried over from general to limited partnerships. However, the rationale for the carryover was never clear, at least as to limited partners who exercise only very limited voting rights. The rule makes more sense in limited liability companies, where members can have a wide range of powers. In any event, apart from the statutory default rules, partnership and LLC agreements often include sophisticated provisions delineating precisely when management rights can be transferred and to whom.[75]

The difference between corporations and uncorporations regarding the market for control might seem inconsistent with the general differences between the two types of entities emphasized above. The market for corporate control seems to be an uncorporation-type constraint to the extent that it relies on self-interested market actors responding to high-powered incentives to profit.

In practice, however, corporate managers' significant power to defend against takeovers makes the market for control only a weak and sporadic check on corporate managers. Over the last twenty years successive takeover waves have faded in the face of increasing regulation.[76] Congress first responded to hostile tender offers in the 1960s with the Williams Act.[77] When hostile tender offers managed to survive this move, incumbent

---

[72] *See* Rafe v. Hindin, 29 A.D.2d 481, 288 N.Y.S. 2d 662, aff'd mem. 23 N.Y.2d 759, 244, N. E.2d 469, 296 N.Y.S.2d 955 (1968).

[73] *See* Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965).

[74] *See, e.g.*, RUPA §502 (1997) (defining a partner's transferable interest as the partner's share of profits and losses and right to receive distributions); 503 (permitting transfer of transferable interest); Revised ULLCA §502 (permitting transfer of economic rights).

[75] *See, e.g.*, In Re Asian Yard Partners, 1995 Bankr. LEXIS 2199 (Bankr. D. Del. Sept. 18, 1995); H-B-S Partnership v. Aircoa Hospitality Services, Inc., 2005 WL 1397045 (N.M.App., Apr 4, 2005) (interpreting right of first refusal as applying on sale of a partner's corporate great-great-grandparent); Kaiser v. Bowlen, 455 F.3d 1197 (10th Cir. 2006) (interpreting a first refusal right in the Denver Broncos partnership not to apply to a transfer of shares in the entity that owned the partnership interest, applying general rules on interpretation of transfer restrictions).

[76] For a brief history, see Larry E. Ribstein, *Imagining Wall Street*, *Imagining Wall Street*, 1 Virginia Law and Business Review 165 (2006).

[77] *See* Securities and Exchange Act of 1934 § 13(d)(1) (requiring disclosure by any person or

managers and corporate lawyers were able to devise effective defenses, including poison pills and state anti-takeover statutes, which were upheld under state law.[78] Then leveraged buyout firms, with Michael Milken's help, met those new challenges through their ability to amass large pools of money and bypass banks. But the high costs of hostile takeovers left these financiers vulnerable to economic and regulatory conditions. The Milken criminal prosecution helped end this threat to incumbent managers by taking out its most skilled and aggressive practitioner.[79]

Since the 1980s hostile takeovers have been relatively dormant. To be sure, restructuring activity has continued, mostly promoted by private equity funds as discussed below in Part II. However, managers' significant power to defend against takeovers means that private equity bidders often must co-opt managers by including them in the restructured firm, and accordingly may not be interested buying poorly managed firms. This suggests that the market for control is not fully serving its disciplinary function.

Removing impediments to takeovers and reviving the market for corporate control could increase managers' accountability to shareholders' interests. But the prospects for a significantly more vigorous takeover market do not seem promising. Takeover regulation results from long-term social attitudes and powerful political forces. More importantly, managers' power to resist hostile takeovers inheres in the strong centralized corporate management, capital lock-in and weak monitoring that characterizes the corporate form. Given managers' strong formal power, shareholders may lack the legal power to take the initiative to vote down or prohibit poison pills or other takeover defenses.[80] Shareholder voting is also subject to the same constraints as shareholder voting on other issues. And Courts understandably are as reluctant to second-guess takeover defenses as they are other business decisions.[81] And even if courts could identify problematic defenses, managers could probably find a defense with a similar effect, but possibly even worse consequences for the firm.[82]

---

group that acquires 5% of a class of securities, thus limiting the initial "stake" that a bidder can acquire before the market becomes aware of the increased likelihood of a premium bid); 14(d)(1), (f) (requiring disclosure by bidders upon the making of a tender offer and upon the seriatim resignation of directors that often accompanies a transfer of control; §14(d)(5)-(7) (regulating the substantive terms of a bidder's offer to shareholders; § 14(e) (general antifraud provision); §14(d)(4) (regulating management recommendations to shareholders).

[78] The Supreme Court held that these statutes were constitutional in CTS Corp. v. Dynamics Corp., 481 U.S. 69 (1987).

[79] For a discussion of Milken's role in the market for corporate control *see* Ribstein, *supra* note 76.

[80] *Compare* Lawrence A. Hamermesh, *Corporate Democracy and Shareholder-Adopted By-Laws: Taking Back the Street?*, 73 TUL. L. REV. 409 (1998) *with* Jonathan R. Macey, *The Legality and Utility of the Shareholder Rights Bylaw*, 26 HOFSTRA L. REV. 835 (1998).

[81] For a review of cases under the Delaware test for managers' fiduciary duties in defending against takeovers, *see* Stephen M. Bainbridge, Unocal *at 20: Director Primacy in Corporate Takeovers*, 31 DEL. J. CORP. L. 769 (2006).

[82] *See* Jennifer Arlen & Eric Talley, *Unregulable Defenses and the Perils of Shareholder Choice*, 152 U. PA. L. REV. 577 (2003).

In short, the idea of a market for control providing high-powered incentives is more theoretical than real. The main difference in this respect between corporations and uncorporations is that while the absence of a market for control leaves corporate shareholders at the mercy of weak-form monitoring devices, uncorporations compensate for the lack of a market for control through increased managerial incentives, owner liquidation and distribution rights.[83] Uncorporation standard forms in effect provide an alternative version of the market for control that forces managers to actively seek capital market approval rather than relying on bidders for control to discern profit opportunities in displacing incumbent managers. Indeed the market for control may not be the best way to displace incompetent or dishonest incumbent managers. By contrast, uncorporate provisions that force all managers to look periodically to the capital markets for new funding potentially can discipline any kind of management deficiency.

To be sure, the market for control remains the way to apply uncorporate structures to existing corporations. Even with a hobbled control market, uncorporate mechanisms can be applied to many firms, and product and financial market competition can gradually drive out firms that resist change. A more important concern is that the political opposition to strong capital that underlies takeover regulation also can impede the use of uncorporate forms to provide more managerial accountability.[84]

F. SUMMARY

This Part contrasts corporate and uncorporate forms of governance. A key characteristic of the corporate form is that it locks strong control over corporate property in corporate managers. Corporations address the resulting agency costs between managers and owners through various monitoring devices, which mostly rely on weakly incentivized agents. By contrast, the uncorporation aims to mitigate the agency problem by giving managers more powerful incentives to maximize owners' wealth. This includes distributing the firm's cash to owners and relaxing the separation of ownership and control. These devices make monitoring less necessary to hold uncorporation managers accountable to owners. In general, the point of this Part has not been to show that corporate governance is defective and needs to be reformed, but rather that there is room in the governance of large firms for an alternative approach.

II. THE VARIETIES OF UNCORPORATION

This Part discusses some of the many approaches to governing large firms that employ uncorporation-type governance like those discussed generally in Part I. It shows how uncorporation features can deal more effectively with agency problems in some types of firms than can monitoring-based corporate features. Instead of completely separating management and ownership, uncorporations give managers significant ownership interests, big payoffs for success and real downside risk. Also, uncorporation managers are exposed to the high-powered discipline of the capital markets by being forced to distribute cash and to go back to the markets to finance growth or new ventures.

In some firms, particularly including MLPs and REITs, uncorporate devices replace corporate structures. Others, including venture capital and private equity firms, preserve the corporate form of the operating company while an uncorporation takes over

---

[83] *See supra* subpart I.B.

[84] *See infra* subpart III.D.

important governance functions. In a third category of cases, including hedge funds, corporate governance structures remain but an uncorporation intervenes to strengthen governance. Finally, in a fourth category, including mutual funds organized as business trusts, a firm organized as an uncorporation plays a governance role, but that role is minimal because uncorporation features have been suppressed, at least partly by regulation.

A. PUBLICLY TRADED PARTNERSHIPS: MLPS AND REITS

The starting point for understanding the structure of MLPs and REITs is the effect on this structure of rules for taxing partnerships. Partnerships generally escape double corporate taxation of income at the entity level and again when this income is distributed to owners.[85] The Internal Revenue Code provides for corporate taxation of uncorporations that have publicly tradable shares.[86] However, the Code permits partnership-type "flow-through" taxation in firms that mostly earn "qualifying income," defined to include, among other things, interest, dividends, rents, and capital gains.[87] As of the end of 2004 there were 41 publicly traded limited partnerships with assets of almost $60 billion engaged in such businesses.[88] As of June 1, 2007, there were 69 publicly traded limited partnerships, the vast majority in energy and resources, with a few in mortgage and investment.[89]

Publicly held or "master" limited partnerships (MLPs) have provisions that deal with agency costs in the "uncorporation" way.[90] First, MLP agreements commonly include provisions in which general partners promise to distribute "available cash" (net cash less reserves). Unlike corporate shareholders, MLP limited partners need not rely on a vague promise by managers to maximize accounting profits. The agreements also restrict specific actions such as issuance of additional equity that might reduce distributions.

Second, MLP agreements mitigate the separation of ownership and control by giving the general partner significant financial incentives to take the owners' interests in receiving distributions into account when managing the firm. For example, the general partners' percentage of total firm distributions increases depending on how much the firm distributes to the limited partners.

These assurances that the firm will distribute rather than retain cash, and the passive nature of the business that makes it relatively immune to other types of agency problems such as inadequate risk-taking or innovation, reduce the members' need for corporate-type rights to sue, sell and vote. Thus, MLP agreements give limited partners

---

[85] See I.R.C. § 701 (partnerships not subject to corporate income tax).

[86] *See* IRC §7704(a).

[87] *See id.* §7704(c)-(d).

[88] *See* John Goodgame, *Master Limited Partnership Governance*, 60 BUS. LAW. 471 (2005).

[89] *See* National Association of Publicly Traded Partnerships, http://www.naptp.org/Navigation/PTP101/PTP101_Main.htm.

[90] The provisions discussed here are analyzed in Goodgame, *supra* note 88.

generally only minimal voting rights, sharply restrict fiduciary duties, and make hostile takeovers virtually impossible.

Trading governance powers for distribution rights cannot eliminate agency costs in publicly traded partnerships. Even in passive resource firms with predictable cash flows, fixing the obligation to distribute at the high end of expected cash flow might require costly renegotiation and readjustment when cash comes in at the lower end of expectations. Setting distribution levels gets more difficult as cash flows get less predictable. Stronger member voting rights therefore may be necessary in firms with variable earnings. Yet the effectiveness of owner voting in MLPs is inherently limited. Many institutional investors are discouraged from investing in MLPs because they are exempt from entity-level tax and so do not benefit from flow-through taxation, or because they would incur unrelated business tax on income from MLPs.[91] Institutional investors therefore do not play the same monitoring role they do in publicly held corporations.

Another form of publicly held uncorporation that can be taxed as a partnership is real estate investment trusts (REIT), which engage in owning, financing and operating real property investments. Approximately two hundred publicly-traded REITs own over $475 billion in assets.[92] In order to get pass-through tax treatment, REITs must invest at least 75% in real estate related assets and receive at least 75% of their income from these assets, with the rest in and from cash or government securities.[93] Like MLPs, REITs distribute most (specifically, 90%) of their income, except that for REITs this requirement is specified in the Code. As with MLPs, this requires REIT managers to seek capital for additional investments from the capital market rather than internally generated earnings.[94]

Although REITs are technically corporations rather than trusts as their name implies,[95] they have important uncorporate characteristics. In REITs as in MLPs, the owners trade strong rights to cash for governance rights that are weaker than those of corporate shareholders. In particular, the REIT structure virtually precludes hostile takeovers and limits the extent to which institutions can acquire large enough blocks to mitigate free riding. The Internal Revenue Code conditions flow-through tax treatment on limiting the five largest shareholders of a REIT to no more than 50% ownership, with an exception for retirement plans. REIT charters reinforce this provision by providing that shares accumulated in violation of the restriction must be transferred to a charitable trust and lose voting privileges. Moreover, the Maryland statute under REITs are formed specifically permits transferability and ownership restrictions to maintain the REIT's tax

---

[91] *See* I.R.C. § 511(a)(1) (2000). The American Jobs Creation Act of 2004. Pub. L. No. 108-357, § 331, 118 Stat. 1418 (2004) mitigated this problem by allowing investments by mutual funds.

[92] *See* National Association of Real Estate Investment Trusts, *The REIT Story*, http://investinreits.com/learn/reitstory.cfm.

[93] *See* IRC §856.

[94] *See* Jay C. Hartzell, Libo Sun, & Sheridan Titman, *The Effect of Corporate Governance on Investment: Evidence from Real Estate Investment Trusts (REITs)*, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=516563.

[95] Most REITs are formed under a separate chapter of the Maryland corporation law. *See* Maryland Corporations and Associations Code, §8-101 et seq.

status or "for any other purpose."[96]

As with MLPs, REITs' tradeoff of cash distributions for governance rights does not eliminate agency problems. Although REITs must distribute 90% of their taxable income to retain flow-through taxation, REIT managers can use depreciation to significantly reduce income while maintaining control over the cash. REITs also face the same constraints as MLPs on forcing distributions in the face of unpredictable cash flows. It follows that REITs need to rely to some extent on monitoring managers to discipline managers' use of the cash. Yet given the ownership restrictions discussed above, REITs get little monitoring by institutional holders or the market for control. REIT governance has dealt to some extent with this agency problem. For example, there is evidence that firms with lower-value portfolios pay higher dividends, thereby constraining managers from investing too much in a down market, and that dividends are lower in firms where the separation of ownership and control is mitigated by giving CEOs higher share ownership.[97]

In short, the tax code limits the use of uncorporations as a substitute for corporate-style monitoring by permitting only specific types of passive investment vehicles to be both publicly traded and exempt from the corporate tax. This treatment reflects the fact that firms that have little need to retain earnings would incur the greatest detriment if their owners had to incur a second-level corporate tax on distributions. However, the scope of the exemption from the corporate tax is not necessarily co-extensive with the economic justification. Other types of firms that do not need to retain earnings, such as mature, slow-growth firms that get fairly predictable earnings from established brands, might derive comparable benefits from being taxed as partnerships. Removing the corporate tax on public ownership at least for these firms therefore might encourage different types of firms to experiment with varying tradeoffs between costly monitoring and loosening managers' grip on the firm's cash. But with the corporate tax, firms have an extra incentive to retain earnings. In other words, some firms may be trading taxes for agency costs. I will return to the tax problems of publicly held uncorporations below in subpart II.E.

B. PRIVATE EQUITY

Uncorporate structures are used not only for operating firms, as with REITs and MLPs, but also to control firms that are operated as corporations. The most important example of this approach is the buyout firms prominent in the 1980s and again today. These firms have revived the institution of the merchant banker exemplified by J.P. Morgan – bankers that served as principals in putting transactions together rather than merely as agents acting for a fee.[98] After a hiatus in the post-Milken era, private equity has enjoyed a significant resurgence in the last few years. There were $660 billion in private equity buyouts in 2006, and at the beginning of 2007 private equity funds had

---

[96] *See id.* § 8-203(a)(5); David M. Einhorn, Adam O. Emmerich, & Robin Panovka, *REIT M&A Transactions-Peculiarities and Complications*, 55 Bus. Law. 693 (2000).

[97] *See* Chinmoy Ghosh & C.F. Sirmans, *Do Managerial Motives Impact Dividend Decisions in REITs?*, 32 Journal of Real Estate Finance and Economics 327 (2006).

[98] *See* Baker & Smith, *supra* note 13 at 170.

$750 billion in cash available for more buyouts.[99] U.S. private-equity firms raised $215.4 billion in new cash in 2006, 33% more than in 2005. Nearly half was raised by eight of the 322 funds, and 69% by leveraged buyout firms.[100] As of the beginning of 2007, the 20 largest buyout firms controlled over $400 billion in companies employing 6,000,000 workers.[101] The following discussion draws from analyses both of the LBO firms of the 1980s and today's private equity firms of today, prominently including Blackstone. Although there are some differences between the firms in the two eras of private equity, the structural similarities dominate for present purposes.[102]

The private equity transaction form essentially involves a buyout firm using money put up by its investors, plus a much larger amount borrowed against the target firm's assets, to fund a cash payment for the firm's equity. When the smoke clears, the target and, often, its top management team remain, while the capital structure has changed. Much of the equity has been replaced by various types of debt while the target managers and the buyout fund own the remaining equity.

An initial question about private equity transactions is why the buyout firm is necessary – that is, why the target managers do not simply borrow the money in the firm's name to buy out the shareholders and dispense with the substantial fees charged by the buyout firm.[103] Some apparent explanations do not hold up under scrutiny. First, it is not enough to say that buyout firms do the transactions because they have the cash.[104] We must explain why investors are willing to put up the money to have buyout firms handle these transactions when they could invest directly in the restructured firm without the costly middleman. We also have to explain why the available cash is chasing buyout

---

[99] *See* Dennis K. Berman, *The Game: Will Private Equity Suffer a Pushback?* Wall St. J., January 2, 2007, C1, http://online.wsj.com/article/SB116769562667564343.html?mod=todays_us_money_and_investing.

[100] *See* Tennille Tracy, *Private-Equity Firms Raked In Record Amounts Last Year*, Wall St. J., January 11, 2007 at C6, available at http://online.wsj.com/article/SB116849058756273548.html?mod=todays_us_money_and_investing.

[101] See *Behind the Buyouts: Inside the World of Private Equity*, Service Employees International Union, http://www.behindthebuyouts.org/media-center/2007/4/24/new-seiu-report-inside-the-world-of-private-equity.html (April, 2007). It is important to emphasize that these numbers present a snapshot of the industry as of a particular date. Private equity's role could grow, or it could shrink significantly, just as did the LBOs of the 1980s. An important factor in the size of the industry is the availability of credit, which is particularly vulnerable to broad economic changes.

[102] One difference is that the private equity funds of today compute the private equity partners' returns based on pooling gains and losses of multiple firms in the portfolio. This ensures that the firm bears the costs of poorly performing companies. *See* Ulf Axelson, Per Stromberg & Michael Weisbach, Ulf Axelson, Per Stromberg, and Michael Weisbach, *Why are Buyouts Levered? The Financial Structure of Private Equity Funds* (January 4, 2007), available at http://www.business.uiuc.edu/weisbach/lbo%20funds%20final%20version%20jan2007.pdf.

[103] *See* Andy Kessler, *Blackstone's World of Cash*, Wall St. J., June 21, 2007 at A17, available at http://online.wsj.com/article/SB118238650375242793.html?mod=todays_us_opinion.

[104] *See id.*

deals instead of, say, venture capital start-ups, natural resources or myriad other types of investments.

A second explanation focuses on the trademark attribute of private equity transactions – that is, turning public into privately held companies. The attraction seems to be the high costs of being public, particularly after the Sarbanes-Oxley Act. However, the puzzle demands some consideration of the costs of being privately held and of withdrawing all of the benefits of a public market for the firm's stock that led the firm to go public in the first place. Indeed, as discussed below in subpart II.E, some buyout firms themselves are now going public.

Third, it has been said that the apparent gains from these transactions are illusory because they ignore the risks of over-leveraging and the long-term costs of restructuring.[105] This is really an argument that stock markets are mispricing buyout deals both at the front end and when private equity reaps the payoff on sale of the restructured company. To be sure, even in efficient markets, prices depend on contemporaneous information. Ultimate returns may be lower or the risk higher than the market originally expected. Moreover, problems getting reliable information about these deals may lead to over-pricing.[106] However, even if the market for private equity is not perfectly efficient, the theory and evidence discussed below suggest that not all of the billions in profits are illusory.

Fourth, one might argue that the incumbent managers are in cahoots with the buyout firm to cheat the public shareholders.[107] Even if buyout firms could accomplish huge heists of publicly held firms in plain sight of other companies, securities regulators and plaintiffs' lawyers, it would still be necessary to account for the role of the buyout firm in the swindle. Presumably the incumbent managers themselves could hire a conventional investment banking firm as an agent to handle the transaction rather than dealing with a buyout firm as costly principal. The answer cannot be simply that the buyout firm is necessary to raise the cash because, again, we need to know why the buyout firm can attract that money.

An answer to all of these questions is that the buyout firm provides a service that others cannot provide at lower cost. Without the buyout firm, a leveraged buyout or similar restructuring may cause more problems than it solves. For example, the transaction form may be inappropriate for the target or poorly structured in the sense that it involves too much or too little debt or poorly designed or chosen financial instruments. The financial structure of the transaction may be appropriate but the portfolio firm's business plan may be faulty, the wrong managers may be hired or retained, or the managers improperly supervised and motivated. The buyout firm's role is to deal with all of these possible problems. But how does it do so?

A possible explanation focuses on the expertise of the buyout partners and their stable of experts who accumulate knowledge by working on many deals, usually concentrated in specific industries. Firms theoretically could hire this advice for less than

---

[105] *See id.*

[106] *See infra* text accompanying note __..

[107] See, e.g., Ben Stein, *On Buyouts there Ought to Be a Law*, New York Times, Sept. 3, 2006, http://select.nytimes.com/search/restricted/article?res=F00E10FE345A0C708CDDA00894DE404482.

the billions in fees and profits buyout firms earn. Management consultants charge flat fees or hourly rates and leave the profits for the original owners. The puzzle is especially striking given that buyout firms have skeletal headquarter staffs compared to a typical large corporation or even consulting firm. For example, the largest private equity firm as of the end of 2006, Blackstone, had 770 employees to manage $69 billion in assets.[108] Twenty years earlier, Kohlberg Kravis Roberts had only 50 employees, including 20 partners, for a portfolio employing 400,000 people.[109]

The question of what buyout firms do for their money can be at least partially answered by focusing on how the structure of buyout firms enables and motivates them to find and design the best deals[110] and follow through on a profitable restructuring. There have been several substantial studies of LBO and private equity business structure, particularly in the 1980s focusing on KKR. For example, in an important paper written at the height of the 1980s buyout boom, Michael Jensen examined what he called the "LBO associations" assembled by leveraged buyout firms.[111] Jensen stressed that these associations do not themselves monitor the portfolio companies. They could not have done so given their paltry number of employees. Rather, they produce results through the incentives created by their firm's structure. These associations have been characterized as "an organizational solution to the agency problems that have long plagued the managerially controlled firm."[112] A key aspect of private equity arguably is not the change in capital structure of the post-LBO firm but rather the incentive structure provided by the private equity association.[113]

Indeed, there is direct evidence of the effect of the buyout firm's structure. Bargeron, et al show that managers of privately held firms pay 55% less for target firms than do managers of publicly held firms for comparable companies.[114] The difference appears attributable to managerial ownership of the bidder, since public bidders with high managerial ownership pay no more than private firms. The authors also find that the premium does not depend on how much stock the target managers hold. This suggests that target managers are not selling out their shareholders for jobs in the surviving firm, since managers with high share ownership would have less incentive than those who own lower shares to hurt the value of their own holdings. Although the Bargeron, et al, study focuses on one element of the structure of buyout firms – that is, managerial ownership –

---

[108] *See* Blackstone Group L.P., Form S-1.

[109] See Kaufman/Englander at 56: quoting Anders.

[110] *See* Baker & Smith, *supra* note 13 at 127 (noting that KKR chose its target well, looking for firms that could safely bear a highly leveraged capital structure without undue bankruptcy risk).

[111] *See* Jensen, *supra* note 10. For other studies of the structure of LBO firms, *see* Axelson, *et al*, *supra* note 102; Allen Kaufman & Ernest J. Englander, *Kohlberg Kravis Roberts & Co. and the Restructuring of American Capitalism*, 67 The Business History Review 52 (Spring, 1993).

[112] *See* Kaufman & Englander, *supra* note 111 at 91.

[113] *See* Axelson, et al, *supra* note 102.

[114] *See* Leonce Bargeron, Frederik Schlingemann, Rene M. Stulz & Chad Zutter, *Why Do Private Acquirers Pay So Little Compared To Public Acquirers?*, NBER Working Paper No. 13061 (April 2007), available at http://www.nber.org/papers/w13061.

as discussed immediately above other factors likely play a role. Extracting value from a buyout obviously depends not just on setting the initial price, but on how the target is governed after the buyout.[115] The buyout firm's structure affects its managers' incentives to maximize the value of its portfolio.

"Uncorporate" features of the structure of buyout firms help account for their role in producing value. First, the owners of the buyout firm, which may be organized as a general partnership or a limited liability company, exercise the overall power of managing the association. These partners can be viewed as the hub of a nexus of contracts, mostly implicit, binding the private equity firm's transactions.[116] The buyout firm is like a franchisor in the sense that it owns a brand that it protects through explicit and implicit contracts with buyout funds and portfolio companies. The buyout principals and the private equity firm's roster of experts also play an active role in serving on the boards of portfolio firms. This substitutes active and engaged managers for the more bureaucratic boards of independent directors in publicly held corporations.[117]

Second, another uncorporate entity – the limited partnership buyout fund – finances the buyouts. The buyout firm partners manage the fund as general partners either directly or indirectly through another partnership entity. The general partners earn an average two percent fee based on assets managed and twenty percent of the fund's profits, or "carry," over a threshold amount. The partners also purchase significant equity in the fund, giving them substantial upside profit and downside risk. Their downside risk is increased by the fact that the fund pools investments from several buyouts, thus subtracting the losses of failed buyouts from the profits of successes.[118] This management structure addresses agency problems by replacing the non-owner agents who sit on corporate boards of directors with buyout firm owner-managers who have a strong incentive to maximize the operating firms' profits.[119]

Buyout partners' incentive compensation has drawn criticism, at least partly because it is hard to understand how they could earn so much money in a functioning market. Jensen stresses the importance of having engaged and expert principals making the critical strategic accountability decisions in a firm.[120] This means hiring people with both the knowledge of how to operate a business and the perspective of a financial

---

[115] See Josh Lerner study showing that public companies backed by private equity firms for more than a year do better than public companies that do not have this backing.

[116] *See* Baker & Smith, *supra* note 13 at 89 (noting that KKR acted as "engaged principals," with implicit obligations to equity and debt investors); *id* at 100-01 (observing that KKR transferred financial techniques, best practices and expertise to its transactions).

[117] *See* Baker & Smith, *supra* note 13 at 106 (noting that formal board meetings in the portfolio firms are less important than interactive discussions); Michael C. Jensen, *The Economic Case For Private Equity*, available at http://papers.ssrn.com/abstract=963530 (February 15, 2007) (private equity partners provide meaningful supervision, in contrast to boards of publicly held firms).

[118] *See* Axelson, et al, *supra* note 102 (showing that this pooling cannot be explained as simple diversification)

[119] *See* Jensen, *supra* note 117 (noting the high-powered incentives created by the partners' fees and profit shares).

[120] *See id.*

analyst on what capital markets value. Firms need to be able to pay these people enough to cover their opportunity costs and motivate them to apply their skills. By contrast, in conventional corporations, as discussed above, there are limits on incentive compensation, including insider trading rules that inhibit managers from cashing in on the value they add to the firm's equity.

Third, the limited partners who invest in the funds contract for a combination of lock-in and liquidation that, as discussed in Part I, is less feasible in the standard corporation. Limited partners may not cash out of the fund during its life, but are automatically cashed out on termination. The promoters therefore have to focus on getting portfolio companies in shape for resale in a public offering or secondary private sale market.[121] Moreover, covenants in the limited partnership agreements provide some assurance of distributions rather than giving full power to the managers to invest earnings in new projects.[122] As discussed above, these uncorporate features, which contrast with capital lock-in in the corporate form, loosen the managers' hold on the cash, forcing them to periodically face the capital market's judgment on their success rather than continuing to manage the investors' funds for an indefinite period. This discipline is especially critical if there is a shortage of good restructuring targets, since promoters' need to return to investors for funding disciplines them not to settle for less profitable targets.[123]

Fourth, unlike the managers of a multi-division publicly held corporation, the fund managers cannot, in effect, delay or forego a judgment on their performance by making inter-company transfers at non-market prices.[124] Rather than relying on using auditors and outside directors to monitor performance in a complex enterprise – a form of scrutiny that spectacularly failed, for example, in Enron – fund managers are structurally bound to separate the investments in different buyout funds. To be sure, some separation is also theoretically possible in corporate conglomerates. For example, Koch Industries, the world's largest privately held firm, uses a system of "market-based management" that relies on economic separation of units.[125] But the success of these systems ultimately depends on management integrity and monitoring rather than uncorporation-type incentive structures. Moreover, it is worth noting that Koch, the leading practitioner of this approach, is a closely held family-controlled firm and therefore lacks corporate-type free rider problems that inhibit effective monitoring in publicly held firms.

Fifth, the managers of private equity portfolio firms, often the pre-buyout managers, own a significant share of their firm's equity after the public shareholders have

---

[121] *See* Brian R. Cheffins & John Armour, *The Eclipse of Private Equity*, ECGI - Law Working Paper No. 082/2007 at 10, available at http://ssrn.com/abstract=982114 ((noting that the private equity partners are motivated to get portfolio firm in shape); Jensen, *supra* note 117 (emphasizing the finite life of the funds).

[122] *See* Cheffins & Armour, *supra* note 121 at 30.

[123] *See* Axelson, et al, *supra* note 102.

[124] *See* Baker & Smith, *supra* note 13 at 171 (noting that benefit of LBO associations compared to conglomerates is the absence of cross-subsidization); Jensen, *supra* note 117 (same); Kaufman & Englander, *supra* note 111 at 70 (discussing the importance of LBO portfolio firms being operated as stand-alone units with market prices controlling dealings among units).

[125] *See* Charles G. Koch, *The Science of Success: How Market-Based Management Built the World's Largest Private Company* (2007).

been replaced by creditors. This reduces the separation of management and control that characterizes pre-buyout corporations and makes the managers more like owner-managers, or partners. Jensen's 1989 article noted that the CEOs of buyout portfolio firms had 6.4% stakes, compared to only .25% equity stakes for non-LBO firms, with the overall result that $1,000 increase in shareholder value produced $64 of gain for LBO executives compared to $3.25 for public firm CEOs.[126]

Sixth, post-buyout firms' heavily leveraged capital structure produces its own high-powered uncorporate-type incentives to perform.[127] The operating company's managers have to produce enough cash to service the debt or face default and potential bankruptcy. Covenants in the debt instruments inhibit managers and shareholders from manipulating the firm's assets – for example, "rolling the dice" by purchasing riskier assets to keep a foundering firm afloat. The debt instruments force the managers to either live by their restructuring plan or get the creditors' consent to alter it. Using debt to turn the corporation into an uncorporation thus replaces the weak monitoring powers of the former shareholders with contractual obligations that the managers and shareholders must obey if they want to keep control of the company.[128] Another way to view this is that a market for corporate control that relies on costly hostile takeovers has been replaced by creditors' contractual option to take control of the company under the debt instruments if the managers and shareholders fail to meet expectations.

As discussed in Part I, the high leverage that is the hallmark of private equity is an important uncorporate feature in the sense that principal and interest payments replace the capital lock-in and weak-form monitoring of the corporate form. The second-level tax on distributions impedes most publicly held firms, including the mature, slow-growth firms typically involved in LBOs, from using the partnership form to compel distributions. The LBO gives these firms a tax workaround for these firms by replacing uncorporation-type distributions with tax-deductible interest payments. A highly leveraged capital structure is analogous to mandating partnership distributions at the high end of cash flow expectations. The key difference is that the "home-made" partnership created by substantial leverage comes with potential bankruptcy cost.

Some writers have analogized LBOs and private equity to the conglomerate trend of the 1960s.[129] However, the similarities between conglomerates and LBO and private equity firms are superficial.[130] A conglomerate is fundamentally a standard form

---

[126] *See* Jensen, *supra* note 10. *See also* Baker & Smith, *supra* note 13 at 184 (discussing how managers could buy into portfolio companies and got a percentage of the firm's bonus pool based on profits); *id.* at 96 (noting the basic principle of LBO associations to make managers owners by having them invest a significant percentage of their net worth, supplemented by options); Jensen, *supra* note 117; Kaufman & Englander, *supra* note 111 at 91 (discussing how managers' substantial equity holdings reduces monitoring cost).

[127] *See* Jensen, *supra* note 10 (discussing the role of debt in "unlocking" investor funds).

[128] *See* Baker & Smith, *supra* note 13 at 89 (noting importance of the debt constraint).

[129] *See* Cheffins & Armour, *supra* note 121 (analyzing conglomerate and private equity in the context of other merger booms and discussing the passing of the conglomerate boom as a possible precedent for the fate of private equity); Kaufman & Englander, *supra* note 111 at 92-95 (analogizing LBO associations to conglomerates in the sense of being an interrelated set of firms).

[130] *See* Baker & Smith, *supra* note 13 at 163-169.

corporation that uses strong central management to actively manage diverse businesses.[131] This entails the significant potential agency costs inherent in empowering non-owner managers. Like other corporations, conglomerates address agency costs through top-down monitoring by a large headquarters staff, division heads who are employees of the parent firm, top-level executives and the board of directors. Like standard corporations, conglomerates have perpetual life and their managers have little incentive to divest non-performing units. Without the incentive structures built into the uncorporation, the conglomerate form compounds rather than alleviate agency costs by adding complexity and opportunities for managers to use multiple divisions to manipulate cash flows.

It is important to keep in mind that private equity has limitations, as do all of the uncorporation devices discussed in this Part, at least under current tax and regulatory law. Because private equity and LBO associations rely on debt-heavy capital structures, they are not suitable for inherently unstable growth companies that can expect wide variations in earnings and that need cash to grow. These firms generally buy existing companies and use their cash flow to repay a substantial debt load without significantly increasing assets.[132] This sharply contrasts with the venture capital funds discussed below, which use a different structure for growing businesses, with its own set of limitations.[133]

C. INTERVENTION: HEDGE FUNDS

The uncorporation is useful not just in restructuring corporations into privately held entities, but also in filling monitoring gaps in firms that retain the conventional publicly held corporate form. As discussed above in Part I, voting in publicly held corporations suffers as a monitoring device because of the free rider problem confronting dispersed shareholders. Institutional shareholders may somewhat mitigate the free-rider problem, but they face conflicts of interest, agency problems of their own, and the costs of foregoing risk diversification. Takeovers are also subject to significant impediments. Although private equity is a potent restructuring mechanism, hostile takeovers are so costly that restructuring usually requires incumbent managers' cooperation. This leaves a substantial set of firms whose managers may be inept but not easily co-opted.

These governance gaps have been filled by activist hedge funds – that is, investment companies that specialize in intervening in corporate governance rather than purely financial arbitrage. Unlike mutual funds, hedge funds take significant short-term minority positions. Hedge funds differ from traditional shareholder activists. With their diversified portfolios, mutual funds and other institutional shareholders face a free-rider problem that impedes them from spending the resources necessary to effect significant changes in portfolio firms. Instead, they must try to work with incumbent managers. When they do act, it is mainly to vote across their portfolios on systemic governance

---

[131] *See* Kaufman & Englander, *supra* note 111 at 60.

[132] *See* Baker & Smith, *supra* note 13 at 60.

[133] *See infra* subpart II.F. However, private equity may allow for hybrid structures, such as a "leveraged build-up" in which the buyout company finances a management team to leave and replicate their former company. This structure, like a leveraged buyout or private equity deal but unlike venture capital, involves restructuring rather than building from scratch. *See* Baker & Smith, *supra* note 13 at 197.

changes recommended by proxy advisory firms.[134] By taking significant positions in portfolio firms, hedge funds can capture the benefits of more strenuous efforts to seek significant and specific changes in the way specific firms are run.[135]

Hedge funds also differ from private equity in not seeking control of their targets. Rather, they take board seats in a substantial minority of the cases, where they serve with fiduciary duties to the existing public shareholders, often as adversaries to incumbent managers. Hedge fund activism therefore arguably involves mitigating the separation of ownership and control not by uniting management and ownership but by increasing the power of outside shareholders.[136]

Because of their active role, hedge funds can be viewed as part of the governance structure of their portfolio firms. As with private equity firms, it is important for present purposes to focus on how the firm's uncorporate structure motivates its role in corporate governance. Hedge funds are commonly organized as limited partnerships. Their managers are general partners, which have higher-powered incentives than mutual fund managers. These incentives are possible because hedge funds, unlike mutual funds, are not subject to limits on the fees they can charge investors.[137] Hedge fund managers accordingly profit handsomely from successful intervention in portfolio firms. Also, unlike mutual funds, hedge funds avoid registering with the SEC by selling only to wealthy or sophisticated investors. The contractual flexibility of the limited partnership form combines with investor sophistication to help ensure that courts will enforce the specific contractual mechanisms the firm has adopted rather than imposing corporate-type fiduciary duties and remedies. This is indicated by the hedge fund fiduciary cases discussed above in subpart I.D.[138] Also, in the *Anglo American Security Fund* case, the court observed that

> The plaintiff limited partners each appear to be sophisticated parties that understood and voluntarily accepted the terms of the Agreement and assumed the risks of investing in the Fund in order potentially to reap the rewards of undertaking such risks.[139]

As with other uncorporate structures, hedge funds have limitations. In particular, the size of the investments necessary to overcome the free-rider problem reduces risk-

---

[134] *See* Rose, *supra* note 41.

[135] *See* Marcel Kahan & Edward Rock, *Corporate Governance and Corporate Control*, U of Penn, Inst for Law & Econ Research Paper No. 06-16 (2006), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=919881.

[136] *See* William Bratton, *Hedge Funds and Governance Targets*, Georgetown Law and Economics Research Paper No. 928689 (2007), available at http://ssrn.com/abstract=928689.

[137] *See generally*, William Fung & David A. Hsieh, *A Primer on Hedge Funds*, 6 J. Empirical Fin. 309 (1999); Alan L. Kennard, *The Hedge Fund v. the Mutual Fund*, 57 Tax. L. 133 (2003); Larry E. Ribstein, *Do the Mutuals Need More Law*? Regulation Magazine, Spring, 2004 at 14 (contrasting regulation of hedge funds with that of mutual funds).

[138] *See supra* text accompanying notes 66-71.

[139] *Anglo American*, 829 A.2d at 143.

diversification, placing a practical limit on the funds' investment horizon. Hedge funds accordingly look for poor-performing firms that can be improved over the short term by potential sale of the whole or a part, distribution of cash and trimming excessive costs.

D. BUSINESS TRUSTS

The business forms discussed so far arguably are only the tip of the iceberg of the uncorporation invasion into the publicly held firm domain. Robert Sitkoff estimates that that around $12 trillion in commercial activity occurs in business trust, including about 75% of the firms in the $10 trillion mutual fund industry.[140] He notes that statutory business trusts are widely used for structured finance, where portfolios of loans and other assets are placed into the trust, which then issues securities that are sold to the public or to institutions. Sitkoff argues that the business trust form is useful precisely because it has no structural limitations, and therefore can occupy niches created by federal bankruptcy, securities and tax law. The business trust is close to a purely "contractual entity" – that is, a business association based entirely on the parties' customized contract with no default rules other than limited liability.[141]

The business trust's most important uncorporation-type incentive device is the owners' ability to put their interests back to the firm, at least in open-end funds. This contrasts with "closed end" funds, which trade publicly, but whose owners have no redemption right. As discussed throughout this paper, put rights weaken managers' control over the assets and therefore give them a strong market incentive to act in owners' interests.

Despite their uncorporate features, the largest category of business trusts – open end mutual funds – differ significantly from the other uncorporate firms discussed in this Part. First, mutual funds are subject to tax and regulatory diversification requirements that render them unsuitable for use in actively managing portfolio firms.[142]

Second, mutual fund passivity is reinforced by the fact that mutual fund investors put rights are not subject to the limitations observed in other uncorporations. Mutual funds therefore cannot commit to active management strategies of portfolio companies like those of private equity firms and hedge funds that may pay off in the long term but lead to short-term underperformance compared to the firm's rivals.[143]

Third, the limits on fees that distinguish mutual fund from hedge fund managers[144] mean that mutual fund managers do not have the same high-powered incentives as other uncorporation managers. Indeed, they are more like the managers of

---

[140] Robert H. Sitkoff, *The Rise of the Statutory Business Trust* (in progress).

[141] *See* Larry E. Ribstein, *Limited Liability Unlimited*, 24 DEL. J. CORP. L. 407 (1999).

[142] See generally, Mark J. Roe, *Political Elements in the Creation of a Mutual Fund Industry*, 139 U. Pa. L. Rev. 1469 (1991).

[143] See Kate Litvak, *Firm Governance as a Determinant of Capital Lock-In* at 6-7 http://ssrn.com/abstract=915004, University of Texas Law School Law and Economics Research Paper No. 95 (2007) (discussing trade-offs between liquidity and lock-in in financial firms such as mutual funds).

[144] *See supra* note 137 and accompanying text.

the firms they are monitoring in getting paid based on assets under management,[145] and therefore in being motivated to grow funds and not necessarily to make them more profitable.

Fourth, mutual funds are subject to other regulation under the Investment Company Act, such as requirements for voting by independent directors.[146] This monitoring requirement is consistent with fact that mutual fund managers do not have the same high-powered incentives as other uncorporation managers.

In general, mutual funds do not offer the same governance benefits as other uncorporations. Not only are mutual fund investors even more passive than corporate shareholders, but mutual funds do entail the sort of high-powered managerial incentives that pick up the monitoring slack in other uncorporations. Indeed, mutual fund investors are best viewed as customers of the fund who can leave when they are unhappy with returns (subject to tax costs and other inhibitions on selling). Moreover, given mutual fund managers' weak incentives, mutual funds play a weaker role in governing their portfolio firms than the other types of uncorporations discussed in this Part. However, it is important to emphasize that the governance limitations of mutual funds do not inhere in their uncorporate structure. Indeed, the business trust can be viewed as the pure form of the uncorporation in being fully contractible and not subject to any structural limitations. In the absence of tax and regulatory constraints, the business trust form might enable various types of investment vehicles along a spectrum from passivity to active engagement in management.

E. GOING PRIVLIC AND THE BOUNDARIES OF THE CORPORATE TAX

The move toward uncorporations is not necessarily a move to private ownership. Subpart A discusses publicly held uncorporations – that is, master limited partnerships and REITs. This subpart discusses the potential for what might be called "privlic" firms – public ownership and trading of instruments in "private equity" firms.

Three main variations have developed so far.[147] First, some private equity firms and other asset management firms, led by Fortress Investment Group, LLC[148] and

---

[145] *See* Xavier Gabaix and Augustin Landier, *Why Has CEO Pay Increased So Much?* (May 8, 2006), MIT Department of Economics Working Paper No. 06-13, available at http://ssrn.com/abstract=901826 (finding that the size of large firms explains many of the patterns in CEO pay).

[146] *See* Investment Company Act of 1940, 15 U.S. § 80a–15(c) (requiring independent director vote on investment advisor contracts).

[147] There is arguably a fourth variation – the so-called "reverse leveraged buyout," or public offering by a firm that had been taken private. The resulting firm appears to be a conventional publicly held corporation. However, the firm retains some of its uncorporate high-powered incentive characteristics. A leading study of these transactions notes that after the public offering the buyout group retains on average a 38% stake, while its managers and directors retain an average 36% share. *See* Jerry X. Cao & Josh Lerner, *The Performance of Reverse Leveraged Buyouts* (October 15, 2006), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=937801, at 11.

[148] *See* http://www.fortressinv.com/site_content.aspx?s=16.

Blackstone Group, L.P,[149] have sold or plan to sell shares to the public in an uncorporated entity (LLC or LP) that manages and receives fees and profits generated by the private equity firm.[150]

Second, Goldman Sachs organized the "GS Tradable Unregistered Equity OTC Market" or GSTrUE, a market for private equity, hedge fund and other firms on which only institutions and wealthy investors can trade. The market is structured to take advantage of the Rule 144A exemption under the Securities Act of 1933 for private resales of securities.[151] Its first listing was Oaktree Capital Management LLC, which sold about 14% of itself for more than $800 million to less than 50 investors in May, 2007. As with the Blackstone-type transaction, equity owners will have little say in Oaktree's management.[152]

In a third category, public investors retain shares, known as "stub equity," in a firm that has been taken private. An important example is Clear Channel, where the device resolved a dispute over valuation of a going private transaction. The public shareholders will own up to 30% of the newly formed company, which will trade in the relatively illiquid Pink Sheets market.[153]

These business structures seem to make little sense. Michael Jensen has called the idea of private equity going public a "non-sequitur both in language and economics."[154] It is especially odd that private equity firms should bring in public owners to share the fees they make from taking other firms private. These transactions are best understood as illustrating this paper's general theme that the benefits of being publicly held are increasingly on the margin, and depend on a variety of factors that vary from firm to firm.

---

[149] *See* Blackstone Group, L.P., S-1, *supra* note 108. The Blackstone offering closed on June 21, 2007. All references to "Blackstone" below are to the publicly traded limited partnership rather than to the managing general partnership.

[150] As of this writing, other firms are considering public offerings. *See* Henny Sender & Dennis K. Berman, *KKR Plans Its Own IPO Blackstone Offering Pushes Equity Firms To Pursue Capital,* WSJ, June 22, 2007, available at http://online.wsj.com/article/SB118246551615744077.html?mod=home_whats_news_us. Two have been announced and filed registration statements. See Och-Ziff Capital Management LLC Form S-1, July 2, 2007, available at http://www.sec.gov/Archives/edgar/data/1403256/000119312507147770/ds1.htm; KKR & Co., LP, Form S-1, July 3, 2007.

[151] 17 CFR 230.144A, 57 FR 48722 (Oct. 28, 1992).

[152] For a discussion of GSTrUE and the Oaktree transaction, *see* Henny Sender, *Oaktree to Try A New Twist For Share Sale Use of Goldman Market Avoids Regulations Doesn't Cede Control,* Wall St. J., May 10, 2007 at C1. Private equity firm Apollo Management, LP was planning to become the second firm to list on this new exchange. See Reuters.com, *Apollo mulling private exchange listing* (July 17, 2007), available at http://today.reuters.com/news/articleinvesting.aspx?type=comktNews&rpc=33&storyid=2007-07-17T051758Z_01_N17386888_RTRIDST_0_APOLLO-SHARES-GOLDMAN.XML.

[153] *See* Michael J. de la Merced, *Clear Channel breathes life into buyout offer*, International Herald Tribune, May 8, 2007, available at http://www.iht.com/articles/2007/05/08/business/clear.1-48050.php.

[154] *See* Jensen, *supra* note 117.

The transactions also show that being closely held is not an inherent aspect of the uncorporate form. Selling shares to the public has the usual benefits in this context. Public ownership enables the firm to raise capital by reducing the cost of risk-bearing. Public ownership also accesses the information and valuation benefits of public securities markets. This, in turn, gives the firm a readily valued currency it can use to compensate its managers, make acquisitions and enable the firm's partners to pass their investments to their heirs.[155] At the same time, the privlic firm would retain the emphasis on incentives and distributions over monitoring that characterizes other private equity firms. A privlic firm therefore is, as the Blackstone prospectus says, "a different kind of public company."[156]

As detailed in Blackstone's prospectus, the firm continues the heavy-duty incentive structure, including share ownership and profit-sharing, that typifies private equity firms.[157] Blackstone – that is, the publicly held entity Blackstone Group, L.P. – is managed by a general partner that is a limited liability company owned by Steven Schwarzman and other Blackstone senior managers. These managers will own equity shares in the operating partnerships and will continue to directly receive a share of the carry.[158] Group, in turn, owns controlling general partnership interests in the operating partnerships.

Blackstone's buyout partnerships pass their fee income up to Group which will, in turn, make quarterly distributions to its owners, including the common unitholders buying shares in the public offering. Although the managers may invest earnings in the business rather than distributing them, the fact that the earnings are taxed to the owners whether or not distributed should make limited partnership unitholders more averse to earnings retention than are corporate shareholders. To be sure, as discussed immediately below, and consistent with the uncorporate tradeoff of monitoring for incentives, the unitholders have little formal recourse if managers excessively retain earnings. But the

---

[155] The common unit-holders' lack of voting power described below, including their lack of power to elect and remove managers, may undercut the information benefits of being public. Without a market for control of privlic firms, potential bidders lack incentives to uncover information, thereby reducing the transparency of these firms. There is evidence that firms with fewer antitakeover provisions have more institutions involved in merger arbitrage trading their shares, and more indicia of information is being revealed in their stock prices, such as more idiosyncratic risk and trading activity. *See* Miguel A. Ferreira & Paul A. Laux, *Corporate Governance, Idiosyncratic Risk, and Information Flow*, 62 J. FIN. 951 (2007).

[156] *See* Blackstone prospectus, *supra* note 108 at 17. *See also* Cheffins & Armour, *supra* note 121 at 56-57 (stressing the significance of private equity partners' retaining control); Larry E. Ribstein, *Going Privlic*, American.com, March 27, 2007, available at http://www.american.com/archive/2007/march-0307/going-privlic (discussing the differences between Blackstone and other public companies).

[157] *See* Blackstone prospectus, *supra* note 108 at _.

[158] Such incentives are also evident in the Och-Ziff offering, *supra* note 150. A key aspect of that offering was the additional investment of $2 billion by the partners, an increase from 7% to 14% of the funds invested in the firm. This was described as "hurt" money – enough that the managers' risk of loss would be significant in relation to their potential for upside gain from their management fees. *See* William Hutchings, *Och-Ziff flotation aims to raise 'hurt money'*, Financial News, July 17, 2007, available at http://www.financialnews-us.com/index.cfm?page=ushome&contentid=2448323994&uid=7107-2107-341714-992146. Going public facilitated this investment by increasing the liquidity of the managers' interests.

tax penalty on distributions increases the likelihood that managers who retain earnings will be judged harshly in the capital markets and face constraints on future capital-raising.[159]

Blackstone Group unitholders get almost no formal control rights. The LLC which manages Group is controlled by a board elected by the LLC members, not by Group or its unitholders. The prospectus makes clear that the unitholders

> will have only limited voting rights on matters affecting our business and therefore limited ability to influence decisions regarding our business. Furthermore, if our common unitholders are dissatisfied with the performance of our general partner, they will have little ability to remove our general partner.[160]

Although privlic firms may be subject to the SEC proxy proposal rule,[161] privlic owners' minimal power under state law may affect their right to insert shareholder proposals into the proxy materials under federal law.[162]

The Group prospectus also makes clear that the managing LLC has "limited fiduciary duties," and may make decisions in its "sole discretion" considering any interests it desires, including its own. If there is any conflict of interest between Group and the general partner, the general partner may resolve the conflict on any basis as long as it involves

> terms no less favorable to us than those generally being provided to or available from unrelated third parties or is fair and reasonable to us, taking into account the totality of the relationships between us and our general partner. . . . A common unitholder seeking to challenge this resolution of the conflict of interest would bear the burden of overcoming such presumption. This is different from the situation with Delaware corporations, where a conflict resolution by an interested party would be presumed to be unfair and the interested party would have the burden of demonstrating that the resolution was fair.
>
> Also, if our general partner obtains the approval of the conflicts committee of our general partner, the resolution will be conclusively deemed to be fair and reasonable to us and not a breach by our general partner of any duties it may owe to us or our common unitholders. This is different from the situation with Delaware corporations, where a conflict resolution by a committee consisting solely of independent directors may, in certain circumstances, merely shift the burden of demonstrating unfairness to the plaintiff. If you choose to purchase a

---

[159] The effect of the corporate double tax on choice of form is discussed *supra* at text accompanying note 85. The effect of partnership taxation on owners' incentives to demand distributions is discussed further *infra* text accompanying note 224.

[160] *Id.* at _.

[161] *See* SEC Rule 14a-8.

[162] *See* SEC Rule 14a-8(i)(1) (permitting exclusion of proposals that are "not a proper subject for action" by shareholders under state law). SEC v. Transamerica Corp., 163 F.2d 511 (3d Cir. 1947) held that a corporation could not use a bylaw to frustrate the operation of the shareholder proposal rule. However, it is clear that permissible proposals are limited by shareholders' governance powers under state law.

> common unit, you will be treated as having consented to the provisions set forth in the partnership agreement, including provisions regarding conflicts of interest situations that, in the absence of such provisions, might be considered a breach of fiduciary or other duties under applicable state law. As a result, common unitholders will, as a practical matter, not be able to successfully challenge an informed decision by the conflicts committee.[163]

Since Group is a Delaware limited partnership, these limitations on fiduciary duties are likely to be enforced pursuant to the statutory and case law discussed above.[164]

The combination of public ownership and uncorporation may be appropriate for other types of firms that can benefit from the valuation and information effects of public markets but do not want to share control with public owners. An example is professional firms where control by the non-professionals arguably conflicts with professionals' duties to their clients. In the sole publicly traded law firm as of this writing, the Australian firm Slater & Gordon, the lawyer owners have majority control and the firm agreement explicitly subordinates the duties the firm's principals owe to investors to their duties to clients and the court.[165]

The Slater & Gordon IPO triggered a debate about the future of the publicly traded law firm. The debate generally assumes that publicly traded law firms will incorporate. But this subpart suggests that some may go privlic and become publicly traded uncorporations. In Slater & Gordon, for example, transfer of the lawyers' shares is only temporarily restricted, so that non-lawyer owners eventually might acquire control. At that point, it may be unclear how the subordination of duties to the public investors will apply in particular cases, or whether the public owners will delete this provision. A more robust approach to subordinating non-lawyer owners' control would be to use the Blackstone transaction form and make these owners non-controlling limited partners, while contractually defining the partners' fiduciary duties as permitted by Delaware and other statutes.[166] Profit-sharing and explicit duties to distribute cash could align the lawyer-owners' incentives with investors' interests.[167]

Law and other professional firms would seem to be appropriate for uncorporation structures since they have traditionally operated as partnerships. Thus, these firms would simply continue to use uncorporation incentive devices. As discussed in subpart I.B., a duty to distribute cash is a key aspect of the uncorporation incentive structure. Law firms normally distribute most of their cash at the end of the year. Though publicly traded law

---

[163] *Id.* at __.

[164] *See supra* text accompanying notes 59-71.

[165] *See* Slater & Gordon Ltd Prospectus (April 13, 2007), available at http://www.slatergordon.com.au/docs/prospectus/Prospectus.pdf.

[166] *See supra* text accompanying notes 59-71.

[167] The law would have to change to accommodate these structures. State law currently prohibits law firms from having non-lawyer owners. See Model Rule of Professional Conduct 5.4. Law firms are also generally prohibited from organizing as limited partnerships. [cites] Even if a single state permitted non-lawyer owners and limited partnership law firms, there would still be questions whether this form would be recognized by other states in which the firm had offices. *See* Larry E. Ribstein, *Ethical Rules, Law Firm Structure and Choice of Law,* 69 U. Cin. L. Rev. 1161 (2001).

partnerships could be expected to invest more heavily than traditional law firms in advertising and technology, they could accommodate these needs by establishing reserves and requiring distribution of income in excess of the reserves.

In assessing the efficiency of the privlic firm, it is important to keep in mind that limited or no voting rights actually is fairly prevalent in corporate governance. The firm's charter might create multiple classes of stock with voting power severed from economic rights. Many leading media firms, including the New York Times, Washington Post and Dow Jones, have adopted this structure to preserve the control of the founding family. Google notoriously locked significant control in the founders when it went public. The founders or founding family may want high-vote stock because they have a stake in the firm's culture or want to protect it from the shifting demands of the capital markets. Shareholders may unilaterally separate ownership and control of shares by selling the voting right to a third party or by encumbering the shares in various ways.[168] Moreover, as discussed in Part I.E, even in conventional corporations voting rights may be ineffective because of constraints on the market for control. The difference between privlic firms and limited voting rights in conventional corporations is that the privlic firm compensates for the lack of monitoring through shareholder voting by substituting incentive structures, while the conventional corporation may lack such structures to protect otherwise powerless owners.[169]

As this is being written, Congress appears to be moving toward cutting down on their use by taxing them as corporations.[170] Indeed, the Senate Finance Committee's release accompanying the bill casts doubt on the availability of partnership taxation to other types of publicly held firms, including MLPs.[171] The release says that "[i]t's unfair to allow a publicly traded company to act like a corporation but not pay corporate tax."[172]

---

[168] For discussions of the policy implications of these structures see Bruce H. Kobayashi & Larry E. Ribstein, *Outsider Trading as an Incentive Device* (with Kobayashi), 40 UC-Davis Law Review 21 (2006); Henry T. C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S.Cal. L. REV. 811 (2006); Henry T.C. Hu & Bernard Black, *Hedge Funds, Insiders, and the Decoupling of Economic and Voting Ownership: Empty Voting and Hidden (Morphable) Ownership*, 13 J. CORP. FIN. 343 (2007); Shaun P. Martin & Frank Partnoy, *Encumbered Shares*, 2005 ILLINOIS L. REV.775 (2005).

[169] For evidence that firm value negatively correlates with separation of insider control from cash-flow rights, see Stijn Claessens, Simeon Djankov, Joseph P.H. Fan, and Larry H.P. Lang, *Disentangling the Incentive and Entrenchment Effects of Large Shareholdings*, 58 J. FIN. 81 (2002); Paul A. Gompers, Joy Ishii, and Andrew Metrick, *Extreme Governance: An Analysis of Dualclass firms in the United States* (2006). There is also evidence that insiders who control voting rights extract private benefits. *See* Ronald C. Lease, John J. McConnell and Wayne Mikkelson, *The Market Value of Control in Publicly-Traded Corporations*, 11 J. FIN. ECON. 439 (1983); Harry DeAngelo & Linda DeAngelo, *Managerial Ownership of Voting Rights: A Study Of Public Corporations with Dual Classes of Common Stock*, 14 J. FIN. ECON. 33 (1985); Alexander Dyck & Luigi Zingales, *Private Benefits of Control: An International Comparison*, 59 J. FIN. 537 (2004); Ronald W. Masulis, Cong Wang and Fei Xie, *Agency Problems at Dual-Class Companies*, http://ssrn.com/abstract=961158 (February 12, 2007); Tatiana Nenova, *The value of corporate voting rights and control: A cross-country analysis*, 68 J. FIN. ECON. 325 (2003).

[170] *See* http://finance.senate.gov/press/Bpress/2007press/prb061407e.pdf.

[171] *See supra* subpart II.A.

[172] News Release, *Baucus-Grassley Bill Addresses Publicly Traded Partnerships* (June 14, 2007),

Publicly held private equity firms get significant tax advantages if they can be treated as partnerships for tax purposes.[173] Not only do they avoid the corporate double tax,[174] but they can take advantage of capital gains rather than ordinary income treatment of the profit share, or "carry," the partnership earns from the portfolio firms.[175] Blackstone avoids corporate taxation by qualifying its income as "passive" under the publicly traded partnership provision[176] – specifically, as capital gains from the funds (i.e., the carried interest), and as dividends from the management LLC out of management fees paid by the funds. Partnership treatment saves Blackstone about $600 million in taxes based on its 2006 carried interest.[177]

The appropriate taxation of privlic firms is a tricky issue. These firms do not obviously deserve a tax *subsidy*, which is what they arguably would get if they were taxed differently from structurally similar non-private equity firms. The exception from corporate taxation targets the "passive" nature of the activity that produces the firm's income – that is, firms that are not actively engaged in operating an ongoing business, but rather simply receiving the fruits of natural resources or other firms. Blackstone seems to be actively engaged in business as an investment intermediary, which at least strains its claim to a passive activity exemption.[178] As discussed throughout this article, it is the hands-on nature of Blackstone's activities that squeezes profits, and therefore gains, from the portfolio firms.

It is not obvious, however, that the corporate tax should be applied to a firm like Blackstone. As discussed throughout this article, an uncorporation such as a private equity firm is not "like a corporation" as the Senate Finance Committee suggests.[179] Most importantly for present purposes, uncorporate firms eschew corporate-type capital lock-in in favor of liquidation rights and distributions. As discussed in subpart A, the firms that are appropriate for this treatment extend beyond the limited category of passive activity firms covered by the Code's publicly traded partnership provision.[180] This includes a firm like Blackstone that plans to distribute most of its earnings, though its business arguably does not strictly fit into the passive activity model. Applying the corporate tax to all non-

---

available at http://www.finance.senate.gov/sitepages/leg/LEG%202007/Leg%20110%20061407a.pdf

[173] Victor Fleischer, *The Blackstone IPO*.

[174] *See supra* text accompanying note 85.

[175] See I.R.C. § 11. This treatment is itself controversial. *See* Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, New York University Law Review, 2008, available at http://ssrn.com/abstract=892440.

[176] *See supra* text accompanying note 87.

[177] *See* Fleischer, *supra* note 173 (including this estimate and analyzing Blackstone's avoidance of corporate tax).

[178] *Id.*

[179] *See supra* text accompanying note 172.

[180] Indeed, Blackstone's tax gambit exposed a more basic problem with making the tax turn on the passive nature of the firm's activities. Income from any active activity can be turned into passive income by running it through an intervening entity, just as Blackstone did in setting up the management LLC.

"passive" firms imposes extra tax costs on firms whose business model does not call for significant earnings retention – precisely the firms that are least appropriate for corporate-style capital lock-in. This means that firms that have the least need to rely on corporate monitoring are deterred from adopting the form that best fits their business model.[181] If they want to avoid the penalty, they need to take the second-best route to adopting an uncorporate structure – that is, a highly leveraged capital structure, with the attendant bankruptcy risks.[182]

A better tax design would focus on the fundamental attributes of the uncorporate structure emphasized in this paper, including the relative absence of capital lock-in and reliance on distribution obligations and liquidation rights. For example, Congress might consider making corporate or partnership treatment in publicly traded firms turn generally on distribution obligations, as it now does specifically for REITs.[183] However, as discussed further below,[184] this move faces opposition from the same political forces that have sought to preserve the central role of the corporate form.

F. VENTURE CAPITAL

The discussion so far has focused on firms for which uncorporation-type incentives are most appropriate – namely, firms where agency costs can practicably be constrained by limiting managers' control over the firm's cash. This is certainly the case in passively managed natural resource or real estate firms that are MLPs or REITs. The going private or "privlic" transactions discussed in subparts II. B and E deal with more mature firms. Other uncorporations deal with more varied types of firms, but with a lighter touch (business trusts) or in a more transitory way (hedge funds).

Venture capital firms, which are organized as limited partnerships, specialize in buying equity shares, usually preferred stock, in start-up phase high-risk firms.[185] Where the portfolio firm is growing and its trajectory is uncertain, monitoring structures may be more appropriate than more constraining incentive structures despite the potentially higher agency costs of the former type of device. Nevertheless, uncorporation-type structures are used both at the level of the portfolio firm and in the VC firm itself.

The portfolio firms are organized as standard-form corporations. The managers, typically the entrepreneurs, are empowered to run the firm, subject to monitoring by the

---

[181] This does not, of course, mean that private equity or similar firms will not incorporate if they want to go public. Indeed, the initial success of the Blackstone IPO (measured by the shares' 13% rise on opening) in the face of Congressional moves to change the taxation suggests that the tax status is not necessarily critical to the business structure. But taxes, like other costs, operate on the margin and may deter some deals. The question, then, is whether the costs of foregone deals are worth the benefits, as measure both by tax revenues and perceptions of equity.

[182] Congress also could limit the tax-deductibility of interest payments. While this would reduce bankruptcy costs, this article's analysis suggests it could increase agency costs.

[183] *See supra* text accompanying note 93.

[184] *See infra* subpart III.D.

[185] *See generally*, Paul Gompers and Josh Lerner, THE VENTURE CAPITAL CYCLE (MIT Press 1999).

board, the shareholders and the court through fiduciary duties. As in other firms, there are significant potential agency costs and conflicts. For example, the entrepreneur may be inclined to roll the dice in an unrealistic expectation of success, while the venture capitalist acts more as a creditor, with less upside potential and therefore more inclination to pull the plug in bad times.[186] Monitoring works somewhat better in these firms than in publicly held corporations because they are closely held and managers are subject to expert scrutiny by the venture investor. The venture capitalist keeps a close eye on the firm through its board positions, and its power on the board increases if and when it makes additional investments in the portfolio firm.[187]

Although monitoring is dominant in these firms, strong-form incentives also play a role. First, the practice of increasing VC control rights with successive investments not only relates to the VC's monitoring power, but also gives the entrepreneur an incentive to be cautious about demanding more financing. This is roughly analogous to liquidity and distribution provisions in other uncorporations, except that instead of forcing the entrepreneur to seek cash from the capital market, demands for cash reduce the entrepreneur's control power within the firm.

Second, the venture capitalists' preferred shares give them significant rights to compel liquidation, redeem or obtain registration of the shares.[188] The latter right functions as a sort of deadline for action by the entrepreneur.[189] The venture capitalist's right to cash out forces the entrepreneur to produce value up to the venture capitalist's opportunity cost. As in the other uncorporate structures discussed above, this subjects the entrepreneur to the judgment of market actors rather than agents such as courts, lawyers or independent directors.

Third, potential agency costs between venture capitalists and entrepreneurs may be constrained to some extent by aligning the VC's incentives with those of the entrepreneur. In particular, the VC's right to convert its preferred into common stock gives it an equity claim that encourages it to take an active role in the business. It has been shown that VCs holding convertible preferred stock give more advice than those holding non-convertible stock, and that the amount of time VCs spend advising entrepreneurs increases with their percentage of equity ownership.[190] The VC's equity claim also may make it hesitate before pulling the plug on a firm that still has a reasonable chance to succeed.

---

[186] *See* George G. Triantis, *Financial Contract Design in the World of Venture Capital*, 68 U. Chi. L. Rev. 305 (2001).

[187] See D. Gordon Smith, *The Exit Structure of Venture Capital*, 53 UCLA L. Rev. 315 (2005) (analyzing agreements in venture-backed firms). For other analyses of board control by venture capitalists, see William W. Bratton, *Venture Capital on the Downside: Preferred Stock and Corporate Control*, 100 MICH. L. REV. 891, 921 (2002); Steven N. Kaplan & Per Strömberg, *Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts*, 70 REV. ECON. STUD. 281 (2003).

[188] See Phillippe Aghion et al., *Exit Options in Corporate Finance: Liquidity Versus Incentives*,8 REV. FIN. 327 (2004); Douglas J. Cumming & Jeffrey G. MacIntosh, *Venture-Capital Exits in Canada and the United States*, 53 U. TORONTO L.J. 101 (2003); Smith, *supra* note 187 at 345-56.

[189] *See id.* at 353-54.

[190] *See* Douglas Cumming & Sofia Johan, *Advice and Monitoring in Venture Capital Finance*, forthcoming *Financial Markets and Portfolio Management*, available at http://ssrn.com/abstract=939338.

Uncorporate structures become even more important at the level of the venture capital limited partnership. As in private equity limited partnerships, VC general partners exercise extensive management power. The general partner's significant share of the partnership's profit constrains potential agency costs in exercising this power. But these investments may trigger other potential agency problems. General partners might be tempted to borrow heavily and to reinvest rather than distribute funds, or to invest in risky firms or firms in industries in which they lack expertise. General partners with their own money in particular portfolio firms may focus their time on those firms to detriment of companies they have not invested in. The general partners may want to maximize their fees based on assets under management by raising money for new funds and neglecting existing ones.

Rather than controlling general partner conflicts through monitoring by limited partners, venture capital agreements include covenants that forbid particular behavior that involves a high potential for conflicts. These covenants can be viewed as incentive-type provisions because, rather than subjecting their behavior to general review by monitors, the general partners must refrain from acting against the limited partners' interests or face financial penalties such as expulsion or damages. Thus, the agreement may restrict borrowing, particular types of investments, investments of general partners' personal funds in portfolio firms, or raising money for new funds. Gompers & Lerner have shown that the number of these covenants correlates with the potential for agency costs. For example, larger and riskier funds have more covenants.[191]

VC agreements also include more explicitly uncorporate provisions. For example, the agreement may require distributions or limit reinvestments of cash.[192] Also, Kate Litvak has analyzed provisions in VC partnership agreements for staged investments that effectively let investors put their interests to the firm by walking away from their contribution obligations.[193] The extent of the put right depends significantly on the penalty, if any, assessed for failing to make contributions. The limited partnership statutes under which these firms are organized are conducive to a range of variations in this regard because they explicitly authorize penalties for members' failure to perform contribution obligations.[194] Litvak showed a negative correlation between "walkaway" rights and the use of governance devices such as advisory boards to control agency costs.[195] This directly indicates that the firms are trading off between incentive-based and monitoring-based structures.

G. END-GAME: PIPES AND VULTURE CAPITAL

In addition to the traditional forms of private equity discussed above in subpart II.B, uncorporated private equity firms participate in restructuring publicly held firms by investing in distressed corporations. Through private investments in public equity (PIPEs), private equity firms provide capital for smaller publicly held firms that need

---

[191] *See* Gompers & Lerner, *supra* note 185.

[192] *See id*.

[193] *See* Litvak, *supra* note 143.

[194] *See, e.g.*, Del. Rev. Unif. Ltd. Partnership Act §502(c).

[195] *See* Litvak, *supra* note 143.

money to survive.[196] Distressed firms also can turn to so-called "vulture lenders," which make secured loans on increasingly stringent terms as firms sink deeper into distress, perhaps using their security to take control of the firms in bankruptcy.[197] These interventions differ from both the hedge funds activism discussed above in subpart II.C and the more drastic restructuring by private equity firms discussed in subpart II.B.

Critics of these devices have focused on risks lurking in the form the investments take in the portfolio firms. PIPEs involve a danger of insider trading on the information the investor obtains about the portfolio firm.[198] Vulture lending has been said to involve a potential abuse by the lender of its effective control position.[199] These could be viewed as different aspects of the same general problem of transition from publicly held to privately held form. The transaction necessarily involves transfer of information that the private party can use to its advantage in public markets, including credit default swap markets that impound information about the firms debt instruments. Also, the change in control that occurs when a lender acquires power may involve a loss of value by the equity holders.

The main point for present purposes is that these transactions share the basic underlying feature of all of the devices discussed in this Part: they use the uncorporate structure to shore up the weaker incentives of the conventional corporate form. In the PIPE context, the firm may be unable to raise money in the public market because the separation of ownership and control imposes too much risk on public investors in these marginal firms. New public investors may want the owners to share the risk of failure. The securities laws, and particularly the Sarbanes-Oxley Act, in effect accomplish this by potentially imposing liability for failing to disclose facts that later ended up figuring in the firm's failure.[200] In the vulture lending situation, the new investors insist on the high-powered incentives that debt provides. In both cases, the owners of the private equity partnership that is doing the investing have the kind of high-powered incentives that are necessary to supervise these perilous investments without the costs of monitoring, which could be very high in this context.

H. SUMMARY

This Part shows that there are many different uncorporate approaches to the governance of large firms. The biggest uncorporate challenge to traditional corporate modes of management is currently through firms that buy and control incorporated firms. These firms' highly motivated managers wring value out of their portfolio firms partly by

---

[196] *See* Susan J. Chaplinsky, *PIPES: Private Equity Investments In Distressed Firms*, http://ssrn.com/abstract=909741; William K. Sjostrom, Jr., *Pipes* (June 9, 2007), available at http://ssrn.com/abstract=992467.

[197] *See* Bernard Wysocki, Jr., *Lending a Hand: New Breed of Hardball Investors Makes Loans, Takes Control*, Wall St. J., December 12, 2006, A1, http://online.wsj.com/article/SB116589200646847241.html?mod=todays_us_page_one.

[198] *See* Sjostrom, *supra* note 196 at 22-24.

[199] *See* Larry E. Ribstein, *Ideoblog, Vulture Lenders*, http://busmovie.typepad.com/ideoblog/2006/12/vulture_lenders.html (December 12, 2006).

[200] This is particularly true for the internal controls disclosures required by Sarbanes-Oxley §404.

tinkering with the corporate structure, including by increasing borrowing and adjusting the managers' incentives. As discussed in subpart II.A, tax rules now support the use of full-fledged uncorporate structures with limited manager power over retaining earnings only in certain types of passively managed natural resource firms that are now currently operated as master limited partnerships and REITs. This situation is in flux, with pressure coming from "private" equity that are going public, and thereby expanding the domain of uncorporated operating firms. Congress has indicated it may react to this pressure by restricting further the ability of publicly held partnerships to enter the securities markets.[201] The social benefits of restructuring through uncorporations discussed throughout this Article should play a role in determining the appropriate tax and regulatory treatment of these entities.

III. THE FUTURE OF THE UNCORPORATION

Despite the widespread use of uncorporations documented in Part II, there may be questions whether this signifies a trend. Many business and legal commentators as well as the general public closely associate or even equates large scale business enterprise and the corporate form. In this view, publicly held uncorporations occupy specialty niches in natural resource and real estate firms that generate cash but do not need it for growth. While private equity and hedge funds' popularity seems to indicate a more important shift, this may be like to the conglomerization fad that turned out not to be the wave of the future many thought it would be in the 1960s.[202] The market may be undergoing a one-time reaction to short-term developments rather than evolving toward a new equilibrium.

The following sections show reasons to conclude that we are, indeed, seeing a general shift in the market for organizational forms that will lead to the gradual long-term shrinking of the corporate domain. To be sure, it seems likely that the pace of restructuring will vary over time. And as emphasized throughout this paper it is unlikely that uncorporate forms ever will replace the corporation for large-scale firms. But the analysis so far suggests that the benefits of the corporate form are not so clearly superior to uncorporate features that the corporation should continue to dominate even large scale firms as it has for the last century. Instead, the corporation's dominance seems more a regulatory artifact that will weaken as the costs of maintaining it increase and the benefits decrease. This Part discusses factors that may contribute to a new equilibrium between corporate and uncorporate forms.

A. REGULATORY AND SYSTEMIC CHANGES

One view of the rise of the uncorporation is that it is the product of regulatory and macro-economic conditions that prevail at particular times. The LBO boom of the 1980s was said to have been spurred by the Federal Reserve's loosening of credit and the reduction of federal capital gains taxes, which favored cash buyouts.[203] Also, private equity firms broadened their funding sources when states lifted prohibition on pension

---

[201] *See supra* text accompanying note 170.

[202] *See* Cheffins & Armour, *supra* note 121 (discussing the rise and fall of conglomerates as a possible precedent for private equity).

[203] *See* Baker & Smith, *supra* note 13 at 23; Kaufman & Englander, *supra* note 111 at 90 (noting the effect of public policies on the LBO boom).

fund investing[204] and when commercial banks started looking for new profit-sources when credit cards became less profitable.[205] These macro developments dovetailed with market innovations, particularly including KKR's invention of the LBO association, and Michael Milken's development of the junk bond market.[206] This story suggests that at least private equity, which is arguably the most important use of the uncorporate form in large-scale firms, is hostage to tax rules and credit and whatever else is going on in the economy. If interest rates and taxes cease to favor LBOs, private equity restructuring will diminish and the equilibrium will shift back to the corporate form.[207]

Under an alternative view, although specific conditions may have triggered the uncorporation's development and popularity, now that these devices have been developed and have shown their potential they are likely to persist even after the conditions that spurred them change. For example, the Eurodollar market, which began in the 1970s in response to rules that capped bank interest rates on U.S. deposits but not on dollar-denominated deposits in the banks' European branches,[208] remained even after interest-rate ceilings disappeared. Market innovations may occur because particular market and regulatory conditions increase the benefits of experimenting with new business forms. Once these new forms prove their value, they may persist long after the market conditions change.

B. UNCORPORATIONS AND THE THEORY OF THE FIRM

Some commentators see the corporation's ability to lock in capital against the liquidation demands of individual owners as not only a key feature of the corporate form, but also an important factor in the rise of the modern firm.[209] This suggests that the use of the corporate form may be contingent on the continued existence of the factors that underlie the modern corporation.

In fact, new technologies and market mechanisms have reduced firms' need for

---

[204] *See* Baker & Smith, *supra* note 13 at 80; Kaufman & Englander, *supra* note 111 at 72-75.

[205] *Id*.

[206] As to Milken's importance to the LBO boom of the 1980s, see Baker & Smith, *supra* note 13 at 82-83; Kaufman & Englander, *supra* note 111 at 75-76.

[207] Indeed, some writers have been persistent in arguing that the rise of credit costs threatens the LBO boom. *See, e.g.*, Dennis K. Berman, *Game Theories: Calling the End of Cheap Debt*, Wall St. J., June 5, 2007 at Page C1; Henny Sender & Serena Ng, *Market Pressures Test Resilience Of Buyout Boom Higher Interest Rates Raise Financing Costs; Signs of Fatigue Appear*, Wall St. J., June 8, 2007 at Page A1; http://online.wsj.com/article/SB118549929176179833.html?mod=todays_us_money_and_investing; Henny Sender, Dennis K. Berman and Gregory Zuckerman, *Debt Crunch Hits Deals, Deal Makers and Key IPO KKR May Find It Hard To Launch Stock Offer, Let Alone Its Financings*, Wall St. J., July 27, 2007 at Page C1, available at. http://online.wsj.com/article/SB118549929176179833.html?mod=todays_us_money_and_investing.

[208] Merton H. Miller, *Financial Innovation: The Last Twenty Years and the Next*, 21 J. Fin. & Quantitative Analysis 459, 462 (1986)

[209] *See* Hansmann & Kraakman and Blair, *supra* note 2.

centralized coordination and to own fixed assets.[210] During the rise of the modern large firm, strong central management of business firm assets was necessary to ensure that firms could match products with customers. Had firms attempted to rely on spot markets, they would have been subject to severe "hold-up" problems as suppliers could use their control of key assets to appropriate a share of the firm's value.

Modern firms, however, can outsource their needs from a broad market of independent suppliers. These suppliers, in turn, can protect themselves from holdup by dealing with many customers. This increased reliance on product and supply markets means that modern firms, which rely on contracts rather than ownership of hard assets, can retain flexibility. Today's firms also rely more on human capital of their employees and less on organizing assets through middle managers. They therefore spread incentive compensation throughout the organization, and run more like large partnerships than traditional large corporations.[211]

It follows that firms now have less need to lock power in central managers than the traditional large-scale corporation. Just as the firm can more easily redeploy assets if business conditions change, so the firm's value does not depend on maintaining a particular configuration of assets under central control. This does not mean that management is less necessary. Indeed, in an increasingly fluid economic and regulatory environment, the need for management skill and ingenuity, and therefore for high-powered owner-type incentives, may be greater than ever.

The main point for present purposes is that increased flexibility and reduced costs of restructuring mean that there is no longer a strong presumption favoring any particular asset configuration. There may therefore be more situations in which the agency costs of capital lock-in exceed the benefits. For example, as discussed in subpart II.A, partnership-type structures are less likely to work in firms that need to retain cash for growth opportunities, as distinguished from firms that are more mature or that mainly hold resources, whose need for cash is predictable and that therefore can commit to distributions. This means that for an increasing number of firms the benefits of strong managerial control over the firm's assets in some cases may be less than the agency costs of disciplining misuse of this control. It follows that demand for the uncorporation form would increase for a broad category firms now organized as conventional corporations.

C. COSTS AND BENEFITS OF PUBLIC MARKETS

As discussed throughout this paper, the uncorporation has been mostly associated with closely held firms. It follows that a decline in the net benefits of public ownership would be associated in a rise in uncorporated business forms, holding other factors constant. In fact, private equity's ascendancy has been attributed mainly to the costs of complying with Sarbanes-Oxley and the rising costs of the litigation system.[212] To the extent that these laws discourage public ownership in situations where public ownership

---

[210] *See* Ribstein, *supra* note 1.

[211] Raghuram G. Rajan & Julie A. Wulf, *The Flattening Firm: Evidence from Panel Data on the Changing Nature of Corporate Hierarchies,* http://papers.ssrn.com/paper.taf?abstract_id=393684.

[212] *See* INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION (December 5, 2006), available at http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf.

otherwise would be appropriate, this might be considered a social cost of the regulation. And it does appear that at least some of the move away from public markets owes to the costs of regulation rather than the benefits of being closely held. For example, one paper comparing the post-SOX rate of going private among American firms with that among foreign firms not subject to the Act produces evidence consistent with the hypothesis that SOX rather than other factors induced small firms to become private during the first year following enactment.[213] This suggests that the exit from public markets was at least partially an artifact of regulation.

Whether or not regulatory changes are solely responsible for the move away from public markets, it is at least the case that the benefits of being publicly held are increasingly not worth the cost. This conclusion remains even if the benefits of SOX and other increases in regulation and litigation outweigh the costs. That is because SOX and private litigation theoretically might be filtering out the firms that should not be public. Without SOX and in the absence of strong civil remedies for securities fraud, managers might have been able to attract public investors by persuading them that the risks of fraud were less than they actually were. The managers thereby were externalizing the risk of fraud. SOX and civil liability might have made the agency costs of the conventional corporate form more apparent, causing an increase in uncorporations.

There are reasons to believe that, while the costs of public markets are rising or at least becoming more apparent, the benefits of these markets are declining. The first has to do with the development of alternative mechanisms for reducing the cost of risk-bearing in large organizations. The traditional corporate structure is designed to accommodate dispersed ownership by diversified securities holders. However, derivatives and insurance products have reduced the cost of risk-bearing. With lower costs of risk, there is less need for public equity ownership to accomplish this purpose.[214] Indeed, Gilson & Whitehead argue that the rise of corporate risk management means that diversified shareholders may no longer be the cheapest risk-bearers for an increasing segment of the corporate world, and accordingly that this development helps explain the rise in private equity.[215]

The increased availability of derivatives for reducing risk complements rather than substitutes for the theories discussed in this paper. Gilson & Whitehead offer a plausible association between the two phenomena but no direct evidence of causation.[216] Many business risks, such as the risk of increased competition or new technologies, cannot be reduced by hedging. But it is a reasonable guess that derivatives can reduce the costs of risk-bearing enough that the incentive advantages of the uncorporation form

---

[213] Ehud Kamar, Pinar Karaca-Mandic, and Eric Talley, *Going-Private Decisions and the Sarbanes-Oxley Act of 2002: A Cross-Country Analysis*, http://www.law.ucla.edu/docs/talley_012306.pdf (November 2005).

[214] *See* Cheffins & Armour, *supra* note 121 at 21 (discussing importance to LBO market of invention of derivatives); Ronald J. Gilson & Charles K. Whitehead, *Deconstructing Equity: Public Ownership, Agency Costs, and Complete Capital Markets*, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=991352, forthcoming Colum. L. Rev.

[215] *Id.*

[216] The hypothesis that risk management is a factor in the flight from the public markets might be supported by evidence that firms use more risk management after they go private, or by a showing that the types of firms that go private are those for which risk management is most useful.

become dominant. Or hedging may cause agency costs, for which uncorporate devices may be a solution. Managers may have an incentive to use derivatives to reduce their own risks associated with non-diversifiable investments in the firm even where the costs of hedging outweigh its benefits from the standpoint of non-managing owners. Perhaps more importantly, derivatives' complexity may reduce transparency and invite managerial agency costs. Indeed, Enron's use of derivatives was a significant factor in the market's failure to understand the firm.[217] In firms where this hedging is valuable *if* the firm can successfully address agency costs, a privately held uncorporate structure may be particularly advantageous. Among other things, private equity managers can apply their management expertise, incentive structure and close supervision of managers to reduce the risk that derivatives are being misused.

A second reason why the benefits of public ownership may be declining is that prediction markets can provide some of the information benefits of public securities markets. For example, the Hollywood Stock Exchange, which allows investors to bet on the likelihood of specific events like film openings, has achieved a high degree of efficiency with a small number of informed traders.[218] Firms can establish prediction markets to trade in successful performance of a large contract or other major event.[219] Such markets can provide more specific information about salient aspects of a firm's business than can be provided by the stock price of a firm that integrates several different businesses. Indeed, it has been suggested that prediction markets might serve as an alternative to judicial and shareholder monitoring in addressing agency costs by providing a mechanism for directly assessing corporate policies.[220] But as with derivatives and hedging, it is unclear whether these markets can explain firms' moves into private ownership and the uncorporate form, as distinguished from providing a theoretical reason why the corporate form may be less useful for future firms.

Finally, it is important to emphasize that the rise of the uncorporation does not depend on a general move away from public securities markets. As discussed above in subpart II.E, public markets can arise for interests in uncorporation even if these interests do not carry the usual control aspect of corporate equity. In this context, the securities markets may become primarily a market for information rather than for control. Thus, ownership interests in publicly held uncorporations may resemble derivatives in

---

[217] *See* William C. Powers, Jr. et al., Report of Investigation By The Special Investigative Committee of The Board of Directors of Enron Corp. (Feb. 1, 2002) 2002 WL 198018 at 67-71 (describing LJM and Raptor transactions that were presented as hedges but were actually bets on Enron's future stock price); Frank Partnoy, *Enron and Derivatives*, available at http://ssrn.com/abstract=302332.

[218] *See* Saul Levmore, *Simply Efficient Markets and the Role of Regulation: Lessons from the Iowa Electronic Markets and the Hollywood Stock Exchange*, 28 J. CORP. L. 589, 602-03 (2003).

[219] *See* Henry G. Manne, *Insider Trading: Hayek, Virtual Markets, and the Dog That Did Not Bark*, 31 J. CORP. L. 167, 172-73 (2005) (discussing use of prediction markets as a substitute for stock market in aggregating information). *See also* Justin Wolfers & Eric Zitzewitz, *Prediction Markets*, J. ECON. PERSP., Spring 2004, at 107 (summarizing academic literature on prediction markets). For discussions of the use of these markets at various firms *see* Barbara Kiviat, *The End of Management?*, TIME (*Inside Business* Bonus Section), July 12, 2004; *Putting Crowd Wisdom to Work*, http://googleblog.blogspot.com/2005/09/putting-crowd-wisdom-to-work.html (Sept. 21, 2005).

[220] *See* Michael B. Abramowicz and M. Todd Henderson, *Prediction Markets for Corporate Governance* (September 2006), U Chicago Law & Economics, Olin Working Paper No. 307, available at http://ssrn.com/abstract=928896.

corporate securities in separating control and ownership rights.

D. POLITICAL PROTECTION OF THE CORPORATION

The use of uncorporations has long been constrained by the political clout of interest groups that favor the existing equilibrium of what Mark Roe has called "strong managers, weak owners."[221] Managers tend to oppose limits on their power and have allies in labor and other interest groups that would worry about a relentless push by capitalists for more profits, efficiency and change. Managers can protect their power or otherwise help themselves by distributing corporate resources to these non-shareholder groups. Their power to do so is assured by the weak accountability of corporate managers discussed above in subpart III.A, and especially by the capital lock-in of the corporate form that assures managers of the control over corporate assets. The corporate form therefore represents a tradeoff of accountability for social responsibility.[222] The uncorporation would reduce managerial discretion and thereby the clout of non-shareholder corporate stakeholders. Thus, even interest groups who decry managerial greed would not necessarily favor the uncorporation medicine that would cure the disease.

An example of the political constraints on capital Roe discusses is the fact that much of the country's investment capital is in mutual funds that, as discussed in subpart II.D., are subject to tax and regulatory constraints on aggregating significant control positions. As discussed in subpart II.C, hedge funds are not currently subject to these constraints. However, politicians might seize on public unease with capitalists and the substantial money they are making to enact regulation that would similarly cripple the ability of hedge funds and private equity to intervene in corporate management. The obvious precedent is the regulation and litigation in the 1980s that hobbled the LBO market.[223]

The tax laws are also important to future of the uncorporation. The double corporate tax can have the effect of encouraging firms to retain earnings, and thereby trap earnings in the firm, by taxing owners on distributions. Put another way, owners of tax partnerships will tend to demand and to contract for distributions to a greater extent than corporate shareholders because they are taxed on the firm's earnings whether or not the earnings are distributed.[224] It is therefore not surprising that double taxation was actually promoted by corporate managers in 1936 as part of a deal to avoid an undistributed

---

[221] *See* Roe, *supra* note 40. *See also* Kaufman & Englander, *supra* note 111 at 62-65 (discussing Roe theory, and restrictions on the influence of pension funds and other institutional shareholders on portfolio firms).

[222] *See* Ribstein, *supra* note 1.

[223] *See* Cheffins & Armour, *supra* note 121 at 45-52 (citing regulatory moves that ended previous restructuring waves, including antitrust, accounting and takeover rules and the Milken indictment, and discussing possible limits on private equity, including fiduciary duties and tax changes); Kaufman & Englander at 87 (discussing how managers fought the LBO boom of the 1980s with regulation, joining with unions).

[224] The Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), Pub. L. No. 108-27, § 302(a), 117 Stat. 752, 760–61 (codified as amended at I.R.C. § 1(h)), reduced the tax on distributions to fifteen percent, thereby reducing the tax disincentive on most corporate dividends. However, because the corporate double tax remains, the point made in the text still holds.

profits tax.[225] Adolf Berle, a key Roosevelt advisor, recognized the agency cost problem, arguing that managers were using corporate surpluses for personal gain. Any effort to significantly curb or eliminate the double tax would spur opposition not only by politicians concerned about potential loss but also managers worried about loss of control over earnings.[226]

In short, the thrust of regulation and tax law has been to discourage large publicly held firms from adopting uncorporate structures. This is particularly evident in the restrictions on publicly traded partnerships, which help ensure that conventional large firms are subject to the double tax and its incentives to retain rather than distribute earnings. If Blackstone Group had to incorporate, it would be no different from the many other publicly traded and incorporated financial firms, such as Goldman Sachs and Merrill Lynch. As partnerships, Blackstone and other privlic firms are subject to the whole panoply of uncorporate devices discussed in this article, including those that weaken managers' hold on the firm's cash. Thus, it is not surprising that Congress is seeking to limit the going privlic structure.[227]

On the other hand, the political equilibrium may shift toward encouraging the uncorporate form, including for publicly held firms. First, the demand for broader availability of single-level taxation already has been manifested in the significant investor demand for single-tax vehicles, as indicated by the hundreds of billions of dollars in investment in these vehicles. As discussed above, this demand led to the broad availability of single taxation in unincorporated firms. Indeed, twenty years ago it looked like publicly traded partnerships might be used quite broadly until Congress extended the corporate tax to all but passive asset publicly traded partnerships.[228] .

Second, Congress may further encourage use of the uncorporation in order to squarely confront the question of the social efficiency of the corporate form. The political attitude toward the traditional corporate form has been schizophrenic. On the one hand, the corporation is often derided as an engine of social irresponsibility.[229] On the other hand, SOX and the rest of the post-Enron pro-regulatory movement focused on the agency cost problem. This article suggests that the corporate form may be a big part of that problem. In other words, moves in favor of the uncorporation would comport with an effort to tighten managers' accountability in the wake of Enron.

Third, the developments discussed in this paper ultimately erode the political protection of the corporation. The rising benefits of the uncorporation and the declining benefits of the corporation increase the costs of the status quo. This gives investor groups and others more incentive to take political action. It also provides incentives to engage in

---

[225] *See* Steven A. Bank, *Corporate Managers, Agency Costs, and the Rise of Double Taxation*, 44 WM. & MARY L. REV. 167, 183–98 (2002); Steven A. Bank, *The Story of Double Taxation: A Clash over the Control of Corporate Earnings*, *in* BUSINESS TAX STORIES 153 (Steven A. Bank & Kirk J. Stark eds., 2005).

[226] *See generally*, Ribstein, *supra* note 222.

[227] *See supra* text accompanying note 170.

[228] See IRC §7704.

[229] *See, e.g.* Joel Bakan, THE CORPORATION (2004).

regulatory arbitrage that may have the effect or eroding restrictions on uncorporate forms. For example, as discussed in subpart II.E, the Blackstone IPO involves sophisticated tax planning that arguably stretches the passive activity exception to corporate taxation of publicly traded partnerships. This sort of maneuvering echoes the manipulation of the limited partnership form that ultimately led to IRS rules allowing closely held firms to elect partnership taxation.[230] On the other hand, the uncorporation's flexibility that facilitates these arbitrage activities may encourage stepped up regulation to discourage its use, just as private equity's arbitrage activities likely triggered the bill to increase the tax on private equity.[231]

E. CONVERGENCE OR SEPARATION OF FORMS?

The lasting importance of uncorporate governance forms may depend on the degree to which the corporate and uncorporate forms converge. Ironically, the recent success of uncorporations may stunt their continued rise as corporations adopt some of their characteristics. The LBO boom of the 1980s left an important legacy by demonstrating to corporate managers and investors the advantages of the various forms of managerial discipline imposed by private equity. This includes firms recognizing the value of a highly leveraged capital structure in addressing manager-owner agency costs, stringent board oversight and the need to link managers' and owners interests.[232] It also includes corporations setting up internal markets among their operating units and eliminating the cross-subsidization among divisions that characterized conglomerates.[233] Indeed, it was argued prior to the current going private wave that going private was no longer necessary because the last wave had already put the incentives in place.[234]

Complete convergence of forms is unlikely, however. Uncorporate governance forms succeed in reducing agency costs essentially by making managers partners in the business and by reducing managers' control over the firm's cash. Even apart from tax and regulatory restrictions, these devices are not workable in all firms. The corporate form may be best suited, at least under current conditions, for firms in their start-up or growth phase. These firms need the freedom to evolve and need to delegate significant discretion to managers without the constraint of repeatedly having to sell particular strategies to investors. Also, partnership-type incentive compensation exposes managers in these firms to significant risk. By contrast, uncorporate forms are best suited to low-growth, stable and mature firms, which can set specific financial targets and time-frames as the parameters of incentive compensation, cash distributions and paying off investors.

---

[230] *See supra* text accompanying notes 6-8.

[231] *See* Release, *supra* note 172 (quoting Sen. Grassley as saying that "Right now, some businesses are crossing the line between reasonably lowering their tax burden and pretending to be something they're not to avoid most, if not all, corporate taxes.").

[232] *See* Baker & Smith, *supra* note 13 at 204-06.

[233] *See* Kaufman & Englander, *supra* note 111 at 96; Koch, *supra* note 125.

[234] *See* Bengt Holmstrom & Steven N. Kaplan, *Corporate Governance and Merger Activity in the United States: Making Sense of the 1980s and 1990s*, 115 J. ECON. PERSP. 121 (2001); Steven Kaplan, *The Evolution of U.S. Corporate Governance: We're All Henry Kravis Now*, Journal of Private Equity (Fall 1997), p. 7.

While differences between corporate and uncorporate forms are likely to persist at the extremes of types of firms, convergence of corporate and uncorporate features is possible. However, this depends on the amount of separation maintained by tax and regulation. The general distinctions between uncorporate and corporate firms just mentioned do not necessarily support tax or regulation that attempts to limit availability of limit mesh with current regulatory and tax patterns. Restricting publicly traded partnerships to passively managed resource-type firms means that the single level tax, which encourages distributions, applies to the firms that least need to retain earnings.[235] However, many firms outside this limited category also could benefit from being free of the corporate tax on distributions. These firms essentially have worked around the limitation by using debt and tax-deductible interest. But this exposes the firms to bankruptcy costs, which otherwise might be avoided through more flexible uncorporate mechanisms.

IV. CONCLUSION

The uncorporation is spreading across the previously uncontested domain of the publicly held firm. Perhaps the most important factor favoring increased use of the uncorporation is increasing recognition of the gaps in the monitoring devices we have relied so long to keep corporate managers in check. Coupled with the effect of Sarbanes-Oxley on the prevalence of smaller public firms and the rise in private equity, the uncorporation may move up from its understudy role.

To be sure, it is not yet clear that the corporation should cease being the dominant form for publicly held firms. In many firms, the benefits of strong managerial control may exceed the costs of relatively weak accountability. More needs to be done in evaluating and testing the efficacy and potential uses of uncorporation forms. This paper has been a first step in suggesting the issues that should be explored. Researchers might consider, for example, the types of firms for which uncorporation governance devices are appropriate. In other words, in a world where choice of form is not constrained by tax or regulation, what types of firms would choose uncorporation devices, and which devices would they choose? Also, to what extent do uncorporate restructuring devices like private equity and hedge funds add value compared to similar corporate restructuring without intervention by these firms? Given the current constraints on uncorporations, it is possible only to speculate on the extent to which broader use of these devices would improve governance. However, this paper's analysis at least suggests that the tax and regulatory scale should not be weighted in favor of the corporate form.

---

[235] *See* IRC §7704, discussed in *supra* subpart II.A.